Decentralization
of the Socialist State

Intergovernmental Finance
in Transition Economies

EDITED BY
RICHARD M. BIRD
ROBERT D. EBEL
CHRISTINE I. WALLECH
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This volume of studies on fiscal federalism and intergovernmental finance in the transition economies of Eastern Europe and the former Soviet Union emerged out of our interest in intergovernmental finances in market economies and our realization, as our work in Eastern Europe and the former Soviet Union proceeded, that intergovernmental fiscal problems in transition economies are both very different from those of market economies and very similar to each other. The objective of this book is to provide a systematic review and analysis of intergovernmental fiscal issues and policies in seven countries in this region as they make the transition from socialism. Key themes of the book are that local finance is not a local matter and that the ongoing reforms in subnational finance taking place in virtually every transition country are more important than is generally recognized.

The literature on the transition from command to market to date has tended to focus on the “big picture” issues of rapid price reform, enterprise privatization, governance, and macroeconomic stabilization policies. But the fiscal decentralization that is now taking place in all of the transition economies of Eastern and Central Europe and in most of the former Soviet Union also has major implications that have not yet received much scrutiny. How the ensuing issues in intergovernmental finance are resolved will influence privatization and the transition to a market economy; macroeconomic stabilization; and the maintenance of the social safety net that is often critical to maintaining support for reform. An important objective of this book is to fill this gap in the literature on transition.
Research on this subject began with fieldwork on Hungary in 1991, immediately after Hungary's first local elections and just weeks after its Law on Local Self-Government became effective. This law provided for full "autonomy" for Hungary's local governments. The breadth of spending responsibilities assigned to local governments was notable and included many spending areas that had not been local responsibilities in Hungary before, such as social welfare, education, and health. But the law gave localities few taxing powers. For macroeconomic reasons, the central government preferred to maintain control over the major national tax bases for its own budget. With the local sector kept on a tight fiscal leash, the autonomy provided for in the law was more apparent than real. However, local governments inherited from the prereform period substantial assets in the form of enterprises, which they saw not only as potential revenue earners but also as entities that could potentially help them carry out public spending functions, supplementing the budget.

This initial study was followed by further research and fieldwork in Albania, Bulgaria, Poland, Romania, Russia, and Ukraine, where similar processes were taking place. Common themes emerged. In many countries macroeconomic strains on the central government were leading to greater assignment of spending functions—including socially important spending—to lower-level governments, often themselves newly created. In Russia, for example, most spending on the social safety net, including unemployment insurance, as well as capital investment, was shifted "downstairs" in 1992. On the other hand, the more productive revenue sources invariably were reserved for the central government. In Hungary, for instance, local governments are assigned five local taxes that together might generate at best some 1 to 2 percent of GDP. Everywhere transfer systems remained ad hoc, negotiated, and often counterequalizing. In many countries the continued local public ownership of enterprises has the potential to threaten effective privatization. In Russia, for example, the entrepreneurial capital city, Moscow, hesitates to privatize key local enterprises, fearing the employment losses that may come about, and has made an important new equity investment in McDonald's to generate foreign exchange revenues. Everywhere, the general lack of local fiscal discretion, responsibility, and accountability, along with a general absence of revenue autonomy and ability to set local tax rates, threaten efficient provision of local public services. Poland's new laws on fiscal decentralization, for instance, fix all local tax rates and tax bases from the center. And everywhere, as enterprises close or privatize, the divestiture of their social assets—schools, clinics, kindergartens, and sometimes more—is wreaking havoc with local budgets as the new local governments are pressed to take on these tasks.
The research presented in this volume suggests that the design of a well-functioning intergovernmental system may often be the key to successfully achieving such major reform goals of the transition economies as macroeconomic stability, privatization, and maintenance of a social safety net that is robust enough to make reform palatable to the population. It also suggests that a broader analytical framework than is usually involved in the study of intergovernmental finance is needed to analyze decentralization issues in the transition economies. Traditional analysis argues that responsibilities for stabilization and income distribution are primarily, and properly, central government concerns. In this model, resource allocation is the primary concern of local governments, which should be financed mainly from user fees and taxes on local residents, with transfers making up any gap. The appropriate assignment of local expenditures and taxes and the design of transfer systems are, of course, key issues in transition economies too, but other aspects are also critical, as set out in chapter 1 of this book, and a broader framework of analysis is therefore needed.

What should this broader framework include? First, it must take account of the likelihood of continued local government ownership of enterprises on a significant scale and factor this into plans for both privatization and intergovernmental reform. Second, it must focus more closely on local governments’ role in stabilization, since stabilization policies have both affected and been affected by the emerging intergovernmental reforms. Of course, subnational spending or deficits cannot on their own create macroeconomic problems, since subnational governments cannot print money. But due to the generally “soft” budget constraints that still apply to banks and enterprises and to many government agencies themselves, local government deficits in many transition economies can be and often are monetized. And third, to the extent the social safety net has been assigned to subnational governments, analysis must address distributional issues in local finance more carefully than is commonly the case. How to change the intergovernmental legacy of the past in order to accommodate the needs of the present and to anticipate the demands of the future in these and other respects is the focus of the book.

* * *

This volume on fiscal federalism and intergovernmental finances in Eastern Europe and the former Soviet Union is thus a companion piece to *Russia and the Challenge of Fiscal Federalism* (Wallich 1994), recently published by the World Bank in its Regional and Sectoral Studies series. This earlier volume stressed the importance of appropriate design of intergovernmental fiscal systems for ensuring a robust safety net, facilitating fiscal balance and stabilization, and promoting privatization in
Russia. The present book explores many of the same themes in a wider country and comparative context.

For Russia, facing considerable centrifugal forces, the contribution of fiscal federalism to nation building could not be overlooked. Politics and history are also important motivating forces behind the demands for greater fiscal autonomy and decentralization in the countries discussed in this volume. The present book, however, does not attempt to address in any detail the dimensions of the political transition in Eastern and Central Europe and the former Soviet Union; its primary focus is on economic aspects. Nor does it deal directly with such "big picture" reform issues as the sequencing of reforms, financial sector reform, or price liberalization, although—as we argue—intergovernmental finances may have a significant impact on the overall success of a reform program. Moreover, while there is significant empirical work in most of the country chapters, this is not a data-intensive study. For most of the countries discussed here, it is too early for such studies, and much of the data needed for concrete analysis of policy options at the subnational level is absent. Indeed, even gathering the sometimes sparse and seldom fully satisfactory information reported here took substantial fieldwork in most countries: information may exist, but it is seldom available in accessible form even in the country itself.

* * *

The aim of the book is to provide as accurate a picture from a policy perspective as is possible at this early stage of the emerging process of fiscal decentralization in Eastern Europe and the former Soviet Union. Countries such as Hungary and Poland that have moved quite far down the path of local government reform and that may now be embarking on a "second generation" of reforms, as well as those that are only now beginning the process, such as Albania and Romania, are considered. The order of the chapters is designed to highlight this focus. Chapter 1 is a comparative overview of the nature of intergovernmental finance in transition economies; it describes how these systems differ from those in market economies and elaborates on the need for a broader-than-traditional framework for analyzing subnational finances in transition economies. The relatively advanced case of Hungary is then discussed in chapter 2, followed by a detailed look in chapter 3 at how the Budapest municipal government is operating within Hungary's emerging intergovernmental system. Chapter 4 discusses Poland, which, like Hungary, is making important progress toward public sector reform. The next four chapters, 5 through 8, examine countries (Bulgaria, Romania, Albania, and Ukraine) in which the reform of intergovernmental finance is at earlier stages. Finally, chapters 9 and 10 take
a close look at recent developments in Russia, by far the largest and most complex of the countries examined here and the only one with a truly federal character. The Russia chapters complement and expand on earlier work by Wallich (1992a, 1994). Each country chapter evaluates the strengths and weaknesses of the emerging structures and suggests possible directions for further reform.

This book, with chapters contributed by fourteen authors, was written as a team effort, and with a broadly common framework of analysis. While each country case differs in its emphasis, reflecting the particular circumstances of the country in question, the chapters follow a common analytical framework to the extent possible. Each discussion touches first on the traditional public finance areas of expenditure assignment, revenue assignment, and intergovernmental transfers. Then, those aspects that are outside the traditional framework of analysis in this field, including privatization, stabilization, and the social safety net, are addressed, with different emphasis in each country according to the importance of the issues in shaping the emerging intergovernmental and subnational fiscal structure.

* * *

The analysis focuses on the period since 1989, the year in which major political change began in most of Eastern Europe, with the decentralization movements following almost immediately. For most countries, the empirical work is necessarily based largely on the 1992-93 period. Although the speed of change is dizzying across Eastern Europe and the former Soviet Union, and it may seem that the timeliness of the material contained here is on occasion limited, this does not necessarily impair its relevance. As shown in this book, much of the change in intergovernmental relations in each country has, after the initial reforms, been evolutionary in nature. In some countries, the changes have been more apparent than real. In others, older forms and practices of local government are resurfacing. The analysis of even the brief period covered here may thus be of much more extended relevance.

Similarly, although the focus of the discussion in this book is on Central and East European countries, similar tendencies and problems may well also be manifest in the other republics of the former Soviet Union and the former Yugoslavia, as well as in similar countries elsewhere. Kornai, in his well-known work, *The Socialist System* (1992), lists twenty-six "socialist" countries in 1987. If we add to this list the fifteen republics of the former Soviet Union and the six of the former Yugoslavia (and deduct the now-vanished East Germany), there would appear to be at least forty-six countries that only five years ago had more or less "socialist" governmental structures. By 1994, however, it is probably fair to say that all but two of these countries (Cuba and the
Democratic People's Republic of Korea) are now in some "transitional" stage, so that some or all of the analysis of this book should be applicable. In essence, therefore, this book represents an interim analysis on what seems likely to prove an ongoing and important problem in many transition economies.

* * *

This book is aimed primarily at readers with an interest in the transition economies of Eastern Europe and those of the former Soviet Union—Russia and Ukraine, in particular. It should also be of interest, however, to those working on the Baltics and other former U.S.S.R. states, including the economies of Central Asia, where the "Soviet model" of intergovernmental finances was transplanted in the middle decades of this century and where new forms also must be found. Finally, it should be relevant to other countries in transition in Asia, such as China and Viet Nam, which adopted Soviet structures. In both these countries intergovernmental reforms are moving apace and, as in Eastern Europe, have been found to have important ramifications for poverty and well-being, macroeconomic policies, and privatization of enterprises.

The basic methodological approach underlying the book is fieldwork. In the rapidly changing circumstances of these countries, the "facts" on intergovernmental fiscal affairs are not found neatly compiled and predigested in a quiet library in the central capital. Often, indeed, central officials, caught up in their own transitional problems, proved to have little knowledge of what was really happening "out there." The authors therefore visited rural and urban areas in each country. Resource-rich and resource-poor areas were visited, as were, in some countries, localities with important concentrations of disadvantaged, ethnic populations, such as those in poorer parts of Romania and in the Russian Federation. The regional character of many countries and the existence of ethnic minorities makes the design of intergovernmental policies especially challenging. Special efforts were made to visit regions in decline as a result of sectoral restructuring and to examine the impact of enterprise divestiture of social assets on local budgets. One region in Russia, for example, found its entire industrial base gone with the closing of the military industries. These enterprises—not the city budget—had also financed all the city's social sector expenditures, including health and education. Authors talked to various central departments and officials in capital cities and in provincial or county seats, as well as to a wide variety of subnational officials, ranging from mayors to tax collectors, in large and small cities and villages. They gathered information where they could, compared conflicting stories and numbers, and tried to make sense out of the often changing and usually unclear reality
of intergovernmental relations in every country. The result, we think, is as accurate and solid a presentation of intergovernmental and subnational finance in Central and Eastern Europe and the former Soviet Union as is possible at this time.

This book provides the starting point for all those who wish to follow us into this fiscal labyrinth. More important, we hope it will alert policymakers in transition countries and the many international experts advising them of the potentially critical role of intergovernmental finance in facilitating a successful transition to a market economy. As this book shows, important subnational fiscal changes are under way in virtually every transition country, and individuals concerned with ensuring successful transition from a command to a market economy neglect the intergovernmental dimension at their peril. Local finance is not a trivial matter that can be tidied up after the “big” decisions are made on such matters as privatization and national tax reform. On the contrary, how local fiscal matters are dealt with may often prove to be a surprisingly central determinant of the extent and success of such reforms.

Richard M. Bird
Robert D. Ebel
Christine I. Wallich
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Richard M. Bird
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Christine I. Wallich
Fiscal decentralization: From command to market

Richard M. Bird, Robert D. Ebel, and Christine I. Wallich

A change of government is not a change of system, merely one of the preconditions for it. The change of system is a historical process that seems likely to require a long period of time.

Janos Kornai, The Socialist System

Dramatic reform is taking place in Central and Eastern Europe. New institutions and economic infrastructure are being created to provide the foundation for a pluralist, democratic society and a well-functioning market economy. The most discussed aspect of this reform is privatization—the move from a command economy to one of liberalized markets and free economic agents. A second aspect, equally critical to the transition to a market economy, is the decentralization of government itself.

Some type of subnational government structure existed in most of the transition economies under the socialist regime. But fiscal systems were highly centralized, with the subnational level acting as an administrative unit or department of the center with no independent fiscal or legislative responsibility. Kornai (1992) sets out the former socialist system in considerable detail. It is revealing that this lengthy study hardly refers to the existence of subnational state administrations, noting only that they are tightly controlled in all respects by the central bureaucracy. Subnational governments were essentially deconcentrated units (or branch offices) of the central government and had little or no financial autonomy. This was true even in countries such as the U.S.S.R. (and Czechoslovakia) that were formally called "federations." Policymaking was controlled and centralized, and local government had virtually no independent tax or expenditure powers—its budget was seen only as the handmaiden of the central plan.
Extensive political and fiscal decentralization is now under way in many countries in Central and Eastern Europe and the former Soviet Union. Politically, this decentralization represents both a reaction from below to the extensive central control of the past, and an attempt from above by the center to further privatize and to relieve its strained fiscal situation. Economically, decentralization is motivated in part by the recognition that it is imperative to utilize public resources more efficiently than in the past. Overcentralization characterized these countries' public administrations, just as it did the rest of economic activity. Decentralization, if appropriately designed and implemented, may lead to improved public service provision.

Decentralization is thus a key dimension of the national transition from a command to a market economy. Like the broader economic transition, it will require many, often difficult, reforms. Not only must the structure of tax and transfer mechanisms be reconsidered and expenditure responsibilities realigned among different levels of government, but views as to what governments can and should do must change. The total level of public sector activity must be dramatically reduced, but at the same time the new subnational governments must be allowed to build staff and institutional capacities in a manner that makes them accountable for their fiscal decisions.

These ongoing reforms in subnational and intergovernmental finance are of considerable importance. Intergovernmental reform and the strengthening of subnational (intermediate as well as local) governments are essential to support the evolving public and private sectors. Subnational governments account for a growing share of public sector activity in most of the transition economies as general government activity is scaled back and subnational governments take responsibility for many services formerly provided by the central government. In Russia subnational budget expenditures absorbed 38.6 percent of the consolidated national budget in 1992 and 42.9 percent in 1993. And local government expenditures as a percentage of consolidated government expenditures in Hungary rose from 22.3 percent in 1988 to 30.4 percent in 1993 (table 1.1). The structure of intergovernmental relations is closely related to such critical policy issues as efficient resource mobilization, privatization, the social safety net, and stabilization. Within the fiscal sphere, for example, tax reform, deficit control, and intergovernmental finance are intertwined: if one of these elements is poorly designed, the entire fiscal structure may be compromised. Similarly, if the incentives built into intergovernmental arrangements are perverse, preserving central dominance or undermining the development of private markets, disillusionment with the reform process may set in, threatening both democracy and the market economy.
Why local finance matters

This chapter synthesizes the main themes and findings of the country-specific chapters that follow. The overriding theme is that a well-functioning intergovernmental fiscal system is key to most of the transition economies’ major reform objectives. In all countries, intergovernmental finances affect the degree to which the public sector can mobilize resources. In addition, in the transition economies, intergovernmental finances can also influence the achievement of macroeconomic stability, the provision of a social safety net, and privatization. And in countries with a limited tradition of self-government, developing effective political and fiscal institutions at the subnational level may be critical to building a nation.

Systemic linkages

In most countries even systematic discussion of decentralization and subnational finances requires only brief reference to such issues as stabilization, income distribution, and privatization. Fiscal decentralization in the transition economies, however, requires explicit recognition and examination of the interplay among these traditional functions of public sector activity.

Stabilization. Subnational finances have important links with macroeconomic stabilization policies in transition economies. Sound fiscal policies (with supporting monetary policies) are key to macroeconomic stabilization. Large public sector deficits are being generated in many transition economies as falling tax revenues combine with the attempt to

Table 1.1 Central and subnational government expenditures, selected transition economies, 1993

<table>
<thead>
<tr>
<th>Country</th>
<th>General</th>
<th>Central</th>
<th>Subnational</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>44.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bulgaria</td>
<td>41.2</td>
<td></td>
<td>9.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>57.2</td>
<td>31.9</td>
<td>17.4</td>
</tr>
<tr>
<td>Poland</td>
<td>48.1</td>
<td>31.8</td>
<td>5.9</td>
</tr>
<tr>
<td>Romania</td>
<td>35.6</td>
<td>21.7</td>
<td>3.7</td>
</tr>
<tr>
<td>Russia</td>
<td>39.6</td>
<td>20.3</td>
<td>17.0</td>
</tr>
<tr>
<td>Ukraine</td>
<td>73.4</td>
<td>57.5</td>
<td>20.9</td>
</tr>
</tbody>
</table>

— Not available.

Source: World Bank and various country sources; see table notes at the end of this chapter.
continue the high spending practices common under the old regime. Subnational revenue and spending outcomes can support, or sabotage, efforts to control deficits and hence limit resort to inflationary finance. While of course policy reform in many areas is needed to meet stabilization goals, it is important not to neglect the intergovernmental dimension. In most transition countries, fiscal pressures have led central governments to use every instrument at their disposal in the attempt to control the deficit. Some have taken steps to "shift the deficit down"—that is, to shift expenditure responsibilities onto subnational governments or to redirect revenues from the subnational level. Shifting the deficit onto subnational governments may increase rather than reduce macroeconomic pressures, however, since soft budget constraints are as common for governments as for enterprises in the transition economies. Subnational governments may respond to budgetary pressure by accumulating arrears, by unrestricted borrowing, by developing undesirable extrabudgetary sources of revenue, or by failing to provide needed services unless additional central funding is forthcoming. They may require the many enterprises they still own to finance public expenditures, especially if the enterprises have easy access to bank credit. Pushing the deficit down may thus not reduce it but simply repress it or convert it into less transparent forms. Of course, subnational governments cannot on their own cause serious macroeconomic problems since they cannot print money. But quantitatively significant subnational deficits may in one way or another end up being monetized by extending central bank credit to local enterprises, locally owned banks, or local governments, and hence may exacerbate the macroeconomic situation in a particularly nontransparent way.

Income distribution and the social safety net. Important parts of the social safety net such as social welfare, family assistance, and consumer subsidies, and in some countries pensions and unemployment, have been delegated to some extent from central to subnational governments in Albania, Bulgaria, Hungary, Russia, and Ukraine. It may sometimes make sense for subnational governments to administer certain social programs, but they cannot deliver such services effectively if they are chronically underfunded (Oates 1990). Where an adequate safety net is critical to a successful transition to a market economy, and its maintenance is therefore a national policy objective—as seems true in all the transition economies—subnational governments cannot reasonably be expected to take on these tasks without being provided with corresponding revenues, for example through intergovernmental transfers. The correct design of such transfers then becomes crucial to the successful achievement of national social policy goals.
Privatization. Privatization is also linked to subnational finance. Many countries have already transferred ownership of some state enterprises to the subnational level. Subnational governments therefore have a major role to play in promoting or inhibiting privatization. But in many cases subnational governments still rely on “their” enterprises for revenues from profits and taxes. Not only would they lose some or all of these revenues if privatization occurred, they would also have to assume the substantial ancillary expenditures, assets, and their associated liabilities—for nurseries, housing, schools, vocational education, and so on—that will be spun off by the enterprises as they privatize. Owning assets that produce revenue is attractive to revenue-strapped communities, so privatization may be undermined unless the intergovernmental fiscal system accommodates these shifts in expenditure responsibilities, for example by providing the needed revenues in some other way. Continued local ownership of enterprises—and vested interests in their revenues—may also lead to domestic protectionism and the creation of interjurisdictional trade barriers to protect local monopolies, perhaps particularly in countries as regionally diverse as Russia. Both the efficiency with which these economies perform and their future growth may be substantially affected by the intergovernmental fiscal system.

Nation building. Finally, some countries such as Russia and Ukraine are explicitly “nation building,” in the sense of attempting to counteract significant centrifugal forces at the subnational level. As experience has demonstrated in many less homogeneous countries, how the intergovernmental fiscal system works may prove to be crucial to national cohesion. The desire for more participatory democracy in the transition economies has heightened subnational demands for local political control and unfettered local autonomy. Such demands are a natural outcome of the end of central planning. But the inadequate fiscal base is placing local aspirations and local fiscal capabilities increasingly at odds in some countries, giving rise to growing tensions.

The choices are not easy, particularly in the more regionally diverse countries like Russia. Giving restless subnational governments the powers, resources, and revenues to go it alone may placate them temporarily. But it may not be possible to go very far in this direction without seriously damaging national interests. On the other hand, failing to go far enough may lead to frustration and rebellion. In Russia, for example, separatist tendencies fueled in part by fiscal pressures and imbalances are causing fundamental political problems (see chapter 10). Regionally diverse countries may require some degree of decentralization to survive politically; but deciding just how much, and how, to decentralize is always a matter of difficult political and economic calculation. Nowhere
is this more true than in the formerly socialist economies, where many of the key factors affecting such calculations are, unsurprisingly, in transition. Although this book necessarily focuses more narrowly on the design and development of intergovernmental fiscal arrangements, the importance of this wider political context must be kept in mind.

Need for a broader framework

Intergovernmental fiscal relations, far from being purely a local matter, are thus key to reform goals in nearly all the transition economies. Traditional analysis of fiscal federalism examines the fiscal functions of subnational and central governments in terms of their respective (and largely separate) roles and responsibilities for stabilization, income distribution (such as the social safety net), and resource allocation (Oates 1972; Musgrave 1983). This focus is not broad enough to address important aspects of local and intergovernmental finances in the transition economies for at least two reasons. First, as this literature has developed, this approach neglects the role of subnational governments with respect to stabilization, the social safety net, and privatization. Second, it does not fully address the legacies of a command economy that transition economies share and must address.

Revenue systems. Central governments faced with the need to reduce deficits (and reduce their recourse to inflationary finance) have tended to maintain the negotiated tax-sharing and intergovernmental transfer systems of the past. But this approach is becoming less acceptable in countries where demands for transparent regional treatment and equalization are strong and where subnational governments are seeking greater autonomy. It is also incompatible with the efficient provision of local public services, which requires a system of intergovernmental tax sharing and transfers that is both firm enough to serve as a basis for action and flexible enough to be compatible with ongoing structural changes and reform.

The new subnational governments need to develop adequate revenue systems. Recent legislation in the transition economies has assigned specific taxes to subnational governments with the stated goal of reducing their dependence on the center for transfers. Invariably, however, subnational governments in most of these countries are still highly dependent on central transfers, including shares of central taxes, which are almost always allocated on the basis of the "origin" of the revenue, that is, to the jurisdiction in which the tax is collected. The tradition of subnational governments receiving revenue from local public enterprises provides the historic basis for this practice of derivation-
Fiscal decentralization: From command to market

Based tax sharing. Because of differences in regional and industrial structure and therefore the taxable base, however, the result is often to exacerbate disparities in access to public sector resources.

Subnational revenue needs must be explicitly considered in national plans for tax reform, since failure to consider the intergovernmental dimensions of national tax policy changes can lead to problems. In Russia and Hungary, for example, where a share of the major national taxes has been assigned to the subnational level, the central government has recently made major policy and design changes to these taxes without considering their impact on subnational budgets. Such changes may wreak havoc on the aggregate subnational revenue flow and have erratic effects across subnational jurisdictions.

Despite the focus on autonomy in the new laws on local self-government (table 1.2), no transition economy provides its subnational governments with much fiscal discretion in the sense of permitting them either to set their own tax rates or define the tax base. Both tax bases and rates continue to be determined by the center, even for such minor levies as a dog tax. No country has assigned a major revenue base to the subnational level—although, as discussed below, many share important national revenue sources with subnational governments. The paucity of locally controlled tax resources in most transition countries, combined with the reluctance of local officials to exercise their taxing powers even when they have them, makes it almost inevitable that hard-pressed local governments will turn to other means of gaining revenue. They will demand increased transfers, attempt to borrow, or exploit the assets they have acquired during the process of decentralization and privatization.

Table 1.2 Laws on local self-government, selected transition economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Name of law</th>
<th>Date adopted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Law 7572 on the Organization and Operation of Local Government</td>
<td>June 1992</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Law on Local Self-Government and Local Administration</td>
<td>September 1991</td>
</tr>
<tr>
<td>Poland</td>
<td>Law on Local Authorities</td>
<td>March 1990, amended May 1990 and December 1990</td>
</tr>
<tr>
<td>Russia</td>
<td>Law on the Rights of Local Self-Governments</td>
<td>July 1992</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Law on Local Self-Government</td>
<td>1992</td>
</tr>
</tbody>
</table>

Source: Council of Europe 1994.
For decentralization to realize its potential in economic terms, however, subnational governments should, at the margin, both have to raise their own revenue and be in a position to do so (Bird 1993).^5

Public sector pricing. Another problem arises with regard to public sector prices (user charges). In the past, central governments in the socialist countries used low and fixed prices (including rents and other urban user fees) and wage controls as part of their income distribution program. Market reforms require the new governments in these countries to get the prices right and to use tax policies and targeted subsidies to redistribute income. Such reforms raise special problems for subnational governments in some transition countries, however, because the central government continues to mandate many of the prices of services for which they are responsible, such as rents, transport, and water.

Expenditures. A more systematic approach is also needed for public spending. The current strategy of devolving expenditures to the subnational level while holding back on transfers is unlikely to be successful. Indeed, net expenditure reductions at the subnational level may prove difficult to achieve. As table 1.1 shows, the subnational sector has significant expenditure responsibilities in many transition economies. In addition, state enterprises still undertake a wide range of social sector outlays that may have to be taken over by subnational governments. Subnational governments are also shouldering much of the burden of replacing and refurbishing obsolete and poorly maintained physical infrastructure. In relative and perhaps even absolute terms, subnational spending thus seems more likely to grow than to shrink in most transition economies.

Transfers. The level, design, and effects of intergovernmental fiscal transfers constitute key elements of the emerging intergovernmental and local finance systems of the transition economies. There are few formula-based transfers. Most transfers continue to be negotiated, both in aggregate and for individual localities. Decisions need to be made regarding the overall size of such transfers (the distributable pool) and the distribution formulas that allocate transfers across localities. Both the severe fiscal pressures on central governments in the transition economies and the vital tasks to be performed by subnational governments in the emerging structure of the public sector need to be taken into account. Practical measures of revenue capacity, expenditure needs, and perhaps fiscal effort need to be developed for use in such formulas. Central and local institutions must be developed to ensure that transfers are put to the best possible use, particularly in the smaller municipalities. Such institutions might include, for example, a central agency—or some form
of intermediary body—to monitor the performance of local governments and to provide them with needed technical assistance and support.

**Borrowing.** Borrowing by subnational governments is also a matter of concern. As discussed later, some countries have granted virtually unlimited borrowing powers to subnational governments, apparently without considering the possible macroeconomic repercussions of failing to monitor and control such borrowing. Although the undeveloped state of municipal credit markets makes abuse of this borrowing power more a potential than a real problem, in some countries (such as Bulgaria) the local debt problem is being “solved” by not honoring payments due to suppliers, creating arrears.

**State-owned assets.** The potential for misuse of locally owned state assets is already apparent. Such assets may represent a windfall—at least in those cases where they are not accompanied by central policies, such as rent or price control, that turn them into a liability (Alm and Buckley 1994). But they are often misused, whether privatized or not. A local district heating plant that is privatized but remains a local natural monopoly raises regulatory problems. Who deals with these problems, and how? What should be done with the proceeds of privatization? When should such proceeds be used to finance recurrent budget expenditures? If an asset is not privatized and is used to generate recurrent revenues for the subnational government, the temptation to sustain and strengthen the monopoly position is again a problem. Another risk is the high probability that many speculative ventures will fail. And many subnational governments are seeing scarce managerial skills dissipated in efforts to squeeze money out of such ventures rather than focusing on the more essential government task of providing local public services efficiently.

In any system fiscal decentralization is invariably an ongoing and dynamic process. Reformers in Central and Eastern Europe and the former Soviet Union, however, face a special challenge in having to distinguish between problems that are structural and those that stem from the transition to a market economy. They must design an intergovernmental framework that is firm enough to serve as a basis for action, for example, regularizing transfers and tax flows, but still flexible enough to coexist with the ongoing structural adjustments in the economy relating to stabilization, redistribution, and privatization.

**Recent trends in decentralization**

One of the most striking features of the political and fiscal decentralization in the transition economies is how recently it was implemented and
how quickly it has proceeded. Legislation on local self-government has been introduced in every country in the region (see table 1.2). In most countries, this legislation was introduced shortly after the breakup of the Soviet bloc, reflecting the importance of local autonomy movements in countries emerging from the central command system. Only Russia, the single formally federal state, has addressed its center-state relations in a constitutional context, with the 1994 Constitution defining the powers of Russia’s eighty-nine oblasts (intermediate-tier governments) vis-à-vis the federal government, and equalizing the status of all intermediate governments vis-à-vis each other (see chapter 9).

Clear assignment of expenditure responsibilities and taxes to different levels of government is desirable to promote efficiency, equity, and accountability, and to ensure predictability. On the whole, however, given the difficulty of amending constitutions and the evolving nature of these economies, it is likely that most countries will continue to take the legislative rather than the constitutional route with respect to decentralization. Expenditure and tax assignments should be clear and fair, but they do not need to be permanent: flexibility within a well-defined structure is likely to be a better approach than prematurely attempting to lock all the ingredients of the shifting economic and fiscal puzzle in place.

A time of transformation

The local self-government laws listed in table 1.2 represent a major departure from the past. Theoretically, they guarantee the political, administrative, and financial independence of subnational authorities. Often guided to some extent by the Council of Europe’s model legislation, these laws address issues ranging from the guarantee of free and open elections and the protection of political boundaries to the nature of central limitations on administrative oversight and the right of local authorities to cooperate and form associations (Council of Europe 1985). Typically, the legislation affirms decentralization, local financial autonomy, and the administrative independence of the subnational level from central control. The language of the laws differs, but the general intent appears to be to free subnational governments from centralized control and allow local democracy to flourish.

Most countries have also enacted additional legislation on subnational revenue sources, the budget process, and the like. In Hungary, for example, which is further along in this process than most other countries in the region, laws have been passed on local taxes and fees, local elections, and the self-government of the capital city and capital city districts. Nonetheless, key elements of the legal framework needed for
efficient subnational government are still missing in most countries, and critical questions—such as the assignment of expenditure responsibilities and the role and nature of institutions intermediate between central and local governments—remain undecided.

Moreover, no country has yet established an adequate political or administrative structure for designing and guiding the decentralization process further. For example, responsibility for local affairs in Hungary is split between the Ministry of Interior and the Ministry of Finance. In Russia the formation and implementation of subnational fiscal policies is the responsibility of the Ministry of Finance and four parliamentary (Duma) subcommissions. The State Tax Service (administration) also has important intergovernmental fiscal responsibilities. In Bulgaria the regional governors are appointed by the Council of Ministers, while the municipal level is managed by municipal councils. In Romania the formulation of decentralization policy and implementation of local government reform is the responsibility of both the Department of Local Government Affairs of the Office of the Prime Minister and the Department of Tax Administration and Local Budget Management of the Ministry of Finance and Economy. In contrast, Poland and Albania have some unified leadership since they have granted a coordinating function to the Council of Ministers and have established an intergovernmental task force (which in Albania’s case is temporary).

Reorganizing government

Decentralization is a broad term encompassing several distinct governmental arrangements. Devolution is the fullest form of decentralization: independently established subnational governments are given the responsibility for delivery of a set of public services along with the authority to impose taxes and fees to finance the services. Devolved governments have considerable flexibility to select the mix and level of services to provide. Some financial support may be provided by the central government.

Deconcentration refers to the decentralization of central government ministries. Deconcentration with authority means that regional branches of central government offices are created with some ability to make independent decisions. Deconcentration without authority occurs when regional offices are created with no independent capacity for decision-making. All deviations from normal practice must be approved by the center. This sort of administrative decentralization within the central government is not discussed further in this book.

Delegation is intermediate between devolution and deconcentration. Subnational governments (not branches of the central government) are
given responsibility for delivering certain services but are subject to more or less detailed supervision by the central government, which also often provides some or all of the finance for the services in question, usually through some form of fiscal transfer.

In principle, devolution should increase the efficiency of service delivery by allowing citizens to determine more directly the mix and level of services and by providing greater incentives for local resource mobilization. People are more willing to pay for services closely attuned to their demands, and local officials are, it may be argued, more readily able than central bureaucrats in some distant capital to determine what they are able and willing to pay for. Such efficiency gains from decentralization benefits may be particularly significant in countries with diverse economies, geography, and tastes for services.

On the other hand, delegation may be efficient when subnational governments can better administer programs of national interest (education, health) in ways that better match local economic and social circumstances. The central government determines, in essence, how much should be spent in these areas and perhaps sets minimum or standard levels of provision, but the detailed decisions on exactly what is done are to some extent decided by local governments. The detailed design of intergovernmental fiscal transfers and the degree and nature of central government monitoring may critically determine the balance of central and local influence in such delegated areas of responsibility.

In transition economies, few of the potential benefits of decentralization—whether by devolution or delegation—have yet been attained, for two reasons: the persistence of old methods and flaws in the new dispensations. In Romania, for example, although the Public Finance Law grants subnational governments budgetary autonomy, it also gives the central government the power to change local budgetary allocations. Moreover, deference to central commands, even if no longer legally binding, persists in many areas. As discussed in chapter 6, local governments in Romania deliver few services themselves. Instead, they contract with local public enterprises (regies autonomes) to deliver most local public services. While a 1990 law makes these enterprises responsible to a board composed of local officials, the enterprises appear to respond more to central than to local control. Finally, as in most of the transition economies, Romania has a large number of small, poor local governments with almost no resources of their own. Autonomy does not mean the same thing to a small, poor rural commune as it does to a large, relatively rich city.

Similar problems—conflicting legal interpretations, tangled relations with enterprises, and wide diversity in local government capacity—exist in varying degrees in most of the transition economies, casting
doubt on the significance of local autonomy. Even where such problems are absent, local autonomy may not be very meaningful if it is not accompanied by fiscal capacity—and it may not be desirable unless it is accompanied by some degree of fiscal responsibility.

To make local autonomy meaningful, subnational governments need adequate locally controlled revenues. Decisions about the provision of services with primarily local benefits must be made by local governments, and these governments must have the resources to carry out such decisions. As shown in detail in the country chapters, subnational expenditure discretion is still limited in important ways in all the countries covered here. Some of these limitations on local discretion may be useful, but others clearly are not. In most countries the subnational revenue base is inadequate and largely centrally controlled, with the result that subnational governments remain undesirably dependent on ad hoc central transfers. Greater spending discretion for those expenditures assigned to the subnational level and greater flexibility for subnational governments to raise their own revenues are thus needed in most countries if subnational governments are to be made more accountable to local residents and local public services are to be delivered more efficiently.

To make local autonomy desirable, subnational governments must not only be accountable to local citizens for spending from revenues raised from them; they must also be accountable to the central government to the extent they are acting as central agents and are financed by transfers. One way to make local autonomy both meaningful and desirable is to provide technical assistance and training activities that enhance the capacity of subnational governments to deliver services effectively and to generate more own-source revenues. Another is to design grants, financial reporting systems, and accountability mechanisms to this end.

The structure of government

Before the reform period all the transition countries surveyed here except Albania had a multitier organization of government, with the central level implementing its control over the local level through an intermediate tier of government. The central government was responsible for the overall plan and budget, and the intermediate level—called oblast in the Russian Federation, Ukraine, and Bulgaria, județ in Romania, megye in Hungary, and voivod in Poland—was the agency of administrative control through which the center dictated and implemented policy. This middle tier oversaw the expenditures of local governments and was the channel for central fiscal flows to the localities. However, from a fiscal perspective, none of the countries discussed in this book was truly organized as a federation.
Russia currently has a three-tier system of government, comprising the central (or federal) government, the intermediate-level regions, and the municipalities (table 1.3). Although the legal structure suggests that Albania, Bulgaria, Hungary, Poland, and Romania have a two-tier government structure (central and local), matters are not so simple. Romania, for instance, has two tiers of local government (the judets and the municipalities). All the area of a judet is divided into municipalities, but in principle each type of local government is independent of the other. The same is true in Albania. In Bulgaria and Hungary the old intermediate tiers continue to exist, but they have so few functions that in effect there are really only two levels of government, central and local. On the other hand, in Budapest (Hungary), Sofia (Bulgaria), and the cities of Russia, there are subcity (district or ward) councils and governments with elected councils and their own budgets and assets, so the “local” level of government itself has two tiers.

The average population size of these middle-tier subnational governments varies widely, often reflecting the size of the country itself (table 1.4). The average size of a Bulgarian oblast is about half that of a Russian oblast and roughly two-thirds larger than the Romanian judet and the Hungarian county. In all countries, however, there is considerable dispersion in the size of both intermediate and local governments, as shown in table 1.4.

### Table 1.3 Structure and organization of government in selected transition economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Prereform Structure</th>
<th>Emerging Structure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unitary/ federal</td>
<td>Unitary/ federal</td>
</tr>
<tr>
<td></td>
<td>Number of tiers</td>
<td>Number of tiers</td>
</tr>
<tr>
<td>Albania</td>
<td>Unitary 1: Central</td>
<td>Unitary 2: Central</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Unitary 3: Central,</td>
<td>Unitary 2: Central,</td>
</tr>
<tr>
<td></td>
<td>regional, local</td>
<td>regional, local</td>
</tr>
<tr>
<td>Hungary</td>
<td>Unitary 3: Central,</td>
<td>Unitary 2: Central,</td>
</tr>
<tr>
<td></td>
<td>voivodship, local</td>
<td>voivodship, local</td>
</tr>
<tr>
<td>Poland</td>
<td>Unitary 3: Central,</td>
<td>Unitary 2: Central,</td>
</tr>
<tr>
<td></td>
<td>regional, local</td>
<td>regional, local</td>
</tr>
<tr>
<td>Romania</td>
<td>Unitary 3: Central,</td>
<td>Unitary 2: Central,</td>
</tr>
<tr>
<td></td>
<td>regional, local</td>
<td>regional, local</td>
</tr>
<tr>
<td>Russia</td>
<td>Federal 4: Central,</td>
<td>Federal 3: Central,</td>
</tr>
<tr>
<td></td>
<td>Union republics,</td>
<td>oblasts, rayons</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Federal 4: Central,</td>
<td>Unitary 4: Central,</td>
</tr>
<tr>
<td></td>
<td>Union republics,</td>
<td>oblasts, rayons</td>
</tr>
</tbody>
</table>

- The period before passage of relevant act in table 1.2.
- Refers to the Soviet period.
- Source: Information is drawn from this volume.
A role for a middle tier?

Few questions are more in flux in most transition countries than the role of intermediate levels of general-purpose government. Most countries seem to associate this intermediate tier with the former control economy and want to eliminate it. In some countries, the intermediate tier is limited to overseeing the constitutionality and legality of local government operations. In others, its main role is to coordinate central government policy at the regional level.

In Hungary, for example, there are now 8 regions, 19 counties, and 3,148 localities. The newly created regions, headed by a central office called the Commissioner of the Republic, have only two functions: information gathering and dissemination, which involves collecting data on local government activities and providing information to local governments to facilitate the implementation of national policies; and monitoring of local government actions (such as taxes) to ensure they are constitutional. The counties, formerly the main territorial control instrument of the state, have had their functions severely restricted. As discussed in chapter 2, counties retain only some minor fee revenues and are responsible in principle only for interjurisdictional functions that serve several localities. On the other hand, localities have extensive expenditure responsibilities, the right to spend national transfers and shared taxes as they see fit, and almost unlimited power to borrow, own, and dispose of property and to manage, establish, or sell public enterprises. In response to local pressures for greater self-determination, the number of local governments has more than doubled from the 1,523 local councils in place before local government reform.

Romania's situation is quite different (see chapter 6). Although the forty-one judets of the old order continue to exist, there are now two parallel administrative structures in each judet. One, headed by an appointed prefect, is essentially the deconcentrated territorial administration of the center. The second, headed by the elected president of the judet council, is the judet government itself, which is responsible for "works of regional interest," but which, like the Hungarian counties, has no hierarchical authority over the 2,948 municipalities. In the populated urban areas, the municipalities have the lead role. In areas characterized by small towns and villages, however, the judet is the coordinating entity. And in some areas judets and municipalities share responsibilities, dividing local and interlocal aspects—although it is not always clear just what this means.

Poland's forty-nine voivodships are not really subnational governments: rather, they are deconcentrated public service intermediaries for certain central expenditures (mostly in health and social welfare),
although other central expenditures are carried out locally by line ministries. All local government functions are carried out directly by the 2,549 gmina governments. As discussed in chapter 4, a new intermediate tier of government (probably about 300 units called powiats) has been proposed but not yet been approved or implemented.

In the Russian Federation a different pattern is emerging, with the oblast level taking on a larger role and emerging as an important unit in its own right. Indeed, if the fiscal reforms at the subnational level proposed in recent legislation (see chapter 9) are implemented, the Russian Federation will have decentralized substantial expenditure responsibilities and, to a lesser degree, revenues to the oblast level and in many ways might take on the character of a true federal state. To date, however, the eighty-nine autonomous regions, oblasts, okrugs, krais, and republics have only nominal autonomy: they are neither fiscally independent nor legally able to determine their own expenditure and tax policies.

In contrast, as discussed in chapter 8, the government structure in Ukraine remains strictly hierarchical. It has four tiers, with the central

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of government/unit</th>
<th>Name</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>District</td>
<td>Rethe</td>
<td>37</td>
</tr>
<tr>
<td></td>
<td>Municipality/commune</td>
<td>Bashki/communa</td>
<td>356</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>County</td>
<td>Oblast</td>
<td>9</td>
</tr>
<tr>
<td></td>
<td>Municipality</td>
<td>Obshtina</td>
<td>255</td>
</tr>
<tr>
<td>Hungary</td>
<td>County</td>
<td>Megye</td>
<td>19</td>
</tr>
<tr>
<td></td>
<td>Municipality</td>
<td>Helyi onkormanyzt</td>
<td>3,148</td>
</tr>
<tr>
<td>Poland</td>
<td>Province</td>
<td>Voivodship/wojewodztwo</td>
<td>49</td>
</tr>
<tr>
<td></td>
<td>Municipality</td>
<td>Gmina</td>
<td>2,459</td>
</tr>
<tr>
<td>Romania</td>
<td>District</td>
<td>Judet</td>
<td>41</td>
</tr>
<tr>
<td></td>
<td>Municipality</td>
<td>Municipii/oras/comună</td>
<td>2,948</td>
</tr>
<tr>
<td>Russia</td>
<td>Province</td>
<td>Oblast</td>
<td>89</td>
</tr>
<tr>
<td></td>
<td>Municipality/county</td>
<td>Rayon</td>
<td>2,000</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Province</td>
<td>Oblast</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td>Municipality/county</td>
<td>Rayon/city</td>
<td>480 rayons and 139 cities</td>
</tr>
<tr>
<td></td>
<td>Rural settlement</td>
<td></td>
<td>30,000</td>
</tr>
</tbody>
</table>

— Not available.
government at the top followed by 27 oblast-level governments, 619 rayon-level governments, and about 30,000 rural settlements and city districts. Tax administration is performed for all levels by a central government agency. Although each level of government formulates its own budget, they are not autonomous units because the share of revenues that each level of government receives is determined by the government directly superior to it.

Albania seems, on paper, to have three layers of government: 356 communes and municipalities, 37 district governments, and the central government. But in fact, the districts have no hierarchical authority over the municipalities and the communes. A draft constitution specifies the role of a judiciary designated to settle intergovernmental disputes and define the relationship between different levels of government. Although Albania has begun to decentralize, problems have arisen (as discussed in chapter 7) because current laws remain vague on how local governments are supposed to finance and coordinate their hefty responsibilities.
Is the size of government units efficient?

The reaction against intermediate governments as undesirable reminders of the old regime is understandable, and so is the desire to replace them with something more acceptable. Most of the transition countries have created a large number of small and probably not fiscally viable local government units (see table 1.4). The average population of local governments in Hungary (excluding Budapest) is about 2,600. In Romania half the population lives in local government units with fewer than 3,000 people; such units account for 90 percent of all local governments. In Bulgaria the average population is 28,000 (excluding Sofia), but one-fifth of its 255 municipalities have populations of fewer than 5,000. And although Albania and Poland’s local governments are less fragmented, many are arguably too small to provide services efficiently.

Fragmentation may place government near the people, but it also complicates intergovernmental relations. The local governments in many transition economies are simply too small to provide efficiently all the public services theoretically assigned to them. Moreover, it is practically impossible for the central government to maintain direct bilateral relations with so many units, and the extensive fragmentation may reduce the political voice of local government as a whole. Even if formal intermediate tiers of government are not created, some mechanism for coordination and consultation is likely to prove necessary. Possible models abound, such as the municipal federations found in the Nordic countries, under which localities organize on a voluntary basis to provide certain local services, such as transport for commuters and certain types of education (Soderstrom 1991). For example, Finland’s 460 local governments are organized on a voluntary basis into 100 municipal federations to provide health care (soon to be reduced to 21). All the Nordic countries have “secondary communes,” county-like bodies with their own elected officials, which are responsible for providing specified services to an area encompassing several localities. Similarly, in the United States there are many “special districts,” entities with substantial administrative and fiscal independence created to carry out such functions as flood control, irrigation, fire protection, and water supply over areas encompassing several local governments.

Given the small size of local governments in many transition economies, there would seem to be a strong case for encouraging voluntary cooperation (for example, through the grant system) or for assigning some services (secondary education and hospital care) to larger special-purpose units. Alternatively, a case may be made for a more effective intermediate tier of general-purpose government in some countries. As shown in the detailed country discussions later in this book, the whole
question of the appropriate role and design of intermediate subnational governments remains very much up in the air in most countries.

The changing role of government: From ownership to service provision

In the command economies, governments at both the national and subnational levels were involved in almost every aspect of economic activity. The state owned all enterprises, from steel plants to the local laundry. Central government ministries organized production, allocated labor, planned exports, and so on. The first stage of decentralization in some countries—Hungary led the way—began as early as the 1960s, when ownership of some smaller industrial units and the retail sector were transferred to subnational governments (Jeffries 1993). Although recent reforms aim to decentralize ownership to the private sector, the transition is far from complete. All the countries studied here appear committed to privatizing state assets, liberalizing prices, and removing from the state its role as direct producer and provider of economic goods; but many productive assets—industrial assets, agricultural and urban land, housing stock, commercial property—remain in government hands, often those of local governments. Under the socialist system, enterprises owned by local governments had their investments financed from local budgets, and local governments derived revenues from the operations of enterprises they owned. Budgetary distinctions between enterprise functions and government functions were unclear. Government often asked enterprises to construct and finance such facilities as roads, schools, clinics, and even sports stadiums and clubs; "donations" to the budget for onetime outlays were also common. It made little difference whether such outlays were undertaken directly by the enterprise or through the more circuitous route of profit transfer and funding through the government budget: the burden on the enterprise and the net budgetary position was the same. All this has now changed, or is in the process of changing.

Transforming the role of national and subnational governments in transition economies is a major challenge. In principle, subnational governments should become service providers and regulators, not owners. The wrenching reforms most countries are undertaking to achieve macroeconomic stabilization and to compress the state budget could produce perverse effects at the local level, however. Unless an adequate framework for intergovernmental finance is put in place, budgetary constraints may create additional hurdles to disassociating local governments from their enterprises. Subnational governments will be tempted to rely on locally owned enterprises to provide public services and to protect locally owned enterprises to ensure their profitability.
The regulatory tasks facing both subnational and central governments have changed. Administrative interventions, such as the detailed regulation of prices, the administration of waiting lists for housing, and the allocation of land and material supplies, are no longer appropriate. What is needed is a regulatory structure that provides the conditions under which the market can function, such as regulation to avoid monopoly, prevent food adulteration, curtail financial fraud, promote transparency and consistency in zoning and land use, and so on. The national government must establish a clear legal framework—setting, for example, environmental standards—not only for the private sector but also for the decentralized local public sector. Subnational governments may also need to regulate areas such as land use, business licensing, sanitation conditions, and localized environmental problems (Oates 1990). To the extent these governments are competitors as well as regulators of the private sector, their actions will be suspect.

Macroeconomic dimensions of intergovernmental finances

Intergovernmental financial reforms are taking place in a constrained fiscal context, at a time when tax reforms and major changes are taking place in national revenue systems. Current stabilization concerns may in some instances unduly dominate the design of a sound, long-term intergovernmental system.

Simultaneity of national tax reform and intergovernmental reform

Fiscal decentralization is taking place at the same time as national tax systems are undergoing major changes. National tax reforms have been initiated in almost every country in transition to make tax systems more compatible with a market economy and to provide a secure source of revenue for essential state budgetary outlays (Gray 1990; Tanzi 1991, 1993a, 1993b). More recently, some tax changes have been driven by the desire of some transition economies to harmonize their fiscal regimes with the European Union. While there are considerable variations of detail from country to country, most national tax reforms have involved:

- Replacing profit remittances to government as enterprise owner with corporate income tax (CIT) to government as tax collector.
- Introducing a value added tax (VAT) to replace the socialist "turnover tax," a cascading tax which consisted of thousands of commodity-specific rates that acted as wedges between administratively set retail and wholesale prices.
- Introducing a personal income tax (PIT) to replace the wage controls that served as the implicit tax on labor income prior to reform.
Introducing property and land taxation.
Introducing or revising payroll taxes to finance social security, unemployment, and health systems.
Eliminating a number of taxes aimed at regulating enterprise behavior, such as the excess wage tax, wage bonus tax, and excess profits tax.

The simultaneous implementation of decentralization and national tax reform has often provided little time to anticipate the effects of revenue reform on subnational finances. In Hungary, for example, the PIT and VAT were introduced in 1988, two years before the Law on Local Self-Government was passed, and the 1988 Budget Act determined that a share of the new personal income tax—the yield of which was unknown—should be the major revenue source for local government under the old system. In Russia revenues from both the just-introduced PIT and the VAT were assigned to the oblast level in 1991, again with little basis for judging revenue yields or adequacy, and before spending functions were clearly assigned. Major changes have since been made to both the VAT (extending the base to imports to increase the yield, and changing the rates) and the PIT (tripling the personal exemption, thereby halving oblast PIT revenues), with profound effects on oblast budgets. In Ukraine, as in Russia, major new taxes are being introduced at the same time that local self-government laws are assigning them to or sharing them with oblast and local governments.

Despite the fact that subnational spending accounts for more than 40 percent of total public sector outlays and one-fifth of GDP in some countries (see table 1.1), in most cases national tax reforms do not seem to have taken the fiscal needs of subnational governments into account. Given the inadequacy of the “own source” revenues specifically assigned to subnational governments in most transition countries, these governments are likely to remain dependent on shares of central taxes (or transfers) for years to come. National tax policy is also subnational tax policy, and this fact should be more explicitly taken into account than seems to have been true so far.

The macroeconomic context for decentralization

Transition economies have had to address stabilization and liberalization concerns simultaneously. Intergovernmental fiscal reforms are taking place in a weak macroeconomic context, often coupled with a weak central government fiscal position (table 1.5). In Hungary in 1990, the year the new system of local self-government was introduced, the consolidated deficit of the general government was 4 percent of GDP, with inflation at 32 percent. In 1992 the deficit was 7 percent, and by 1994 it
had risen to an estimated 9 percent of GDP, with local and national needs competing in an environment of increased fiscal austerity. In the Russian Federation the fiscal deficit was more than 15 percent of GDP in 1991 and 1992, it remained high at nearly 8 percent of GDP in 1993, and a deficit of more than 10 percent of GDP has been estimated for 1994; inflation also remains high. Bulgaria's deficit in 1993 was almost 10 percent, and Albania's was even higher, at 16 percent. In Romania, although the budget deficit has been small, the high inflation rate reflects an underlying instability, and it seems likely that fiscal accounts understate the deficit. Such pervasive fiscal constraints have had a major impact on the design of intergovernmental fiscal systems.

The move to private entrepreneurship has contributed to a more vital economy, but it has also reduced central government revenues. Many smaller private enterprises elude the tax net, and the burgeoning informal economy presents major challenges to tax compliance and tax administration. State-owned enterprises no longer provide a secure revenue base. Tax reforms are desirable for market efficiency, but it will take time for tax administration to adapt to the radically new environment. Budget balance is also complicated by the fact that the expenditure budget in most countries continues to be burdened by outlays for subsidies, generous cash benefit programs, and new and sometimes large support of enterprise and bank restructuring and recapitalization.

Intergovernmental reforms are taking place in the context of a concentrated effort to reduce the size of government. In Hungary expenditures shrank from about 62 percent of GDP in 1988 to about 57 percent in 1993. In Russia the general budget was more than 60 percent of GDP in the late 1980s and about 40 percent in 1993; the target for 1994 was just 20 percent. In Albania spending fell from 62 percent of GDP in 1991 to 44 percent in 1993 (see table 1.1).  

### Table 1.5 Fiscal balance in selected transition economies, 1993  
(deficit/surplus as a percentage of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>General government</th>
<th>Central government</th>
<th>Subnational government</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>-16.0</td>
<td>-16.0</td>
<td>---</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-9.2</td>
<td>-9.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>-6.0</td>
<td>-5.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>Poland</td>
<td>-2.5</td>
<td>-2.9</td>
<td>0.0</td>
</tr>
<tr>
<td>Romania</td>
<td>-0.4</td>
<td>-1.5</td>
<td>-1.7</td>
</tr>
<tr>
<td>Russia</td>
<td>-7.9</td>
<td>-6.7</td>
<td>0.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>-6.2</td>
<td>-6.2</td>
<td>---</td>
</tr>
</tbody>
</table>

--- Not available.

Note: General government may include budgets of agencies and autonomous entities and is therefore not, in all cases, the sum of central and subnational government shares.

Source: World Bank and various country sources; see table notes.
Not surprisingly, stabilization concerns often dominate the national and intergovernmental agenda. Reducing fiscal imbalances, both at the center and at the subnational level, is fundamental to the adjustment programs of most transition countries. The current situation is in sharp contrast to the prereform period, when strict central controls ensured subnational finances had few macroeconomic consequences (Blejer and Szapary 1989; Bahl and Wallich 1992). Under the old system, revenue sharing served only as an administrative device to simplify a system of central resource allocation, and expenditures were guided by planning norms. The result was that the budgets of subnational governments were always in balance, in an accounting sense at least, with required adjustments made simply by transfers from the central budget.

The new concern for macroeconomic stabilization has led central governments to view fiscal decentralization as an opportunity to reduce central expenditures in two ways. First, "spinning off" expenditure responsibilities to the subnational level reduces the central deficit. Second, reducing fiscal transfers, purportedly to make subnational governments more independent, also reduces central outlays.

**Shifting expenditure responsibilities.** In some countries budgetary responsibility for social expenditures and the social safety net is being transferred to subnational government. In Hungary, for example, responsibility for welfare expenditures was transferred to the localities in 1993 under the Social Assistance Law. In Ukraine, too, the social safety net is a subnational responsibility. In Russia the central government transferred social expenditures equivalent to some 6 percent of GDP to localities in the 1992 budget, in effect pushing the deficit down. The hope seems to have been that subnational governments would perform the politically painful cutting required, even though the demand for these services is likely to grow with the worsening economic situation. And in 1993, again in Russia, responsibility for key national, interjurisdictional investments (such as in transport) was transferred to the subnational sector.

Even some of the asset transfers to subnational governments that have occurred appear to have been motivated partly by budgetary concerns. Some of the transferred assets—notably housing and some enterprises—are really liabilities given the heavy burden of maintenance and operation of these units and the fact that rental income (adjusted in 1993 in the Russian Federation for the first time since 1928) does not cover even a small part of costs (Alm and Buckley 1994).

**Reducing intergovernmental transfers.** Fiscal difficulties have led some central governments and their finance ministries to focus on reducing intergovernmental transfers. Such reductions are often promoted on the principle of budgetary independence—that is, that
subnational governments should be financially self-sufficient—although they have not been matched by giving those governments any additional revenue-raising authority.

A good case may be made for reducing the old discretionary transfers. This system perpetuates the socialist structure of deconcentration and works against the development of responsive and efficient subnational governments. In practice, however, most transfer reductions have not been accompanied by any attempt to rationalize the system through a reassignment of tax bases to subnational governments, or to efficiently design and target grants (for example, along the lines sketched later in this chapter).

In all countries central transfers to subnational governments remain large (table 1.6), reflecting both the center’s reluctance to give up a tool for controlling subnational governments and the failure of some local authorities to modernize and strengthen the limited revenues they do control. In Romania and Bulgaria, for example, the central government has maintained its political control and thwarted local creativity through its control of old line institutional mechanisms (the judets in Romania) or simply by coming down with a heavy hand (Bulgaria): see chapters 5 and 6 for further discussion. In Hungary, however, part of the problem appears to be with some local officials who behave as if the laws on local self-government and local taxes will implement themselves and who put off the need to act today to strengthen, say, the property tax, which could be a major source of revenue five years from now.

**Improving overall budgetary outcomes**

While budgetary flexibility is clearly desirable from the central government’s short-run perspective, transfers should not be seen as a compressible part of the national budget, as they are in some countries. Many of

<table>
<thead>
<tr>
<th>Country</th>
<th>Own tax</th>
<th>Nontax/other revenue</th>
<th>Transfers and shared revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>0.0</td>
<td>0.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1.2</td>
<td>4.1</td>
<td>94.7</td>
</tr>
<tr>
<td>Hungary</td>
<td>4.0</td>
<td>19.9</td>
<td>76.1</td>
</tr>
<tr>
<td>Poland</td>
<td>25.7</td>
<td>18.8</td>
<td>55.5</td>
</tr>
<tr>
<td>Romania</td>
<td>17.0</td>
<td>6.0</td>
<td>77.0</td>
</tr>
<tr>
<td>Russia</td>
<td>8.8</td>
<td>1.6</td>
<td>89.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>0.7</td>
<td>2.5</td>
<td>96.8</td>
</tr>
</tbody>
</table>

Source: See table notes.
the services provided by subnational governments are essential to political stability and economic development. Many local governments cannot provide these services at an adequate level from their own resources alone. Even from a short-run stabilization perspective, cutting transfers may be inadvisable. Underfunded subnational governments may cope with budgetary pressure by using such economically undesirable sources of revenue as profits derived from the exploitation of income-earning assets and from direct public ownership of local businesses. At the same time, in some countries subnational governments' open-ended responsibility for social assistance may result in emergency recurrence to the central government for additional funds, the unsustainable accrual of arrears, or undesirable short-term borrowing. Subnational government arrears are currently a major problem in Bulgaria, Romania, Russia, and Ukraine. Budapest is borrowing to finance recurrent expenditures (see chapter 3). Russia's oblasts are sometimes several months behind in paying mandated adjustments to pensions and teachers' salaries. The only way to keep down such presumably undesirable developments in the coming years in most transition countries is likely to be to maintain some form of intergovernmental transfers.

Deficit controls. Direct control over subnational deficits is one way for central governments to ensure that subnational governments do not create macroeconomic pressures. Such limits are used in Russia, for example. Provisions of this kind may make sense in a framework of "hard" budget constraints, but the combination of deficit controls and soft budget constraints in the enterprise sector can create perverse outcomes. In response to an apparent surplus in overall subnational budgets in Russia and Bulgaria, for example, the central government transferred expenditure responsibilities to the subnational level, readjusted tax-sharing levels, and minimized transfers. But since Bulgarian subnational governments cannot legally run deficits or borrow, even for liquidity, and since borrowing abilities and authorities in Russia are limited, budgets by definition must contain a surplus sufficient to meet the cash requirements of monthly local outlays. Reducing revenue shares or transfers will not eliminate this surplus; since subnational budgets cannot be in deficit, such measures will lead only to measured expenditures below "normal" levels and increased cumulative arrears. In this environment, a simple requirement for subnational governments to balance their budgets is not sufficient.

Restricting borrowing. A good case can be made for permitting local governments to borrow for certain capital investments. A striking feature of the current arrangements for subnational finances in some countries,
however, is the virtually unrestricted legal access given to subnational governments for unlimited borrowing including, in some cases, foreign borrowing (table 1.7). In Hungary, for example, the Law on Local Self-Government grants all local governments unrestricted domestic borrowing rights for current and capital expenditures. Local governments in Albania can also borrow without restrictions for capital investment. Most of the other countries impose some limitations, however. In Poland, for example, localities are not allowed to borrow more than 5 percent of current budgeted expenditures.

In the command economy period, subnational governments’ borrowing was determined by the overall credit plan, and the central government guaranteed repayment to banks, just as it did for state enterprises. Under current circumstances, however, such generous local access to loan finance seems out of place. Restricted and limited own-source revenues may tempt local governments to overuse debt finance. The precarious macroeconomic situation in many transition economies makes the case for limiting local government’s access to borrowing even stronger. Borrowing for recurrent costs, and free access to credit through such routes as local government ownership of banks, seem wholly undesirable. Few of the new subnational governments have experience with investment financing, and most are not yet capable of preparing complete and meaningful projects. In most countries, intergovernmental fiscal flows are still in flux, and subnational governments have limited autonomy to set

### Table 1.7 Subnational government borrowing, selected transition economies

<table>
<thead>
<tr>
<th>Country</th>
<th>Local borrowing authority</th>
<th>Local borrowing activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Unlimited borrowing authority for investment purposes onlya</td>
<td>No information</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Limited borrowing authority but governments accumulate arrearsb</td>
<td>From Ministry of Finance</td>
</tr>
<tr>
<td>Hungary</td>
<td>Unlimited borrowing authority</td>
<td>Some municipalities have past debt. Minimal new borrowing</td>
</tr>
<tr>
<td>Poland</td>
<td>Limited borrowing authority</td>
<td>Debt service not to exceed 15 percent of revenuec</td>
</tr>
<tr>
<td>Romania</td>
<td>No borrowing authority but governments accumulate arrearsb</td>
<td>Virtually no activity</td>
</tr>
<tr>
<td>Russia</td>
<td>Limited borrowing authority, limited by decree in 1993</td>
<td>Minimal new borrowing (for liquidity purposes)</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Limited borrowing authority from domestic sources</td>
<td>Minimal new borrowing (for liquidity purposes)</td>
</tr>
</tbody>
</table>

Note: For indicated footnotes, see table notes.  
user fees and little experience (or room) to tax on their own. It is thus difficult to judge their creditworthiness. Most financial institutions in transition economies are not yet capable of evaluating long-term risks or handling long-term financial instruments. All these factors argue for caution in allowing local governments to borrow. Nevertheless, to the extent that benefits from some projects are enjoyed in the future, borrowing for local infrastructure projects has a sound theoretical base. Financing capital expenditures from current revenues would unnecessarily limit the pace and efficiency of subnational investments. The challenge is to define appropriate financing mechanisms that do not threaten macroeconomic stability. In most countries, however, this task, while important, must wait on the more immediate challenge of developing a sound structure for financing subnational current expenditures.

Privatization and subnational governments

As noted earlier, an important feature of the fiscal landscape in transition economies is the continued significant ownership role of subnational governments at a time when national priorities support privatization. One reason this role persists is that in many countries a key element in the decentralization process has been the center’s transfer of assets to subnational authorities. Another reason is the inadequate revenue base given to localities and their continued financial dependence on enterprise revenues. For privatization to succeed, subnational governments must get out of the business of business and into the business of government. This process raises questions relating to the use of transitory revenues from privatization and how best to take advantage of the assets held by subnational governments.

Asset transfers to the subnational level

One of the most important features of fiscal decentralization has been the transfer of assets to subnational governments (table 1.8). Subnational governments are increasingly becoming owners of enterprises, housing, vacant urban land, and retail establishments as these assets are transferred from the center. In Hungary the 1991 Act on Property Transfer transferred ownership of the housing stock to local governments. Local governments in Romania have been given all formerly state-owned properties within their territories, ranging from public domain property such as parks to private domain property such as enterprises. Enterprises in Russia have long been owned by each level of government, and housing and land were transferred to municipal and rayon-level governments beginning in 1991. In both Poland and
Albania small-scale enterprises have been transferred to subnational governments, which have been charged with privatizing them.

Asset transfers can be a mixed blessing, however. Indeed, one motivation for some transfers of public utilities, some blocks of public housing, and certain other enterprises may have been to avoid the fiscal burden (such as subsidies, maintenance, and repair) that ownership carries. Subnational governments thus face major maintenance and subsidy burdens unless costs are recovered quickly. The net effect of asset transfers may be a long-term fiscal drag on local financial maneuverability, as has been argued may be true in Budapest (Alm and Buckley 1994).

**Entrepreneurial subnational governments**

In some countries there is evidence that property transfers are increasing the entrepreneurial ambitions of subnational governments as they use their new property rights to activate idle property. A worrisome pattern in the transition economies has been the involvement of governments at different levels in joint economic ventures in purely private, market-oriented activities. As Romania's Law on Local Public Administration states (and it is not unusual in this respect): “Local governments are authorized to create, contribute equity [to], and/or take shares in commercial enterprises formed with their assets [and] belonging to or transferred to their ownership, including the possibility of forming joint ventures with foreign or domestic partners.”

**Table 1.8 Ownership of housing and of commercial and economic property, by level of government, selected transition economies**

<table>
<thead>
<tr>
<th>Country</th>
<th>Housing</th>
<th>Retail units</th>
<th>Domestic industrial enterprises</th>
<th>Public utilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Subnational</td>
<td>Central and subnational</td>
<td>Central and subnational</td>
<td>Central and subnational&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Subnational</td>
<td>Subnational</td>
<td>Central and subnational</td>
<td>Central and subnational&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>Hungary</td>
<td>Subnational</td>
<td>Central and subnational</td>
<td>Central and subnational</td>
<td>Central and subnational&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>Poland</td>
<td>Subnational</td>
<td>Subnational&lt;sup&gt;6&lt;/sup&gt;</td>
<td>Central and subnational</td>
<td>Central and subnational&lt;sup&gt;6&lt;/sup&gt;</td>
</tr>
<tr>
<td>Romania</td>
<td>Subnational&lt;sup&gt;6&lt;/sup&gt;</td>
<td>Subnational&lt;sup&gt;6&lt;/sup&gt;</td>
<td>Central and subnational</td>
<td>Subnational (local) contracts&lt;sup&gt;7&lt;/sup&gt;</td>
</tr>
<tr>
<td>Russia</td>
<td>Subnational</td>
<td>Subnational</td>
<td>Subnational</td>
<td>Subnational</td>
</tr>
<tr>
<td>Ukraine</td>
<td>Subnational</td>
<td>Subnational</td>
<td>Central and subnational</td>
<td>Central and subnational</td>
</tr>
</tbody>
</table>

Note: Subnational includes local and/or provincial (oblast, judet, and so on) governments. For indicated footnotes, see table notes.

Localities appear excessively optimistic about their abilities to enhance revenue from entrepreneurial activities. Some hope to establish joint ventures with a domestic or foreign partner or another state enterprise, using local assets such as land as their equity share. Some localities also see potential in developing and servicing empty land to enhance its value as equity. Real estate development and financing is one of the riskiest business areas in market economies, and it is not likely to be a better bet in the transition economies. In Hungary tourism lodges, recreational facilities, and golf courses were cited as examples of such ventures-in-process, and in localities that inherited important real properties potential was seen in developing these as contributions to such industrial joint ventures as bakeries, construction firms, and food processing. In Russia all the rayon-level governments visited in the course of fieldwork were developing and exploiting their asset base through domestic joint ventures, anticipating revenue from the projects once completed. Similarly, in Poland providing private services as a means of earning additional local revenue appears to have strong support, with housing and real estate development, food processing, and furniture manufacturing cited as examples.

Subnational governments have good reasons for being involved with these new market ventures. Available land can be privatized only with difficulty, so the cost of contributing this resource to a joint venture may be perceived as being low. Also, many local public officials want to create business employment opportunities in their jurisdictions, which often are economically depressed and lack private entrepreneurship. But the hope for profits from such ventures could quickly turn into demands on local budgets to cover losses. Public officials tend to be poor business managers. It is hard for a government to close a failing business, especially when the local employment situation is unhealthy (Kornai 1986). There is also the risk that subnational governments and their businesses will undercut private competitors, possibly by employing regulatory devices that protect local monopolies, with the result that the role of government in the economy will not diminish. And subnational governments are subject to the ownership risks of any business. The rate of small business failure is high in developed market economies: there is no reason to expect that the transition economies can beat these odds.

More important, entrepreneurial activity by subnational governments is fundamentally inconsistent with privatization and represents a bottleneck to true decentralization—that is, decentralization not from the state to subnational governments, but from government to the private sector. Local government entrepreneurial activity does not promote privatization or true decentralization. Such "entrepreneurialism" inhibits or even reverses the privatization process—the long-term goal of removing government from those activities that can be handled by the private sector.
An essential element in privatization is thus the creation of adequate revenue instruments and flexibility at the subnational level. If the only resource available to subnational governments in response to budgetary pressure is profits from direct public ownership of local businesses, it is the source governments will use. Municipalities should not develop local monopoly enterprises to secure the revenue they need to function, just as they should not be forced to establish small taxes on a wide range of products and activities that are expensive to administer, generate widespread resistance, and typically yield little. Providing access to the national tax base (through transfers), granting the ability to levy local surcharges on national taxes where appropriate, and transferring sufficient revenue sources to subnational control are essential if decentralization is to support privatization.

**Asset sales versus giveaways**

The sale of assets (housing, enterprises, land) is a potential source of significant revenue to subnational governments in most transition economies. But there is considerable controversy over how this process should take place and whether assets should be sold or given away. Different countries are employing different methods, ranging from auctions to spontaneous privatization to voucher systems (Hinds and Pohl 1991; Kikeri, Nellis, and Shirley 1992; Milanovic 1992b; Frydman 1993). In most of the countries under study, assets at the subnational level are being sold, not given away. In Russia privatization of the local housing stock and locally owned factories is at the discretion and under the direction of their oblast and rayon owners. In Hungary the sale of large enterprises is the responsibility of the State Property Management Company, while privatization of housing and many locally owned enterprises is a local responsibility. Local governments are responsible for the sale of small enterprises and locally owned housing in Albania and Poland.

Maximizing the yield from asset sales in a manner that does not undermine privatization is a major challenge. Should they be sold now or later? Selling assets now, when markets for ownership and property rights are underdeveloped, may mean that they do not bring a good price. But local governments need revenue, and privatization cannot wait. Yields may be higher later, but other financing sources will also be available later. In addition, many locally owned properties cost more to operate and maintain than they realize in rents, constituting a drain on subnational public finances. Getting rid of this burden is a high priority. Unfortunately, the sale of locally owned assets, especially housing, has been slow in most countries, in part as a result of the absence of credit.
Using privatization revenues

What should subnational governments do with the proceeds from the privatization of public enterprises and the sale of other assets? It is important to remember that these are nonrecurring revenues and do not represent permanent sources of financing. Should such revenues be capitalized in special funds, invested in capital projects, or used to finance current expenditures?

In practice, no restrictions have been placed on the use of revenues from privatization in any country. As a result, funds have commonly been used as an additional source of revenue in the recurrent budget. This is not all bad: it may be more distributionally attractive and economically efficient to raise revenues from privatization than from taxes. But such revenues are not unlimited. Sometimes these revenues have been kept in extrabudgetary accounts. A more conservative principle of public finance would call for the investment of these proceeds in long-term assets to allow local governments to draw income from assets over time. Alternatively, revenues could be used to repay debt (Newbery 1991). In Hungary revenues from privatization involving foreign joint ventures and generating foreign exchange have been largely channeled through the State Property Management Company to repay Hungary's external debt, although fiscal pressures emerging since 1994 may lead to demands for privatization revenues to finance the deficit. In the Russian Federation, where most privatization has been domestic, it has been recommended (Lieberman and Nellis 1994) that the stock of domestic government debt be reduced using this approach. In Poland, where revenues from privatization are being used by the central government to finance recurrent operations and to compensate for inadequate tax yields, hardly any revenues accrue to subnational governments. In contrast, half of the (smaller) proceeds from the privatization of state enterprises in Ukraine will accrue to subnational governments in 1994, although previously all proceeds went to the central government. Similarly, in Albania subnational governments have recently been allotted 28 percent of privatization revenues.

Expenditure assignment

The primary economic role of subnational governments relates to the delivery of local and regional goods and services. In principle, each function of government should be assigned to the lowest level of government that encompasses all or most of the service benefits (Oates
1990)—provided that it can effectively manage the activity. This does not mean, however, that the level of government that delivers a good or service should also be the one that produces it. Government provision is not the same as government production. Many “local” public goods might be better produced by higher-level governments or perhaps by private producers.

Local variations in tastes and costs may make it more efficient for public sector activities to be carried out in as decentralized a fashion as possible. As noted earlier in this chapter, expenditure choices are more likely to reflect local preferences when made by local officials who have been democratically elected, and who are spending funds raised from the citizens who elected them. A decentralized system may also promote innovation, as local governments (and even the central government) can learn from each other’s successes and failures.

**The efficiency case for decentralization**

On efficiency grounds, central authorities should generally be responsible for defense, postal services, telecommunications, national roads and highways, and ports and civil aviation. Such services provide benefits beyond a single jurisdiction and are typically covered by the national budget. Judicial functions, national law enforcement, foreign affairs and diplomacy, industrial and environmental legislation, and interregional commerce are also usually seen as central responsibilities.

The public services that are best delivered locally, with local decision-makers deciding which services are provided, to whom, and in what quantity and quality, include transportation services such as

**Table 1.9 Expenditure responsibilities between levels of government, selected transition economies, 1993-94**

<table>
<thead>
<tr>
<th>Country</th>
<th>Education</th>
<th>Water and sewerage</th>
<th>Health</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Primary</td>
<td>Higher</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Housing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Albania</td>
<td>C</td>
<td>C</td>
<td>C</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>SN</td>
<td>C</td>
<td>SN</td>
</tr>
<tr>
<td>Hungary</td>
<td>SN</td>
<td>C</td>
<td>SN</td>
</tr>
<tr>
<td>Poland</td>
<td>SN</td>
<td>C</td>
<td>SN</td>
</tr>
<tr>
<td>Romania</td>
<td>C</td>
<td>C</td>
<td>SN</td>
</tr>
<tr>
<td>Russia</td>
<td>SN</td>
<td>SN</td>
<td>SN</td>
</tr>
<tr>
<td>Ukraine</td>
<td>SN</td>
<td>SN</td>
<td>SN</td>
</tr>
</tbody>
</table>

*S—Shared responsibility.
SN—Primary responsibility is with the subnational governments.
C—Primary responsibility is with the central government.

Note: Many of the subnationally provided services are provided by locally owned enterprises.
a. Many of these services are being transferred to subnational governments.
construction and maintenance of local roads and provision of public transit, security services such as fire protection and enforcement of local laws, public utilities such as those for water, sewerage, and various forms of energy distribution, and general urban services such as provision of parks, recreation facilities, markets, and slaughterhouses. These services mainly benefit the local area and are often provided by local governments. Alternatively, some can be provided privately or contracted out to private providers.

Where there are significant spillovers, such as for education, health, and social welfare, expenditure assignments are less clear. Local schools and clinics clearly benefit residents of the local area, but a well-educated and healthy population also has national benefits. Because of such benefit spillovers, some components of education and health are sometimes national responsibilities (Musgrave and Musgrave 1989). When such services are local, the central government may help (or require) local governments provide services to a certain standard, for example, through grants conditional on the provision of the requisite level of service. In most of the transition economies of Eastern Europe, decentralization has led to a substantial transfer of these responsibilities to the subnational level (table 1.9), but the related transfers received from higher levels of government to carry out these and other spending functions are almost wholly unconditional (see later discussion).

Often, shared responsibilities may be carried out either through a central-local arrangement or an association of subnational governments. Sometimes both levels of government share spending responsibility within a sector. For example, in primary education, textbook selection and teacher training and certification might be at the national
level, capital planning at the middle and local tier, and recurrent financing at the local level. Similarly, whereas water delivery is a local responsibility, treatment plants may require the creation of a special-purpose subnational government.

Another issue involves financing responsibility and service delivery. Governments need not always directly provide services for which they are responsible. In market economies many local governments contract for services to be delivered by the private sector; garbage collection is a common example. Subnational governments may contract with higher levels of government—in Canada, for example, the federal police provide contracted services to some provinces and municipalities, while other subnational governments have their own police forces. Similarly, central responsibility for such functions as poverty relief can be delegated to local governments. Services are often delivered most efficiently at the local level, even if financed in whole or in part by central transfers. For instance, the Albanian social assistance program (ndihme economike) is centrally funded but locally managed. The assignment of functions in transition economies is complicated by the fact that many goods and services once supplied by governments are now being privatized. The extent to which government-supplied goods and services are public rather than private is debatable even in market economies, many of which are privatizing such functions as transportation and communications utilities. Even traditional public monopolies—postal systems, for example—have been considered for privatization in countries such as Chile, Finland, and Sweden.

In principle, many public services can be delivered locally. In practice, however, spending responsibilities vary considerably and there is no single best way to allocate responsibilities. Decisions about which level of government provides a service are often in practice as much or more a function of a country’s history and political heritage as they are based on considerations of economic efficiency.

Current expenditure assignments in transition economies

Since subnational governments acted as units of the centralized administration under the socialist regime, subnational expenditures were included in the unified budget of the central government. All responsibilities were with the central government, either directly or through its local administrative units. Recent legislation in some countries under review has assigned certain expenditures to the subnational level of government (see again table 1.9). In Bulgaria, Hungary, and Poland, for example, local governments have specific expenditure responsibilities in education (primary and kindergarten), transportation (local or urban streets), environment (garbage collection, disposal, industrial waste), and housing and
related services. Local governments are also assigned a wide range of general spending responsibilities in areas such as nonschool education (nurseries, reform schools, orphanages), health, and social welfare. As a rule, however, these spending responsibilities are defined vaguely. The laws do not spell out, for example, whether responsibility for primary education implies responsibility for capital spending and rehabilitation of school holdings or just for recurrent spending. Moreover, spending responsibilities are almost never quantified in terms of their cost, making it difficult to address concerns over the adequacy of the local revenue base.

Russia and Ukraine go further in the direction of vagueness. These countries have no legal definition of expenditure assignments at the subnational level. The budget has thus far been the vehicle by which spending authorities are codified. Since both countries have explicitly assigned revenues to the subnational sector, this approach puts the cart before the horse: subnational spending decisions are being driven by revenue availability instead of the other way around. As it happens, tradition and inertia have established expenditure assignments in Russia and Ukraine that in many cases seem sensible. Thus, the federal or central level is responsible for functions with a national benefit area, oblasts for regional functions, and local governments for expenditures with a local benefit area. But these principles are increasingly being violated as subnational governments are being forced to take on functions with national benefit areas (such as large-scale public investments and social welfare).

Romania and Bulgaria allow even less local expenditure autonomy than Russia and Ukraine. In Romania expenditures that have strong local benefit characteristics are still controlled centrally. The central government is entirely responsible for education and health, reportedly to ensure a minimum standard in the provision of these important services. The main spending responsibilities assumed by local governments in Romania are for water, local transportation, and district heating, as well as various minor activities in social assistance, municipal service, culture and arts, public investment, and maintenance. Public security and fire protection are also provided throughout Romania by local branches of a central ministry.

In Bulgaria central mandates on, and preemptions of, local authority are pervasive. Although many important local services are financed through local budgets, there is no local control over the provision of most services. For example, local officials have little discretion over personnel expenditures in their budgets—they can neither set payroll levels nor effectively control the size of the workforce. In education, the central government appoints school directors who control the hiring of personnel—even though the mayor is legally responsible for such appointments. Localities in Bulgaria (as is the case in Russia and Ukraine) are
also subject to central mandates for payroll wage increases, which are often made without prior notice and without much attempt to determine the impact of the increases on local budgets. In some cases local officials are not even aware of such mandates until they become effective. These policies are not limited to such big-ticket items as payrolls. In the case of municipal hospitals, for example, the Ministry of Health mandates some expenditures down to the most minor details—from the number of hospital beds to the inventory of medicine and materials. A recent study reveals that some Bulgarian hospitals are operating at only 17 percent of capacity; yet local governments, which must finance these facilities, are unable to do anything to reduce the substantial excess capacity that appears to exist (Anderson and others 1994).

Public expenditures and public enterprises

No discussion of expenditure assignment in transition economies would be complete without a discussion of the public expenditures assigned to the enterprise sector. Subnational governments in most transition economies continue to look to enterprises to finance many essential public services. Enterprises provide their employees and families with many services that elsewhere are the government’s responsibility. For example, they build and support hospitals, construct and maintain housing, build and run kindergartens and preschools, and make donations toward public transport and subnational extrabudgetary funds. The capital spending of larger public enterprises extends to roads, sewerage, water lines, and environmental protection. Most enterprises provide housing for employees and many build and operate child-care facilities, such as summer camps. Enterprises provide money for construction of such facilities and often contribute labor and materials and participate in upkeep.

With privatization, such expenditures cannot continue to be an enterprise responsibility. In all likelihood, they will be transferred to subnational governments. Owing to the financial difficulties of many enterprises, this transfer is already occurring in some cases. Enterprises cannot continue to provide such services and compete successfully in an increasingly privatized and market-oriented economy. But who is to assume what? Central governments appear to have neither quantified this problem nor considered possible solutions. Nor have subnational governments been given the fiscal authority to solve the problem themselves. If subnational spending responsibilities are to be increased, subnational revenues must be expanded either through strengthened local own-source revenues or a rationalized system of intergovernmental transfers. Alternatively, of course, the services previously provided by enterprises may simply cease to be provided.
Financing subnational governments

The need to redesign the public sector is particularly evident with respect to the revenue system that has been inherited from the command era. Current user prices for public services, for example, are a classic combination of subsidy, inefficiency, and inequity. The lack of experience with raising local own-source revenue hinders the proper exercise of the local fiscal discretion that is called for in the various laws on local self-government. And the lack (apart from Hungary and Poland) of a transparent system of intergovernmental transfers creates incentives for subnational government to revert to—rather than free themselves from—central regulation and control of their fiscal decisions.

Until recently the only form of local own-source revenue in most transition economies came from enterprises’ profit remittances. Tax reforms have largely replaced these remittances with profit taxes, though some countries still provide for some local “ownership” rights to enterprise profit taxes. In Romania, for example, local governments (judets and municipalities) have the right to both profit and dividend taxes levied by the central government on locally owned public enterprises. Prior to the recent tax reform in Poland, both profit and dividend taxes went to the subnational government of origin and these governments (voivodships and gminy) also received shares of similar taxes levied on national enterprises that had significant activities in their territories. This process was so complicated that the Polish tax administration spent almost as much time allocating enterprise taxes among jurisdictions as it did collecting them.

Even where modern systems of tax administration have been adopted, as in Hungary, there is still a tendency for local governments to feel they have a primary claim on tax revenues generated within their jurisdiction. This “source entitlement” approach to the allocation of revenue is familiar in such contexts as the international taxation of corporate profits and the taxation of natural resources. But it is seldom so visible at the local level as in some of the transition economies. Source-based taxation (also known as derivation-based) is unusual at the subnational level in market economies because of the inequities and inefficiencies that are likely to result from allowing subnational governments to keep large shares of the taxes levied on firms producing for a national or world market. Source-based systems will give rise to the same problems and inequities in the transition economies.

Financing through user charges

Governments in the command economies used fixed prices and wage controls as essential elements of their distributional toolkit. Health
services and education were free. As a part of the social contract, govern-
ments also provided some private goods either free or at a low price,
including rents, many urban services, transport, utilities, food, and some-
times clothing. These measures attempted to rectify fundamental or per-
ceived distributional problems through inefficient pricing of scarce
resources and, as in other cases where such policies have been followed,
probably resulted in little equity being purchased at a high price in effi-
ciency terms. With subsidies available to all, leakages to the nonpoor
represented a major fiscal cost. Moreover, the failure to target meant that
the level of benefits available to the poor was frequently inadequate to
keep them from poverty (Milanovic 1995). As part of their adjustment
programs, transition economies are thus being urged to correct public
sector prices and to use national fiscal policies and targeted allowances
and subsidies to achieve their distributional aims.

The benefit approach to local government finance suggests that,
where possible, services should be paid for by those who benefit from
them (Bird 1976). Put another way, the first rule of local finance should
be: “Wherever possible, charge.” For efficiency, charges should be levied
on those who receive the benefits where such beneficiaries can be clearly
identified, unless there is a strong policy argument to the contrary. The
importance of charging for public services goes beyond the revenues that
can be collected from such levies. Only when the correct prices are
charged (roughly marginal cost) will the correct amount and type of ser-
vice be provided to the right people—that is, those willing to pay for it.
Correct pricing helps public officials make sensible judgments on match-
ing scarce resources with rising demand. When the true cost (and the
related user charge) rises so high that quantity demanded falls, it is a
clear signal that service costs have exceeded the perceived benefits of the
service. Decisions must then be made on whether to maintain high prices
and serve fewer people, cut back on a service’s costs and standards to
keep it affordable, or subsidize the service from general revenues. In the
absence of price-generated demand information, such decisions must be
made through bureaucratic rather than market-oriented processes.

Public sector pricing is one of the last areas to be reformed in most of
the transition countries. While price reforms have liberalized the prices of
most goods in the private sector, both central and subnational govern-
ments are having trouble adjusting prices for public services, even for pri-
vate goods provided by the public sector such as housing rents, water,
heating, and transport fares. For example, among the transition economies
of Eastern and Central Europe, only Albania and Croatia, in mid-1994, had
household electricity tariffs set at levels (comparable to West European lev-
els) that approached economic (long-run marginal) costs. Adjusting such
prices at the subnational level is essential for both achieving efficiency and
enhancing subnational revenues. Doing so, however, implies significant changes in the cost of living and in welfare, so changing public sector prices will result in large and unpopular distributional shifts if not properly coordinated with other reforms. Such shifts could upset the fragile democracies that are emerging in the transition countries. In Poland, for example, it has been estimated that increasing the price of electricity to its appropriate economic level of long-run marginal cost could result in a doubling of its current price. In the short run, and assuming no reduction in demand, energy would consume as much as 20 percent of some households’ budgets (Freund and Wallich 1995, forthcoming).23

Not surprisingly, most subnational governments in transition economies—like those elsewhere (Bird and Slack 1993)—make less use of user charges than seems desirable, and many of the charges that are levied are poorly designed. Weak accounting systems that do not clearly identify costs (especially depreciation that covers the cost of capital) are another reason these services are commonly underpriced. In addition, newly elected subnational governments find it difficult to impose substantial price increases on those who have just elected them.

Central pricing mandates. A major problem even for reform-minded subnational governments in many transition economies is that user charges continue to be centrally controlled. In Albania, for example, water charges are set at uniform rates across the nation even though provision costs differ across districts. In Russia transport fares were fixed in nominal terms at a uniform rate for all localities until late 1993, creating costly subsidies for most municipalities. Some progress is being made in Hungary, however, where authority for setting sewer and water management fees has recently been transferred from the central government to municipal companies.

Social pricing mechanisms. Raising public sector prices and user charges to the appropriate levels may require special transitional approaches and pricing mechanisms. For example, lifeline rates, which set prices for small volumes of consumption at low levels, and senior citizen rates, which provide pensioners on fixed incomes with low-cost access, may help make price reforms more politically palatable (Bahl and Linn 1992). For major price increases, some price compensation scheme—perhaps a one-time payment—may be needed to compensate households for the impact on incomes. If well-designed, such schemes would facilitate cost recovery and allocative efficiency while cushioning the impact on incomes, thereby facilitating the price rise.

Replacing the panoply of subsidized goods and services provided by subnational governments with targeted subsidies to those in need
will also require the development of new information and tracking systems. Some observers think that effective targeting will be relatively easy in the transition economies because of the large "command and control" data base that existed in these countries (Milanovic 1995; Jarvis and Micklewright 1996, forthcoming). This hope may be naive, however, since substantial flaws appear to exist in these data bases—in Poland several million people seem to be "off the books"; Hungary and Romania have important low-income ethnic groups that are similarly elusive. Recent initiatives to undertake more broadly based household expenditure and income surveys should help fill the gap. In Poland and Hungary such surveys have helped to identify the poor and their socioeconomic characteristics, and have been used to analyze the impact of changing cash benefit systems on the poor (World Bank 1994c).

Although central information systems have disintegrated in the transition economies, local information on social needs appears to be better. The best results in terms of "targeting" might thus be achieved through locally administered social assistance schemes, as in Albania and Hungary, though such schemes generally require substantial central financial support.

**Subnational taxes**

Where it is impractical to impose fees or levy user charges, services should be financed by taxes levied on local residents to the extent they benefit from the services. "Local taxes" in this sense are those over which local authorities have some control—for example, they can set the rate or determine the base, in addition to receiving the revenue. Such taxes need not be locally administered. Some countries permit subnational governments to share national tax bases by allowing subnational surcharges ("piggybacking") on such centrally administered levies as the personal income tax. Like local taxes, such piggybacking arrangements increase the autonomy of local governments and also, in principle, the efficiency with which they are likely to spend the money, compared with so-called tax-sharing arrangements, which simply direct a share of national taxes to local governments without the latter having any say, or responsibility, for the tax levied. Of course, channeling significant revenues to the subnational level restricts the center's ability to provide national goods and services and to support structural adjustment. Moreover, permitting subnational governments to determine the taxes applied to mobile factors-of-production bases may impair macroeconomic flexibility and affect the efficient allocation of resources. Care should therefore be taken in deciding which taxes are assigned to which level of government.
Assigning taxes. Ideally, subnational governments should have access to relatively stable sources of revenue, the burden of which is not easily exported beyond local boundaries. In most countries, the central government controls those taxes considered to be most redistributive, such as personal income taxes with progressive rate schedules. In most of the transition economies, however, some personal income tax revenues are currently directed to subnational governments, although in no case do those governments have any control over the rate or base of the tax (table 1.10).

Tax administration. A special problem in some transition economies arises from the fact that the tax administration is decentralized in the sense that subnational governments collect revenues on behalf of the center and transfer them upward. Strictly speaking, in these cases the tax administrations are deconcentrated arms of the federal or central administration. However, evidence in some countries, such as Russia, suggests that local tax officials may have strong ties and loyalties to the local governments—which often provide their housing and fringe benefits—and hence are responsive to local policy. In Russia and Ukraine all revenues other than customs and trade taxes are collected by local administrations. This delegation of collection responsibility, with its potential for noncompliance, is unlikely to prove a viable means of financing the central government in the absence of strong central political control. The fiscal deathblow to the Soviet Union came when the republics failed to remit resources to the Union budget. The same risk of oblasts withholding tax revenues threatens the central budget in Russia and Ukraine today (chapters 8, 9, and 10).

Which taxes to assign? Some taxes are less suited to subnational governments than others. In particular, to minimize potential tax distortions, a high degree of national uniformity seems desirable with respect to the corporate income tax and the value added tax. The border controls needed to implement "local value added taxes" as a national value added tax with differential subnational surcharges would impede interjurisdictional trade and likely be impossible to administer effectively (McLure 1983d; Cnossen 1987; Tait 1988). The European Union has been trying for decades to deal with this problem and has not yet succeeded. The problem becomes even worse across, say, 3,000 municipalities or even 89 oblasts. Moreover, even with identical rates, the value added tax is not suited as a local tax. If it is levied as an origin tax, some regions would see their revenue base enhanced or compromised, depending on the stage of the production process taking place within their borders. And if it is imposed as a "destination" tax, those regions with a heavy export orientation would lose (because of the zero-rating of exports), while those with high import ratios would benefit.
Assigning corporate taxes to the subnational level also raises resource allocation concerns. While not uncommon in federal systems in market economies (Canada, Switzerland, and the United States), considerations of both administrative complexity and allocative efficiency suggest that subnational corporate levies should be avoided in the transition economies (Boadway 1992). Permitting subnational governments to set corporate tax rates (or adjust the tax base) is likely to lead to substantial differentiation in enterprise taxation, influencing enterprise location decisions in perhaps undesirable ways—for instance, richer regions could set lower rates and hence exacerbate regional differences.

Countries with subnational company taxes also have to decide how to prorate revenues when the company operates in more than one jurisdiction. There is no objective scientific basis for determining the geographic origin of income of a multi-jurisdictional enterprise. In the United States complex formulas use various sales, employment, and asset values to apportion profits across states and to determine what can legitimately be taxed in each jurisdiction, with different states using different

| Table 1.10 Local government revenue shares, selected transition economies, selected years (percent) |
|-------------------------------------------------|----------------|----------------|----------------|
| Central taxes                                |                |                |              |
| Turnover tax/value added tax (VAT)            | 0              | 0 or 100\*     | 0            |
| Corporate income tax                         | 0              | 10 or 100\*    | 0            |
| Personal income tax                          | 0              | 50             | 30\*         |
| Natural resources tax                        | --             | n.a.           | n.a.         |
| Export taxes                                 | 0              | 0              | n.a.         |
| Tax on assets of locally owned state-owned enterprises | n.a. | 100 | n.a. |
| Local taxes                                  |                |                |              |
| Property tax                                 | 60\*          | 100            | 100          |
| Auto/road tax                                | n.a.          | --             | 50\*         |
| Small business taxes                         | n.a.          | --             | 100          |
| Agricultural tax                             | n.a.          | 100            | n.a.         |
| Poll tax                                     | n.a.          | n.a.           | 100\*        |
| Other                                        | Significant user fees for services, such as fee on garbage | Cost recovery charges and user fees | All tourism taxes and miscellaneous local taxes |

n.a. Not applicable.
— Not available.
### Fiscal Decentralization: From Command to Market

#### Table: Tax Ratios and Rates (Selected Countries) (in percent)

<table>
<thead>
<tr>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>0</td>
<td>0</td>
<td>20-50%</td>
<td>20 (VAT)^4</td>
</tr>
<tr>
<td>Romania</td>
<td>5</td>
<td>0</td>
<td>65^5</td>
<td>50^6</td>
</tr>
<tr>
<td>Russia</td>
<td>15</td>
<td>n.a.</td>
<td>100</td>
<td>50</td>
</tr>
<tr>
<td>Ukraine</td>
<td>n.a.</td>
<td>n.a.</td>
<td>60-80^7</td>
<td>—</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Miscellaneous local taxes</th>
<th>100</th>
<th>100</th>
<th>100</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timber duty, state duty, water fee, other local fees, and 16 other miscellaneous taxes</td>
<td>70^9</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

#### Note
For indicated footnotes, see table notes.

#### Source
Various; see table notes.

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formulas (McLure 1984). In Canada some of the resulting problems are avoided because all provinces use the same formula—although it took many years of negotiation to reach this result (Bird and Brean 1986). Some variant of the Canadian approach may perhaps work for the larger intermediate governments in countries such as Russia and Ukraine, but it is unthinkable for the small, fragmented local-government sector that is more characteristic of Eastern Europe and much of the former U.S.S.R.

In contrast, it may be possible to utilize local personal income taxes even for small local governments. Much of the literature on tax assignment argues that the personal income tax, which is often implicitly assumed to be one of the most important taxes in revenue terms, should be retained by the central government, largely for redistributitional and stabilization reasons (Musgrave 1983; Boadway 1992). Nevertheless, a variant of the piggybacking approach used to finance local governments in the Scandinavian countries (Bird and Slack 1993) is suggested for Hungary in chapter 2 of this book. Similar surcharges are suggested in the later chapters for Poland, Russia, and Ukraine, and might well be
considered in other transition countries. Combining a uniform national base and national collection with locally set rates makes such "local" income taxes administratively feasible. Compared with countries such as the United States, there is a relatively low level of population mobility in countries such as Hungary, owing in part to housing problems and in part to tradition, so the potential effects of variable local income taxes on location are reduced. Moreover, since the personal income tax is a relatively new, and as yet minor, source of revenues in transition economies, the immediate implications for central redistributive and stabilization policy of giving up some "tax room" to subnational governments are limited—although in the long run matters may be different.

In some ways, excise taxes and single-stage retail taxes seem to be prime candidates for subnational taxation, especially if the taxing region is large enough to avoid revenue loss from consumers crossing the border to regions with lower tax rates. Such taxes thus seem more suitable for larger intermediate governments than for small local governments. As sources of revenue for subnational governments in transition economies, however, excises and retail sales taxes are notable by their absence.

In the case of excises, one reason is that such taxes provide a surprisingly important source of national revenue—often more than the personal income tax—and the center does not want to give them up. Another explanation lies in the way excises are administered: because excises are levied on the (often single-monopoly) manufacturer—say, of cigarettes or alcoholic beverages—the excise tax base (production) is not broadly distributed across regions. Substantial administrative reform would be necessary to allocate revenues on the basis of consumption, let alone to levy taxes varying with the place of consumption (which would, for example, create "border" problems such as smuggling). But without such administrative reforms, the excise tax would accrue to only the few producing localities. Apart from the case of motor vehicles (discussed below), there seems little near-term potential in subnational excise taxes in most transition countries.

As for retail sales taxes, no East European country has yet introduced such a tax and none seems likely to do so. Retail sales taxes are, in principle, feasible at the subnational level, even when the national government has a value added tax: as experience in Canada—currently the only country with this setup—suggests, however, the result is likely to be an unduly costly and complex tax system (Mintz, Wilson, and Grédon 1994; Bird 1994). In transition economies the task of implementing a robust national-level value added tax is central to tax reform (Tanzi 1993a, 1993b). It is unlikely that any transition country would or should be interested in complicating matters still further by experimenting with subnational retail sales taxes on top of the value added tax at this time.
The taxation of natural resources presents a special case (see chapter 10). Natural resources are completely location-specific and thus could be taxed by the subnational jurisdiction in which they are located without any fear of their moving. Other economic efficiency considerations argue for national taxation, however (McLure and Mieszkowski 1983). In particular, the abundant revenue from natural resources may lead resource-rich jurisdictions to set other taxes below the level needed to pay for public services or to pay dividends to residents, resulting in overexpansion of public services or excessive labor or capital migration from other parts of the country. The equity argument against subnational taxation of natural resources is also a powerful one. Since natural resources are typically unevenly distributed across regions, assigning this tax to the subnational level would generate substantial differences in fiscal capacity and be highly inequitable. In Russia, for example, three oblasts (with 2 percent of Russia's population) produce 80 percent of Russia's oil and gas (see chapter 10).

Such arguments restrict the tax assignment choices available for subnational governments. But there are a few options. The first and most efficient is taxing bases that are relatively immobile. This is the fundamental case for a real property tax, particularly on residential property.

Local own taxes. As table 1.10 shows, most of the taxes specifically assigned to subnational governments in transition countries are what might be labeled "nuisance" taxes rather than potentially robust own-revenue sources. In Russia, for example, the combined revenue from twenty-one local taxes assigned in the 1991 Law on the Basic Principles of Taxation is not likely to yield even 0.5 percent of GDP. These taxes include such gems as taxes on the resale of used computers, on horse racing, on the use of logos in advertising, and on dog owners. In Hungary there are five local taxes, which, in addition to the property tax, include a poll tax, a local business tax, and a bed tax in tourist areas. On the whole, it seems fair to say that subnational governments in most transition economies have been assigned residual tax sources that are generally not likely to yield much revenue.

One tax that has some growth potential is local taxation of automobiles. For the transition economies, such a tax tends to promote a rough degree of equity—by definition, it is mostly the well-off who have automobiles. In addition it can serve as a user charge for public services since it taxes the people who contribute to pollution and congestion and wear out roads. The explosion of the automobile population makes this a large and growing tax base. Few transition economies, however, have given motor vehicle taxation the attention it deserves. In Hungary, one of the four countries with a local vehicle tax at present, only 7 percent of
vehicles were subject to the small and poorly designed duties levied by local governments. Albania, where private ownership of automobiles was illegal until 1991, imported 25,000 cars in 1993, yet has an import tax of just $400 a vehicle and a yearly tax of only $50 a car—though neither is a local tax. Many countries have extensive centrally mandated exemptions from their existing vehicle taxes, such as exempting vehicles used by state-financed public institutions, those used by war veterans, and so on.

Vehicle taxes could become a revenue source for at least the larger localities. All vehicles should be subject to taxes that at least offset the social and environmental costs of vehicle use. While such taxes should probably be designed and imposed uniformly across a country to minimize administrative problems, there is no reason revenues should not be partly assigned to the local governments in which the vehicle is registered.

**Tax sharing.** Tax sharing refers to a system in which one government (usually the central government) collects revenue from a tax and shares it with subnational governments, usually on the basis of the geographic origin of the revenues. Such sharing is common in transition economies. In Hungary, Poland, Russia, and Ukraine—and in all of the former U.S.S.R. republics—some or all of the personal income tax is assigned to the subnational level. In the former U.S.S.R. this is a carry-over from the days when the (unimportant) personal income tax was a local tax on the wage bill (rates and base were centrally defined) assigned to the oblast level and passed on to rayons and cities.

Tax sharing has emerged as a response to the growing revenue needs of subnational governments in transition economies. While subnational governments were initially assigned only a few minor taxes, these revenues did not come close to financing the significant expenditure responsibilities with which they were charged. Thus, in countries (Hungary, Russia, and Ukraine) where the subnational sector is expected to finance an increasing share of public expenditure, access to major national tax bases was needed. Russia now shares all of the personal income tax, part of the value added tax, part of the corporate tax, and most excises with oblast governments, in proportions that have been rising over time. In contrast, in Hungary, where the personal income tax is also shared, the portion of this tax flowing to the local level has shrunk as the fiscal pressures on the center have increased. The personal income tax share to local governments was initially 100 percent in 1991, while in 1994 it was just 30 percent, shared on a derivation basis. Similarly in Bulgaria, the local (obshtini) share of the personal income tax fell from 100 percent in 1991 to 70 percent in 1992 to 50 percent in 1993.

Tax sharing has the advantage of simplicity, and subnational governments are guaranteed some degree of revenue certainty. Its drawbacks are that it does little to enhance either accountability or efficiency. Localities
receive revenues regardless of their tax effort, and have no responsibility for setting the tax rate or base. If they view these revenues as costless, as seems likely, their incentive to spend efficiently is obviously low. The result may be undue expansion of subnational spending.

The extensive revenue sharing in transition economies is entirely on a derivation basis. Taxes are retained by the jurisdiction in which they are collected. Alternatively, shared taxes might (like the value added tax in Germany) be shared through a formula based on such factors as population, per capita income, or urbanization. The roots of derivation-based sharing in transition countries are twofold—historical and pragmatic. The important ownership role of subnational and local governments under the old system gave them an “entitlement” to enterprise profits and, consequently, to the direct and indirect taxes paid by “their” enterprises. The concept of entitlement to revenues on an ownership or origin basis remains strong and accounts for the present-day reliance on this method. In addition, derivation-based sharing (or revenue retention in the case of Russia, Ukraine, and other former Soviet republics) is obviously relatively easy to administer and monitor since it really amounts to little more than the former system of regional allocation of revenues in a different guise.

Derivation-based sharing, as a rule, channels resources to higher income areas where tax bases and therefore revenue collections are largest. It is thus inherently counter-equalizing. This may be a problem in countries where regional inequities are serious, and where the intergovernmental system lacks other instruments (such as transfers) to address such imbalances. In Hungary, for example, there are some townships that derive no revenues whatsoever from the personal income tax, since all their residents earn incomes that fall below the tax’s threshold. Other aspects of Hungary’s transfer system are designed to offset this, ensuring more equitable service provision. Most transition countries have much less sophisticated transfer systems.

The larger the fraction of subnational resources that accrue on a derivation basis, the more the richer localities will benefit. Regional differentials in service provision will emerge as a result. The alternative of sharing revenues on the basis of an equalizing formula (as in most federal countries, for example; see Shah 1994) penalizes better-off regions whose industrialization and growth potential are greatest. Transition economies must balance this tradeoff between growth and equalization. Choosing the degree of equalization is an inherently political judgment. In some countries there are vast disparities between regions, and some degree of equalization is a political priority. In other countries the need for political unity may require less equalization. In Russia, for example, frustrated better-off and rapidly growing regions may simply opt out of the revenue-sharing system if too many resources are taken from them and shared with poorer regions (see chapter 10).
Surcharges. As noted earlier, another option for subnational financing is to levy local surcharges (piggybacking) on national taxes. Piggybacking on the national tax base is administratively simple for subnational governments since they can usually rely on the superior central administrative machinery for collection. For transition economies, surcharges on the personal income tax may represent an attractive alternative to the current derivation-based sharing of this tax. Instead of receiving a centrally mandated share of the personal income tax (as is now the case in a number of countries), subnational governments would instead receive “their” share by imposing a surcharge on the national income tax, up to some ceiling, to be collected by the national government and remitted to each subnational government. As discussed further in chapter 2, the center could reduce its personal income tax rate to the level implied by the central share of the income tax to create “tax room” for a local surcharge; depending on the local surcharge introduced, the combined central-local rate could be as much as the previous national rate.

The case for the personal income tax (or a surcharge on it) as a tax for the subnational level is pragmatic, and to some degree historical. In many East European transition economies, the personal income tax, or its precursor, the wage tax, was assigned to subnational governments. In a context where the choices among local revenue bases are limited—as noted earlier, the corporate income tax, the value added tax, natural resource taxes, most excise taxes, and retail sales taxes should probably be ruled out—the personal income tax is one of the few robust revenue sources that remain, one that is capable of generating significant revenues and likely to grow over time, especially as wages are liberalized.

In most transition countries, workers are not highly mobile and few problems of revenue apportionment should arise. To the extent any differential local personal income tax falls on the local population, it may be considered a benefit tax. Merely assigning personal income tax revenues to subnational governments in whole or in part does little for local autonomy or accountability. Permitting a local surcharge should, in contrast, enhance both accountability and local autonomy. Since the central tax base and rates will remain unchanged and uniform across all jurisdictions, any central income distributional objective being pursued through the personal income tax should not be affected.

International experience certainly demonstrates that local income taxes and local income tax surcharges are feasible (Bird and Slack 1993). Perhaps the best-known examples of local income surtaxes are those in the five Nordic countries (Denmark, Norway, Sweden, Finland, and Iceland). In these countries, with some important variations, the local tax is basically levied at a flat, locally established rate on the same tax base as the national income tax and is collected by the central government. In
contrast, in Belgium (as in most Canadian provinces) the local surcharge is levied as a percentage of the national tax liability rather than the national tax base. A similar system exists in Switzerland, where most cantons—the intermediate level of government—allow local governments (communes) to levy surcharges at locally established rates on the cantonal income taxes, taxes that are (like most U.S. state income taxes) in no way harmonized with the central income tax. The Canadian provincial income surtax accrues in part to the provinces participating in the tax collection agreement, and is assessed and collected by the national government. However, the provinces themselves set the rates of “their” tax. In effect, the provinces have contracted with the national government to take advantage of its comparative advantage in tax collection.

How big a role for property taxes?

In some countries, especially those in the Anglo-Saxon tradition, the property tax is the most significant subnational tax (Bird and Slack 1993). Although relatively expensive to administer, property taxes have good efficiency characteristics compared with most other potential sources of local revenue. To the extent locally provided services increase property value, the beneficiaries of public expenditures are made to pay. From another perspective, the residential property tax may be broadly equitable in the sense that the better-off generally have better housing and hence usually pay relatively higher taxes. In practice, however, the performance of the property tax as a revenue source has been mixed. Outside the Organization for Economic Cooperation and Development (OECD) countries, especially in the developing world, most subnational governments do not raise much from the property tax, in part because assessments are quickly eroded by inflation and do not automatically increase with economic growth (Dillinger 1992). In addition, cadastral surveys and registration are generally poor, and collection and enforcement efforts weak.

Institutional shortcomings in implementing property taxes. Property taxes in some form have been introduced in many transition economies, including Hungary, Poland, Romania, Russia, and Ukraine. Albania approved a property tax in the beginning of 1994 and Bulgaria has a draft law, though it has yet to receive serious legislative attention. Indeed, the property tax is the only potentially significant tax that transition countries have assigned directly to subnational governments. But much needs to be done if this tax is to fulfill its potential (Kelly 1994). Current yields are minimal, and yields in the near term will be insignificant, partly because housing ownership remains limited in many
countries and housing privatization has lagged. Moreover, most transition countries do not have a basic cadastre in place. The property tax is not likely to be a buoyant revenue source until these and other problems are ironed out.

**Structural problems with the property tax.** In transition economies the property tax rate is usually set by the central government, and tax bases are often riddled with exemptions. In Romania, for example, the property tax is in principle levied on all privately owned real estate. But tax rates are differentiated and, in an undesirable holdover from the old regime, vary according to the social characteristics of the property owners: 1.0 percent on urban property owned by workers and employees of commercial societies; 1.5 percent on property owned by independent professionals, self-employed individuals, and family associations of no more than ten employees; and 0.75 percent in rural areas. Taxable value is reportedly based on insurance assessments, sales contracts, and construction costs, and appears to be grossly underestimated. Moreover, all publicly owned buildings are exempt and, in a feature guaranteed to minimize the yield of this tax in a country privatizing its housing stock, all houses and apartments bought by individuals from the state are exempt for ten years.

In Hungary the central government mandates full exemptions (carried over from the socialist regime) lasting ten to twenty years for any privately owned housing that has had improvements (such as a new bath or roof). The center also defines the tax base and the maximum tax rate the locality can impose: either 3 percent of "corrected sales value" (which, though defined as 50 percent of market value, is usually about 25 percent because of the manner in which market value is calculated) or a flat nominal amount per square meter. As a rule, area measures and in some cases fertility of land are at present the only data available to local governments for valuation. The exemptions and nominal rates ensure that, as in Romania, little revenue will be collected from this source in the near future. The new Property Tax Law in Albania assigns 60 percent of revenues to subnational governments, but the central government has been granted complete control over value assessment, rates, and collection.

Such structural defects, combined with the difficult and costly task of updating property valuations and keeping them current, mean that although property taxes may become an important source of subnational revenues in the long term, they are unlikely to produce substantial revenue in the near future. Many improvements will be needed for the property tax to become an important component of subnational finance in transition economies.
Intergovernmental transfers

Since it is unusual for the revenue-raising capacity and the expenditure needs of subnational governments to be perfectly matched, fiscal transfers are usually required to close the resulting gap. Such fiscal deficits could also be closed in principle by shifting tax powers to subnational governments, assigning expenditure responsibilities back to the central government, or reducing subnational expenditures and service standards. Transfers may be preferable to these approaches, in part because they allow local governments to provide services and the central government to set standards. Transfers can be used to influence spending patterns at lower levels of government in line with higher-level priorities, to limit inequalities in the quality and quantity of regional services, and to ensure that necessary services are provided (Boadway and Hobson 1993; Shah 1993).

Designing a transfer system is difficult. Transfers often have a number of objectives: correcting vertical imbalance (the gap between the expenditure responsibilities assigned to the subnational level and the revenues assigned to or shared with this level), reducing horizontal imbalance between rich and poor provinces to equalize expenditures among jurisdictions, stimulating subnational tax effort (encouraging localities to raise more own-source revenue), and influencing subnational spending decisions in accordance with central preferences.

Rules versus discretion in transfers. Should a transfer system be defined by rules, or should it be discretionary? If the central government's macroeconomic objectives were the only consideration, the discretionary approach would have much to recommend it. But transparency favors a formal, rules-based approach that allows subnational governments to plan their fiscal operations and makes the central government's policy aims clear (Bahl 1986). Specifying the transfer of a set percentage of national revenues, or of a particular national tax or taxes, has substantial advantages for both central and subnational budgeting. With this system, central government is somewhat insulated from pressure to increase its support of local governments, and subnational governments can budget with greater certainty, knowing that the level of central support will vary with a known formula and is not subject to discretionary central policy.

In most transition economies the aggregate volume of transfers is determined entirely by the central government. In Hungary aggregate transfers are determined as part of the annual budget process, and are strongly affected by the fiscal stringency facing the central government. The situation is the same in Poland, although since aggregate transfers are (as discussed in chapter 4) formula-driven, transfers have been
relatively transparent and predictable. Russia and Ukraine had no explicit transfers until recently: ex post subventions were negotiated between deficit regions and the Ministry of Finance; the Ministry also determined an agreed or appropriate level of expenditures as the basis for calculating any gaps. For example, transfer decisions in Russia until 1994 were determined on the basis of negotiated spending levels (agreed between the Ministry of Finance and each oblast in the course of the budget negotiation process) and oblasts' fiscal gaps after accounting for their agreed share in selected central taxes, and other revenues.

Once the aggregate volume of transfers is determined, the next step is determining its distribution across subnational governments. Conceptually—if not always politically—this step too should be as transparent as possible. One approach, discussed further with respect to Hungary in chapter 2, would be to estimate minimum subnational expenditure needs related to objective demographic or economic indicators (population, per capita income, or social indicators), to assess the local own-source, assigned, or shared revenues available to finance these needs, and to provide a transfer related to the difference. Depending on how much interregional equalization of expenditures (and thus services) is desired, such transfers may fill all or part of the estimated revenue gap.

In principle, the estimates of expenditure needs in this approach should be independent of the actual policies of any individual government: they may, however, be based on the average policies of all governments, as shown in chapter 2. The idea is to relate the estimates to underlying demographic and economic factors that serve as an objective indicator of the "workload" for each spending function. This approach should be contrasted with the "norms" currently used for regional budget allocations in a number of transitional countries. These "norms" (as outlined in the discussions of Bulgaria, Hungary, Russia, and Ukraine) typically relate to the existing installed capacity for particular services (number of hospital beds and the like). As a basis for distributing intergovernmental aid, such norms clearly reward jurisdictions that have had high rates of capacity/expenditure in past periods. For example, a norms-based approach may distribute funds on the basis of the number of hospital beds in a jurisdiction regardless of whether or not the beds were used (that is, "needed"). In contrast, a needs-based distribution scheme might target aid using a demographic indicator such as the number of elderly, which is highly correlated with the likelihood of going to a hospital and using one of those beds. Similarly, the number of students registered in an elementary school would reflect capacity, whereas the number of children of elementary school age would more accurately measure need.

Despite the theoretical attractiveness of estimating "needs," however, experience suggests that such estimates are difficult, and few
countries (one example is Australia) have made them (Shah 1993). For the most part, countries with a formula-based transfer system have attempted mainly to distribute funds on a more or less equal per capita basis, sometimes adjusted for the size of the jurisdiction, while taking into account differential local capacities to raise revenues from sources under their own control. How this might be done is spelled out in more detail for Hungary in chapter 2.

In any case, rules-based allocation formulas are not yet common in the transition economies. Apart from Hungary and Poland, where an explicit formula for the normative grant includes an equalization component and a complex formulation of expenditure needs, most intergovernmental fiscal flows continue to be essentially discretionary and negotiated. Empirical studies of the transfer systems in Bulgaria, Romania, Russia, and Ukraine (see chapters 5, 6, 8, and 9) were unable to determine a significant relationship between needs-based allocation criteria and income levels across oblasts. In none of the empirical studies were the transfers explicitly equalizing across regions.

Simplicity in the design of the transfer system. If a formula is used to determine transfers, measurements of fiscal capacity and perhaps also of expenditure needs are required. Such calculations are difficult under any circumstances, and particularly so in the changing circumstances of the transition economies. In some countries it may be difficult even to determine which regions are rich and which are poor—that is, where expenditure needs are high in relation to means. Compressed wages, distorted prices, regional inflation differentials, and in some cases shortages of goods may make it hard to interpret statistics on per capita income. For these and other reasons, transition economies require simplicity in formula design. Some countries may be ready for a formula based on per capita income and other sophisticated indicators. In others, it may be possible to identify broad indicators of fiscal capacity and need. Some countries may use demographic indicators such as population size, number of pensioners, and levels of urbanization. Others may base their formulas in part on key indicators of locally assigned public service needs, such as miles of roads or deficiencies in school or hospital space. Experiments will be needed to determine which transfer formula is most appropriate in light of the needs and aims of the new subnational finance system. (For a preliminary exploration along these lines, see chapter 2.)

Transition economies could also, of course, retain their existing systems of expenditure "norms" to estimate expenditure needs. One drawback of this approach is that it requires constant updating, which can be expensive and complex. In addition, as noted above, since the expenditure norms in the countries that use this system were designed mainly to
cover the recurrent costs of existing facilities, different standards of facility provision across regions result in different recurrent budgets. Transfers based on these factors will therefore perpetuate significant disparities in the level of public service provision across the country.

A case for conditionality? A striking feature of transfers in the transition economies is that they are, without exception, fully unconditional. In Hungary, which has the best-developed transfer system, grants can be spent any way the local government sees fit. Similarly, in Romania, Russia, and Ukraine, transfers are lump sum, and subnational governments can spend them free of all conditions and constraints. In principle, there is little case for bestowing such large unconditional transfers on local governments. In a nonfederal system, local authorities should be fundamentally responsible to the central authorities (or more accurately to taxpayers at large) when they are spending central funds (Bird 1993). So far, however, there seems to have been little consideration in the transition economies of the possibility of introducing a degree of conditionality into transfers—perhaps in part to avoid the danger of recurring to the centrally dominated model of past intergovernmental relations.

A good case can be made for some conditionality in intergovernmental fiscal transfers in transition economies: the central government has a legitimate interest in what is done with its grants and the country has a legitimate need to ensure that services such as education and health are available throughout the country at some minimum standard. In Hungary, for example, without conditionality the present system permits larger towns with secondary schools to discourage students from smaller towns without such schools from attending. Indeed, since the norm provided in Hungary's grant system for secondary education does not cover its costs of provision, towns have an incentive to do just this. In most Central and East European countries the central government, as was the practice under the socialist regime, has continued to supervise the implementation of subnational budgets to make sure that specified targets in local budgets are achieved. But such "command and control" conditionality is not in keeping with the fiscal autonomy of the self-government movement and is increasingly unacceptable.

Systems need to be developed that ensure subnational governments spend grant funds to provide agreed services of a specified quality and level.3 Standards might include, for example, adherence to national curricula, or hiring only credentialed medical personnel or teachers. Another approach is to impose conditions on transfers. For instance, support for health services might depend on whether residents from other localities have access to treatment; support for education might require adopting a prescribed curriculum.
Matching special-purpose grants. Central governments often make grants other than general transfers to subnational governments specifically to influence their spending patterns. A matching grant may provide a prescribed level of support to “match” subnational spending for a specific purpose. If nonresidents enjoy a percentage of the benefits of a subnational government’s spending, in principle a matching grant equivalent to that percentage would ensure that the good is supplied efficiently. Such grants may also generate increased tax-raising efforts by local governments as the opportunity cost of not raising revenues goes up. Unfortunately, so little is known about spillovers that this rule provides little practical guidance to the design of matching grants. Another problem with most matching grants is that they provide greater benefits to wealthier local governments that can afford more extensive discretionary expenditures. Differential matching rates could handle this problem (Feldstein 1975), but again it is difficult to determine what such rates should be.

With the exception of Hungary (which uses transfers for infrastructure completion projects), systematic conditional matching grants hardly exist in the transition economies. Local infrastructure and capital outlays are typically still directly funded and determined by the center. The development of an appropriate design for the grant system and a system for infrastructure financing remains a major challenge for the transition economies.

Although a conditional matching grant system may be a key element of intergovernmental finances in the future, the lack of budgetary autonomy in some countries and local tax authority in all of the countries studied makes implementing such a system in the transition economies more complex. Matching grants encourage local governments to increase spending on the targeted good through the price effect. When the price of the designated service relative to other services falls, local governments have incentive to shift spending to that service; however, in order to do so they must have power over their expenditures and the ability to improve tax effort. In Romania no significant services are the responsibility of the local governments and in Bulgaria local governments have almost no spending discretion. In Russia and Ukraine the picture is somewhat more mixed, but there is far from full spending discretion. A conditional grant system in these countries can therefore influence neither their spending pattern nor their tax effort. Without tax authority, governments have little ability to enhance tax effort and without spending discretion, little incentive to promote tax effort. This is a problem in all of the transition economies; the small size of local governments’ own-source revenues implies matching grants will not do much in the way of encouraging localities to increase their tax effort (Martinez-Vazquez and Bogetic 1995, forthcoming).
Nonmatching special-purpose grants. Like matching grants, nonmatching grants lead to increased public service provision, but unlike matching grants they do not alter the marginal cost of the service. Such conditional block transfers are one way of ensuring a minimum standard of provision: in effect, the subnational government acts as an agent of the central government. Again, however, the effectiveness of this device depends very much upon the capacity of the central government to monitor performance.

Continuing problems: Underfunded and transfer-dependent?

The fiscal situation facing most central governments in transition economies is such that few major revenue sources have been ceded to subnational governments. Only Hungary and Russia have given subnational governments a significant share of certain national-level revenues. Subnational governments in transition economies are generally underfunded and overly transfer-dependent. Vehicle taxes and especially the property tax may have significant long-term revenue potential, but the subnational own-tax package in most transition economies leaves much to be desired. Most subnational tax rates and tax bases are established by the central government. Many taxes thus established have rates fixed in nominal terms, making them highly vulnerable to erosion through inflation. Others are minor nuisance levies that may yield less than they cost to collect. None provides an adequate fiscal foundation for an active and viable subnational government.

The transfer systems in transition economies are also vulnerable to criticism. They discourage local responsibility, so recipients are tempted to run bigger deficits to increase transfers. To the extent they involve negotiation, they may also be criticized for lack of transparency and accountability. The future development of transfers in transition economies should incorporate simple formula-based criteria to discourage negotiation and, where politically desirable, to promote equalization. Subnational governments need a hard budget constraint on their expenditures—as well as sufficient budgetary flexibility to accommodate the growth of subnational finances. The distribution formula should be based on feasible and acceptable measures of capacity and need, and transfer payments should to some extent be made conditional on performance. Most transition economies need to derive measures of local fiscal capacity and to develop systems for monitoring subnational fiscal performance. Close attention should be paid to supervision, accounting, and monitoring of transfers, associated subnational expenditures, subnational borrowing and, in the future, the use of matching funds (such as for investment purposes).
The institutional requirements for intergovernmental systems

Intergovernmental relations will require oversight after the current legislation is implemented, particularly in technical and nonpolitical functions. An appropriate institutional forum for intergovernmental coordination fulfills several needs. It could analyze local budgets and report social, economic, and financial data on local revenues and spending outcomes. It could provide technical assistance to subnational governments to build up financial and management skills. It could also help local governments act cooperatively where they have common interests, such as providing services where joint cost savings are possible. Finally, it may also represent local governments' interests with the center.

Intergovernmental coordination

The lack of appropriate central government structures to monitor and support decentralized subnational governments is a common problem in Central and Eastern Europe. Despite the involvement of a number of central government institutions in a number of countries, many essential tasks are being left unattended. Central authorities in all countries need a better understanding of both the current situation and the likely effects of any proposed changes. Among the tasks for which responsibility must be clearly established are the monitoring and assessment of subnational finances, both in aggregate and for individual subnational governments. This could be the responsibility of the Ministry of Finance, a special subnational government department, or an agency with semi-independent status and some subnational government involvement.

Fiscal accounting and reporting. Regular and detailed financial data should be maintained on subnational governments. Ideally, uniform financial reporting and budgeting systems should be established, possibly with varying degrees of complexity for different categories of local governments. An appropriate agency needs to be made responsible for regular and timely data collection and processing, the execution of a census of governments, and ideally, publication of the public finance data that are needed for monitoring, revenue estimation, and economic research and analysis.

The development and implementation of financial reporting and information systems generally requires substantial training and follow-up efforts. Developing such informational and technical infrastructure is neither quick nor cheap, but it is essential if important public sector activities are to be decentralized without the center losing sight of the
activities taking place in the subnational part of the public sector. Implementation of these systems may require additional central institutions to develop and maintain the reporting systems, to train and support local government officials, and, as mentioned, to run the statistical side of the operation.

Training is also needed to upgrade the technical capacity of subnational governments to perform efficiently and effectively the expenditure functions for which they are responsible and with which they may be entrusted in the future, whether autonomously or as delegated agencies of the central government. Technical assistance could come from the relevant central ministry, regional agencies, universities, private sources, or some combination of these. In view of the heterogeneous nature of the services that have been or may be decentralized among the countries, it is unlikely that the same solution will be appropriate in all cases. Each functional area—including the budgeting and financial reporting discussed earlier—has different needs, problems, and possibilities, and will likely have to be treated differently.

*Policy analysis capability.* An especially high-priority task for the needed central monitoring unit is analyzing and evaluating intergovernmental fiscal transfers. As noted, many questions must be considered with respect to the objectives, design, and effects of such transfers. More open and informed discussion of these matters is needed in many countries, particularly when the process is as novel as it is in the transition economies. Regular publication of data will help, but no central government can be expected to carry out objectively and publish the economic and political analysis that is needed in any country where intergovernmental financial issues are important. Accordingly, most countries could usefully establish a small (and perhaps nongovernmental) research institute to focus on subnational government problems.

Development and quantification of options for redesigning systems of intergovernmental relations in the transition economies requires concrete empirical work. The system design and performance monitoring of intergovernmental systems will be a long-term, data-intensive exercise. Needed data are not available in many countries. (Investment data for Russia's oblasts, for example, have not been published since 1975.) Income data are often hard to interpret. Although the task is formidable, if decentralization is to work in the sense of delivering desired services as efficiently as possible, governments across the region should develop such databases as disaggregated tax collection and tax base statistics, expenditure composition and expenditure needs measures, socioeconomic characteristics of the population, and the stock of physical infrastructure and the state of its maintenance.
Conclusion

What do the concerns expressed above imply for the design of subnational and intergovernmental fiscal systems in the transition economies? While the details with respect to particular countries may be found in the rest of this book, the general goals for the design of an ideal system of subnational government financing in transition economies are as follows:

- Supporting the emergence of a subnational government role consistent with market-oriented reforms.
- Ensuring correspondence between subnational expenditure responsibilities and financial resources (including transfers from the central government) so that functions assigned to local governments can be carried out effectively.
- Increasing the autonomy of subnational governments by providing incentives for them to mobilize revenues of their own.
- Supporting the center's macroeconomic management policies.
- Giving expenditure discretion to subnational governments in appropriate areas to increase the efficiency of public spending and to improve the accountability of local officials to their constituents in the provision of local services.
- Establishing a system of intergovernmental transfers that is transparent, based on objective and predictable criteria, and not subject to negotiation and ad hoc bargaining.
- Minimizing administrative costs to conserve scarce administrative resources.
- Providing some equalizing transfers to offset differences in fiscal capacity among some localities and to ensure that poor localities can offer sufficient amounts of key public services.
- Incorporating mechanisms to support public infrastructure development and its appropriate financing.

As argued earlier, a broader framework than is customary is needed to analyze fiscal decentralization and subnational and intergovernmental fiscal issues in the transition economies. This framework must incorporate such elements as the likelihood of continuing structural changes in the economy and continuing political shifts, the need to undertake intergovernmental reforms while coping with stabilization pressures and the increased importance of the social safety net, the likelihood of continued (local) public ownership on a significant scale, the financial implications of such ownership and its possible conflicts with privatization, and continued vestiges of price and wage controls and other rigidities.

Including these elements in the framework of system design is essential if either decentralization or some of the other key transition
reforms are to be achieved fully or soon. Each country in transition is
different, and each will require close examination to determine the struc-
ture of the incentives, constraints, and opportunities that must be com-
bined to design as hard a budget constraint as is acceptable.

It will be a major challenge in the transition economies to develop an
intergovernmental fiscal system that is an optimal combination of rules
and flexibility—one that is flexible enough to be compatible with macro-
economic stabilization and the major structural shifts that are taking
place in the economy, and firm enough to provide a stable framework for
the effective operation of both central and subnational governments in
the longer term.

Countries in transition should, given the clear political pressures to
decentralize and the potential economic advantages—and dangers—of
doing so, move empirically and cautiously toward the design and imple-
mentation of new subnational and intergovernmental finance systems.
The issues are complex, technical, political, and location-specific, and
knowledge of the effects of various alternatives is often lacking. In these
circumstances, good analysis based on sound knowledge of local condi-
tions may have a major impact on improving the design of the systems
that are being put into place and, hence, improving the lives of those
undergoing one of the major upheavals of our time—the move from a
command economy to a market economy. This book is offered as a first
step in this ongoing process.

Notes

1. In this book, the term “subnational government” includes all levels of
government below the national level: it thus includes such intermediate bodies as
(in different countries) the oblast, county, or voivod, as well as the cities and
other local governments that are in some sense “below” these intermediate gov-
ernments. The term “local government” refers to the lower level of general gov-
ernment—such as cities, municipalities, or villages—where an intermediate level
exists. As discussed later in this and other chapters, the role and structure of
intermediate in relation to local governments is unclear in a number of countries.
In some countries local governments may in turn be divided in certain instances
into smaller “districts” or “settlements”; again, the relationship between these
sublocal units and local governments is not always clear, although this matter is
not discussed in detail in this book, except with respect to Budapest in chapter 3.

2. Data for Russia are from the Ministry of Finance and those for Hungary
from the IMF’s Government Finance Statistics yearbook (GFS) and Hungary’s
Ministry of Finance.

3. A small sampling of the extensive economic and political literature bear-
ing on this theme might include May (1969), Dafflon (1977), Breton and Scott
(1978), Courchene (1984), Bird (1986b), Burgess and Gagnon (1993), and Banting,
Brown, and Courchene (1994).
4. See table 1.10 for examples.

5. It should perhaps be noted that this argument applies strictly only in non-federal countries. As Bird (1994) has argued, in federal countries one aspect of the basic federal contract may be that some or all subnational governments are, in effect, "licensed" to be inefficient—at least when viewed from a central government perspective. With the possible exception of Russia—which is also the only formal federation among the countries considered here—none of the transition countries considered in this book appears to be "federal" in this sense.

6. Wherever possible the data used in this book have been taken from published sources available to the general research community such as national statistical yearbooks and the IMF's Government Finance Statistics. In many cases, however, unpublished data, made available by central or, in some instances, subnational governments, have had to be used. The availability, consistency, and comparability of data on subnational finance in many countries clearly leaves much to be desired. Every effort has been made to verify and update the data used here, but many gaps and problems inevitably remain.

7. It is sometimes argued that devolution may provide a better overall framework for the development of private market forces since devolved governments have greater incentives to compete for businesses and residents by selecting an efficient set of revenue sources and service levels, but this point is subject to considerable controversy (see Kenyon and Kincaid 1991) and cannot be discussed further here.

8. Article 51 of the Public Finance Law states that "the distribution of the revenues and expenditures or categories of local budgets ... is established by the decision bodies of each county [district] and of the city Bucharest." But Article 22 of the same law states explicitly that the central government has decisive power in the formation of local budgets. Local budgets are submitted to the Ministry of Finance each year no later than July 1. The Ministry of Finance examines the draft budgets and has ten days in which to "ask for the necessary modifications" to establish budget balance. Most important, "in case of divergence the [central] Government is to decide."


10. The larger metropolitan areas in transition countries, like their fellows throughout the world, often have special problems arising in part from governmental fragmentation and in part from their more complex and often different internal governmental structure. Chapter 3 discusses some aspects of the latter problem in the case of Budapest, but otherwise special "large city" problems are not treated in this book.

11. The Russian deficit for 1991 is hard to measure owing to the treatment of Union-level expenditure responsibilities taken over by the Russian Federation beginning in November 1991, following the dissolution of the U.S.S.R. Some sources cite higher numbers than reported here, referring to a "notional" deficit, which assumes that Russia had financed Soviet Union expenditures for the full year.

12. Almost certainly the central bank in Romania carries out heavily quasi-fiscal operations, and the banking system finances expenditures that are fiscal in nature.
13. Sources for the national budget expenditures are the ministries of finance of Hungary, Russia, and Albania.

14. For examples of dysfunctional incentives for economic liberalization as a result of fiscal decentralization policies in China, see Wong (1991, 1992).

15. The subnational budget surplus in Russia, measured on the reported “cash basis,” amounted to 1.2 percent of GDP in the first quarter of 1992, when the same rules applied in that country. See Wallich (1994) and Anderson and others (1994).

16. For a discussion of this problem in the more general context of developing countries, see Dillinger (1992).

17. A note of caution is also needed with respect to the apparent desire of many local governments to use fiscal incentives to bolster private business in their jurisdictions. The record of such policies is not very encouraging in any country (see Wasylenko 1981 and 1991 for evidence from the United States), and efforts in this direction are all too likely to degenerate into a zero-sum game for local governments unless great care is exerted.

18. Newbery (1991) argues against a rapid, “fire sale” or giveaway approach because many of the assets may have been financed with debt (as noted in the country chapters in the present book, some local governments in transition economies have substantial liabilities), in which case the proceeds should be used to pay off this debt, rather than burden current and future local taxpayers with debt service.

19. As discussed in chapter 6, many of these services are actually provided by local public enterprises.

20. This system can have advantages for enterprises. In Russia, for example, local tax offices reportedly permit illegal tax breaks to firms that finance their own kindergartens or other social services.

21. See Tanzi (1993a, 1993b) for a discussion of national tax reforms that are in process in most countries. In the former U.S.S.R., all enterprise taxes went to the level of government that owned the enterprise.

22. For a review of the literature on this subject in developing countries, see Bird and Miller (1989) and Jimenez (1989).

23. Calculated by the authors based on price data for 1993 and on the Polish Household Budget Survey.

24. This problem, like that of evasion, has proved to be very serious in Brazil, the only country in which subnational units levy value added taxes. See Longo (1990) and Purohit (1991).


26. Countries such as Canada and the United States, with important subnational levies on easily smuggled products such as tobacco, have experienced significant administrative problems with these taxes. Recently, for example, the province of Ontario in Canada was forced to cut its tobacco taxes in half to match a similar cut in the neighboring province of Quebec (which in turn lowered its taxes to match the lower taxes in neighboring New York state).

27. For a general discussion of automobile taxation, see Bahl and Linn (1992).

28. As suggested in the earlier discussion, and discussed at more length in chapter 8 with respect to Ukraine, the value added tax and the corporate income tax do not lend themselves as easily to surcharges.
29. There is, of course, an extensive (and to some extent controversial) literature on the incidence of local taxes, especially local property taxes, which cannot be discussed here; for a recent summary, see Bird and Slack (1993). The discussion in the text concentrates on residential property taxes: taxes on business property—apart from the extent to which they serve a "benefit" tax purpose—raise problems similar to other taxes on business such as the corporate income tax and the value added tax, and, as in those cases, a good argument can be made for restraining subnational access to this potential revenue source (see chapter 2 for further discussion).

30. There is little to be said for using area as a basis for urban property taxes. The case is different in rural areas, however, where taxes such as that in Romania—a differentiated rate ranging from 35 lei to 400 lei per hectare, depending on fertility and location—may make sense, provided the fixed levies are adjusted annually in accordance with an appropriate price index. Unfortunately, those who have received land under land reform in Romania are exempt from land taxes for eight years, thus weakening this potential source of local revenue.

31. The same will be true of the benefit levies (charges) that are sometimes imposed on the assessed value of real property, or on some characteristic of that property such as area, frontage, or location, to "charge" for improvements in the stock of public capital.

32. Assigning a percentage of a specific tax may undesirably bias national tax policy decisions.

33. Of course, such legal requirements are to some extent only pro forma. The fungibility of money and the ability of local governments to alter other expenditures and taxes mean that requiring a grant to be spent on a particular activity does not necessarily imply that total (centrally funded plus locally funded) expenditure on the activity goes up by the entire amount of the transfer. Indeed, in most cases it will not. Nonetheless, the empirical evidence (from Gramlich 1977 to McDowell 1994) suggests that transferred funds to some extent "stick"—that is, they are for the most part spent on the designated functions.

Table notes

Tables 1.1 and 1.5

Source for Albania: Government of Albania; World Bank and IMF staff estimates.


Source for Poland: Ministry of Finance, Government of Poland; World Bank staff estimates.

Source for Romania: World Bank staff estimates.
Source for Russia: Ministry of Finance, Government of Russia; IMF staff calculations.

Table 1.4

a. The average figure is the simple arithmetic mean of the country population, excluding the capital city population.
b. According to Feldman (1993), a three-tier system of local government has been established in Albania: districts, municipalities, and communes. The districts include the municipalities and communes in all cases except the District of Tirana. The Municipality of Tirana is separated from the District of Tirana. The largest district in Albania in terms of population is Elbasan in Central Albania; and the smallest district is Has. Based on this source and United Nations (1992), it can be inferred that Tirana is the largest municipality, with a population of 245,000 in the city-proper.
c. Based on Council of Europe (1993), the most populated oblast in Bulgaria in 1991 was Plovdiv, and the least populated was Michailovgrad. Among municipalities, Samokov had the biggest population, while Chelopech had the smallest.


Table 1.6

Total revenue: For each of the above countries, total local government revenue consisted of own-source taxes and nontax revenues and shared taxes and transfers.

Bulgaria:

- Own taxes: own-source property tax and inheritance tax.
- Nontax revenues: own-source fee and other own-source nontax revenues.
- Shared revenues and transfers: shared revenues (profit tax, income tax, and turnover tax) and other transfers.

Source: Chapter 5, table 5.5.

Hungary:

- Note: These are 1993 estimates.
- Own taxes: all local taxes.
- Nontax revenues: includes profits of locally owned enterprises, fees, old taxes, duties, and own revenues from sale of assets.
- Shared revenues and transfers: shared personal income tax, grants (normative and specific), transfers from within and outside general government, and social security fund transfers.

Source: Chapter 2, table 2.3.
Poland:

*Note:* Available information on local government revenue includes data on consolidated revenues earnings of "budgetary local enterprises" only. Revenue earnings of other local government-owned enterprises, incorporated in a different form, such as water and sewerage companies, public transportation enterprises, and so on, are not reflected in gmina accounts. The latter are known to account for the bulk of municipal enterprises.

Own taxes: own taxes such as real estate tax and other taxes levied by the local governments (gminy).

Nontax revenues: includes revenues from enterprises, stamp duties, lease or sale of assets, interest income, and other nontax revenue sources.

Shared revenues and transfers: include local government taxes that are shared with the center, such as the personal income tax and corporate income tax, plus directed and general subsidies from the Treasury.

*Source:* Chapter 4, table 4.2.

Romania:

Own taxes: Own-source direct and indirect taxes.

Nontax revenues: own-source capital revenue and local activities revenue.

Shared revenues and transfers: budgetary transfers (tax sharing and subsidies) and extrabudgetary transfers.

*Source:* Chapter 6, table 6.3; World Bank estimates based on Romanian Ministry of Finance data.

Russia:

*Note:* These are actual 1992 figures provided by the Russian Ministry of Finance.

Own taxes: include land and property tax and other local taxes.

Nontax revenues: include stamp duties and other nontax revenues, and revenues from privatization. No information was available on the total revenue earned from stamp duties and other nontax revenues.

Shared revenues and transfers: include personal income tax, enterprise income tax, value added tax and excise taxes, natural resource tax, and subventions and transfers to autonomous regions.

*Source:* Chapter 9, table 9.2.

Ukraine:

Own taxes: include motor vehicle taxes and other local taxes.

Nontax revenues: include timber and state duties, state enterprise privatization revenues, water fees, and nontax revenues.

Shared taxes and transfers: corporate profit tax, excise tax, land tax, personal income tax, and net transfers from central government.

*Source:* Chapter 8, table 8.4.

Table 1.7

a. Currently, much of the capital expenditure on local infrastructure in Albania is being financed by foreign grants or loans on concessional terms.
b. Even though local governments in these countries (Bulgaria and Romania) are permitted to borrow in principle, in reality no borrowing exists—instead, governments carry arrears (nonpayment of bills).

c. In 1991 Poland's subnational government borrowing as a percentage of total revenue was 1.4 percent. The government finance law for 1994 states that central government guarantees will be provided for some local borrowing within the prescribed limits of local debt services of 15 percent of programmed local revenues. The law also allows for facilitation of local government access to capital markets, through promotion of credit ratings of local governments and their investment programs. Generally speaking, local governments (gminy) do not have access to financial markets. Loans to gminy from the commercial banking system totaled a paltry US$8 million at end-1992.

Table 1.8

a. Local governments in Albania have recently been given control of some small and medium-size enterprises. It is evident that small and medium-size enterprises, which are subject to Decree No. 248 (1993) on “Measures for Acceleration of Privatization of Small and Medium Enterprises,” are being moved expeditiously into private hands. According to the decree, local governments are to receive 28 percent of the net proceeds of privatization of small and medium-size enterprises.

b. Telecommunications and electric utilities are under central jurisdiction in Albania.

c. In Bulgaria, budgetary authority and responsibility for several important public services are not clearly divided among central and local governments. The Law on Local Self-Government transferred the ownership of all infrastructure related to local services to municipal governments. However, water, sewerage, and electricity continue to be provided by state enterprises. The city of Sofia is a special case because the water and sewerage services are provided by municipal enterprises.

d. Ownership of telecommunications and energy utilities in Hungary is central; urban transport and water is shared between central and local government, while ownership of sanitation utilities is local.

e. Retail units in Poland are mostly privately owned.

f. Water and sewerage utilities in Poland are usually locally owned, while ownership of electric utilities is central.

g. Ownership of retail units in Romania is almost exclusively local.

h. In Romania local governments contract with regies autonomes (local public enterprises) for the delivery of most local public services.

Table 1.10

a. The “Property Tax Law,” passed in Albania in mid-March 1994, requires the central government to undertake property valuation, set rates, and administer the tax, with the proviso that 60 percent of the revenues are to be distributed to
local governments according to the source of the revenues. In this respect there is little sense in which the proposed tax is a local property tax.

**Bulgaria:**

b. Local governments received the entire tax paid by municipal and private enterprises, while the tax paid by state enterprises went to the central government. The turnover tax was replaced by a value added tax in January 1994.

c. Municipalities kept 100 percent of tax levied on municipal and private enterprises operating in their jurisdiction and a 10 percent surtax levied on state enterprises operating in their jurisdiction.

**Hungary:**

d. The personal income tax share was reduced from 100 percent in 1990.

e. Auto tax sharing is 50 percent; a road tax is not assigned.

f. The poll tax is levied at the communal level. Local governments retain 100 percent of the tax.

**Russia:**

*Note:* All taxes in Russia are shared on an origin basis with the oblast where revenues are generated.

g. The shared value added tax ranged from 20 percent to 50 percent, depending on the oblast (until 1994), and is a homogeneous 25 percent since 1994.

h. Oblasts receive up to 25 percentage points of a 38 percent corporate income tax (first quarter 1994).

i. Oblasts receive 60 percent of natural resource taxes. Okrugs received 80 percent in 1993.

j. Producing oblasts received 25 percent to 65 percent of the export tax on petroleum, depending on the oblast (third quarter 1993).

k. Oblasts receive 100 percent of all excises except excise on vodka and petroleum, for which they receive 50 percent and 30 percent, respectively. The 60 percent figure is based on actual revenue share in first quarter 1993.

**Ukraine:**

*Note:* In 1994 the government used for the first time homogeneous sharing rates for all oblasts and increased the number of regulating taxes.

l. In 1993 the value added tax was more heavily used as a regulating tax with nineteen different oblast sharing rates, ranging from 23.1 percent to 100 percent.

m. National enterprise income/profits tax shares were set at three levels in 1993: 25 percent, 50 percent, or 100 percent.

n. Oblast shares from excise taxes were set at three levels in 1993: 10 percent, 50 percent, or 100 percent.

o. Real estate taxes imply land taxes only. In 1993, 100 percent of land taxes were retained by the local governments. Property taxes were abolished in 1993. Prior to that they were exclusively assigned to local governments.

p. Local governments collect 100 percent of the company profit falling on enterprises owned by the local government.
HUNGARY

- County (megye) centers
- National capital
- County (megye) boundaries
- International boundaries

Budapest is a municipality that has county (megye) status. It is also the capital of Pest County (Megye).
Financing local government in Hungary

Richard M. Bird, Christine I. Wallich, and Gábor Péteri

Hungary's bold, far-ranging reform of its system of subnational finances, undertaken against a background of national fiscal reform, is dramatically altering the expenditure responsibilities and revenue authorities of subnational governments. It is also changing their political relations with the central government.

The new system of local government finance has many merits—both political and economic. It involves Hungarians throughout the country in a positive and democratic way with their local governments, at least in principle. It could also improve the efficiency of government by subjecting government actions to the scrutiny of responsible local officials and voters. But because the system is so new, there is still much to be learned and some serious decisions to be made, both by officials and by citizens, to ensure that the potential gains are realized.

The new system of local government finance has two objectives: to free local authorities from the heavy hand of central control and to make them more responsible and accountable. The first objective is to be accomplished by removing all central control over local spending, whether financed by central transfers or by own revenues, and the second by providing new sources of locally controlled revenue. But the fundamental inadequacy of the new local taxes raises the specter of undesirable outcomes from this well-intentioned experiment. Among the possible consequences: increased local demands for transfers from an already hard-pressed central budget, increased regional divergence in the provision of basic social infrastructure and services (particularly
to the poorest elements of society), and increased pressure on local governments to engage in unwise entrepreneurial activities.

This chapter outlines the changes introduced in the system of local finance as a result of the Law on Local Self-Government, one of the first laws approved by Hungary's newly elected Parliament in 1990. The Law outlined the basic structure of a modern local government system in the context of a legal, administrative, and fiscal environment that was highly uncertain, in part because it was passed only three months after the national elections and much of the old institutional order still prevailed. Over the next four years, other laws elaborated and modified this system. The laws define the new assignment of expenditures between the central government and the 3,148 new local governments. They also set out the new local revenue sources. And they establish the economic foundation, property rights, and entrepreneurial functions of the localities. After presenting the basic elements of the new local and intergovernmental finance system, the chapter outlines policies that should avoid undesirable outcomes of the current system and help Hungary achieve its goal of a smaller, more efficient local government sector.

The new system of local government

Under the system of national public finance in place until 1990, Hungary had a unitary system of government finance. Local governments had little independent revenues and few independent spending functions. The government was organized in a multitier system, with the center imposing its control over 1,523 local councils through 19 county councils. The local councils had no legally separate identity and were governed by the county councils. The local councils undertook a wide range of expenditures as agents of the central government. Some fees and duties—such as tourist fees, stamp duties, and license fees—were collected locally, but the central government fixed the rates. Any added revenue that was needed to cover spending was negotiated with the central government and channeled, mostly through the counties, from the central budget.

The Law on Local Self-Government eliminated the middle tier of government, and at the same time the number of local governments multiplied—to 3,148 in 1993 (see map of Hungary, p. 68)—as many of the local councils broke themselves up into discrete units. The new units have an average of only 3,482 inhabitants—2,834 if Budapest is excluded—and three-quarters of them have fewer than 2,000 inhabitants. Many of these local governments are simply too small to provide efficiently all the public services demanded from them. Although the number of municipal associations is growing, only recently have local municipalities started to deal jointly with common problems, and there is still almost no
cooperation in service delivery or in administrative functions (Péteri and Wright 1994). As in other countries of the region, Hungary may have something to learn from countries with two-tiered structures at the local level (Bird and Slack 1993) and from those localities in Scandinavia that have cooperated in regional service provision (Soderstrom 1991).

The Law on Local Self-Government redefined the rights and responsibilities of the two levels of local government (figures 2.1 and 2.2). The responsibilities of the regional bodies (the nineteen counties) have been dramatically scaled back (Davey 1990; Péteri and Wright 1994). The newly created Commissioners of the Republic—there are eight—coordinate, supervise, and review the constitutionality and legality of local decisions. But they have no fiscal functions. A parallel system of thirty-six deconcentrated central ministerial organizations was created at the regional and county level to operate and supervise regional activities that range from supervising public health and education to providing information. The Commissioners of the Republic are supposed to coordinate these activities, but little coordination is yet evident.

Counties remain responsible for interjurisdictional spending that serves more than one locality, but their revenue raising has been reduced. Most fees and duties previously retained by the county are now retained by localities, and counties no longer serve as a conduit for local finance from the central government. Governed by indirectly elected bodies, the counties have no independent political basis. Cities with county status do not send representatives to county councils, and counties have no power over these cities. Since local governments can take over any county service, counties end up providing only services that are costly—such as special homes for the elderly.

Figure 2.1 Prereform administrative structure of central and local governments, Hungary, 1990

![Diagram of administrative structure](image)

Source: Authors.
Local governments (referred to here as localities) are now directly responsible for most traditional local government functions. The corresponding shift in expenditure responsibilities has been paralleled in part—but only in part—by a shift in taxing authority. Localities receive grants from the central government to help them meet spending responsibilities, as laid out in the Law on Local Self-Government. Though unconditional, the grant is related in part to spending norms linked to these responsibilities. Localities are also authorized to own, borrow, and dispose of property and to establish, manage, and sell public enterprises.

**Local government finance in a macroeconomic context**

In the previous system of finance and budgeting the finances of subnational governments had few macroeconomic consequences. Transfers to localities and transfers to extrabudgetary funds and institutions were set to be consistent with the budgetary stance of the day. Localities might have wanted higher expenditures and transfers, but their access to funds was fixed.

Under that system transfers to local government were about 10 percent of central government consolidated expenditures (table 2.1). With the Law on Local Self-Government, transfers rose sharply in 1991 to more than
### Table 2.1 Local finance in the national fiscal context, Hungary, 1985–94

(billions of forints)

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<tr>
<td>Total general consolidated expenditure(^a)</td>
<td>632.9</td>
<td>719.0</td>
<td>792.4</td>
<td>892.3</td>
<td>1,041.5</td>
<td>1,194.5</td>
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<td>Local expenditure as a percentage of total general</td>
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<td>27.1</td>
<td>25.0</td>
<td>22.3</td>
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<tr>
<td>Transfers to local government(^b)</td>
<td>66.5</td>
<td>75.1</td>
<td>78.2</td>
<td>97.6</td>
<td>123.3</td>
<td>113.3</td>
<td>190.7</td>
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<td>Revenues</td>
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<tr>
<td>Local revenue</td>
<td>147.6</td>
<td>156.9</td>
<td>169.5</td>
<td>205.2</td>
<td>243.0</td>
<td>300.5</td>
<td>391.7</td>
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<td>Local own-source revenue(^c)</td>
<td>40.3</td>
<td>48.1</td>
<td>53.0</td>
<td>42.8</td>
<td>53.2</td>
<td>62.0</td>
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<td>91.0</td>
<td>106.0</td>
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<tr>
<td>revenue</td>
<td>27.5</td>
<td>30.7</td>
<td>31.1</td>
<td>20.9</td>
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<td>20.6</td>
<td>17.2</td>
<td>17.9</td>
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<td>Transfers as a percentage of GDP</td>
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<td>6.9</td>
<td>6.7</td>
<td>6.9</td>
<td>7.2</td>
<td>5.4</td>
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<td>Consolidated deficit/surplus</td>
<td>-11.8</td>
<td>-31.8</td>
<td>-43.5</td>
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<td>9.7</td>
<td>-53.5</td>
<td>-158.3</td>
<td>-211.4</td>
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</table>

**Memo items**

| Inflation in consumer price index (percent)          | 7.0   | 5.3   | 8.6   | 15.5  | 17.0  | 28.9  | 35.0  | 23.0             | 22.5             |
| Average exchange rate (Ft/$)                        | 50.1  | 45.8  | 47.0  | 50.4  | 59.1  | 63.2  | 74.7  | 79.0             | 91.9             |

- Not available.
- \(^a\) Capital and current only.
- \(^b\) Excludes personal income tax share and transfers from the social security fund for health care payments.
- \(^c\) Excludes personal income tax.

14 percent of consolidated expenditures and financed about 51 percent of local expenditures. In 1993 budgeted transfers (including those from the social security fund for health) rose because of additional spending responsibilities for health services, housing, and transport and accounted for nearly two-thirds of local expenditures. The level in 1994 is largely unchanged.

The system is still new, so it is premature to judge its long-term implications for the national budget. Nonetheless, local dependence on transfers and the limited taxes assigned to the local level could give rise to macroeconomic difficulties. Localities may have to turn to the central government for additional help with their newly assigned responsibility for social assistance, the demands for which would grow with a worsening economic situation. There is also a backlog of unmet infrastructure improvements for which localities may, within the framework of the Law, have to turn to the center for financial support—unless other ways of financing infrastructure are developed. If the center can hold the line, subnational government deficits will not imply any increase in the overall deficit. If, however, these demands are met by the center, they can contribute to aggregate demand pressures and inflation, if ultimately they are monetized.

Hungary's macroeconomic position is uncertain. After three years of negative growth, the economic climate is starting to show signs of improvement, with manageable inflation and real growth in 1994 and forecasted for 1995. Real GDP fell by about 21 percent between 1990 and 1993 and real growth of 2.5 percent is expected in 1994. And rising prices, which put an additional strain on the economy during the transition, are beginning to stabilize. Following an acceleration in 1990 and 1991, inflation fell to an average rate of about 23 percent in 1992 and 1993, and declined further in 1994.

Still, Hungary's bleak economic situation continues to make stabilization difficult. The huge loss in output, and hence taxable income, has reduced government revenues and increased the budget deficit and unemployment. Since 1990, expenditures as a percentage of GDP have risen and revenues have fallen, resulting in an expansion of the deficit from 0.5 percent of GDP in 1990 to 6.4 percent in 1993. The fiscal deficit in 1994 is projected to deteriorate to more than 9 percent of GDP. The current account has also worsened, to some 10 percent of GDP. Unemployment, once negligible, was about 12 percent in 1994.

The recent output expansion is encouraging, but insufficient to alleviate the financial constraints facing the government. The change in government in May 1994 makes the direction of the economy even more uncertain. The speed of reform remains to be seen, as does the government's response to inflation and unemployment. Regardless, local and intergovernmental fiscal policy will continue to be developed in the now very constrained fiscal environment of the central government.
Given the assignment of expenditures and revenues in Hungary, the need for central transfers and shared taxes will continue to be large. In 1993 transfers (mainly the so-called normative grant) and shared taxes accounted for more than 70 percent of localities' total revenue receipts. Many of the services that local governments provide (education, health, infrastructure) are essential for Hungary's development. It is impractical to think that small local governments will be able to finance such services adequately with their presently assigned own resources. Even the large capital city of Budapest will find this difficult. And with Hungary's weak economy, local governments' open-ended responsibility for social assistance may lead them to turn to the center for additional funds, threatening fiscal balance. Transfers to local governments are not an easily compressible chunk of the national budget.

As argued in chapter 1, what is required is a grant system that is clearly defined, transparent, and that balances the needs of both central government and the localities in a consistent fashion. Some countries have opted for a formula to determine the aggregate transfer volume, such as a specified percentage of total national revenues. This approach is a compromise. The center gives up some revenue but insulates itself from unexpected and possibly escalating demands from localities. The localities avoid surprises such as stabilization-induced cutbacks in transfers. For Hungary, regularizing the size and distribution of transfers and strengthening local finances by broadening the local tax base should be priority reforms. The central government may also want to limit its commitment to providing open-ended targeted (matching) grants for local investments to a level consistent with macroeconomic constraints.

Local government expenditure responsibilities

Under the Law on Local Self-Government localities in Hungary have both mandatory and optional expenditure responsibilities. Among the tasks legally mandated for local governments are the provision of potable water, primary education, basic health and social services (including social assistance), public lighting and maintenance of public roads and public cemeteries, and guarantees of the rights of national and ethnic minorities. Neither the standard nor the level of provision is described in the Law, and the exact nature of the mandate is thus unclear. The Law also defines a range of other activities that are within the scope of local competence but are not mandatory. These include housing management, garbage collection, fire protection, public security, development of sports facilities, and so on. Indeed, localities can undertake any task not explicitly assigned to another body or government level. In practice,
Table 2.2 Local government expenditures, Hungary, 1988–93
(billions of forints)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount (billion)</td>
<td>Share (percent)</td>
<td>Amount (billion)</td>
<td>Share (percent)</td>
<td>Amount (billion)</td>
<td>Share (percent)</td>
</tr>
<tr>
<td>Total expenditure</td>
<td>201.4</td>
<td>100.0</td>
<td>252.9</td>
<td>100.0</td>
<td>256.9</td>
<td>100.0</td>
</tr>
<tr>
<td>Education</td>
<td>68.2</td>
<td>33.9</td>
<td>79.4</td>
<td>31.4</td>
<td>107.3</td>
<td>41.8</td>
</tr>
<tr>
<td>Health</td>
<td>36.6</td>
<td>18.2</td>
<td>48.4</td>
<td>19.1</td>
<td>16.5</td>
<td>6.4</td>
</tr>
<tr>
<td>Social security and welfare</td>
<td>8.8</td>
<td>4.4</td>
<td>17.7</td>
<td>7.0</td>
<td>18.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Housing and community amenitiesb</td>
<td>32.3</td>
<td>16.0</td>
<td>16.5</td>
<td>6.5</td>
<td>27.4</td>
<td>10.7</td>
</tr>
<tr>
<td>Recreational, cultural, and religious affairs</td>
<td>4.5</td>
<td>2.2</td>
<td>12.8</td>
<td>5.1</td>
<td>15.8</td>
<td>6.2</td>
</tr>
<tr>
<td>Transportation and communication</td>
<td>13.6</td>
<td>6.8</td>
<td>27.9</td>
<td>11.0</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Other expendituresc</td>
<td>37.4</td>
<td>18.6</td>
<td>50.2</td>
<td>18.8</td>
<td>71.6</td>
<td>27.9</td>
</tr>
<tr>
<td>Current expenditures</td>
<td>146.7</td>
<td>72.8</td>
<td>194.3</td>
<td>76.8</td>
<td>201.1</td>
<td>78.2</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>54.7</td>
<td>27.2</td>
<td>58.6</td>
<td>23.2</td>
<td>55.8</td>
<td>21.7</td>
</tr>
</tbody>
</table>

Memo items

- Inflation in consumer price index (percent) | 15.5 | 17.0 | 28.9 | 35.0 | 23.0 | 22.5 |
- Average exchange rate (Ft/$)               | 50.4 | 51.1 | 63.2 | 74.7 | 79.0 | 91.9 |

a. Estimate.
b. For 1991–93, includes only housing and water.
c. Other expenditures include public order and safety, fuel and energy, agriculture, general public services, and other expenditures.

localities not only deliver public services, they also invest in infrastructure provision, such as energy and telecommunications, and foster employment and economic development.

Local spending functions

The largest expenditure category is education, which accounts for more than 30 percent of total local expenditures (table 2.2). Primary education is mandatory for all localities. (Indeed, having a primary school and a general practitioner define the minimum scale of a village [paragraph 52, Law on Local Self-Government].) Preprimary education and after-school day-care take a big part of total education outlays. A centrally set fee schedule applies to such services, but in some localities it covers less than 10 percent of costs. Moreover, central guidelines exempt some families from paying fees—families with more than three children, for example, pay reduced fees. This confusion of social objectives and financial policies concerns some localities, which believe they are better able to identify those in need. Secondary, technical, and vocational schools, while not mandatory, are typically financed by county governments or larger towns. Each of these functions is supported to a varying degree by the central normative grant channeled to the locality providing the service.

In the health sector, localities act as agents of the National Health Insurance Fund in providing health services, including hospitalization in the larger towns. Services are determined by the national government, and local governments are reimbursed for the cost of providing services and medicine. Investment outlays are also a local responsibility, though financial support is available from central investment grants. Along with recent changes in the social security system (self-governance and separation of health care and pension funds from the budgetary accounts), health service financing has also recently been modified. For instance, doctors can now privately contract to provide municipal health services.

Housing is also a local government responsibility. The Law on Local Self-Government transferred ownership of some properties to localities—including parks, recreation centers, utility companies and their lands, commercial enterprises formerly owned by local councils, and other businesses. The Property Transfer Act of 1991 transferred much of the public housing stock (social flats) and commercial buildings to local governments. But two years later the Act on Housing constrained local autonomy in housing by defining the conditions for privatization of the housing stock and other premises, including a rent freeze that lasted until mid-1994. After the rent freeze ended, some local governments set new, market-based rents. However, the local elections of December 1994 made such actions politically unpopular.
With the transfer of communal housing and other assets to localities, maintenance on houses and properties has become a local responsibility. But rents, fixed until recently by the central government, remain well below the market. Losses of the local housing maintenance corporations were partly offset by central government subsidies until 1990, but then were fully phased out. For Hungary’s cities, the fiscal implications were considerable (Alm and Buckley 1994). Localities are reacting in different ways. Some are pushing to sell housing rapidly to reduce the recurrent costs on the budget. Some are making costly improvements to the properties—hoping for a higher future sale price. Indeed, many localities appear to be developing vacant urban land in search of future profits.

Considerable responsibility for administrating social welfare and several forms of social assistance has also been delegated to localities through the Law on Local Self-Government and the more recent Law on Social Assistance (1993). Responsibilities include the management of long-term social care facilities, such as homes for the elderly and for the handicapped. Local governments receive funds from the national budget—the normative grant discussed later in this chapter—to support the maintenance of some of these institutions. Localities also finance home-care services for the old and for the handicapped, also supported through the normative grant. Other forms of social assistance prescribed by the laws constitute new municipal functions. Under the 1993 Law on Social Assistance local governments must now provide assistance for the unemployed who are not eligible for unemployment benefits. This outlay is partly compensated with an intergovernmental grant of 50 percent of the assistance provided. Discretionary housing subsidies are paid out of local budgets; child allowances for third children and maternity benefits are locally administered but centrally funded.

The central government provides assistance for unemployment benefits, retirement pensions, and similar types of assistance. Local governments are then responsible for meeting the needs of those inadequately served by the central welfare system. Central and local governments' responsibilities for social assistance vary, with the central government responsible for setting guidelines for minimum incomes of pensioners and the unemployed and local governments tasked with establishing need, determining eligibility, establishing assistance levels, and funding outlays. There may thus be substantial differences across localities in the level of welfare provided, as well as in eligibility criteria, depending on the resources available to the locality (Fábián and Straussman 1994). It has been said that Hungary has 3,200 different social assistance policies. In general, in areas where the incidence of poverty is high, the per capita benefits provided are lower than in areas where poverty incidence is low (Jarvis and Micklewright 1996, forth-
coming; World Bank 1994c). In villages local government councils make determinations based on applications brought by needy villagers. In larger towns a more formal process involves social workers and the Ministry of Social Welfare. To help local governments carry out their responsibilities under the 1993 Law on Social Assistance, the allocation of social assistance funds to localities, which in the past followed a uniform per capita allocation, now uses a weighted formula incorporating the percentage of inactive population, unemployment, and income capacity in each jurisdiction. Nonetheless, it is claimed that these weights have not resulted in sufficiently differentiated funding levels, and many local governments are having difficulty in delivering the programs mandated by law. Social assistance payments have risen from 0.2 percent of GNP in 1990 to 1.5 percent in 1993 (World Bank 1994c). The demands on central resources to enable localities to fulfill these tasks may further burden Hungary’s economy.

Local public service delivery by the private sector

The nonprofit sector is increasing rapidly in Hungary. In 1992 there were 8,900 foundations and 18,000 unions, compared with 400 foundations and 8,500 unions in 1989. This sector often delivers local public services. Based on agreements with the local government, nonprofit organizations have taken over public functions, including schooling, and receive normative grants from the central budget equal to the grants that would be provided to the local government for the functions they perform. Most (70 percent) of the institutions funded in this way are religious in nature. Grants to nonprofit organizations have increased substantially during the past three years: in 1992, 2 percent of the normative grant for schools was allocated to nonprofits; in 1993 this share increased to 3 percent.

Are spending assignments appropriate?

For the most part, the expenditure functions assigned to local governments in Hungary appear logical. Given the small size of many Hungarian localities, however, there is a strong case for assigning some services—such as secondary education and hospital care—to larger units of government. These could be special-purpose governments or voluntary associations of local governments, such as in some Scandinavian countries (Soderstrom 1991). The rationale is that the benefit area for these services is likely to encompass several localities. Another important reason for involving larger units in the provision of services such as education and health may be the desire for more uniform quality standards.
Local government revenues

Like most countries, Hungary assigns more expenditure functions to local governments than can be financed from the revenue sources directly allocated to these governments. The result of this vertical imbalance is that local governments generally depend on transfers from higher levels of government—the more so, the more spending they are charged with. Another problem of local finance in Hungary is that not all local governments are equal: there are big cities and small, urban localities and rural ones, rich units and poor. Providing local services fairly and efficiently in the absence of a well-designed revenue and transfer system can give rise to horizontal imbalance—differences between localities in the services they can afford (even when they levy

Table 2.3 Local government revenues, Hungary, 1990–93
(billions of forints)

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>Amount</th>
<th>Share of total budget (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own revenuea</td>
<td>62.0</td>
<td>20.3</td>
</tr>
<tr>
<td>Of which, local taxes</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Own revenue from sale of assets</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Shared personal income tax (PIT)</td>
<td>74.5</td>
<td>24.4</td>
</tr>
<tr>
<td>Of which, PIT equalizing funds</td>
<td>4.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Vehide tax</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Grants</td>
<td>113.3</td>
<td>37.1</td>
</tr>
<tr>
<td>Normative grants</td>
<td>74.0</td>
<td>26.0</td>
</tr>
<tr>
<td>Per capita–based grants</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Expenditure norm–based grants</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Specific grants</td>
<td>29.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Targeted and addressed grants</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Grants for disadvantaged localities</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Other grant funds</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Transfers from central government</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Social security fund transfers</td>
<td>50.6</td>
<td>16.6</td>
</tr>
<tr>
<td>Credit, bonds, and borrowingb</td>
<td>5.1</td>
<td>1.7</td>
</tr>
<tr>
<td>Total current revenues</td>
<td>205.6</td>
<td>100.0</td>
</tr>
<tr>
<td>Balance from previous year</td>
<td>5.9</td>
<td></td>
</tr>
<tr>
<td>Total revenues</td>
<td>211.5</td>
<td></td>
</tr>
<tr>
<td>Local government revenue as a share of GDP (percent)</td>
<td>14.6</td>
<td></td>
</tr>
<tr>
<td>Memo items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation in consumer price index (percent)</td>
<td>28.9</td>
<td></td>
</tr>
<tr>
<td>Average exchange rate (Ft/$)</td>
<td>62.2</td>
<td></td>
</tr>
</tbody>
</table>

— Not available.

n.a. Not applicable.
exactly the same taxes). Hungary's system of local government finance deals only in part with these two imbalances. Moreover, the design of local taxes and the heavy reliance on transfers give rise to major efficiency concerns.

**Local own-source taxes**

The Law on Local Self-Government provides for local own-source taxes, shared taxes, and grants (table 2.3). The 1991 Act on Local Taxes assigns only five own-source taxes to local government. These taxes can be introduced by local governments, but are not mandatory. No other taxes or fees can be established at the local level, and maximum tax rates and the tax bases are fixed by the central government (table 2.4).

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount</th>
<th>Share of total budget (percent)</th>
<th>Amount</th>
<th>Share of total budget (percent)</th>
<th>Amount</th>
<th>Share of total budget (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>67.4</td>
<td>17.0</td>
<td>91.0</td>
<td>17.6</td>
<td>106.0</td>
<td>17.3</td>
</tr>
<tr>
<td></td>
<td>9.5</td>
<td>2.4</td>
<td>17.2</td>
<td>3.3</td>
<td>27.1</td>
<td>4.4</td>
</tr>
<tr>
<td></td>
<td>15.6</td>
<td>3.9</td>
<td>28.5</td>
<td>5.5</td>
<td>48.9</td>
<td>8.0</td>
</tr>
<tr>
<td></td>
<td>47.0</td>
<td>11.9</td>
<td>63.0</td>
<td>12.2</td>
<td>51.4</td>
<td>8.4</td>
</tr>
<tr>
<td></td>
<td>7.0</td>
<td>1.8</td>
<td>4.5</td>
<td>0.8</td>
<td>3.8</td>
<td>0.6</td>
</tr>
<tr>
<td></td>
<td>n.a.</td>
<td>n.a.</td>
<td>2.3</td>
<td>0.4</td>
<td>2.5</td>
<td>0.4</td>
</tr>
<tr>
<td>1992</td>
<td>48.1</td>
<td>17.0</td>
<td>219.5</td>
<td>42.5</td>
<td>256.6</td>
<td>41.8</td>
</tr>
<tr>
<td></td>
<td>148.6</td>
<td>37.6</td>
<td>169.8</td>
<td>32.9</td>
<td>207.3</td>
<td>33.9</td>
</tr>
<tr>
<td></td>
<td>58.9</td>
<td>14.9</td>
<td>67.4</td>
<td>13.0</td>
<td>83.1</td>
<td>13.5</td>
</tr>
<tr>
<td></td>
<td>89.7</td>
<td>22.6</td>
<td>101.9</td>
<td>19.8</td>
<td>124.7</td>
<td>20.3</td>
</tr>
<tr>
<td></td>
<td>42.1</td>
<td>10.6</td>
<td>49.7</td>
<td>9.6</td>
<td>49.0</td>
<td>8.0</td>
</tr>
<tr>
<td></td>
<td>17.3</td>
<td>4.4</td>
<td>22.6</td>
<td>4.4</td>
<td>18.3</td>
<td>3.0</td>
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<td></td>
<td>5.0</td>
<td>1.3</td>
<td>3.1</td>
<td>0.6</td>
<td>1.6</td>
<td>0.3</td>
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<td></td>
<td>19.8</td>
<td>5.0</td>
<td>24.0</td>
<td>4.6</td>
<td>29.1</td>
<td>4.7</td>
</tr>
<tr>
<td></td>
<td>3.9</td>
<td>1.0</td>
<td>23.4</td>
<td>4.5</td>
<td>23.1</td>
<td>3.8</td>
</tr>
<tr>
<td></td>
<td>67.1</td>
<td>16.9</td>
<td>80.8</td>
<td>15.7</td>
<td>91.6</td>
<td>14.9</td>
</tr>
<tr>
<td></td>
<td>4.8</td>
<td>1.2</td>
<td>7.5</td>
<td>1.5</td>
<td>35.7</td>
<td>5.8</td>
</tr>
<tr>
<td></td>
<td>396.5</td>
<td>100.0</td>
<td>515.9</td>
<td>100.0</td>
<td>613.6</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>20.4</td>
<td>39.6</td>
<td>63.5</td>
<td>35.7</td>
<td>667.0</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td>416.9</td>
<td>55.5</td>
<td>67.0</td>
<td>16.0</td>
<td>17.5</td>
<td>16.0</td>
</tr>
<tr>
<td></td>
<td>16.0</td>
<td>35.0</td>
<td>23.0</td>
<td>7.4</td>
<td>22.0</td>
<td>7.4</td>
</tr>
<tr>
<td></td>
<td>74.7</td>
<td>79.0</td>
<td>91.9</td>
<td>74.7</td>
<td>91.9</td>
<td>74.7</td>
</tr>
</tbody>
</table>

*Includes profits, fees, old taxes, and duties.*

*b. Included in revenues under Hungarian accounting system.*

Table 2.4 Local taxes, Hungary, 1994

<table>
<thead>
<tr>
<th>Base of tax assessment</th>
<th>Maximum rate of tax</th>
<th>Exemptions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax on buildings and property</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| • Useful area of the building in square meters | Ft 300 per square meter | • All poor social flats  
• All properties less than 100 square meters  
• Living spaces with less than 25 square meters per person  
• All temporary lodgings  
• Garages of less than 16 square meters |
| • "Corrected sales value" of the building*  | 3 percent of value  | • Properties owned by any income tax-exempt entity (churches, foundations, non-profit organizations, historical buildings, educational institutions, health care facilities)  
• All properties with prior exemptions |
| **Tax on undeveloped plots and land**       |                     |                                                                           |
| • Area of the plot in square meters         | Ft 100 per square meter | • Land owned by transport or telecommunications companies |
| • "Corrected sales value" of the plot*      | 1 percent of value  |                                                                           |
| **Communal taxes**                          |                     |                                                                           |
| Communal tax on private persons            | Ft 3,000 per year per premise |                                                                           |
| • Premises serving dwelling or other purposes and downtown plots |                     |                                                                           |
| Communal tax on entrepreneurs              | Ft 2,000 annually per person employed. If the activity is not carried out during the whole year, the tax is calculated by months |                                                                           |
| • Average number of people employed (proprietors included) by the entrepreneur |                     |                                                                           |
| **Tax on tourism**                          |                     |                                                                           |
| • Tourists and nonpermanent residents staying more than forty-eight hours | Ft 100 per person each night or 4 percent of hotel charges, to be collected by hotel or homeowner | • Children under 16  
• Students  
• Employed relatives  
• Tenants in social institutions or homeowners |
| • Vacation residences                       | Ft 300 per square meter of building's basic area |                                                                           |
Table 2.4 (continued)

<table>
<thead>
<tr>
<th>Base of tax assessment</th>
<th>Maximum rate of tax</th>
<th>Exemptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax on gross receipts/</td>
<td></td>
<td></td>
</tr>
<tr>
<td>local practice of industry</td>
<td>0.8 percent of corrected net business turnover</td>
<td>• All final-level retail sales</td>
</tr>
<tr>
<td>• Gross sales receipts of products sold or services performed, net of value added tax paid</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. The corrected value is 50 percent of the central government's assessed price, which corresponds on average to 50 percent of actual observed market price.

Business tax. This local tax is a gross turnover tax that is levied at all stages of production/sale (except retail sales) at a maximum rate of 0.8 percent or 5,000 forints (Ft) a day for temporary business activities. It can be levied on all enterprises on gross sales revenue net of value added and other consumption taxes, less the purchase value of goods sold and the value of services provided by subcontractors.

Communal tax. The communal tax can be levied on household dwellings or on businesses. If on dwellings, the occupant pays Ft 3,000 per dwelling annually, regardless of the number of inhabitants. This tax is suited to localities that have many government-owned social flats and cannot rely on property taxes for revenue. If levied on businesses, the enterprise pays a maximum annual rate of Ft 2,000 per employee.

Land tax. The land tax is essentially an annual property tax on unimproved, privately owned land. It is levied at a maximum rate of Ft 100 per square meter, or 1 percent of the so-called corrected value of the land, where corrected value is defined (in regulations) as 50 percent of the government-determined assessed value. This value is typically equivalent to about 50 percent of actual observed market values. Publicly owned land used for purposes not exempt from income or other taxes is also taxable. Land owned by transportation companies and telecommunications companies is exempt.

Property tax on buildings. Local governments can levy an annual property tax—at a rate of 3 percent of corrected value or Ft 300 per square meter—on all privately owned buildings, such as flats, summer houses, garages, workshops, and other residential housing. As mentioned, the corrected value is about 25 percent of market value. (With more than 50 percent of housing in private hands, market transactions take place with some frequency.) The property tax base suffers from numerous centrally mandated exemptions, many of them extending well into the next century.
Under current law, for example, improvements to a property (such as a new roof or addition of a bathroom) exempt the entire property from tax for ten years. Also exempt are temporary lodgings, garages of less than 16 square meters, all so-called social flats (for the poor), all properties of less than 100 square meters, all living spaces of less than 25 square meters per person, and properties owned by any entity exempt from income tax. Records show widespread exemptions and almost exclusive reliance on area measures, not values.

**Tourism tax.** The tourism tax is an extension of the earlier tourism fee, which could be levied only in resort areas. The current tax can be levied by all localities at Ft 100 per person for each night spent in a holiday hotel or private hostel, or 4 percent of the charge paid for the accommodation. It is payable only for stays of more than forty-eight hours. Students, employed relatives, tenants in social institutions, and children under 16 are exempt. The tax can also be levied annually at Ft 300 per square meter for vacation residences.

**Local taxing discretion**

Except for the business tax, which was new in 1991, these local taxes represented an extension of the taxes the local councils collected and administered under the previous system. The decision to assign these taxes to local government was driven by the objective of greater local independence and a separation of taxing functions between local and central governments. The possibility of building on the strengths of superior central tax administration and on the broader central tax base, accompanied by tax devolution or a system of surcharges, appears to have been unacceptable in a political environment where localities wanted to shed any semblance of central control.

Localities can levy any or all of these taxes. For 1991, the transitional year between the old system and the new, the old local taxes remained in place—at centrally mandated rates. (These taxes are described below in the discussion of other revenues.) It was expected that by end-1991, when the preexisting taxes expired, localities would establish tax rates (within the centrally mandated ceiling) for the new taxes under their new revenue authority (Sivak 1992). This was optimistic: local governments proved reluctant to introduce new local own-source taxes.

In 1991 local taxes provided only 2.4 percent of local budget revenues, the same share as the preexisting taxes in municipal budgets. In 1992 the share of local taxes in local budgets (total revenues, including grants and shared taxes) was only 3.3 percent, and in 1993 this share
increased to only 3.9 percent (see table 2.3). About half the local governments have levied at least one of the new local own-source taxes, with most revenue gained from business tax (70 percent in 1992). The property tax on buildings provided 12 percent of local own-source tax revenue, and communal taxes 8 percent, in 1992. By mid-1992, 1,233 local governments had introduced some local own-source taxes, most frequently in localities with population between 5,000 and 50,000. As might be expected, the yield from business tax is highest in bigger cities (75 percent of it is collected in cities with population of more than 50,000). By contrast, per capita local own-source tax revenues—excluding the business tax and the communal tax on entrepreneurs—are higher in smaller municipalities. Local own-source tax revenues in 1992 were considerably less than projected by the Ministry of Finance (table 2.5), but by 1993 they had exceeded the projections.

The choice of tax, additional exemptions, and rates (subject to a ceiling) is left to localities, subject to three conditions. First, two taxes may not be levied on the same object. This is interpreted in various ways by local government, but appears to mean that the same base cannot be taxed twice: a vacation home, for example, might be taxed under the property tax, the tourist tax, or the communal tax—but not more than one of them. Second, preexisting, centrally mandated preferences and exemptions must be respected. Third, locally set rates cannot exceed the centrally mandated maximums set in the Act on Local Taxes. All local taxes are treated as deductions from both the personal and corporate income tax base.

In implementing these new taxes, local governments had to grapple with several issues. Hungary’s tax burden at the national level was among the highest in Europe, and localities were loath to overburden residents with new taxes—citing rent arrears as evidence of low capacity

<table>
<thead>
<tr>
<th>Table 2.5 Local tax yields, Hungary, 1992 and 1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>(millions of forints)</td>
</tr>
<tr>
<td>1992</td>
</tr>
<tr>
<td>Estimate</td>
</tr>
<tr>
<td>Buildings</td>
</tr>
<tr>
<td>Land</td>
</tr>
<tr>
<td>Communal tax on social flats</td>
</tr>
<tr>
<td>Tourism tax</td>
</tr>
<tr>
<td>Business tax</td>
</tr>
<tr>
<td>Other taxes</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>Memo item</td>
</tr>
<tr>
<td>Average exchange rate (Ft/$)</td>
</tr>
</tbody>
</table>

— Not available.
Source: Ministry of Finance, Department of Local Finance, Government of Hungary.
to pay. There was also concern that higher local taxes might increase the demand for social assistance. Administration and collection were also issues, with many localities favoring the exemption of small business. Local governments had little time—or administrative capacity—to set up effective tax systems. Nonetheless, the extent to which the localities have exploited their new freedom and tax discretion remains disappointing. Initiatives thus far have been too limited, almost as though localities were still in the command economy mode, waiting for direction from the top and for implementation to be initiated, and decisions made, on their behalf.

_Duties, fees, and preexisting taxes_

In addition to the taxes defined under the Act on Local Taxes, localities continue to levy a range of other centrally regulated taxes, fees, licenses, duties, and penalties. In 1992 Ft 9.3 billion were collected from these levies. Fees on inheritances, property transfers, and gifts range from 5 to 10 percent of the value of the transfer, with land transfers paying a reduced rate of 2 percent. The county and the local government share these fees, which are one of the few independent sources of county government revenue.

Fees are also paid for the use of public facilities (books, meals, dormitory rents, library fees, after-school daycare). Set by the central government, these fees typically do not cover service costs.

_Shared taxes_

In the preparation of the Act on Local Taxes, consideration was given to sharing a number of central taxes with localities. Because of the unequal spatial distribution of revenues from the value added tax, sales taxes, and enterprise income tax, it was decided that the personal income tax would be the basic shared tax. In 1990 localities received 100 percent of the personal income tax collected two years before. These revenues were allocated to the place of residence of the taxpayer—in other words, on a derivation, or origin, basis. The tax is paid to localities with a two-year delay because the central tax administration takes this long to sort returns according to the location of the taxpayer's residence (which may differ from the taxpayer's workplace or tax office location).

Local governments derived some 12 percent of their total revenues in 1991–92 from their share of the personal income tax, the major shared revenue for localities. In 1991 the allocation formula was changed; while local governments still received 100 percent of the personal income tax, 50 percent was allocated on the basis of derivation, and the remaining 50 percent was added to the amount available to all localities under the
normative grant. Starting in 1993 local government’s derivation-based share was decreased to 30 percent, such that the personal income tax contributed only 8.4 percent of local revenues (see table 2.3). For 1995 the share is increased to 35 percent. These determinations are made in the context of the annual Budget Act.

Since there was unequal regional distribution of personal income tax revenues (some localities—for example, where there is a concentration of pensioners or low-income taxpayers—would have received none), the 1993 Budget Act also guaranteed that smaller localities would each receive a minimum per capita grant (which was larger in towns than in villages) financed from central government revenues. While this additional grant totaled only 1.5 percent of the normative grant allocated in 1991, 89 percent of localities—most with fewer than 2,000 inhabitants—received this equalization supplement.

Another shared tax, the vehicle tax, was introduced in 1992. Motor vehicles—except those owned by public institutions or nonprofit organizations and used for public transportation or communal services—are taxed according to their weight. Local governments are the taxing authorities, but tax proceeds are shared equally with the central budget. With the vehicle tax only 0.5 percent of local revenues and the administration rather costly, this is not a cheap revenue source for localities.

**Grants**

Localities receive six types of grants from the central government. The first and most important is the *normative grant*, which is unconditional and broadly intended to redress the imbalance in the fiscal system. The second, introduced in 1991, consists of *targeted grants* for investment in a prespecified list of investment activities. The third type are the *addressed grants* for completion of specific unfinished investment projects, many of which were started under the previous regime. The second and third types of grants, approved annually by Parliament, replaced similar grants channeled through and administered by the former county councils (discussed later in connection with investment finance). The fourth type of grants are centralized appropriations for specific purposes (theaters, public transportation in Budapest, and so on). Fifth are grants for distressed areas. And sixth is the personal income tax equalizing grant (described above), as well as such special payments as compensation for centrally mandated salary increases.

*Normative grants.* Since 1990 the center has given local governments a normative grant, the localities’ single most important source of funds (see table 2.3). The grant, which is used for operations and maintenance
expenditures, is fully unconditional, in accord with the autonomy granted to local governments in spending and economic management. Although its allocation across localities is based on a complex formula that incorporates twenty-four needs-based measures, in keeping with mandated local expenditure categories (called norms), and two per capita-based measures, there are no requirements on how localities actually allocate their funds within these categories. The per capita measures allow for some horizontal equalization. The grant is paid in twelve equal monthly installments.

Neither the magnitude of the normative grant nor its allocation is set forth in the Law on Local Self-Government, which prescribes only that a grant must be given and that a formula, rather than discretion, be used for allocating grant funds. In this respect the normative grant is an important improvement over the previous system of bargaining. It is also distinguished from the former system in that localities now see the transfer as a right, not a subsidy.

The Budget Act fixes the amount of the normative grant each year, following certain principles. Aggregate local spending is first estimated. Then the estimated revenues accruing to all localities from their own and other sources are subtracted to generate a measure of the fiscal gap. That is, personal income tax share, local own-source tax collections (as estimated by the Ministry of Finance), targeted grants, addressed grants, social security funds, and revenue from fees, duties, and other centrally regulated revenue sources are deducted from estimated local spending. This generates a measure of the resources needed for the local sector as a whole.

In a second stage the allocation of the aggregate transfer across localities is determined. For example, the norms, or estimated expenditure needs of the localities, are adjusted to account for such factors as inflation. Expenditure norms were adjusted by 16 percent in 1991 and 18 percent in 1992. Although norms are thus intended to be set in real terms, both the per capita transfer and the norms may be readjusted to stay within the state's budget. There was no adjustment for inflation in 1994, and the norms were left at 1993 levels despite significant inflation during 1993.

A change in design made the 1991 normative grant almost double in nominal terms over 1990, while recorded inflation was 35 percent. However, the localities' direct personal income tax share was reduced by 50 percent, so local nominal revenues from the grant and personal income tax together increased by only 32 percent (see table 2.3). In 1992 the normative grant was increased by 19 percent, while the official inflation rate was 23 percent. There is thus no guarantee that either the normative grant or total local revenues are maintained in real terms.

Under the Law on Local Self-Government, the normative transfer and its amount have been subject to ongoing modification. In 1990, with
localities receiving 100 percent of the 1988 personal income tax (PIT) (equal to 58 percent of the 1990 PIT), better-off localities (whose tax base was largest) benefited since the PIT was distributed largely on the basis of residence. In 1991, 50 percent of the 1989 PIT was added to the normative grant transfer pool. Simultaneously, the norms governing its allocation increased from twelve to twenty-two—to include, for example, kindergartens, primary schools, and $1.20 per capita to support theaters. In effect, the proportion of total funds allocated by residence fell and the share distributed for expenditure needs rose.

Since 1991, apart from small changes, the factors used in the grant formula have been much the same (table 2.6). Four norms were added in 1993, driven by the need to accommodate political interests. There are major philosophical differences between local and central government about the functions of the norms. Localities take the view that all mandatory local expenditure functions defined in the self-government law should be supported by either central grants or delegated revenue capacity (such as the personal income tax). The center takes the view that it should not be financing all locally assigned expenditures—and that localities would have adequate financing if they fully used the own-source tax powers available to them. The truth lies somewhere in between. Own-source revenues are far from adequate to finance local functions—somewhere 15 to 20 percent of GDP. But localities have not fully exploited the revenue sources they have been given.

The norm-based grant looks very complex at first glance, but it has just two basic elements. The first are population-based weights consisting of lump-sum transfers to each locality plus a component based on the number of inhabitants and the population in defined age cohorts. Intended to provide a financial basis for small towns and some degree of equalization, this element accounts for about 40 percent of the total normative grant. The second element consists of "expenditure-related" norms relating to localities' expenditures on their main areas of responsibility, such as primary schools, care for the old, and care for the handicapped. Thus, localities will receive Ft 27,500 for each child enrolled in a municipally run kindergarten, Ft 70,000 for each mentally handicapped student, and so on (see table 2.6). Allocations were initially made only for local governments that provided such schooling or care.

These norms, despite their apparent precision, are based neither on actual expenditures nor on actual costs, however, and the proportion of actual outlays they cover differs widely by sector and locality. These normative expenditure-related weights cover about 60 percent of the nationwide average cost of providing the services, with wide variations from service to service and place to place. In 1991 the per student grant
Table 2.6 Normative grant allocation criteria, Hungary, 1991 and 1993

<table>
<thead>
<tr>
<th>Expenditure norm</th>
<th>1991</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total allocation (millions of forints)</td>
<td>Share of total grant expenditure (percent)</td>
</tr>
<tr>
<td>Lump-sum grant to village municipalities</td>
<td>5,804</td>
<td>3.97</td>
</tr>
<tr>
<td>Lump-sum grant</td>
<td>21,095</td>
<td>14.41</td>
</tr>
<tr>
<td>Matching grant per forint of tourist tax collected</td>
<td>2</td>
<td>0.53</td>
</tr>
<tr>
<td>Housing subsidies</td>
<td>14,776</td>
<td>10.10</td>
</tr>
<tr>
<td>Subsidy for economically inactive citizens§</td>
<td>13,822</td>
<td>9.44</td>
</tr>
<tr>
<td>Underdeveloped municipalities§</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Social tasks§</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Institutional child care</td>
<td>6,042</td>
<td>4.13</td>
</tr>
<tr>
<td>Homes for the elderly</td>
<td>5,786</td>
<td>3.95</td>
</tr>
<tr>
<td>Daycare for the elderly and the handicapped</td>
<td>1,188</td>
<td>0.81</td>
</tr>
<tr>
<td>Other homes for the elderly and the handicapped</td>
<td>110</td>
<td>0.08</td>
</tr>
<tr>
<td>Accommodations for the homeless§</td>
<td>n.a.</td>
<td>n.a.</td>
</tr>
<tr>
<td>Institutional care for young handicapped and retarded children</td>
<td>1,468</td>
<td>1.00</td>
</tr>
<tr>
<td>Kindergarten (owned by municipalities)</td>
<td>5,662</td>
<td>3.87</td>
</tr>
<tr>
<td>Kindergarten for nationalities and minorities</td>
<td>70</td>
<td>0.05</td>
</tr>
<tr>
<td>Category</td>
<td>Per Student 1991</td>
<td>Per Student 1993</td>
</tr>
<tr>
<td>-------------------------------------------------------------------------</td>
<td>------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>Elementary and primary schools</td>
<td>30,000</td>
<td>33,938</td>
</tr>
<tr>
<td>Elementary music schools</td>
<td>19,000</td>
<td>1,383</td>
</tr>
<tr>
<td>Mentally handicapped at elementary schools</td>
<td>56,000</td>
<td>1,729</td>
</tr>
<tr>
<td>Secondary schools</td>
<td>44,000</td>
<td>5,471</td>
</tr>
<tr>
<td>Vocational secondary schools</td>
<td>54,000</td>
<td>10,895</td>
</tr>
<tr>
<td>Skilled-worker training schools</td>
<td>33,000</td>
<td>6,879</td>
</tr>
<tr>
<td>Elementary music schools</td>
<td>19,000</td>
<td>1,383</td>
</tr>
<tr>
<td>Mentally handicapped at elementary schools</td>
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<td>10,895</td>
</tr>
<tr>
<td>Skilled-worker training schools</td>
<td>33,000</td>
<td>6,879</td>
</tr>
<tr>
<td>Workshops for apprentices and students at training schools</td>
<td>36,000</td>
<td>1,286</td>
</tr>
<tr>
<td>National, ethnic, and bilingual education</td>
<td>14,000</td>
<td>676</td>
</tr>
<tr>
<td>Residents of dormitories and hostels</td>
<td>53,000</td>
<td>4,556</td>
</tr>
<tr>
<td>(elementary and secondary schools)</td>
<td>100</td>
<td>1,060</td>
</tr>
<tr>
<td>Local culture and public education</td>
<td>50</td>
<td>527</td>
</tr>
<tr>
<td>Sports activities</td>
<td>450 per viewer</td>
<td>n.a.</td>
</tr>
<tr>
<td>Maintenance of theaters</td>
<td>894</td>
<td>0.61</td>
</tr>
<tr>
<td>Lump-sum grant for counties for education and other activities at regional level</td>
<td>50 million per county</td>
<td>1,000</td>
</tr>
<tr>
<td>Total</td>
<td>146,360</td>
<td>100.00</td>
</tr>
</tbody>
</table>

n.a.: Not applicable.

Note: The average exchange rate in 1991 was Ft 74.7 = US$1; the average exchange rate in 1993 was Ft 91.9 = US$1.

a. Applies to municipalities with population of more than 200. For towns with fewer than 200 residents, grant is 10,000 per capita.
b. For population younger than 17 and older than 60.
for secondary schools covered some 90 percent of service provision costs, that for primary schools, less than 50 percent, and that for old age homes, more than full cost. The reason for the differentiation allegedly relates to some presumptions made by the center about local priorities in service provision. For services provided largely to nonresidents or for services that might otherwise get low priority (such as care for the handicapped), coverage is fuller.

The norms themselves do not distinguish between small and large jurisdictions, yet there appear to be differences in service provision costs between larger towns and villages. Generally speaking, the norms cover a smaller fraction of costs in cities, such as Budapest, on the grounds that their resource mobilization capacity is greater. Future reforms are intended that will establish these costs more accurately and adjust the normative elements more by type and size of locality—despite the unconditionality of the grant—to improve the perception of equity and transparency.

Grants for distressed localities. Beginning in 1991 the budget also allocated Ft 5 billion for localities that, through no fault of their own, cannot achieve basic budgetary balance. The beneficiaries include localities whose population structure (pensioners, the unemployed) implies a limited tax base or personal income tax share. These funds, intended to meet only recurrent budgetary shortfalls, are for municipalities that cannot meet even minimal maintenance and expenditure needs. Funds cannot be used for investments or infrastructure, and localities whose budgets include investment expenditures are not eligible. The maximum allowed each locality was Ft 150,000 (population less than 1,000) or Ft 200,000 (population more than 1,000). Of 480 applications, 184 were accepted, providing 1.4 percent of local revenues.

In the 1992 budget only Ft 2.7 billion went to distressed localities, with Ft 500 million set aside as a reserve for catastrophes or unexpected events. The balance was allocated by government decree (not by Parliament), with most going to small localities (population less than 1,000) on a per capita basis. The same principle was followed in 1993, although the grant volume was reduced. Localities with a recurrent budget deficit are eligible for this grant, but they must undergo a detailed approval process. Parallel to the decrease in this grant, an extrabudgetary Fund for Regional Development was established.

Other grants. Finally, a large number of central budgetary payments—seventeen in 1993—go to localities as centralized appropriations for such items as social assistance, subsidies for public transportation in the capital, and allowances for central heating. These grants are almost entirely discretionary.
Local revenues: Issues and options

The basic principles of local revenue assignment apply in Hungary, as elsewhere. First, local revenues should be collected from local residents, preferably in relation to the perceived benefits from local services. Of course, to the extent that nonresidents receive benefits, taxes on nonresidents may be justified. Second, where transfers are needed to finance expenditures, they should allow for some equalization and be used to encourage local governments to provide services with regional spillovers, but they should not be so generous as to discourage local revenue mobilization. From both these perspectives, reforms of Hungary’s system seem warranted.

Reforming local own-source taxes

The new own-source taxes assigned to local governments in Hungary are not correctly aligned to benefits and suffer from other design problems. Much the same can be said for local revenue from user charges and the old duties (to the extent they continue under the new system).

The property tax is desirable and has significant revenue potential, but only in the longer run. The only information many local governments (Nyiregyháza City is an exception) have as a base for such taxes is square meters of area. Information on assessed value is rare although market transactions are becoming more common. The centrally mandated exemptions specified in the law (and carried over from the old system) ensure that not much revenue is likely from this source for several years. Moreover, the property tax rate differential established in the law between vacant and built-up property is questionable, and local governments are not given any freedom to set their own tax rate on residential property, which is essential to make this tax a mainstay of responsible local finance. (The ability of local governments to tax business property should be restricted to restrain tax exporting—that is, shifting the tax burden to those outside the community.) Some recasting of the national framework for local property taxes is needed—and assistance in developing an adequate valuation base for such taxes must be provided—if the property tax is to become an important part of local finance (Kelly 1994).

The primary new local tax with revenue potential is the tax on business turnover. One possible justification for such a tax is to charge enterprises for the use of local infrastructure, although user fees that recover costs and the property tax, which taxes immobile buildings and land, are in principle more desirable ways of achieving this. Moreover, with the explicit exclusion of retail sales from the base, this
tax encourages tax exporting and local manipulation of the tax system. Tax exporting (unless it matches benefit exporting) is the antithesis of rational local finance. However, until other sources of revenue can be tapped the business tax will be a necessary source of local finance. If it is to be retained, however, certain distortionary effects should be remedied. For example, although the tax is designed to fall on net turnover, banks and insurance companies are taxed on gross turnover and thus are taxed more heavily than other commercial enterprises.

The high proportion of social housing in Hungary—a proportion that will decline slowly—may justify levying a local communal tax on public housing tenants. If social assistance and general income support are provided primarily through national channels, the communal tax on social flats is consistent with the distributive rationale for local governments not to misprice their services. But the communal tax will probably prove more difficult to administer in Hungary's increasingly mobile society than seems generally to be realized. And such a tax, never likely to yield much revenue, will play, at most, a minor role in local finance. As for the property tax, local governments should be given more leeway in specifying the rates.

With respect to the tourist tax, in principle tourists should be taxed to the extent that they receive benefits from local services. Tourist establishments (including second homes and cottages) should be subject to general local business and property taxes. In certain circumstances a special tax on tourists might even be justified (Bird 1992a), but it seems unlikely that most Hungarian villages fit such circumstances. There is no reason, however, to encourage an inordinate expansion of the tourist tax—to a degree that tourists bear a tax burden that outweighs the benefits received—by making it especially attractive (as is currently done through the bonus feature in the normative grant; see table 2.6), for local governments to impose taxes on nonresidents.

Opportunity for greater own-source revenue of Hungarian local governments lies in the systematic exploitation of the potential for local user charges and the development of an adequate base for local property taxation, perhaps combined with a more adequate local vehicle tax. For the immediate future, limited local access to business taxation may prove necessary—until the property tax system is adequately developed. The low-rate business tax needs to be reformed to cover retail sales and must be designed to treat all activities more uniformly.

Since it is unlikely that even the richest local governments can be expected to finance most of their expenditures from local sources, local governments will continue to need access to one or more of the national tax bases—such as the value added tax or the personal income tax—either through revenue shares, surcharges, or the transfer system.
Reforming the transfer system

Transfers, in many ways the heart of subnational finance, are intrinsically neither good nor bad. What matters are their policy outcomes—for allocative efficiency, distributational equity, and macroeconomic stability. Intergovernmental fiscal transfers have several purposes in countries with decentralized governmental structures. First, such transfers close the fiscal gap between levels of government—helping countries achieve vertical fiscal balance and ensuring that the revenues and expenditures of each government level are about equal. Second, transfers achieve horizontal fiscal balance (equalization) among local governments. Third, transfers can be designed, if desired, to stimulate local fiscal effort—or at least not to discourage it. Finally, transfers can influence local spending decisions in accord with central preferences—for example, encouraging local governments to choose an efficient level of public services, where there are benefit spillovers. From these perspectives, several changes seem desirable in the current structure of Hungary’s central-local fiscal transfers.

The normative grant has three important characteristics. The grant is unconditional—local governments can spend the money however they see fit. The total amount distributed to all local governments is entirely discretionary, set in the annual budget exercises. And the distribution formula contains both per capita- and needs-based components.

Because the central government and taxpayers in general have a legitimate interest in what is done with grants to local governments, and the nation as a whole has a concern for ensuring that services such as education and health are available throughout the country at minimum standards, there is a case for limited conditionality of normative grants. For instance, there could be requirements for spending grant funds on education or health—or for local governments receiving grants to provide services of a specified level and quality. But since local governments can alter other expenditures and taxes, requiring a grant to be spent on a particular activity does not necessarily imply an increase in spending on that activity—resources are fungible. Still, there is considerable evidence that conditionality is likely to increase the amount spent on designated services (Bahl and Linn 1992). In Hungary, to the extent the normative grant is allocated by indicators related to social problems (such as the number of registered unemployed), it appears widely approved that the grant be used for social expenditures. But there is no legal requirement to this effect. In the current political environment where local autonomy remains a sensitive issue it is probably too soon to make grants conditional. Still, the national government should make a reasonable effort to improve local financial reporting—for example, making the provision of financial reports a condition for receiving...
grants—and to improve the information base on the provision of local public services. In the longer run, performance-based grants would seem appropriate.

The size of the normative grant also requires consideration. It is entirely determined by the national government, which sets the transfer each year in the national budget. Because it is based on need, and less an estimate of local revenues, it has the appearance of a gap-filling transfer. This feature reduces the accountability of local governments and should be eliminated. Many countries use a nondiscretionary mechanism that fixes the size of the grant transparently. Such a system has substantial advantages for central and local budgeting. Since the amount of local transfer is predetermined, the central government is insulated from pressure to increase its support of local governments. And rather than be at the mercy of discretionary central policy, local governments can budget with greater certainty if they know that the level of central support will vary with, say, income tax or value added tax collections, which can be more easily predicted.

Regardless of how the volume of the normative grant is set, its distribution formula should be altered. There now are two main elements in Hungary’s formula: equalization (the per capita norms) and expenditure needs. A third essential element in a general grant formula is explicit allowance for the revenue-raising capacity of local governments. To incorporate these three elements, the basic formula for Hungary’s normative grant should be some version of \( G_i = eE_i - tR_i \), where \( G \) is the amount of the grant, \( i \) refers to a particular municipality, \( E \) is some measure of expenditure need (for example, the current normative grant formula, or need defined in relation to population, or another indicator that seems appropriate and can be satisfactorily measured), \( e \) is an assumed expenditure level for each unit of measured need, \( R \) is a measure of revenue capacity, and \( t \) is the rate at which this capacity is assumed to be tapped (or taxed) on average, across the nation.

The critical elements in this formula in Hungary are its simplification and the measurement of tax capacity. The simplification involves changing the current \( eE \), now allocated by twenty-four norms as proxies for needs. The broader study that was the basis for this chapter identified and explored several ways of simplifying the grant (Bird and Wallich 1992). The relationship between grant distribution and Hungary’s demographic indicators (closely related to some of the existing norms) was explored using regression analysis. The regressions indicated that the normative grant’s current distribution across localities, presently based on twenty-four norms, could be approximated with a simplified formula based on only three variables: total population, the age cohort under 18, and the age cohort over 60 (see annex 2.1 at the end of this chapter).
The tax capacity element \( tR \) in this formula will shift grant funds from high-tax capacity to low-tax capacity localities. As shown later, it will also stimulate all localities, regardless of their estimated tax capacity, to tax their capacity at the assumed rate—if they do not, their revenues will be reduced by the amount they fall below the assumed rate. If a locality chooses to levy higher taxes than those assumed in the grant formula, it can keep the extra revenue.

Calculations of tax capacity, difficult in any circumstances, are particularly difficult in Hungary today and it is hard to say the extent to which localities exploit their tax capacity. Estimating revenues collected in relation to tax bases is one approach. Among the tax indicators one might examine—as data become available—are collections from the new duties, from the shared personal income tax, the property tax, and the business turnover tax. In the absence of data on the tax base, alternative estimates of local revenue capacity based on instrumental variables and regression analysis could be explored. The broader study that is the basis for this chapter used population, and industrial employment and personal income tax transfers (as a proxy for income levels), as independent explanatory variables proxying the tax base. Local tax revenues levied in 1989 were used as a proxy for taxes under the new tax regime and served as the dependent variable. These estimates of tax capacity indicated that smaller localities are exploiting (what small) capacity they have, while larger municipalities’ taxes are below capacity (Bird and Wallich 1992; see also annex 2.1). Analysis based on more recent and complete data is needed to draw firm conclusions on these matters and will become more important as the revenue sources assigned to the local level increase in scope.

**Three options for reforming local government finance**

Three options for reforming local finance were simulated to explore different dimensions of the redesign of Hungary’s grant and local tax system. Each reform option meets the fundamental reform objective of improving local own-source taxes, simplifying the normative grant, and introducing a tax capacity measure into the grant. What differentiates them is treatment of the personal income tax (PIT) transfer. Option 1 reforms local own-source taxes and modifies the normative grant to incorporate some measure of tax capacity, leaving the PIT transfer as is. Option 2 distributes all of the PIT transfer by the same formula as the normative grant. Option 3 adds, instead, a proposal to make the PIT a truly local tax by converting it into a surcharge instead of a shared tax (for a discussion of the simulation technique employed, see annex 2.1).
**Option 1.** Option 1 incorporates a tax capacity estimate into the present grant formula, providing implicit stimulus to fiscal effort. Using a tax capacity measure (based on local PIT collection, population, and industrial employment) to proxy the tax base, and a simplified grant formula (needs indicators based on total population and the age cohorts specified earlier), the grant distribution simulated under option 1 would favor small and medium-size localities with up to 10,000 inhabitants (table 2.7 and annex 2.1). They would gain because the simplified grant emphasizes per capita needs indicators, and because the limited tax capacity of smaller localities results in a higher grant. Grants to municipalities with more than 10,000 inhabitants would fall because their estimated tax capacity is greater. The broad outcome: slightly more equalization than under the present system.

In another alternative, the transfer norms (eE) could also be simplified or made more transparent and better tailored to localities' different cost structures. There is some ambiguity over just how weights in the grant should be calculated and chosen—that is, the relative expenditure and per capita-related weights and the extent to which the cost of specified services should be covered. One possibility might be to cover, as closely as possible, the local cost of providing each designated service. Since no data were available on these cost structures, no estimates were made for this approach to redesigning the grant system.

**Option 2.** Another approach would be to modify the existing shared tax-cum-transfer system by allocating both transfers and shared taxes to local governments on a formula basis. Option 2 simulates the effects of adding the share of the PIT distributed on a derivation basis (35 percent in 1995) to the total normative transfer and then distributing the combined total by the simplified needs-cum-tax capacity formula in

<table>
<thead>
<tr>
<th>City size</th>
<th>Option 1</th>
<th>Option 2b</th>
<th>Option 3c</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2,000</td>
<td>-0.3</td>
<td>8.9</td>
<td>-4.5</td>
</tr>
<tr>
<td>2,000–4,999</td>
<td>14.7</td>
<td>27.4</td>
<td>12.6</td>
</tr>
<tr>
<td>5,000–9,999</td>
<td>7.7</td>
<td>15.3</td>
<td>5.2</td>
</tr>
<tr>
<td>10,000–49,999</td>
<td>-11.3</td>
<td>-10.2</td>
<td>-12.8</td>
</tr>
<tr>
<td>50,000–99,999</td>
<td>-20.0</td>
<td>-20.4</td>
<td>-17.3</td>
</tr>
<tr>
<td>More than 100,000</td>
<td>-15.0</td>
<td>-29.6</td>
<td>-11.9</td>
</tr>
</tbody>
</table>

*Note:* Personal income tax (PIT) plus simplified grant plus equalizing grant, less representative tax capacity.

*Option 2b:* Simplified grant applied to full revenue transfer, less representative tax capacity.

*Option 3c:* PIT surcharge plus simplified grant applied to all transfers, less representative tax capacity.

Source: Authors’ simulations (see annex 2.1)
option 1. In this case the entire transfer is made via the simplified formula less revenue capacity. Conceptually, the size of the transfer in this formula (together with conditional matching grants) determines how much the fiscal gap is closed. The formula then determines how horizontally equalizing the transfer is with respect to expenditure needs and fiscal capacities. Simulations of this approach show that it provides greater equalization than the current system or than option 1 (see table 2.7 and annex 2.1). Grant distribution favors cities with populations of less than 10,000, while cities with populations of more than 100,000 lose grant money. This is not surprising, since by definition derivation-based sharing of PIT benefits better-off areas where more PIT is collected. Allocating it instead on the basis of the formula would favor more equalization.

Option 3. This option assumes the same simplified normative transfer and tax capacity measure; in addition, local governments are assumed to impose their own PIT—via a surcharge on the national PIT. This option thus remedies the inadequacy of the local own-source tax base by supplementing it with a local share of the PIT, but provides this share in a form that encourages local fiscal responsibility and effort. Surcharges on taxes such as the value added tax or corporate income tax are also possible in theory, but would be undesirable on administrative efficiency and equity grounds. Surcharging the PIT, as outlined in chapter 1, is preferred because a tax imposed on local residents is more suitable for local finance than either a corporate income tax or a value added tax whose incidence is not likely to be local. Furthermore, pragmatically, localities already share the PIT in Hungary but in a way that contributes neither to accountability nor to efficiency. Finally, the PIT surcharge would provide localities with a more stable tax base (wage income) and is relatively simple to administer in the Hungarian case.3

This option deserves attention because it could lower income taxes in Hungary without hurting the budget deficit and induce more efficient local expenditure. But the advantages are not costless. The approach might make administering the national tax system more difficult. It would also require an amendment of the Law on Local Self-Government, which might not be politically popular. Furthermore, income tax payers could move from high to low tax jurisdictions if the dispersion of surtax rates among neighboring towns became too wide. This efficiency cost needs to be weighed against the advantages of local accountability. Moreover, to make this approach possible in a high income tax economy such as Hungary, the central government would first have to create some "tax room" by modestly reducing its own PIT rates. Local governments could then avail themselves of this room if
their expenditure requirements warranted it—and if local voters valued the expenditures enough to pay the taxes.

To show how option 3 mimics the current PIT transfer we ignore, for the sake of simplicity, the two-year lag in the distribution of local tax revenues (and the equalizing PIT transfer). First, the central government would lower PIT rates by, say, 30 percent. (The reduction in the national income tax could be less, or more, than 30 percent; the remaining 70 percent could still flow to local governments, as at present, through the normative grant.) Local government could then levy a surcharge of 42.86 percent on national taxes \(0.3/0.7\), collecting their 30 percent PIT share through the surcharge rather than through a transfer. The surcharge would be collected by the national government and remitted to the localities, and the national/local tax burden would be unchanged. (The two-year lag in the distribution of PIT revenue to localities means that the loss of central budget revenue from a 30 percent income tax cut would exceed the gain from eliminating the PIT transfer. To make the proposal budget-neutral, the local surcharge would have to equal the amount of the PIT transfer plus the equalizing grant.)

In this example, the same normative grant and PIT transfer is paid by the national government to local governments in aggregate, and the same PIT transfer and normative grant is received by each local government. In the formula set out earlier, \(eE\), would be the current normative grant received by each locality plus the PIT revenues that would accrue to that locality if it applied a surcharge equal to 42.86 percent of the national PIT (again ignoring the two-year lag and the equalizing PIT).

Although the results may look the same, the effects would be quite different. First, the local share of the PIT would now be a truly local tax. Localities would choose the rates they impose. If they levy lower taxes than assumed in the grant formula the result would be both lower total taxes and lower expenditures, since the total revenue amount (grant, PIT surcharge, and other revenues) at their disposal would be lowered by the amount they do not collect. There is thus incentive for localities to levy taxes at least as high as the tax rate assumed by the grant formula—in the example above, the taxes forgone by the national government. But since these taxes now have to be justified directly to their voters, there should be incentive to spend this money efficiently.

If a locality decided to increase taxes above the current local PIT share, it would be able to increase its spending accordingly, since there is no reduction in the central normative grant as a result of additional tax effort. Again, however, there would be considerable incentive to ensure that additional funds are spent to the satisfaction of the voters—an incentive missing in the current system. Such a check on local spending seems
especially desirable when central transfers are likely, for political reasons, to remain unconditional.

Option 3 thus gives localities access to a tax base that can finance more adequately the extensive range of services they are supposed to provide. It may even result in lower taxes. And it should increase the efficiency of local expenditures—whether taxes go up, down, or stay the same. These are major virtues. But it represents a major change and will require close consideration by authorities at all levels. And it is only a variant of the basic reforms needed in the present system—to strengthen local own-source taxes and simplify the normative grant.

If option 3 were to be pursued, the amount of the central tax rate reduction and the phasing in of the surcharge are important transitional issues. It might be appropriate for the center to impose a surcharge on behalf of localities for the first year or two, giving local communities time to decide the rate they want to set.

An additional transitional issue relates to the equalization implications of this option. Some local governments have no income tax base or have one so small that they would not gain much from a PIT surcharge. It might therefore be inequitable to let local governments that do have a large tax base exploit it. But the unequal distribution of local tax resources is precisely what the capacity element (\(t_R\)) in the proposed grant formula is designed to deal with. In poor localities revenue capacity may be close to zero: so they will get a larger normative grant. In the proposed system equalization could be more fully and fairly achieved through the revised grant formula.

Simulations indicate that allowing the PIT surcharge and allocating the equalization transfers through the revised grant formula, as in option 3, is slightly less equalizing than allocating it directly to poor localities, as in option 1. But the difference is negligible and could be offset by additional variants of the grant formula. The assumption of a zero surcharge—no locality imposes any surcharge—is essentially captured by option 2, in which the PIT transfer disappears. Not surprisingly, this variant is more equalizing than the present system, benefiting villages and small cities (populations less than 10,000) because of the added emphasis on per capita indicators and on revenue capacity.

Another attraction of option 3 for national authorities may be the explicit dependence of localities on the PIT—strengthening the case for strong national action to prevent the erosion (and evasion) of this tax base through such devices as nontaxable allowances. The national government should do this in its own interest; option 3 might give it more than 3,000 local allies in the political struggle to do so. These simulations are only exercises, and only indicative of broad directional effects. Data gaps and substantial additional work remain. The
three variants are only some of many that could be explored of the basic reform.

Pros and cons of a personal income tax surcharge

Combined with the basic reforms to local taxes and the transfer system suggested earlier, allowing local governments to impose income tax surcharges has four advantages. First, local governments—at least the richer ones—would have access to a broad tax base to finance more adequately from local resources the range of services they are supposed to provide. Second, although the revised grant formula would encourage local fiscal effort, the result might be lower income taxes. Third, whether taxes increase, decrease, or stay the same, the accountability of local governments and the efficiency of their expenditures should increase. Fourth, adjusting the parameters of the grant formula permits any degree of equalization and any level of total central-local transfers. While some of these advantages could be secured without allowing local governments direct access to the income tax, the objective of lowering overall taxes can be achieved only by these means.

One main argument against local income taxation is administrative. Other arguments can also be made—that it reduces national fiscal flexibility or induces inefficient fiscal competition or inefficient resource allocation. However, when the functions local governments carry out are essential, expenditures have to be financed. And the local income tax approach seems capable of freeing the national government from the responsibility of financing such services while leaving it free to alter its own tax system. The central government could reduce the national income tax and allow local governments some flexibility in setting their own income tax rates. Moreover, such taxes are the prices of local public services and have fewer adverse effects on resource allocation or on fiscal competition than the surtaxing or assignment of the value added tax or the corporate income tax (see chapter 1). On the contrary, some of their allocative effects may be considered desirable, as is the competition they induce in lower-cost provision of public services.

The ownership role of local governments

As a result of the Property Transfer Act, local governments own retail and commercial units, considerable vacant land, and most of the municipal housing stock. Localities also became shareholders in state-owned enterprises in proportion to the value of the land held by such enterprises. This portfolio may become an important revenue source for larger localities, but it is likely insignificant for most.
Revenues from ownership

Local governments receive income from the sale of state property and from rentals of flats owned by the locality. Rents in the past have been fixed by the central government, and rental property is typically managed by a local property management company, Ingatlan Kezelő Vallalat (IKV). Expenditures on maintenance and rental income are "extrabudgetary" and do not appear in the local budget. All rents accrue to the IKV and are earmarked for maintenance and other expenses (including property development and rehabilitation). A 1993 Housing Act allowed local governments to set rents in principle, but in practice rents remained frozen until June 1994.

Housing sales are administered by the IKV, which receives a fee for the service. Proceeds accrue to the local budget. Developmental and sales activities are viewed in some localities as a significant source of future income, while in others there is concern about maintenance costs and the possibility of low sale prices. Many housing sales are financed by local governments at highly subsidized interest rates, and local governments are obliged to sell apartments and units such as garages and shops to tenants (Hegedüs, Mark, and Pigey 1994).

Localities and their agencies also receive revenue from the rental or sale of commercial properties, from the sale of locally owned enterprises, and from the sale and rental of plots (table 2.8). Data were not available on proceeds from these sources. In broad terms, rents accrue to the IKV. Sales of small plots, small or communal enterprises, and commercial properties accrue directly to the municipal budget. And sales of major enterprises or commercial properties (significant privatizations) are managed by the national-level Property Agency, which shares the proceeds with the locality and uses its portion to reduce the national debt.

In addition to revenue from rentals and property sales, localities own commercial and industrial enterprises, from which they receive dividends or the proceeds from a sale or privatization. While privatization revenues are limited, localities have been optimistic about their ability to get more revenue from this source. Many localities have established joint ventures with a domestic or foreign partner, using local assets as the locality's equity share. In localities with extensive land holdings, land has been a preferred equity contribution. Localities have also seen potential in developing and servicing empty land to enhance its equity value. Tourism lodges, hunting parks, recreational facilities, and golf courses were examples in 1991. Localities that inherited important properties saw similar potential in developing these as contributions to joint ventures, with potato processing, bakeries, construction, and wood products among the range of such enterprises encountered.
Table 2.8 Local government assets: disposal, sale, and revenues, Hungary, 1992

<table>
<thead>
<tr>
<th>Asset</th>
<th>Administering body</th>
<th>Retention of proceeds</th>
<th>Budgetary status</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Residential housing</td>
<td>IKV</td>
<td>IKV</td>
<td>Off municipal budget</td>
<td>Rents controlled by central government. Local control over rents awaits passage of Housing Act.</td>
</tr>
<tr>
<td>Rentals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>City council or local assembly determines whether to sell</td>
<td>Locality; IKV obtains fees for handling sale</td>
<td>Sales proceeds on budget; IKV fees off budget</td>
<td>Sales prices confined to &quot;corrected&quot; value—25 percent of market value</td>
</tr>
<tr>
<td>Commercial property</td>
<td>IKV or a municipal service enterprise</td>
<td>IKV</td>
<td>Off municipal budget</td>
<td></td>
</tr>
<tr>
<td>Rentals</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales of less than 1,000 square meters</td>
<td>City council or local assembly decides whether to sell</td>
<td>Locality; IKV obtains fees for handling sale</td>
<td>Sales proceeds on budget; IKV fees off budget</td>
<td></td>
</tr>
<tr>
<td>Sales of more than 1,000 square meters</td>
<td>SPMA</td>
<td>Shared evenly by SPMA and locality</td>
<td>Local proceeds on budget; SPMA proceeds off budget</td>
<td></td>
</tr>
<tr>
<td>Enterprise</td>
<td>Locality</td>
<td>Locality</td>
<td>On budget</td>
<td>Includes utilities transport, garbage, parks, baths, and so on</td>
</tr>
<tr>
<td>Sales of communal enterprises</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales of noncommunal enterprises</td>
<td>SPMA</td>
<td>Shared evenly by SPMA and locality</td>
<td>Local proceeds on budget, SPMA proceeds off budget</td>
<td>Owned by locality as a result of 1940s nationalization</td>
</tr>
<tr>
<td>Sales of Budapest's district enterprises</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>More than 1,000 square meters</td>
<td>SPMA</td>
<td>SPMA</td>
<td>--</td>
<td>Under preprivatization program</td>
</tr>
<tr>
<td>Less than 1,000 square meters</td>
<td>Locality</td>
<td>Locality</td>
<td>--</td>
<td></td>
</tr>
<tr>
<td>Enterprise profits and dividends</td>
<td>Locality</td>
<td>18 percent dividend to locality</td>
<td>On budget</td>
<td>Under preprivatization program</td>
</tr>
<tr>
<td>Plots</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td></td>
</tr>
<tr>
<td>Rentals</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>Locality</td>
<td>Locality</td>
<td>On budget</td>
<td></td>
</tr>
</tbody>
</table>

IKV Ingatlan Kezelő Vállalat, a local property management company.
SPMA State Property Management Agency.
-- Not available.

Note: In Budapest sales proceeds and rental income may not apply as shown in this table, as there are frequently different arrangements.

a. In Budapest 40 percent of the proceeds of housing sales go to the Budapest Housing Development Fund and 60 percent go to the districts.

Entrepreneurial local governments

In contrast to taxation, which was viewed as having low revenue potential, local governments appear to see entrepreneurial activity as generating stable dividends for the budget and providing the locality with access to technology and to export markets and foreign contacts. Localities apparently felt direct involvement in such ventures was necessary. Providing conditions in which local business might flourish—as a market-economy local government might do—was seen as insufficient for bringing private enterprise to their region.

There is danger that the exploitation of new property rights—driven by the pressure to activate idle property, and faced with the difficulties of selling property or businesses in the current environment—will lead to the emergence of businesses owned by local governments, which would limit both private competitors and the tax base. In market economies the rate of small business failure is high: reputedly only one in five such businesses survives its first three years. Localities in Hungary are unlikely to beat these odds. Pressures will arise to subsidize local business to maintain employment, and the role of the government in the economy will not have diminished. Moreover, entrepreneurial activity by localities is inconsistent with privatization. And it is a bottleneck to true decentralization. The sooner the risks of business activity are understood by localities, the better. An improved framework for local finance could provide a suitable occasion for moving toward this goal.

It may be distributionally attractive and economically efficient to raise revenues from privatization instead of taxes. In a high-tax economy, the distortion of additional taxes may be quite high. Obtaining revenue from appropriate nontax sources is thus both efficient and equitable (Newbery 1991). But such revenue must be appropriately used. Some localities are using proceeds from asset sales (buildings and land) to finance current operations. This approach is clearly unsustainable. Asset sales are viewed as an attractive substitute for—and are delaying the development of—local taxing capacity, while stripping localities of valuable properties. One argument against rapid sales is that many assets may have been financed with debt—some localities have substantial liabilities. In such cases, the proceeds should pay off this debt.

The proportion of local revenues from asset sales increased from 2.3 percent in 1991 to 3.3 percent in 1992, equal to the yield of local taxes. While asset sales yield revenues in the near term, they are not a permanent source of funds, and localities should develop the capacity to raise recurrent revenues. Asset sales could be used to finance new local investments, for example, thus changing the form of the locality’s assets (from housing to local amenities) but leaving the locality’s asset base unchanged.
Investment finance and local borrowing

The financing of local investment is not directly addressed in the Law on Local Self-Government. But local governments have access to several types of investment grants. They may also, in principle, borrow.

**Investment grants**

Two types of grants are in use to finance local investments: targeted grants and so-called specific grants, designed to finance uncompleted infrastructure projects initiated before the introduction of the Law on Local Self-Government. Targeted (matching) grants are available to localities undertaking investments consistent with central government priorities. Under the Law on Local Self-Government, localities have a right to grants for all investments meeting the criteria set forth in the Law. The matching requirement differs by sector and by type of local government, ranging from 30 percent to 90 percent. For urban water and sewerage systems, for example, the grant finances 30 percent of total expenditures. In small municipalities, 90 percent of such investments are financed.

Extrabudgetary funds also support development at the municipal level through grants and interest-free loans. Examples include the Water Fund, the Environment Protection Fund, and the Regional Development Fund.

Since 1993 the Act on Municipal Targeted and Addressed Grants has regulated the allocation of this grant. This Act specifies water, sewerage, education, health and social care, and culture for grants during 1993–95. There is a 10 percent premium for joint investments (to encourage municipal cooperation) and a 20 percent premium for localities with population below 1,000. In addition, there is a supplementary fund for localities with unemployment rates twice the national average if in a depressed area. In 1992 targeted grants were directed mainly to water, sewerage systems, and wastewater treatment plants (52 percent), education (28 percent), and health care equipment and homes for the elderly (18 percent).

Localities forward requests to the Ministry of the Interior, which eliminates those not conforming to the Act’s criteria. The 2,800 requests received in 1991 amounted to Ft 15.8 billion, of which Ft 8.5 billion met the criteria. The Ministry paid Ft 6.2 billion, consistent with the amounts allocated in the budget (1.7 percent of local revenues). A compromise was reached to fund eligible but unfunded investments in 1992. To avoid this problem after 1995, the unit costs of investments financed under targeted grants will be defined by the relevant national government departments.

Local governments are constrained in the activities that these grants finance. When the central budget is invoiced, the bank where the local government has its accounts (96 percent of the municipalities have their
accounts at the National Savings Bank) automatically withdraws the amount from the local government's account. Localities are not allowed to sell assets or modify the function of any building for ten years if financed by a specific grant. If they do, they must pay back the grant. This contrasts strikingly with the fully unconditional nature of the normative grant to finance recurrent expenditures.

Specific (addressed) grants were intended to finance investments initiated during the earlier regime. In 1992 most were allocated for investments in hospital reconstruction and health (74 percent). The rest went to water projects (13 percent) and to education and culture (12 percent). Since 1993 these grants have gone for purposes defined by the central ministries, which are responsible for requesting the funds. There is no local matching requirement, but funds must be spent on the intended investment. In 1993 a mere 21 of 366 applications for such grants were funded. Eligibility criteria are broadly defined to include projects that are large, of regional importance, and for a diverse population. The local council is accountable to the Ministry of the Interior for expenditures, and operations and maintenance are the responsibilities of the local government.

In principle, only the targeted investment grants are permanent features of the local finance system. They have economic and fiscal advantages in allocative efficiency (spillovers) and in the efficient use of scarce central government resources. Although making local governments more susceptible to central influence and control, targeted grants in principle have the political advantage of introducing local involvement, commitment, and accountability. Moreover, matching grants can contribute to equalization (horizontal fiscal balance). And like all other transfers, they can help resolve any basic fiscal mismatch (vertical fiscal balance) problem. But neither theory nor evidence provides clear guidelines to determine the appropriate matching rate for particular expenditure programs—let alone how these rates should vary with the characteristics of different local governments.

The central government could restructure the grant system to identify more closely both spillover and central-local priorities. The government may prefer to extend finance through loans rather than grants. Addressed grants—if not transitional—should be combined with the targeted grants program and subject to the same matching principles. The close control over investment grants designed to correspond to central, more than local, priorities is in striking contrast to the autonomy granted localities in their recurrent budgets. A case was made, earlier in the chapter, for some conditionality on the latter, to the extent they are financed by central transfers. The split between grants for investment and normative grants for current expenditure
Local borrowing

The Law on Local Self-Government grants localities unlimited borrowing authority, but bond issues and bank loans are the only financing sources now available. Short-term borrowing for liquidity management can be initiated by the local mayor, with financing from the local financial institution at market interest rates. Long-term borrowing to finance infrastructure, investments, and property improvements requires the approval of the local assembly. There are some subsidized loans, but the majority of funds are borrowed from banks and carry market interest rates and medium-term (five to eight year) maturities. The National Savings Bank accounts for 99 percent of lending to municipalities. Bonds are another potential source of funds. Five municipalities have issued bonds, guaranteed by the central government, to finance infrastructure investment in gas, telephone, water, and drainage systems. There are also proposals to establish a special Municipal Bank that would facilitate access to credit by municipalities, and some municipalities are considering the creation of regional banks.

In obtaining loans, localities are permitted under the self-government law to mortgage properties owned by them as collateral, with the exception of core properties, such as streets and public parks and areas. County guarantees of local borrowing—common in the past—remain legally possible but are not likely. Counties no longer have secure revenue sources, and their role as a guarantor has correspondingly been weakened.

The indebtedness of some localities is striking, stemming from local councils' borrowings for projects under earlier investment plans. (Under the earlier system, repayments due on any borrowings approved under the national credit plan would also be guaranteed.) This debt has become the responsibility of the new local governments, and for some it is a major burden.

Data on borrowing since the inception of the Law on Local Self-Government show an increase in municipal borrowing. In 1991 Ft 4.5 billion in credit was taken locally. In 1992 the total was Ft 7.5 billion—only 1.5 percent of total local budget revenues. In 1993 the share of borrowing rose to 4.0 percent. Although most localities are cautious in the use of the borrowing authority, it seems likely to increase.

Revenue system reform and the abolition of credit planning and central guarantees of local investment put municipalities in a new position. There are three causes for concern. First, their level of investment...
financing is low, reflecting in part a large backlog of unmet needs. Second, the revenue base that can be pledged for repayment is limited—only 4 percent of total revenues is from local taxes. And third, borrowing authority is unrestricted. The localities' unconstrained borrowing and scope for entrepreneurial activity may be a regrettable mix.

In most countries localities do borrow, albeit in restricted ways. These include bond finance (unusual in developing countries because of limited capital markets and the absence of long-term finance), borrowing from the commercial banking system, borrowing from a central government loan fund, and borrowing from a municipal development bank funded by the center. In most countries, the central government or its agency sets parameters for local access to credit—not least because it is generally undesirable from a macroeconomic point of view to increase overall public sector borrowing. The options and controls appropriate for Hungary require further study. Since Hungary's economic performance is likely to improve, the case can be made that intergenerational equity justifies deficit financing of public infrastructure.

If localities are given the ability to set user fees, the central government might consider replacing some investment grants with loans. User fees provide demand information for public services. This information is crucial for local governments allocating investment to the public sector. They are more likely to invest in projects for which the benefits exceed the costs if true prices are known. Hence, borrowing favors self-financing projects, which places responsibility for decisionmaking with the local government—where it belongs—and reduces the burden on the center and on taxpayers.

Charges for local public services

User fees and other charges for public services had a limited role in command economies—a tradition carried over to most transition economies, including Hungary. Under the former social structure wages were low, but housing and other services were either free or below cost. Today local governments must review housing rents, transport fees, water and sewer charges, and other prices for the services they provide.

There appear to be user charges for municipal services in some localities—connection charges for water, gas, and sewerage were encountered. Fiscal pressures are increasingly inducing local governments in Hungary (as in nearly all market economies) to impose such charges. In 1994 the authority to set water tariffs was delegated to local governments, although it is not clear that they or local water enterprises have the capacity to assume this responsibility. A thorough review of local fees and charges is needed. The appropriate policy is usually to charge a price that
covers economic costs (long-run marginal cost), unless externalities or other market imperfections justify a subsidy. This approach provides correct amounts and types of service to consumers willing to pay. Where the beneficiary of the service is hard to identify, or the benefits are generalized over the population, or the service is characterized by large benefit spillovers, tax revenues are the appropriate financing mechanism (Netzer 1966; Bird 1976; Meier 1983). Thus, education, police services, and fire protection would not lend themselves to financing via user charges.

User charges are likely to be viewed by local officials as a potential source of additional revenue. But their main value is promoting economic efficiency by providing demand information to public sector suppliers and by ensuring that local supply is valued at cost by citizens. Efficiency is particularly important for local government since the main economic rationale for local government is allocative efficiency. Whenever possible, local public services should be charged for rather than given away (unless they are pure public goods or the explicit intention is redistributive). Indeed, one reason for using the residential property tax for local finance is that property values bear, however roughly, some relation to services of local governments. Unfortunately, most countries charge less at the local level than is desirable, and many charges are poorly designed. The first rule of good local finance should be: “Wherever possible, charge” (Bird 1976). The distributive consequences of charging for local public services is not necessarily regressive (Bird 1976; Bahl and Linn 1992).

Fees, benefit levies, and user charges for locally provided services could be more fully exploited. Where private beneficiaries can be identified (property owners benefiting from public improvements, recipients of daycare, and so on) and there is no distributive argument or externalities to suggest the contrary, beneficiaries should pay the correct price for what they receive, whether in fees, user charges, or special improvement levies or contributions. To the extent that local governments can set such charges, they should be encouraged to do so. Any centrally mandated fees imposed by localities should also emphasize cost recovery. In the transition, since the tariff increases implied by cost recovery may be quite high, some compensating mechanisms—lifeline rates, senior citizens fees—may be needed. In some cases, actual compensating payments may be needed to make the large price increases palatable. These would need to be designed carefully to ensure that prices are consistent with allocative efficiency while income effects are offset.

**Conclusion**

Local government finance in Hungary is in transition, and much remains to be done to ensure the resulting decentralization of government
activities will be economically efficient and politically sustainable. The Law on Local Self-Government has assigned—and localities have taken on—far more expenditure responsibilities than before. Because local taxes are too limited to pay for these new responsibilities, local governments depend on transfers from the central government. They have few incentives (or opportunities) to generate revenues or to spend efficiently. Despite its defects, however, the basic structure of the system offers several possibilities for reform that would make it both more efficient and more equalizing. It remains to be seen whether the changing political scene will encourage—or even permit local government finance to develop more efficiently, along the lines proposed here.

Annex 2.1 Simulations of local transfers in Hungary: Simplifying the normative grant and incorporating revenue incentives

This annex explains how the effects of the three options for grant reform described in the text were determined. The first option was to simplify the grant design by replacing capacity norms with indicators of need, such as demographic variables. The second option also simplified the grant allocation formula and in addition it allocated the personal income tax (PIT) transfers according to the formula. And the third option simplified the grant formula and allowed localities to place their own surcharge on the PIT. To develop a simpler grant allocation formula to be used in each one of the options, regressions were run to estimate the weights that should be placed on different demographic indicators. Own-tax capacity for each municipality was estimated based on regressions using PIT, population, and employment as independent variables. The total revenue that would accrue to each municipality was then determined for each option based on the derived formula grant, the derived tax capacity, and the available data.

The data

Three databases were used. The first consists of data on 3,069 municipalities, including data for all elements of the normative grant, and the absolute amounts of PIT and PIT-equalization grants in 1991. As simulations were focused on municipalities, county local governments were excluded. The second data set contains demographic and employment data for 1989 from the Central Statistic Office local database in which 3,032 local governments were characterized. Demographic and employment data for 1989 were aggregated by municipalities according to their administrative status in 1990, and 998 units were developed and used in the regressions. The third database has municipal fiscal/tax revenue
data from fiscal year 1990 based on a sample of the 1,586 local governments that existed in 1990, of which 1,301 municipalities were used.

Simplifying the normative grant

Simplification of the normative grant design means a significant decrease in the number of elements included and a shift away from capacity norms toward a needs indicator-based allocation model. To accomplish this task of simplification the first question that needed to be answered was How strong is the connection between local public institutional capacities and population age groups within the same municipality? To answer this question the capacity indicator of institutions of a particular type was regressed on the population that utilizes the institution (table A2.1). A significant linear connection between the capacity indicators and the demographic variables is evident. The coefficients show that for every 1,000 youngsters there are 889 students in educational institutions. The number of rooms in social institutions and the age cohort representing the elderly population are also highly correlated.

Since demographic variables appear to be good indicators of need, they can be used as elements of the grant formula. Based on these results, the new grant design was determined by examining the relationship between the existing normative grant and the age cohorts suggested above. Other norms did not need to be related to age groups because many were already based on such groupings. Using grant allocation as the dependent variable, the appropriate formula weights on the demographic variables were determined. Population and two age cohorts were used as independent variables, all of which were significant (table A2.2). The coefficients represent the elements of a simplified grant formula—that is, how much should be allocated to a municipality according to these need indicators. The negative constant can be explained as the minimum level of population, relative to the age cohorts, necessary for the central government to allocate grants to the municipality on a formula basis. Using this formula results in a lower grant to municipalities formerly receiving less than Ft 5 million, higher grants to small poor municipalities, and lower grants to large rich municipalities.

Improving revenue effort

In addition to simplifying the grant, improving local revenue capacity is an important part of local fiscal reform. Own-revenue capacity was estimated from fees and charges, local taxes, and actual PIT collection. Municipal tax capacity can be measured by a representative tax system or
by regression, based on existing fiscal information. Because of information constraints, a representative tax system approach could not be used. So a regression model was used to measure tax capacity, where the dependent variable was the aggregated prior tax yield of each municipality and the independent variables were the available fiscal and real indicators—the PIT, population, and employment variables. The formula chosen to estimate tax capacity for further simulations was based on all of the above indicators (equation 4, table A2.3).

Table A2.1 Simplifying the normative grant: Regressions of selected capacity norms against age cohorts by municipalities, Hungary, 1991

<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>Constant</th>
<th>B1 Age cohort [0–18]</th>
<th>B2 Age cohort [60–x]</th>
<th>B3 Inactive population [0–18,60–x]</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Students¹</td>
<td>-31.445</td>
<td>0.795</td>
<td>..</td>
<td>..</td>
<td>0.9962</td>
</tr>
<tr>
<td></td>
<td>(-3.981)</td>
<td>(890.321)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Students²</td>
<td>-117.700</td>
<td>0.919</td>
<td>..</td>
<td>..</td>
<td>0.9853</td>
</tr>
<tr>
<td></td>
<td>(-22.019)</td>
<td>(450.245)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Students³</td>
<td>-16.861</td>
<td>0.889</td>
<td>..</td>
<td>..</td>
<td>0.9945</td>
</tr>
<tr>
<td></td>
<td>(-1.585)</td>
<td>(739.533)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Social institutions⁴</td>
<td>1.247</td>
<td>0.036</td>
<td></td>
<td>..</td>
<td>0.9839</td>
</tr>
<tr>
<td></td>
<td>(1.753)</td>
<td>(430.224)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Social institutions⁴</td>
<td>-3.427</td>
<td>0.019</td>
<td></td>
<td>..</td>
<td>0.9873</td>
</tr>
<tr>
<td></td>
<td>(-5.413)</td>
<td>(485.006)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

¹ Variable was not used in the regression.

Note: N = 3,032. t-statistics are in parentheses below the regression coefficient.
a. Kindergartens, elementary and secondary schools, vocational and skilled workers training schools.
b. Same as (a), without Budapest.
c. Same as (a), plus kindergartens for nationalities and minorities, music schools, elementary schools for the handicapped, workshops for apprentices, bilingual education, and dormitories.
d. Child care, day care for the elderly and the handicapped, homes for the elderly, and institutions for young people who are handicapped.


Table A2.2 Simplifying the normative grant: Regressions against selected population variables by municipalities, Hungary, 1991

<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>Constant</th>
<th>B1 Age cohort [0–18]</th>
<th>B2 Age cohort [60–x]</th>
<th>B3 Age cohort [60–x]</th>
<th>R²</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local grant</td>
<td>-845.81</td>
<td>13.134</td>
<td>..</td>
<td>..</td>
<td>0.9969</td>
</tr>
<tr>
<td></td>
<td>(-1.705)</td>
<td>(981.73)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local grant</td>
<td>-4.411.7</td>
<td>60.947</td>
<td>-6.104</td>
<td>-17.0</td>
<td>0.9992</td>
</tr>
<tr>
<td></td>
<td>(-12.463)</td>
<td>(175.873)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local grant</td>
<td>-845.81</td>
<td>13.134</td>
<td>1.141</td>
<td>-0.504</td>
<td>0.9969</td>
</tr>
<tr>
<td></td>
<td>(-1.705)</td>
<td>(981.73)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

¹ Variable was not used in the regression.

Note: N = 3,032. t-statistics are in parentheses below the regression coefficient.

Formula options

Given these estimates, the total revenue to each municipality from employing option 1 was calculated as the sum of the PIT, the simplified grant based on the new formula, and the equalizing grant, less the estimated tax capacity. Option 2 revenues were simulated as the simplified grant formula applied to the full revenue transfer (PIT + PIT-equalizing grant + normative grant) less tax capacity. And option 3 revenues were estimated from the PIT surcharge plus the simplified grant applied to all transfers less the estimated tax capacity (see also text table 2.7).

These simulations are only illustrative and are at most the first steps in preparations for a new local transfer system in Hungary. Many questions remain. The fiscal data are incomplete: some counties have been excluded from the calculations, and there are many estimates in the data. And, absent comprehensive data on tax bases, especially incomes and profits, the calculations of capacity and the simulations employing these data are very tentative. But the uncertainty of the estimates does not discredit the idea. Preliminary as it is, this work is presented here in the spirit of illustration, to indicate what might be refined by further work, and to point the way toward further improvements in calculations, which will depend in large part on availability of data.

<table>
<thead>
<tr>
<th>Dependent variable</th>
<th>Constant</th>
<th>PIT</th>
<th>Population</th>
<th>Industrial employment</th>
<th>( R^2 )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Revenue capacity/own-source tax</td>
<td>-243.843</td>
<td>0.207</td>
<td>-0.147</td>
<td>..</td>
<td>0.8573</td>
</tr>
<tr>
<td>(0.7)</td>
<td>(15.755)</td>
<td>(-1.445)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Revenue capacity/own-source tax</td>
<td>-378.280</td>
<td>0.150</td>
<td>..</td>
<td>1.546</td>
<td>0.8595</td>
</tr>
<tr>
<td>(-1.239)</td>
<td>(15.640)</td>
<td>(4.206)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Revenue capacity/own-source tax</td>
<td>-1,177.49</td>
<td>..</td>
<td>0.692</td>
<td>3.780</td>
<td>0.8397</td>
</tr>
<tr>
<td>(-3.280)</td>
<td>(9.631)</td>
<td>(10.631)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Revenue capacity/own-source tax</td>
<td>37.806</td>
<td>0.176</td>
<td>-0.248</td>
<td>1.737</td>
<td>0.8603</td>
</tr>
<tr>
<td>(0.108)</td>
<td>(12.052)</td>
<td>(-2.406)</td>
<td>(4.630)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

.. Variable was not used in the regression.

Notes

1. The counties of the former middle tier still exist but they no longer play the role of an intermediate level of government. They are now parallel authorities and unrelated to the localities.

2. For a general discussion of the design and principles of transfers see Shah (1994), but note that he argues in favor of unconditional grants on "federalist" grounds, which does not seem particularly appropriate in the Hungarian case.

3. The problem is residence. If people live outside of the jurisdiction in which they work, the benefit principle will be violated.

4. In principal, the unconditional grant or shared revenues could be pledged, but this has not yet gained currency.

5. This annex draws on Bird and Wallich (1992). A fuller description of the method used is described in that paper.
HUNGARY

BUDAPEST

District boundaries

Budapest municipality boundary

Roman numerals denote districts.
Financing a large municipality: Budapest

Robert D. Ebel and Peter Simon

Through a series of parliamentary acts and administrative reforms in 1990–91, Hungary established a legal framework for a significant decentralization of governmental power. The goal of fiscal decentralization is to create a new public sector that will promote the efficient use of Hungary’s economic resources, free up other scarce resources for employment in the private sector, and establish a fiscal environment in which localities, through the provision of public capital, play a key role in promoting national economic growth.

The legal framework is a major accomplishment. It is also just a first step in the fiscal decentralization process, which, because it ties together the issues of public resource mobilization, stabilization, and privatization, is one key to the success of the country’s transition from a command economy to a market economy (see chapter 1). Nowhere is the need to implement local fiscal autonomy more urgent than in Budapest. It is not only the nation’s largest urban agglomeration, but also, as it has been throughout history, Hungary’s economic, social, and cultural center. Nonetheless, the municipality is only at the starting point in its implementation of fiscal reforms and rebuilding of a local institutional capacity that is worthy of the city’s lead role in Hungarian affairs.

In just four years Budapest Municipality has made remarkable progress in identifying the financial and administrative problems it must address to effect its transition from an instrument of the state to an autonomous government. Not surprisingly, much of what has been accomplished to date has been ad hoc. A concept for intergovernmental fiscal assignment has been articulated, but an effective strategy for
implementing fiscal autonomy is yet to be initiated (Hegedüs, Pallai, and Tosics 1994). Budapest's financial system is still largely patterned after the set of arrangements that obtained when the municipality was considered a sector of a national plan. In addition, the division of the city into twenty-two (as of January 1995, twenty-three) autonomous general-purpose district governments reflects the previous local council system rather than an attempt to systematically sort out intergovernmental responsibilities equitably and efficiently (see map of Budapest, p. 118, and chapter 1).

As a result, the municipality is facing enormous structural fiscal pressures stemming from a deconcentration of expenditure responsibilities unaccompanied by a capacity to receive and finance these functions. That, in turn, is contributing to a circumstance in which many citizens feel they are worse off economically than in the past, thus increasing the risk that citizens will lose confidence in the merits of the transition from a centralized to decentralized (private and public) society.²

Background

Budapest is at once the capital of a small nation and a city built for an empire. Located on the site of one of Europe's oldest settlements, the city is a product of the larger Central European region (Enyedi and Szirmai 1992; Pallai 1991). It has served as the center of a Hungarian kingdom that stretched from the Balkans to the Baltics (during the 15th and 16th centuries) and, with Vienna, as twin capital of a dual monarchy (from mid-1860 until World War I). When cut off from Central European resources by historical events, it "shrank into insignificance and provincialism" (Enyedi and Szirmai 1992, p. 3).

Budapest's modern era began in the mid-1850s with the completion of the Hungarian railway system, which had as its hub the Danube's largest port—the navigable section that linked the towns of Obuda, Buda, and Pest. From there, a transport system radiated in all directions across the Carpathian Basin. By 1873 the Hungarian government, in rivalry with Austria and Vienna, had created a large European city through the merger of the three towns. During the next quarter-century, the city underwent a massive public works program. By the turn of the century there were grand public buildings, avenues, boulevards, a sewer system, public lighting, horse-drawn trams, parks, bridges, and an underground railway. Throughout this period and until the end of World War II, new intergovernmental arrangements were developed. Although there were periods of sharp conflict between the city and the central government, planning in the capital became increasingly autonomous and dynamic.

With the communist takeover after World War II, a radical process of centralization was initiated. Throughout Hungary previously
autonomous governments were replaced with a national council system that consisted of twenty councils—nineteen counties and the capital. Budapest was further divided into districts. Although all these "governments" were closely supervised and controlled by the central government, the county-city-district hierarchy was nonetheless significant because the counties were given a place on the central government's planning committees. The cities, and in the case of Budapest, the districts, were merely conduits for carrying out the center's plans.

The central government's priority was heavy industry. Agriculture became a secondary concern, ecological interests were ignored, and urban development was undertaken only as part of a national plan. As a result of a separation of capital investment and maintenance decisions—the center made new investment and capital replacement decisions but left maintenance to local governments—infrastructure was allowed to deteriorate as local governments, which would count on central replacement of deteriorated capital, underequated funds for renovation. Also, most other local expenditures were centrally planned and mandated. Operational and development transfers were approved on a negotiated basis. If a council lacked the financial means to meet its service mandates, the central government negotiated a transfer of funds to cover the budget gap. Thus, the councils had little incentive either to utilize their resources efficiently or even to measure their potential revenue base since collecting local revenues deprived them of state assistance.

Budapest enjoyed a special status as county and city and, thus, was directly represented in the central government planning process. In 1949 several neighboring settlements were annexed, which enlarged the city to its current boundaries. This put Budapest in a favorable position relative to other urban areas, and the city became the focus of intensive industrialization and new infrastructure development. But it also created social and institutional tensions that still exist between the capital and its districts.³

Although local governmental administrative and decisionmaking power gradually increased over the next forty years, the system as a whole remained highly centralized. Budgets were subject to approval by the central government, and revenue transfers from central to local units remained a matter of negotiation. Moreover, local governments could be combined with other localities without their consent.

In 1990 and 1991 four new laws called for major reforms in the roles and responsibilities of governments and in the ownership of the nation's public housing, transportation, and other utility assets.⁴ The reforms transferred numerous spending and revenue powers to the local governments (which replaced the "local council" system), specified the process for the election of local officials, and transferred ownership of the properties previously owned by the local councils to their constituent local governments. 
The Law on Local Self-Government (1990) and the subsequent Law on Self-Government of the Capital City and the Capital City Districts (1991) established the rules on the governmental structure of the capital. The laws, as amended:

- Recognize a “special role and position” for the capital.
- Provide for the direct election of the mayor.
- Provide for a General Assembly of eighty-eight members.
- Establish twenty-three separate district governments within the geographical boundaries of the capital. As autonomous general-purpose governments, each district is represented by one non-voting delegate in the General Assembly. The other sixty-six members are directly elected and have voting rights.5
- Generally direct that districts shall execute tasks related to “neighborhood services,” while the municipality shall execute functions that affect the “whole or a large part of the capital.” With respect to transportation, for example, the districts are responsible for maintenance of local roads, while the municipality is responsible for maintenance and development of main roads and routes used by public transport and of national roadways within city boundaries, traffic control, and all services related to public transport—trams, buses, underground services, and suburban train lines (Sárkány 1993).
- Link the municipality’s fiscal condition to the municipal-district relationship. This occurs for three reasons. First, each year, the municipality must negotiate a municipal-district split of nearly all municipal revenues, including those it derives from own as well as central sources. Second, under current arrangements, the districts have access to several taxes that the municipality does not employ. Finally, a district has the option of unloading certain initially assigned public responsibilities (for instance, schooling) onto the municipality. The municipal-district issues are discussed below.

Statutory provisions

Between 1989 and 1990 Hungary enacted a series of national reforms to bring the national revenue structure into conformity with that of Western Europe.6 Although the tax structure is now similar to West European systems, the overall size of the public sector is large compared not only with those of European Union members, but also with the Central European average (Kodrzycki 1993).7

Despite—or perhaps because of—its high tax burden, the state has been running budget deficits that are among the highest of the transition economies (see chapter 1, table 1.5). The large size of the Hungarian state
is most relevant to Budapest because intergovernmental aid to local governments is the second-largest item in the state budget that Parliament can readily adjust. If, as seems clear from both a private sector promotion and stabilization perspective, the central government must pare down its financial role in the economy, central-local transfers are a likely target for spending reduction. Such a strategy could have significant implications for Budapest's ability to provide local services since centrally controlled revenues (grants plus shared taxes) account for nearly two-thirds of its revenues.

Revenues

The 1990–91 legislative reforms provide for a range of revenue sources for local governments, grants and transfers from the central government, shared taxes and fees, own-source revenues, and receipts from the sale of assets. The structure of each of these is discussed in detail in chapter 2. To briefly summarize with respect to the municipality:

Central-local transfers. Five types of state fiscal transfers appear in the Budapest budget. The most important of these is the formula-based normative grant, which is unrestricted and unindexed. The total amount of the grant as well as all aspects (number, type, and amount of each component) of the distribution formula are negotiated annually. For 1994 the grant consists of one lump-sum transfer of Ft 2 million per village (Budapest does not qualify) plus twenty-four "norms" for which a unit cost is specified (for example, Ft 40,600 per vocational school student and Ft 250 per capita for cultural activities). The amount (unit cost) of each norm is always less than the actual (average) per unit cost of the service. This (unit cost–actual cost) ratio tends to be directly related to the proportion of benefits thought (by Parliament) to spill over to other jurisdictions. Thus, services such as secondary education, which are provided to residents of other jurisdictions, are given a high cost coverage. Somewhat lower cost coverage is given for services for people who depend on government, for example, orphans and the elderly. The cost coverage is lowest for services such as primary education in the belief that local authorities will offer such services even if not required to by the state. The total amount of a local grant is determined by multiplying the numbers of norm units (per case or per capita) by the unit cost and then summing all the norms. In the case of Budapest the grant is allocated in a lump sum to the city, and then a municipal-district split is negotiated in the General Assembly.

Centrally shared revenues. As for other Hungarian local governments, there are three shared revenues, each fully controlled and administered by
the central government. The first is the personal income tax collected from residents: the state keeps 70 percent and returns 30 percent to the locality by origin of collection. A two-year lag between the central tax collection and distribution of the proceeds to the municipality results in significant inflation erosion. Initially (1990), 100 percent was directly returned to localities. Then, in 1991, the split became 50 percent origin and 50 percent central. The change has important implications for Budapest: the more the revenue allocated by origin, the more accrues to higher-income jurisdictions (chapter 2). Since Budapest is a high-income jurisdiction relative to other Hungarian localities, the municipality tends to be a net fiscal winner as the derivation share rises. At Budapest's behest, the newly elected national government (the Hungarian Socialist Party and the Alliance of Free Democrats) has negotiated an increase of the local government share to at least 35 percent in 1995 (with distribution effective in 1997). Budapest officials argue that this share increase is justified by the fact that the larger grants accrue disproportionally to the districts of the city and, of course, to other Hungarian cities and villages. In 1993 the total amount of personal income tax sharing was Ft 48.9 billion, and the total of all state contributions and allocations (80 percent of which is accounted for by the normative grant) was Ft 260 billion. The Budapest municipality, district, and all other local government per capita shares were, for the personal income tax, Ft 4,447 to Budapest, Ft 3,960 to the districts, and Ft 3,885 to all others; and the per capita shares for all grants were Ft 9,578 to Budapest, Ft 10,810 to the districts, and Ft 26,494 to all others.\(^{10}\)

The second shared revenue, the motor vehicle (engine) tax, is an acquisition fee on vehicles brought into the city. These revenues are split evenly between the municipality and the state.

Finally, Budapest receives 30 percent of state environmental penalties imposed within its borders.

**Own-source revenues.** The Laws on Local Self-Government and Local Taxes generally assign certain taxes to localities plus the revenues from entrepreneurial activities, rents and profits from government-owned enterprises, and user fees. In Budapest most user fees and charges are collected by the municipality's seven utilities and dedicated to special funds. As noted in chapter 2, Hungarian local governments have authority to levy five taxes. In Budapest, however, because of the geographically overlapping nature of the municipality and the autonomous districts, the tax authority is further divided between the municipality and the districts. In practice, owing to central restrictions ("exclusive tax authority"); see box 3.1) plus a Budapest General Assembly decision to disallow the use of a poll tax (one of the five) by any government within the city's boundaries, the municipality has tax access to only a general business
Financing a large municipality: Budapest

The districts have exclusive authority for taxes on property (buildings and land) and transient accommodations.

*General business (turnover) tax.* The municipal local business tax is largely limited to nonretail businesses and is based on net sales revenue of products sold and services provided, reduced by the purchase value of goods sold and the value of services provided by subcontractors. The cost-of-goods-sold deduction is denied for items that are sold but are transformed (as in manufacturing, for example), and the deductibility for contractor services is denied if the services enter the price of the product sold or if the service is provided indirectly (for instance, legal services purchased for a client). In the case of financial institutions the tax base is gross turnover—the total interest received in the case of banks (no deduction for interest paid) and, for insurance firms, the total revenue with no deduction for claims settled. The tax rate may vary by type of business activity, but the state mandates that in no case may it exceed 0.8 percent (the rate Budapest applies to all taxpayers). Also, the locality may grant deductions and exemptions according to type of business activity. Thus, in Budapest there is a Ft 1 million specific exemption for trading activity and Ft 300,000 for other activities. For businesses operating in Budapest and other jurisdictions the tax base is apportioned by the simple percentage of total receipts occurring in Budapest. Tax base information is provided by the central government’s Tax Administration office.

*Tourism tax.* Eight of the twenty-two districts (1994) levy some form of transient accommodations tax, which may be imposed at a rate of up to Ft 300 per square meter per night or up to 4 percent of the lodging fee. A specific exemption is centrally mandated for the first-night stay for visitors. Statutory exemptions are granted to children, the elderly, students, and relatives of the owner of a holiday house. Health and social care institutions are institutionally exempt.

*Property taxes.* The districts may also impose two types of narrowly based taxes on real property—a building tax and a plot (land) tax. Each tax is on the owner (or owners) of the property; or if the property is encumbered by pecuniary rights, on the user of those rights. The building tax component may be levied on residential (two districts) and nonresidential (eleven districts) structures, including the plot of land as determined by the local authority to be necessary for the proper use of the building. The maximum tax rate is 3 percent of the adjusted market value (50 percent of market) or Ft 300 per taxable square meter. At present, the districts that levy the tax use area. There
Box 3.1 Law on the Capital City and the Capital City Districts

In 1991 Parliament passed the fourth in a series of laws on the structure of intergovernmental relations: Public Law XXIV, on Self-Government of the Capital City and the Capital City Districts. This law fundamentally changes the system of governance from that which existed under the council system.

The law declares the capital city to be bilevel—the city and its twenty-two geographically (but not politically) subordinate districts each operate as an independent local government. Each jurisdiction has its own legislature and mayor, and there is no administrative hierarchy between the municipality and the districts. In the matter of economic and fiscal responsibilities, the capital and its districts are viewed as partners with differing duties and responsibilities.

The law is intentionally designed to “maintain at all costs” the principle “that the capital city and district self-governing authority not be arbitrarily curtailed by the Parliament” (Public Law XXIV, General Justification, paragraph 8). The key points of law:

**Boundary changes.** In order to change the configuration of district boundaries, the affected district and city must be in agreement. Moreover, the assembly of the affected district(s) must hold a local referendum on the change. The Parliament retains the prerogative to change boundaries, but again, a local referendum is required. Finally, a district may separate from the city altogether.

**Intergovernmental cooperation.** Intergovernmental (city-district, district-district) cooperation, including the establishment of special-purpose districts, is explicitly allowed. Indeed, the legislation is clear that it is up to the various self-governments to work out their own service delivery components.

are several exemptions, both statutory (for example, the first 25 square meters per person permanently registered in a home and a ten-year exemption for privatized and newly built flats) and institutional (social, health, welfare, and educational). The plot tax (nine districts) may be levied on unimproved privately owned land at a maximum rate of Ft 100 per taxable square meter or 1 percent of adjusted market value. The institutional exemptions provided for buildings also generally apply to the plot tax.

**Sale of assets.** Under the Law on Local Self-Government, state ownership of housing and commercial-type enterprises was transferred to local governments, which, it was thought, would quickly and systematically privatize these assets. This privatization strategy was designed to promote competitiveness and economic development, and at the same
Assignment of functions. Districts must provide kindergartens and elementary education, health and social care, water supply, street lighting, and the maintenance of local streets. The list of municipal responsibilities is much longer, and includes historic preservation, water, gas, steam and storm sewerage services, maintenance of main thoroughfares, traffic coordination, public transport, cooperation in energy provision, public cleanliness, flood protection, and urban development planning once the views of the state and districts have been obtained.

Asset transfer and service responsibility. State-owned assets pertaining to basic public services (such as education) are to be further transferred to the districts except when the district self-government is unable to provide the service. The districts may then transfer back to the municipality assets relating to services it (the district) does not wish to perform.

Overlapping functions. The municipality is further required to provide educational, artistic, sport, health, and social services if such services affect more than two districts extending beyond city boundaries. This provision has led to what Hegedus and Tosics (1993) observe as a form of cream-skimming: the districts provide funding for prestigious services (certain secondary schools), but leave other responsibilities, such as vocational education, to the municipality.

Exclusive tax authority. Revenues that are exclusive to the districts include fines related to district activities and the tourist and property taxes. No significant tax sources are exclusive to the city.

Shared revenues. Nearly all municipal revenues are placed in a revenue-sharing pool subject to distribution on the basis of district-municipal negotiation.


time give local governments a cash windfall that would start them on the path to financial viability. Thus, economic decentralization and fiscal decentralization could be accomplished simultaneously.

For some district governments, the strategy seems to be working. But for other localities, especially the municipality, the strategy has a built-in fiscal time bomb of significant fiscal drag because the assets have a large, negative net worth.

Under the Law on Local Self-Government, ownership and responsibility for the 410,000 state-owned housing units in Budapest, which account for half the city's total housing units, have been distributed to the districts in which the housing is located. Ownership and responsibility for the seven state-owned, property-related public utilities (transportation, water, sewerage, garbage collection, gas, central heating, and public baths) have been transferred to the capital.
The rationale for devolving centrally owned public assets to the new local governments is appealing: because the localities need a source of up-front (or start-up) monies in their early years that will give them time to strengthen their own-source (tax and fee) revenue system, such a large stock of assets—many of which should be privatized anyway—provides the needed early revenue. This is especially true if some of that revenue can be set aside for the type of spending (infrastructure) that will lead to sustainable economic development by using public capital to complement private sector investment.

The reality of the composition of the property transfer, however, undermines the municipality's long-term financial health. If one adopts a net worth rather than cash-budgeting perspective, the potential market value of housing now owned by the twenty-two districts as a whole is high—perhaps as much as Ft 275 billion. For the municipality, however, the long-run situation is the mirror opposite—a negative Ft 275 billion (Alm and Buckley 1994). The result is that rather than provide windfalls, the state asset transfers have become a source of revenue softness and uncertainty to the municipality.

Expenditure arrangements

The Law on Local Self-Government transferred a number of important public service functions to local governments (largely bypassing the counties as service providers). As discussed in chapter 2, localities have both mandatory and optional expenditure responsibilities. In addition to these functional assignments, local governments must also now cover many areas of responsibilities that were performed by companies and cooperatives under the previous regime. For example, municipally financed vocational schools may pick up various human resource training programs.

The Law on Self-Government of the Capital City and the Capital City Districts (see box 3.1) further divides the newly decentralized expenditure responsibilities between the municipality and the district governments, as discussed in greater detail below. As with revenues, many municipal expenditures are centrally regulated. For example, spending for social security accounts for nearly a quarter of total expenditures (1993). Functionally, the municipality focuses on health care, social welfare, elementary and secondary education, culture, historic preservation, and transportation. A major part of these expenditures (nearly a fifth of the total) are for the maintenance and renovation of public infrastructure. Structurally, the municipality operates both through direct general fund financing for the general operations of government and municipal institutions and through the operations of its
seven utility companies. One of the seven, the Budapest Traffic Company (BKV), establishes its own fund and fee structure, but also requires a significant subsidy from the municipality's general fund (16 percent of total 1993 revenues).11

The municipal budget

Like other local governments in the transition economies, the Budapest budget incorporates prereform practices that depart from conventional Western budget presentation. Two features merit special mention. First, the budget is reported in a terminology that is somewhat unfamiliar to Western analysts. Because distinctions between Hungarian and Western budget terms are important, explanatory notes accompany the detailed appendix tables. Second, the budget is presented on a cash basis that mixes recurrent and nonrecurrent revenues, making it difficult to distinguish between operating and investment-related activities.12

Major features

Each of the municipality's revenue sources described above are presented for 1991-93 (table 3.1). In addition to the actual budgeted amounts in nominal forints, the table provides information on the annual percentage composition of each revenue item for all three years, and an index of change in real (inflation-adjusted) forints. Similar data for expenditures are presented in table 3.2.

Although it is difficult to draw firm conclusions from just three years of data (the reform period for which final budget data are available is 1991-93), the numbers show that though the central government dominates the fiscal picture, a modest trend toward local fiscal control may be emerging. In 1993 central sources accounted for 66 percent of total revenues. Central dominance is also indicated by the fact that own-source revenues consistently account for only about a quarter of funds (see table 3.1, and table A3.1 in the annex at the end of the chapter). Expenditure data reveal this same feature of central control (see tables 3.2 and A3.2).

However, the changing mix of centrally controlled versus local own-source revenues indicates that there has been some progress toward fiscal autonomy. Three pieces of evidence support this view. First, between 1991 and 1993 total centrally regulated resources declined from 70 percent to 61 percent of total municipal funds (revenues plus loans). The second piece of evidence is the year-to-year change in real terms of local own-source revenues. While the centrally regulated percentage of total municipal funds is declining, local own-source revenues are playing a steady (though still relatively small) role. Third, local taxes (measured here by
Table 3.1 Municipal revenues, Budapest Municipality, 1991–93
(billions of forints)

<table>
<thead>
<tr>
<th>Item</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
<th>Real change as index of previous year(^a)</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
<th>Real change as index of previous year(^a)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total centrally regulated sources</td>
<td>40.6</td>
<td>47.0</td>
<td>46.8</td>
<td>40.6</td>
<td>71.2</td>
<td>70.1</td>
<td>60.9</td>
<td>82.4</td>
</tr>
<tr>
<td>Intergovernmental transfers</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normative operating grant</td>
<td>12.5</td>
<td>13.0</td>
<td>15.6</td>
<td>92.5</td>
<td>22.0</td>
<td>19.5</td>
<td>20.4</td>
<td>99.1</td>
</tr>
<tr>
<td>Normative development grant</td>
<td>0.0</td>
<td>0.8</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>1.2</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Targeted grants</td>
<td>1.6</td>
<td>1.0</td>
<td>1.1</td>
<td>1.6</td>
<td>2.9</td>
<td>1.5</td>
<td>1.4</td>
<td>48.0</td>
</tr>
<tr>
<td>Addressed grants</td>
<td>0.3</td>
<td>1.0</td>
<td>0.7</td>
<td>0.3</td>
<td>0.5</td>
<td>1.4</td>
<td>0.9</td>
<td>50.0</td>
</tr>
<tr>
<td>Other assistance</td>
<td>1.2</td>
<td>1.5</td>
<td>2.6</td>
<td>1.2</td>
<td>2.2</td>
<td>2.3</td>
<td>3.4</td>
<td>14.8</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>9.4</td>
<td>12.1</td>
<td>9.3</td>
<td>9.4</td>
<td>16.5</td>
<td>18.1</td>
<td>12.2</td>
<td>63.6</td>
</tr>
<tr>
<td>Social security contribution</td>
<td>15.5</td>
<td>17.5</td>
<td>9.4</td>
<td>15.5</td>
<td>27.2</td>
<td>26.1</td>
<td>17.4</td>
<td>82.2</td>
</tr>
<tr>
<td>Total own-source revenues</td>
<td>11.1</td>
<td>16.4</td>
<td>20.0</td>
<td>11.1</td>
<td>19.5</td>
<td>24.4</td>
<td>26.1</td>
<td>101.2</td>
</tr>
<tr>
<td>Current revenues</td>
<td>8.2</td>
<td>14.3</td>
<td>16.9</td>
<td>8.2</td>
<td>14.3</td>
<td>21.4</td>
<td>22.1</td>
<td>97.8</td>
</tr>
<tr>
<td>Accumulation and capital-type revenues</td>
<td>3.0</td>
<td>2.0</td>
<td>3.1</td>
<td>3.0</td>
<td>5.2</td>
<td>3.1</td>
<td>4.0</td>
<td>125.1</td>
</tr>
<tr>
<td>Value added tax revenue</td>
<td>1.1</td>
<td>0.9</td>
<td>1.5</td>
<td>1.1</td>
<td>1.9</td>
<td>1.4</td>
<td>1.9</td>
<td>130.3</td>
</tr>
<tr>
<td>Residual funds</td>
<td>2.5</td>
<td>2.0</td>
<td>2.2</td>
<td>2.5</td>
<td>4.5</td>
<td>2.8</td>
<td>2.9</td>
<td>92.8</td>
</tr>
<tr>
<td>Other revenues</td>
<td>1.6</td>
<td>0.8</td>
<td>0.0</td>
<td>1.6</td>
<td>2.9</td>
<td>1.2</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total revenues</td>
<td>56.4</td>
<td>66.5</td>
<td>70.4</td>
<td>56.4</td>
<td>99.0</td>
<td>99.2</td>
<td>91.8</td>
<td>87.7</td>
</tr>
<tr>
<td>Loans for operations and development</td>
<td>0.6</td>
<td>0.5</td>
<td>6.3</td>
<td>0.6</td>
<td>1.0</td>
<td>0.8</td>
<td>8.2</td>
<td>950.4</td>
</tr>
<tr>
<td>Total funds</td>
<td>57.0</td>
<td>67.0</td>
<td>76.8</td>
<td>57.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>94.7</td>
</tr>
</tbody>
</table>

\(^a\) Real change = \(\left(\frac{\text{year } t}{\text{year } t-1}\right) \times 100\).

Source: Table A3.1.
Table 3.2 Municipal expenditures, Budapest Municipality, 1991–93
(billions of forints)

<table>
<thead>
<tr>
<th>Item</th>
<th>1991 Amount</th>
<th>1991 Share (percent)</th>
<th>1992 Amount</th>
<th>1992 Share (percent)</th>
<th>Real change as index of previous year</th>
<th>1993 Amount</th>
<th>1993 Share (percent)</th>
<th>Real change as index of previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current expenditures</td>
<td>46.5</td>
<td>84.6</td>
<td>53.8</td>
<td>81.8</td>
<td>92.6</td>
<td>58.4</td>
<td>78.8</td>
<td>89.7</td>
</tr>
<tr>
<td>Social security financing</td>
<td>16.8</td>
<td>30.6</td>
<td>19.0</td>
<td>28.9</td>
<td>90.3</td>
<td>18.4</td>
<td>24.8</td>
<td>80.1</td>
</tr>
<tr>
<td>State financing</td>
<td>29.7</td>
<td>54.0</td>
<td>34.8</td>
<td>52.9</td>
<td>93.9</td>
<td>40.0</td>
<td>54.0</td>
<td>95.0</td>
</tr>
<tr>
<td>Accumulation and capital-type expenditures</td>
<td>8.2</td>
<td>15.0</td>
<td>11.5</td>
<td>17.5</td>
<td>112.2</td>
<td>15.4</td>
<td>20.8</td>
<td>110.7</td>
</tr>
<tr>
<td>Investment</td>
<td>7.0</td>
<td>12.8</td>
<td>10.6</td>
<td>16.2</td>
<td>121.0</td>
<td>14.2</td>
<td>19.2</td>
<td>110.8</td>
</tr>
<tr>
<td>Assistance to entrepreneurs</td>
<td>0.2</td>
<td>0.4</td>
<td>0.1</td>
<td>0.2</td>
<td>38.3</td>
<td>0.3</td>
<td>0.4</td>
<td>204.7</td>
</tr>
<tr>
<td>Other expenditures</td>
<td>0.0</td>
<td>0.0</td>
<td>0.3</td>
<td>0.5</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>54.9</td>
<td>100.0</td>
<td>65.8</td>
<td>100.0</td>
<td>95.8</td>
<td>74.1</td>
<td>100.0</td>
<td>93.2</td>
</tr>
<tr>
<td>Balance</td>
<td>2.1</td>
<td>3.8</td>
<td>1.2</td>
<td>1.9</td>
<td>47.3</td>
<td>0.0b</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Memo item
Nominal GDP

2,477.0  2,886.0  3,503.0

a. Real change = \(\frac{\text{year } t}{\text{year } t-1} \times 100\).
b. Includes borrowing of Ft 6.3 billion to cover an expenditure-revenue gap (deficit). See table 3.1 and text discussion.
Source: Table A3.2.
total current revenues) are rising as a percentage of total expenditures—from 14.3 percent to 22.1 percent between 1991 and 1993. Although this is a change in the right direction, the Budapest average is well below that of both large cities in developing countries, where taxes provide more than half of local funds, and subnational governments in the OECD, which generate about a fourth of total revenues from local taxes.\textsuperscript{13}

Decentralization and its contributions to accountability and efficiency cannot become reality without a growth in the own-source revenue responsibilities of local governments. As demonstrated elsewhere, fiscal decentralization not only enhances the efficient mobilization of the public's resources, but also serves as a negative and significant determinant of public sector size.\textsuperscript{14}

The question of fiscal condition

A variety of fiscal indicators determine the fiscal health or condition of a municipal government operating in a market economy (Berne and Schramm 1986). But conclusions about Budapest Municipality's financial condition are limited by the short history of the transition and the lack of a well-developed system of financial accounts appropriate to fiscal decentralization that would generate the information necessary for the municipality to enter world municipal credit markets.

Still, some public finance issues apply to both transition economies and more fully developed intergovernmental systems. These include:

- A government's ability to live within its fiscal means.
- The use of government proceeds generated from issuing debt and selling assets.
- The growth orientation of municipal expenditures.
- The capacity to repay debt.
- The long-term relationship between revenues and expenditures.

Balancing the budget. The first two of these issues can be addressed by referencing the revenue and expenditure data, which show that Budapest moved from a cash budget surplus to a deficit during its first three years. This conclusion is indicated by the bottom rows of tables 3.1 and 3.2. These rows are linked to one another in an important way. In table 3.1 the revenue side of the budget includes, as an addition to total revenues, an entry for "loans for operations and development." Table 3.2 then reports a balance entry, which is the difference between total funds (revenues plus loans) and total expenditures.

Loans for operations and development are funds borrowed by the municipality to cover temporary or longer-term revenue shortfalls, or both. In 1991 and 1992 this borrowing was not only rather small (Ft 0.6
Financing a large municipality: Budapest

billion and Ft 0.5 billion, respectively), but was paid off during the same calendar year as revenue flows increased to the cash budget. Thus, Budapest is legitimately able to report a surplus in both of those years.

Calendar year 1993 is a different matter. That year, the municipality again borrowed for loans for operations and development (from a consortium of private lenders), but this time the amount was larger and was not covered by end-year revenue flows. Accordingly, the municipality's borrowing of Ft 6.3 billion was the amount of the 1993 deficit (table 3.1).

To examine some of the implications of this shift to a deficit position, receipts from loan proceeds should be combined with the use of receipts of the sales of commercial-type municipal assets. The basic idea is to apply a "correspondence principle," such that the local government decision to obligate its citizens to a stream of future payments (or in the case of privatization, to a stream of forgone receipts) should be tied to a stream of future services. From a practical perspective, this requires that the sum of receipts from loans for operations and development plus asset sale proceeds be used either for long-term investment (such as infrastructure) or retirement of outstanding debt. A corollary to this principle requires that when investment is undertaken, it should be largely financed through borrowing rather than on a pay-as-you-go basis.

For its surplus as well as deficit years, Budapest satisfies the correspondence principle. In each of the years, the sum of loan plus asset sale proceeds is exceeded by the amount of funds channeled to real investment. This indicates that proceeds from capital-type activities are not being used to cover operating deficits. In 1993, for example, the sum of capital receipts (Ft 3.1 billion) plus borrowing (Ft 6.3 billion) equals only two-thirds of investment expenditures (Ft 14.2 billion). Indeed, the data further suggest that if the 1993 Budapest cash budget were broken down into operating and capital components, the operating budget would show a surplus.

This conclusion must be tempered with three caveats. A cash budget such as that used by Budapest does not employ accrual accounting and thus can be manipulated to shift reported spending across fiscal years. The definition of "investment" spending is not clear enough to provide reassurance that all investment corresponds to the addition of the city's stock of real capital. And preliminary fiscal 1994 estimates suggest that a significant change may be occurring, and that in order to cover its cash deficit Budapest may have to borrow to cover current operations. In the absence of a buoyant and broad own-source revenue base, this is an important sign of fiscal danger.

Because of its special importance to transition economies, the relationship between the use of asset sale receipts and investment spending deserves further comment. For transition economies the rule that
receipts from assets should be used to pay for only physical capital needs to be flexible. There are two factors to consider. The first is the privatization argument that no locality should put itself in the position of relying on receipts from owned commercial-type enterprises to fund itself. Fiscal efficiency and accountability are compromised once the public purse becomes directly linked to the profitability of particular public enterprises. Because privatization makes sense on its own merits in an economy in transition from command to market, little damage is done if receipts from asset sales are used for a short time to facilitate the transition (say, by insuring the social safety net).

Second, investment in physical assets such as infrastructure is not the only type of activity that creates a long-term flow of benefits. Institution building—that is, establishing processes for strengthening the own-source revenue system that will lead to true fiscal autonomy—has similar characteristics, especially in the transition years. As discussed in chapter 1, success at fiscally decentralizing the socialist state is key to the transition from a command economy to a market economy.

*Indicators of financial condition.* To help assess whether Budapest’s fiscal policy is growth oriented and whether it is able to carry debt, five indicators of financial condition are presented in table 3.3. The merit of these indicators is that they reveal critical relationships among key budget entries over time and in a multidimensional context. But the number of comparable observations is limited, and benchmarks for gauging whether various indicators are too high in a transition framework have not been established. To summarize:

- **Investment as a percentage of revenues and expenditures.** Both sets of indicators reflect the fact that the municipality is allocating an increasing amount of resources intended to create a base for growth in the economy. The investment-growth link stems from the direct relationship between public investment in physical infrastructure and private sector productivity. That these indicator ratios rose during 1991–93 may

<table>
<thead>
<tr>
<th>Table 3.3 Indicators of financial health, Budapest, 1991–93</th>
</tr>
</thead>
<tbody>
<tr>
<td>(percent)</td>
</tr>
<tr>
<td>Indicator</td>
</tr>
<tr>
<td>Investment as a share of revenues</td>
</tr>
<tr>
<td>Investment as a share of expenditures</td>
</tr>
<tr>
<td>Surplus or deficit as a share of revenues</td>
</tr>
<tr>
<td>Borrowing as a share of revenues*</td>
</tr>
<tr>
<td>Per capita borrowing (forints)</td>
</tr>
</tbody>
</table>

a. Loans for operations and development.

Source: Tables 3.1 and 3.2; tables A3.1 and A3.2.
perhaps be taken as a sign of fiscal prudence. If current expenditures were consuming an increasing share of the total budget, that would be a matter of concern.

- **Deficit (borrowing) as a percentage of revenues.** For a cash budget, an increase in the deficit may be viewed as a positive indicator if it reflects financing for needed new capital. Although the municipality must balance its total current (operating) budget, a surplus in the present cash budget is not necessarily desirable. In a community that has substantial unmet needs in infrastructure that complements long-term private sector growth, a surplus may indicate a financially unhealthy circumstance. As the discussion on correspondence indicates, this test has been met at least through 1993.

- **Per capita borrowing.** Budapest entered the transition relatively debt free. Thus, per capita borrowing, although it rose from Ft 300 in 1991 to Ft 2,732 in 1993, remains manageable at less than 1 percent of disposable personal income. To put this in another perspective, Ft 2,732 was equal in 1993, to the cost of a cotton blouse or the price of dinner at a moderate Budapest restaurant for a family of four.

The long-term revenue-expenditure relationship. Each year the General Assembly attempts to balance spending needs with available financial resources. In doing so, members must consider what will happen to revenues and expenditures if current laws, policies, and program structures continue without change, realizing that the budget will automatically grow as the result of interplay between the fiscal system and changes in Hungary's economic and demographic status.

To explore whether the municipality is facing a structural deficit, current services budgets were estimated for 1993-99. The data are presented in table 3.4 for 1996 and 1999, with actual 1993 data for the base. These projections assume that no legislative changes will be made in the revenue system or in the scope or structure of expenditure programs. This assumption allows the projections to be policy neutral; no

<table>
<thead>
<tr>
<th>Item</th>
<th>1993</th>
<th>1996</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenues</td>
<td>70.5</td>
<td>114.6</td>
<td>155.0</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>74.1</td>
<td>131.1</td>
<td>199.9</td>
</tr>
<tr>
<td>Surplus or deficit</td>
<td>-6.3</td>
<td>-16.5</td>
<td>-44.9</td>
</tr>
<tr>
<td>Deficit as a percentage of revenues</td>
<td>8.2</td>
<td>14.4</td>
<td>29.0</td>
</tr>
<tr>
<td>Per capita borrowing (Ft '000)</td>
<td>2.7</td>
<td>7.2</td>
<td>19.5</td>
</tr>
</tbody>
</table>

Source: World Bank staff estimates.
judgments are made regarding the quality of current law. Although projections are useful, they need to be interpreted with caution. The economic database required for the projections is not well developed. In addition, Budapest has some unique noncurrent revenue and expenditure entries for which projections are especially risky, particularly receipts from asset sales. The primary use of this analysis is to determine whether the municipality is facing a structural deficit or surplus. A structural deficit (surplus) exists if revenues grow slower (faster) than expenditures as the Hungarian economy grows and its demographics change. Identifying a structural deficit serves as a warning to take corrective administrative and legislative action and bring future budgets into balance. If done periodically, the analysis can also be designed to give policymakers a neutral benchmark from which to project the long-term effects of proposed short-term changes in current law.

Each major revenue and expenditure item is projected using economic and demographic factors ("drivers"). For example, the social security contribution was projected to grow with annual wages, while personal income tax collections reflected a two-year lag, and local business taxes were projected to change with GDP. Other revenue items were increased at the rate of inflation. The individual revenue results were summed. The same method was used for expenditures, using wages and GDP as the main system drivers.

The numbers reveal a structural deficit. Under the current revenue system and municipal expenditure program, expenditures will rise faster than revenues as the economy grows. By 1996, for example, the deficit is projected to have increased from 8.2 percent to 14.4 percent of total revenues. In 1999 the gap will be wider still.

It should be remembered that these numbers are a projection, not a prediction. Whether Budapest ends up with long-term deficits depends on how officials respond. The results express quantitatively what Budapest officials already know—that throughout the remainder of the decade they face a series of difficult fiscal decisions.

The results are not surprising. There are several plausible explanations: lack of buoyancy in the city's own-revenue structure, inefficiency in the intergovernmental delivery of education, health, and social services, the fiscal drag of the negative net worth of some city-owned assets, and an explosion of social spending previously hidden within the state-owned enterprise system. Without further information on such topics, as well as on the city's potential own-source revenue base (capacity) and the efficiency of alternative municipal-district service delivery arrangements, officials will have a difficult time identifying policy options and their long-run fiscal implications in addressing the
Financing a large municipality: Budapest

structural deficit. The problem is not that municipal officials are not wise, but that they lack the information needed to weigh the pros and cons of alternative policies. Institutionalizing a fiscal study capability is, thus, yet another element important to the success of the Budapest (or indeed, any) fiscal transition.

The municipal-district relationship

The twenty-two general-purpose district governments created within the City of Budapest by the Law on Local Self-Government were meant to link postcommunist reforms to existing institutions as well as respond to a political imperative to decentralize the state. To emphasize these reforms, the Constitution was amended to require a two-thirds parliamentary majority to change the law. Although a literal reading of the law suggests a clear definition of municipal-district roles, fiscal and political tensions remain high. The nature of the tensions has been extensively examined (Hegedüs and Tosics 1993). On the expenditure side they range from conflicting responsibilities to load-shedding. In either circumstance, administrative coordination among districts and between the twenty-two districts and the municipality raises additional problems.

Urban planning illustrates the problem of conflicting interests. Under current arrangements (1994), a district assembly determines the district’s basic plan and authorizes building and occupancy permits. Municipal duties include the planning and provision of area-wide infrastructure, setting the stage for conflict. Consider the wastewater plant that Budapest planned to build in the northern part of Csepel (district 21) on land it owns and for which it has the required zoning. District officials recognized the site’s value because of its proximity to the proposed 1996 Budapest Exposition. Thus, they planned an industrial development project for the site and found a group of potential investors. This led to a stalemate: the municipality, which had been offered an alternate but more costly site, refused to rezone, and the district refused to issue the necessary permits for sewerage.

The education system illustrates the tension arising from load-shedding. Parliament made education the responsibility of both the districts and the municipality. When a district fails to take on a particular task, however, the municipality is obligated to perform the service. The result has been “cream skimming.” Districts have an incentive to establish prestigious secondary schools and to shed responsibility for vocational education and similar programs. Although the municipality is expected to take such load-shedding into account in its revenue-sharing negotiations with the districts as a whole, a program such as vocational
education poses further problems because it requires the municipality to serve district students as well as those once eligible for state-financed training through state commercial enterprises.

This lack of clear expenditure roles and responsibilities also complicates the task of assigning revenue authority and, thus, responsibility for revenue administration. This problem is likely to grow over the long term now that districts have access to the more buoyant own-source revenues.

Data provided in table 3.5 illustrate the emerging nature of the expenditure and revenue assignment issue. As the data show, some important intergovernmental fiscal shifts have occurred in the past three years. While it may be premature to sound an alarm, it is also true that if current trends continue, the possibility arises that in the absence of a systematic realignment of expenditure and revenue roles the municipal sector may become permanently weak.

The data show that during the first three reform years, district government became the senior partner in the local intergovernmental relationship. In 1991 total municipal and district own-source revenues were nearly equal, whereas total municipal revenues were approximately one-

**Table 3.5 Municipal and district budgets, Budapest, 1991–93**

(brillons of forints)

<table>
<thead>
<tr>
<th>Budget item</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total centrally regulated resources</td>
<td>40.6</td>
<td>71%</td>
<td>22.6</td>
</tr>
<tr>
<td>Normative grant</td>
<td>12.5</td>
<td>22%</td>
<td>13.1</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>9.4</td>
<td>17%</td>
<td>7.4</td>
</tr>
<tr>
<td>Own-source revenues</td>
<td>11.1</td>
<td>20%</td>
<td>10.5</td>
</tr>
<tr>
<td>Current revenues</td>
<td>8.2</td>
<td>14%</td>
<td>7.7</td>
</tr>
<tr>
<td>Capital revenues</td>
<td>3.0</td>
<td>5%</td>
<td>2.3</td>
</tr>
<tr>
<td>Total revenues</td>
<td>56.4</td>
<td>99%</td>
<td>35.8</td>
</tr>
<tr>
<td>Loans for operations and development</td>
<td>0.6</td>
<td>1%</td>
<td>0.8</td>
</tr>
<tr>
<td>Total funds</td>
<td>57.0</td>
<td>100%</td>
<td>36.6</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>46.5</td>
<td>85%</td>
</tr>
<tr>
<td>Capital</td>
<td>8.2</td>
<td>15%</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>54.9</td>
<td>100%</td>
</tr>
</tbody>
</table>

a. Real change = [(year t)/(year t - 1) x 100].
and-a-half times that of the districts (Ft 56.4 billion compared with Ft 36.6 billion). By 1993, on the strength of a buoyant district own-source revenue system (primarily capital revenues) and a less dramatic but nonetheless important shift in composition of normative grant revenues, the districts surpassed the municipality in terms of total revenues and total funds.

Because the own-source numbers reflect receipts from asset sales, the differential growth in capital revenues is especially noteworthy. They convey two important pieces of information. The first is the role of capital revenues in explaining the relative growth in total district receipts. In nominal terms municipal capital revenues have been flat (Ft 3.0 billion in 1991 and Ft 3.1 billion in 1993) and, thus, show a substantial decline in real terms for 1991–93. In contrast, capital revenues (largely asset sales) have been growing much more rapidly for the districts, from Ft 2.3 billion in 1991 and Ft 8.2 billion in 1992, to 17.1 billion in 1993—nearly a 200 percent increase in real terms for 1991–92 followed by a 76 percent increase for 1992–93. Second, the data give empirical content to the concerns regarding the unevenness of the net worth of physical assets transferred from state to local ownership under the 1990 reform legislation.

<table>
<thead>
<tr>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>District</td>
<td>Municipality</td>
</tr>
<tr>
<td>Amount (percent)</td>
<td>Share (percent)</td>
</tr>
<tr>
<td>28.2</td>
<td>50</td>
</tr>
<tr>
<td>15.8</td>
<td>29</td>
</tr>
<tr>
<td>10.0</td>
<td>18</td>
</tr>
<tr>
<td>21.6</td>
<td>39</td>
</tr>
<tr>
<td>13.3</td>
<td>24</td>
</tr>
<tr>
<td>8.2</td>
<td>15</td>
</tr>
<tr>
<td>55.1</td>
<td>98</td>
</tr>
<tr>
<td>1.1</td>
<td>2</td>
</tr>
<tr>
<td>56.1</td>
<td>100</td>
</tr>
<tr>
<td>37.4</td>
<td>80</td>
</tr>
<tr>
<td>7.5</td>
<td>16</td>
</tr>
<tr>
<td>46.9</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Municipal Research Center, Budapest (May 1993); tables 3.1 and 3.2.
whereby the districts received a positive net worth base while the municipality received an equally significant negative net worth transfer.

For spending, the overall story is the same as for revenues. District spending is rising both relative to the municipality and in real terms. In contrast, municipal expenditures are declining as a percentage of total local (municipal plus district) activity. In 1991 the municipality’s total spending accounted for 63 percent of total local spending. Two years later, the municipality’s share had declined to 53 percent. And whereas the municipality is beginning to incur debt, in the aggregate the districts are running a healthy surplus.

In sum, the delivery of local public services within the capital’s jurisdictional boundaries is developing in an ad hoc, uncoordinated manner. A systematic, empirical examination should be undertaken to sort out these expenditure assignment and revenue authority questions, and to determine whether, in order to satisfy the political imperative to decentralize the state, the Parliament has overfragmented the capital city, thereby unintentionally undermining the development of a fiscally healthy municipal government.

Conclusion

An evaluation of Budapest’s municipal finances should be kept in perspective. It was only four years ago that the Hungarian Parliament laid out a framework for devolving fiscal responsibilities from the state to newly established local governments and that Budapest held its first postcommunist elections. At that time, historic challenges arose as Hungary began its transition from a command economy to a market economy. Among these was the need to create a public sector that would satisfy market demands for efficiency and accountability in the delivery of public services and facilitate the nation’s goal of becoming a full partner in the global marketplace.

In the short time it has had to act, Budapest has managed its fiscal affairs well. The city has made progress in establishing a modern budget system, become more explicit in its sources and uses of funds, faced up to difficulties of choosing among competing demands for municipal resources, and begun to articulate the case for a systematic reexamination of the municipal-district relationship. In addition, a group of municipal finance experts has been assembled within the government and in non-governmental institutions.

Budapest is now at a policy crossroads, and how it proceeds—and is allowed to proceed—in the next four years may profoundly affect not only the city’s ability to emerge as a viable, creditworthy, autonomous government, but also the extent to which Hungary as a whole realizes the
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potential efficiency and equity benefits of decentralizing its fiscal system as a logical and critical component of its transition from a command economy to a market economy. Under current arrangements, the municipality remains much too closely tied to the central government, making it vulnerable to the national government's financial condition and the whims of Parliament. What is needed now is for local officials to be able to redirect efforts away from activities such as negotiating the structure of central transfers (for example, grant norms) and levels of shared taxes (the personal income tax negotiations for distribution in 1997) and toward the task of strengthening their own fiscal system.

On the tax side, one immediate step is to begin now to identify own-source revenue options that would add buoyancy to municipal financial accounts. Within this context, the time is right to begin the process of implementing a municipal ad valorem property tax system, a process that, even if started now, would take about two years to initiate and probably several more to fully implement. The potential fiscal payoff, however, is significant. At present, Budapest accounts for about four-fifths of Hungary's total housing property tax base measured at market value (Ft 2,108 billion of a total Ft 5,366 billion). If today a 1 percent effective tax rate were applied to that base, the tax would generate enough new revenue to pay for 30 percent of total spending.2

Ultimately, of course, Budapest cannot become viable without a large dose of intergovernmental cooperation from the center. Part of the center's role is, simply, to facilitate (in some cases by just getting out of the way) the ability of the city to truly act, as the parliamentary law proclaims, as a "self-government." As a first step with respect to spending, the Parliament must be willing to look at an overhaul of the municipal-district relationship and examine options ranging from eliminating the mandatory assignment clauses to repealing the Law on the Capital City. With respect to revenues, the center must look to the repeal of rules that seriously undermine the municipality's ability to add buoyancy to its revenue system (for instance, the assignment of the property tax solely to the districts). Unless there is a rethinking of the intergovernmental fiscal relationship, Budapest may not "shrink into provincialism," as it has in the past, but it will remain a ward of the state—and an inefficient, unaccountable, and expensive one.
### Annex 3.1 Revenue and expenditure tables for Budapest

#### Table A3.1 Municipal revenue detail, Budapest, 1991–93

*(thousands of forints or percent)*

<table>
<thead>
<tr>
<th>Item</th>
<th>1991</th>
<th>Actual amount (Ft '000)</th>
<th>As a percentage of all funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Normative state assistance for operations</td>
<td>12,521,564</td>
<td>22.0</td>
<td></td>
</tr>
<tr>
<td>Normative state assistance for development</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>12,521,564</td>
<td>22.0</td>
<td></td>
</tr>
<tr>
<td>Targeted grants</td>
<td>1,635,000</td>
<td>2.9</td>
<td></td>
</tr>
<tr>
<td>Addressed grants</td>
<td>267,709</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>Central wage adjustment</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Central assistance to public employees</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other state assistance</td>
<td>1,231,720</td>
<td>2.2</td>
<td></td>
</tr>
<tr>
<td>1. Total state assistance</td>
<td>15,675,993</td>
<td>27.5</td>
<td></td>
</tr>
<tr>
<td>2. Personal income tax</td>
<td>9,403,148</td>
<td>16.5</td>
<td></td>
</tr>
<tr>
<td>3. Social security contribution</td>
<td>15,525,133</td>
<td>27.2</td>
<td></td>
</tr>
<tr>
<td>4. Total centrally regulated sources</td>
<td>40,604,264</td>
<td>71.2</td>
<td></td>
</tr>
<tr>
<td>5. Municipal government’s own-revenues</td>
<td>11,141,514</td>
<td>19.5</td>
<td></td>
</tr>
<tr>
<td>Current revenue</td>
<td>8,155,346</td>
<td>14.3</td>
<td></td>
</tr>
<tr>
<td>Institution’s own-revenues</td>
<td>4,242,770</td>
<td>7.4</td>
<td></td>
</tr>
<tr>
<td>Local tax</td>
<td>281,194</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>Duties</td>
<td>2,894,892</td>
<td>5.1</td>
<td></td>
</tr>
<tr>
<td>Environmental penalty fees</td>
<td>13,925</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td>Treasury protection fines</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other revenues</td>
<td>479,553</td>
<td>0.8</td>
<td></td>
</tr>
<tr>
<td>Received financing instruments</td>
<td>243,012</td>
<td>0.4</td>
<td></td>
</tr>
<tr>
<td>Accumulation and capital-type revenue</td>
<td>2,986,168</td>
<td>5.2</td>
<td></td>
</tr>
<tr>
<td>Sale of physical assets</td>
<td>326,192</td>
<td>0.6</td>
<td></td>
</tr>
<tr>
<td>Revenue from privatization</td>
<td>159,895</td>
<td>0.3</td>
<td></td>
</tr>
<tr>
<td>Sale of rental rights</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale of other physical assets</td>
<td>664,029</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Income on financial investment</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Municipal government’s receipt of financial instrument for accumulation</td>
<td>1,836,052</td>
<td>3.2</td>
<td></td>
</tr>
<tr>
<td>Institution’s income for accumulation</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Value added tax income</td>
<td>1,083,377</td>
<td>1.9</td>
<td></td>
</tr>
<tr>
<td>7. Residual funds</td>
<td>2,339,237</td>
<td>4.5</td>
<td></td>
</tr>
<tr>
<td>8. Other revenues</td>
<td>1,644,631</td>
<td>2.9</td>
<td></td>
</tr>
<tr>
<td>Total revenues</td>
<td>56,434,163</td>
<td>99.0</td>
<td></td>
</tr>
<tr>
<td>9. Loans for operations and development</td>
<td>578,870</td>
<td>1.0</td>
<td></td>
</tr>
<tr>
<td>Total funds</td>
<td>57,013,033</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>From this: residual borrowed funds</td>
<td>578,870</td>
<td></td>
<td></td>
</tr>
<tr>
<td>New loans</td>
<td>578,870</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Note: See glossary for table A3.1, p. 146.*

*a. Real change = [(year t)/(year t−1) × 100].*
<table>
<thead>
<tr>
<th>Actual amount (Ft '000)</th>
<th>As a percentage of all funds</th>
<th>Real change as index of previous year</th>
<th>Actual amount (Ft '000)</th>
<th>As a percentage of all funds</th>
<th>Real change as index of previous year</th>
</tr>
</thead>
<tbody>
<tr>
<td>13,047,184</td>
<td>19.5</td>
<td>83.3</td>
<td>15,631,793</td>
<td>20.4</td>
<td>99.1</td>
</tr>
<tr>
<td>782,727</td>
<td>1.2</td>
<td>0.0</td>
<td>0</td>
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<td>0.0</td>
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<tr>
<td>13,829,911</td>
<td>20.6</td>
<td>88.3</td>
<td>15,631,793</td>
<td>20.4</td>
<td>93.5</td>
</tr>
<tr>
<td>997,500</td>
<td>1.5</td>
<td>48.8</td>
<td>1,096,631</td>
<td>1.4</td>
<td>90.9</td>
</tr>
<tr>
<td>951,984</td>
<td>1.4</td>
<td>264.5</td>
<td>677,884</td>
<td>0.9</td>
<td>58.9</td>
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<td>0</td>
<td>0.0</td>
<td>0.0</td>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>1,524,721</td>
<td>2.3</td>
<td>99.0</td>
<td>2,613,830</td>
<td>3.4</td>
<td>141.8</td>
</tr>
<tr>
<td>17,304,116</td>
<td>25.8</td>
<td>88.2</td>
<td>20,020,138</td>
<td>26.1</td>
<td>95.7</td>
</tr>
<tr>
<td>12,139,737</td>
<td>18.1</td>
<td>103.2</td>
<td>9,338,667</td>
<td>12.2</td>
<td>63.6</td>
</tr>
<tr>
<td>17,526,178</td>
<td>26.1</td>
<td>90.2</td>
<td>17,409,989</td>
<td>22.7</td>
<td>82.2</td>
</tr>
<tr>
<td>46,970,031</td>
<td>70.1</td>
<td>92.5</td>
<td>46,768,794</td>
<td>60.9</td>
<td>82.4</td>
</tr>
<tr>
<td>16,371,399</td>
<td>24.4</td>
<td>117.5</td>
<td>20,028,784</td>
<td>26.1</td>
<td>10.2</td>
</tr>
<tr>
<td>14,322,462</td>
<td>21.4</td>
<td>140.4</td>
<td>16,929,973</td>
<td>22.1</td>
<td>97.8</td>
</tr>
<tr>
<td>4,825,036</td>
<td>7.2</td>
<td>90.9</td>
<td>4,890,500</td>
<td>6.4</td>
<td>83.8</td>
</tr>
<tr>
<td>3,930,131</td>
<td>5.9</td>
<td>1117.2</td>
<td>6,527,347</td>
<td>8.5</td>
<td>137.4</td>
</tr>
<tr>
<td>2,850,908</td>
<td>4.3</td>
<td>78.7</td>
<td>2,708,010</td>
<td>3.5</td>
<td>78.6</td>
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<tr>
<td>30,267</td>
<td>0.0</td>
<td>173.7</td>
<td>15,400</td>
<td>0.0</td>
<td>42.1</td>
</tr>
<tr>
<td>0</td>
<td>0.0</td>
<td>0.0</td>
<td>0</td>
<td>0.0</td>
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<td>571,480</td>
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<td>700.0</td>
<td>2,217,236</td>
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<td>2,048,937</td>
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<td>1,962,258</td>
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<td>2,201,469</td>
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<td>94.2</td>
<td>70,493,952</td>
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<td>546,953</td>
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<td>75.5</td>
<td>6,284,867</td>
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<td>75.5</td>
<td>6,284,867</td>
<td>8.2</td>
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### Table A3.2 Municipal expenditure detail, Budapest, 1991–93

<table>
<thead>
<tr>
<th>Item</th>
<th>Actual amount (Ft '000)</th>
<th>As a percentage of all funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Current expenditure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Functions of social security financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Wages</td>
<td>6,680,533</td>
<td>12.1</td>
</tr>
<tr>
<td>b. Social security contribution</td>
<td>2,881,496</td>
<td>5.2</td>
</tr>
<tr>
<td>c. Material expenditure</td>
<td>7,268,398</td>
<td>13.2</td>
</tr>
<tr>
<td>Functions of state financing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public transportation</td>
<td>9,579,456</td>
<td>17.4</td>
</tr>
<tr>
<td>Other</td>
<td>20,076,667</td>
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<tr>
<td>a. Wages</td>
<td>6,310,052</td>
<td>11.5</td>
</tr>
<tr>
<td>b. Social security contribution</td>
<td>2,641,531</td>
<td>4.8</td>
</tr>
<tr>
<td>c. Road and bridge maintenance</td>
<td>1,305,068</td>
<td>2.4</td>
</tr>
<tr>
<td>d. Debt service</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>e. Material expenditure</td>
<td>9,820,016</td>
<td>17.9</td>
</tr>
<tr>
<td>2. Accumulation and capital-type expenditure</td>
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<td></td>
</tr>
<tr>
<td>Investment</td>
<td>7,027,224</td>
<td>12.8</td>
</tr>
<tr>
<td>a. Institutional investment</td>
<td>1,241,178</td>
<td>2.3</td>
</tr>
<tr>
<td>b. Municipal government's assistance for institutions for specific purposes</td>
<td>410,187</td>
<td>0.7</td>
</tr>
<tr>
<td>c. Municipal government's investment</td>
<td>5,329,252</td>
<td>9.7</td>
</tr>
<tr>
<td>Of which, debt service</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>d. Assistance to districts for specific purposes</td>
<td>46,607</td>
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<tr>
<td>Renovation of institutional assets of great value</td>
<td>1,190,703</td>
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</tr>
<tr>
<td>3. Assistance to entrepreneurs</td>
<td>217,959</td>
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</tr>
<tr>
<td>4. General reserves</td>
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<td>0.0</td>
</tr>
<tr>
<td>Operational type</td>
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<td>0.0</td>
</tr>
<tr>
<td>Accumulation type</td>
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<td>0.0</td>
</tr>
<tr>
<td>5. Reserves for specific purposes</td>
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</tr>
<tr>
<td>6. Other expenditures</td>
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<tr>
<td>Total expenditures</td>
<td>54,922,436</td>
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<tr>
<td>Surplus/deficit</td>
<td>2,090,597</td>
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Note: See glossary for table A3.2, p. 147.

a. Real change = \( \frac{(\text{year } t)}{(\text{year } t-1)} \times 100 \).
Financing a large municipality: Budapest

<table>
<thead>
<tr>
<th></th>
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<th>1993</th>
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<td>As a percentage of all funds</td>
</tr>
<tr>
<td></td>
<td>amount</td>
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<tr>
<td>53,845,285</td>
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<td>19,010,326</td>
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<td>3,259,116</td>
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<td>93.5</td>
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<td>34,834,959</td>
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<td>93.9</td>
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<td>11,249,802</td>
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<td>23,585,157</td>
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<td>93.9</td>
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<td>7,515,751</td>
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<tr>
<td>1,644,887</td>
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<td>90.9</td>
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<td>814,797</td>
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<td>902,980</td>
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<tr>
<td>309,621</td>
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<tr>
<td>65,798,425</td>
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<tr>
<td>1,238,294</td>
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<td>0.0</td>
</tr>
</tbody>
</table>

Glossary for table A3.1

Accumulation and capital-type revenue—Income from the sale of real estate, equipment, vehicles, and other material possessions of the local government. The definition includes receipts from securities, municipal bonds, investments, and the sale of compensation coupons or tickets.

Current revenue—Revenues collected by the local government in the form of taxes, duties, fees, and central-level transfers. Taxes can include the local business tax, a communal tax per capita, property taxes on land and buildings, and the tourism tax. Fees can include user charges, such as those for water, gas supply, and sewerage. Transportation fares also fall under this category. The Hungarian terminology excludes some items that would be included in Western accounts (shared revenues, central assistance to wages).

Institutions’ income for accumulation—Revenues designated for rehabilitation or renovation works that outlast one accounting period.

Loans for operations and development—Funds borrowed by the municipality to cover operational and capital expenditures.

Normative state assistance for operations—Unconditional central-local grant based on centrally designed per capita or per case norms for operations and maintenance costs.

Normative state assistance for development—Funds transferred by the central government to the municipality on a per capita basis for development or value-adding renovation and rehabilitation works.

Received financing instruments—Receipts from another autonomous government, social security, or other separate funds, or from the public in the form of contributions to a common interest.

Value added tax income—This figure is the amount of refunded value added tax the municipality receives from the central tax authority after the authority reviews all value added taxes paid and received by the local government in the delivery of public services and goods. After the review, the tax authority totals these sums. If the municipality paid more into the central budget than it received delivering these goods and services, that net amount represents the base of the refund.
Glossary for table A3.2

Accumulation and capital-type expenditure—Investments made to establish, expand, or add economic value to fixed assets. The purchase of compensation coupons or tickets, which because of underdeveloped security markets serve as security investments, is also included.

Assistance to entrepreneurs—Transfers to institutions owned jointly by the autonomous government to subsidiaries of budgetary institutions. All expenditures are current for operational purposes.

Current expenditure—Expenditures related to general operations, maintenance, and minor repair works that do not add value to the specific assets. The Hungarian terminology for current expenditures excludes some terms that would be included in Western budgets (assistance to entrepreneurs, general revenues, reserves for specific purposes).

General reserves—Appropriated funds to ensure the orderly execution of the municipal government's expenditures in case of an unexpected revenue decline or cost increase. These funds are allocated to operational and accumulation expenditures.

Investment—There are three words for “investment” in Hungarian: beruházás (investment project), fejlesztés (development), and felújítás (renovation and rehabilitation). The third term has been defined as an investment only since the 1992 accounting law.

Institutional investment—Capital-type expenditures executed by the budgetary institutions of the local government, mainly renovation and rehabilitation works. In 1992 two-thirds of these expenditures occurred in education and health-care institutions.

Municipal government's assistance to institutions for specific purposes—Assistance mainly to health-care institutions for renovation or rehabilitation works.

Reserves for specific purposes—Funds appropriated to ensure the orderly execution of the local government's budgetary expenditures in case of unexpected revenue declines or cost increases. These reserves differ from general reserves in that they are allocated for the execution of specific tasks.
Notes

1. The municipality accounts for 2.1 million of Hungary's 10.3 million residents. Another 0.4 million live in the greater Budapest-Pest County agglomeration, which comprises forty-four other municipalities (1990).

2. Budapest Mayor Demszky Gábor addressed this issue in his remarks before the Group-24 meetings in Strasbourg, November 1993.

3. The related issue of the broader metropolitan relationship is not considered here.


5. Prior to January 1995, there were twenty-two districts. The question of whether the number of General Assembly members will increase as a result of the new district is yet to be resolved. The discussion in this paper refers to the twenty-two district arrangement.

6. The reforms included an enterprise or corporate profits tax (statutory rate of 36 percent), a progressive personal income tax (a standard deduction, then brackets of 25, 35, and 40 percent), a value added tax (standard 25 percent rate reduced to 10 percent for food and certain household staples), a social security tax (44 percent of gross wages on the employer plus 10 percent on the employee), a Solidarity Fund tax (5 percent of business gross salaries), and a central development fund tax (4.5 percent of the previous year's profits).

7. Several cautions must be made about such comparisons between transition and Western economies. The degree of government intervention through "off budget" state-owned enterprises and the government's role as owner of capital and setter of prices is more pervasive in socialist/transition countries than in Europe generally. And GDP as a measure of total economic activity is subject to a high degree of uncertainty. For example, whereas in 1993 the undocumented economy accounted for 4 to 6 percent of GDP in OECD countries, the number could be as high as 30 percent in Hungary (Oxford Analytica, May 23, 1994).

8. For 1994, debt service, which cannot be adjusted in the short term, is the largest budget component (24 percent). Transfers to central budgetary institutions rank second (22 percent), and central-local transfers rank third (20 percent). At the beginning of the transition (1991), central-local transfers were 34 percent of the total state budget.

9. The twenty-four norms in 1994 include eight population- (needs-) based measures, and eighteen capacity- (per case) based norms; there are also three non-norm-based components of the formula. The heavy tilt toward a capacity- rather than a needs-based approach is a reason many local governments may have failed to take advantage of own-source revenue options available to them.

10. State contributions and allocations include the normative, addressed, and targeted subsidies and the personal income tax supplement (chapter 2). Data were provided by the Hungarian Ministry of Finance, September 1994.
11. The BKV is responsible for all forms of public transportation. The Hungarian Law of Transformation of State Property requires that BKV become a publicly held company by December 31, 1996, with joint ownership of its stock held by the Municipality of Budapest and BKV employees. Other municipalities could become shareholders later on.

12. There are three basic types of budget (which are complementary): operating, capital, and cash. Conceptually, operating and capital budgets differ in several ways, although in practice, the definition of "operating" and "capital" varies across governments. Generally, operating budgets contain revenue and expenditure data relating to services delivered in the current year. A capital budget provides information for activities that yield a flow of services over a period of years that extend beyond the operating cycle. A cash budget focuses on receipts and disbursements and identifies anticipated cash flows into and out of the government each period. Such an approach has merit when governments receive revenues infrequently and in large amounts or experience long lags in expenditure reimbursements.

13. The averages presented mask a wide range of practice. Developing countries are examined by Balh and Linn (1992, chapter 2), and OECD data are provided in OECD (1994).

14. The resource mobilization argument is particularly relevant to socialist economies (Bird 1993; Hicks 1992; Wallich 1992a). Recent empirical evidence on the relationship between fiscal decentralization and the size of government is provided by Ehdaie (1994).

15. The general obligation borrowing process has at times been very secretive, and the public has not been informed of the membership of the consortium or the terms of the indebtedness. This lack of transparency raises questions of fiscal accountability.

16. Under the pay-as-you-go scheme, the entire cost of a capital project is paid by taxpayers during the construction period. In contrast, borrowing is a mechanism for spreading the capital costs over time. When a government borrows to finance new investment, efficiency is enhanced because the flow of service benefits matches the flow of revenue costs over the life of the fixed investment. The equity argument for spreading out the tax and fee contribution over the useful life of an investment derives from the proposition that each of the several generations that receive the benefits of the investment should contribute to its cost.

17. Typically, both operating and capital budgets use accrual accounting, recording revenues when they are earned (whether or not cash is received) and expenditures when their services are delivered (whether or not cash payments are made).

18. Receipts from asset sales are uncertain. In January 1993 the municipality projected asset sale receipts of Ft 7.4 billion; the final 1993 numbers for all capital-related revenues (of which asset sales are only a fraction) were less than half that (Ft 3.1 billion). The 1994 budget estimate for asset sale receipts in 1994 is Ft 4.0 billion, which is nearly eight times that of actual 1993.

19. These social costs include unemployment benefits and the costs of supporting, through pensions and social assistance, the people displaced from the workforce by the transformation. See Barbone and Marchetti (1994).
20. The legislative intent of the Law on Self-Government of the Capital City and the Capital City Districts (1991) is for the municipality and the districts to be “partners with differing duties and responsibilities,” and that “at all costs, the capital city and its strict self-governing authority not be arbitrarily curtailed by the Parliament.” This preference for political decentralization is a reversal of (and, some would argue, a response to) Budapest’s earlier role under the council system, under which it received special powers and thus could repress district interests (Public Law XXIV, 1991, General Justification).

21. Following the 1994 elections, and reflecting the municipality’s view that the Expo’s offsite infrastructure was too fiscally burdensome, the Expo was canceled.

22. Data provided by József Hegedüs and Robert Kovács, Metropolitan Research Institute, September 1994. Although this is clearly an upper-bound estimate for a residential property tax (it excludes the potential effect of exemptions from the tax base), it should also be noted that the estimate excludes commercial and industrial properties.
BALTIC SEA

POLAND

Province (voivodship) centers
National capital
Province (voivodship) boundaries
International boundaries

Province (voivodship) names match the province (voivodship) capitals.
Local and intergovernmental finances in Poland: An evolving agenda

Luca Barbone and James F. Hicks

Poland has been, in many respects, the flagship of Central and Eastern Europe in the decentralization of the state and transition to a market economy. Impartial rules have replaced the negotiable rules of the previous central planning system, and legal constraints on arbitrary actions by political authorities have been strengthened. In a radical departure from the past, Polish citizens may recall elected officials for incompetence or corruption. Property rights are being clarified and broadened, and economic decisions are being decentralized. On the whole, political and economic power in Poland is shifting from a small group of people to a set of rules.

This chapter examines how the relations between central and local governments have been evolving in Poland and presents the main issues and challenges of consolidating local self-government and making the transition to a market economy. It takes stock of local government actions under the postcommunist order and examines behavioral linkages to macroeconomic performance, including local revenue mobilization, dependence on central fiscal transfers, and local government expenditure patterns. It also assesses how reform of Poland's local intergovernmental finances can support and consolidate the transition to a market economy.

Evolution of central-local relations

When the communist ideology and the states that were organized around it collapsed at the end of the 1980s, Poland was better prepared than most other Eastern European countries to move to a market-based
democracy (Hicks and Kaminski 1993). The disintegration of the old system was more advanced than elsewhere, and the various political and economic reforms implemented to sustain the regime, instead of prolonging its existence, created an environment conducive to the development of democracy and markets.

**Legacies of communism**

The departure point for Poland’s transformation was a crumbling centrally planned system, markedly different from the pure Stalinist version of the 1950s, but still far from a real democracy and a market economy. Following the imposition of martial law in December 1981, several reforms were initiated to introduce limited power sharing and improve economic mechanisms. As a consequence, Poland’s political and economic system at the end of the 1980s combined both communism and market-based democracy. Economic powers were significantly decentralized and state-owned enterprises enjoyed substantial autonomy, but property rights were poorly defined and state enterprises were not exposed to competition and hard budget constraints. Although the party-state had unlimited formal powers, in practice these were greatly diluted. In the 1980s the state was deconcentrated to a significant extent, with voivodships (regional entities of the central government; see map of Poland, p. 152) having their own revenue sources and substantial financial autonomy.

The political and economic reforms of the 1980s stalled when they could no longer improve economic efficiency or governability without destroying the identity of the centrally planned state. Market-oriented reforms could not work without markets—that is, without price liberalization and competition. Appropriate incentives for responsible financial behavior could not be established in state enterprises without recreating property rights. With citizens unable to choose their government, political reforms had limited meaning. The reforms left a mixed legacy: by decentralizing some decisionmaking, they created an institutional environment more conducive to market-based democracy, but their unfinished character quickly deteriorated into the economic chaos and hyperinflation of 1989–90.

**Local administrative and legal arrangements under socialism.** After World War II Poland adopted a three-tiered, unitary public administration system essentially identical to the one that existed before 1939. The country was divided into 17 voivodships, 330 powiats (intermediate-level administrations), and, at the local level, 704 towns and 2,993 gminy (municipalities). The administrative structures had little decisionmaking
autonomy, but were considered local subdivisions of the central power. Substantive power rested with the party, with the state administration relegated to the role of an executive machine.

In January 1955 the gminy were replaced by 8,790 gromada districts. During 1955–72 many of the gromada were liquidated, and the powiat structure was reformed. By the end of 1972 Poland had 392 powiats (including 78 towns with powiat status) and 4,315 gromadas.

In June 1973 these reforms were reversed. The gromada districts were abolished and replaced by 2,365 gminy. In June 1975 the powiats were abolished, with their administrative functions shifted to the voivodships, which increased from seventeen to forty-nine. This structure was inherited by the regime that came to power after the 1989–90 political transition.

Local political and financial responsibilities during the 1980s. In addition to causing political crisis and the gradual dissolution of the socialist state, the imposition of martial law in December 1981 (in effect until July 1983) shifted the balance of power between central and local administrative branches. By the end of the 1980s voivodships had achieved considerable independence from the central government, with central intervention circumscribed by constraints on information access and political activities (Kaminski 1989). Voivodships were responsible for numerous public services, including health, welfare, and transportation, while gminy were mainly responsible for local services, including garbage collection and public housing maintenance. Although the gminy had some autonomy, it was not clearly delineated or guaranteed. Deconcentration reforms, though accompanied by some devolution of power, essentially transferred authority within an integrated administrative system. Lower administrative levels remained subject to central control.

Some of these protolocal entities facilitated the reform program initiated by the first national Solidarity government, elected in June 1989. Local entities organized around Solidarity had started to emerge before the socialist regime collapsed. These groups easily won the 1990 local elections. Their considerable experience in local politics was useful in the implementation of reforms (Gazeta Wyborcza, May 27, 1992).

Public finance shortcomings of the previous regime. Although some of the seeds of political reform were sown before the socialist regime collapsed, this was not the case for intergovernmental financial relations. The system in place was purposefully murky and devoid of incentives for fiscal responsibility. Budgetary allocations were based on bargaining between the center and the deconcentrated units of government. Administrative reforms in the 1980s, though designed to restore central
control, ultimately eroded the center's power over regional and local authorities (Kaminski and Soltan 1989).

The inherited public finance system and attitudes toward financial management presented major obstacles to local government reform. Under the socialist system, everything was subject to negotiation, and access to resources depended on bargaining power. Such traditions are difficult to eradicate unless new rules are introduced quickly and fully enforced. With the proliferation of extrabudgetary funds, accompanied by haggling over allocations, some people may have learned to negotiate—but most remained unaware of the requirements of sound financial management.

The methods of public service provision (including choice of technology, coverage, administrative practices, public finance instruments, and legal arrangements) used in the communist state were incompatible with the requirements of market-based democracy. As democratic elections took place in 1990, local governments faced many problems caused by inefficient and centralized enterprises, the obscure legal status of state-owned properties, a distorted budget revenue structure based on state enterprises, and enormous stocks of public housing. Resolution of these issues required a transition period for intergovernmental relations.

Local government reform initiatives, 1990–91

Decentralization of government decisions was a priority of the Solidarity-led administration. Transferring power to local communities became a precondition of the effective expression of democracy, superseding equity and economic efficiency.

Legal framework. The first Solidarity government passed the Law on Local Self-Government on March 22, 1990. The Law—which is broadly consistent with the Council of Europe's European Charter of Local Self-Government—gives local governments (gminy, now numbering nearly 2,500) legally protected autonomy. It also grants local governments responsibility for all public matters of local significance not legally reserved for other units. Specifically, the Law gives local governments varying degrees of authority over housing, health services, social assistance, energy and heat, local transport systems, water supply and sanitation, kindergarten and primary education, public order and fire protection, and spatial organization, land use, and environmental protection. This authority ranges from full devolution to gminy of financing and delivery responsibilities, to delegation from the central to local governments of delivery responsibilities.
The Law on Local Self-Government also states that:

- Local governments are to be held accountable to their constituents through free elections (with provisions for recall) and local budget execution is to be audited by regional accounting offices.
- As a tier of government, local governments have legally protected autonomy.
- National laws may delegate to gminy the delivery of certain “mandated tasks” (such as social assistance programs) for which the central government provides financing and guidelines for coverage and service levels.
- Local governments are autonomous for budget formulation and implementation, but the Ministry of Finance will allocate general subsidies on the basis of objective criteria.
- Gminy may form associations for the joint provision of services (river basin management association, for example) or for purposes of representation (as with voivodship-level associations of gminy).

Elections for gmina councils were held in May 1990, and the Local Government Duties and Powers Act was passed that same month. A transitory legal framework was in place for the remainder of 1990, and a more stable local public finance framework was introduced in 1991. This framework consisted of the Act on Local Revenues and Rules of Financing (December 14, 1990), the Budget Law Act (January 5, 1991), and the Act on Taxes and Local Fees (January 12, 1991). These acts separated the local budgets from the central budget and simplified the public finance system by abolishing extrabudgetary arrangements and by linking financing with assigned tasks. The acts also incorporated voivodship budgets in the central budget and eliminated the voivodship share of enterprise taxes.

In July 1990, 254 regional offices (rejony) were established to support the general administrative work of voivodships, especially with regard to rural gminy. One rejon usually contains three to twelve gminy. Gminy have their own administrative support units called solectwo, with the responsibilities of these units defined by gmina councils. The administrative and territorial structure of Poland introduced in 1990 is summarized in figure 4.1. This basic structure is still in place.

Devolution of expenditures. Local officials began 1991 with a hastily prepared patchwork of legislation covering their rights, responsibilities, and revenue sources. They faced many ambiguities. Implementation of the political agenda set out by the Law on Local Self-Government has been conditioned by the political, financial, and technical realities that true decentralization must face. Ambiguities have persisted and continue to be an important issue for gmina operations.
Although gminy have had considerable autonomy in the provision and pricing of many public services (including water and sewerage, sanitation, and public transportation), in other important areas they have little or no control. For example, although housing stock was transferred to gminy, the central government controls the rents, and while gminy are responsible for urban transport planning and control, voivodships still administer parking areas. The central government also maintained caps on some local revenues, including the real estate tax, and through the voivodships regulates land use, building, and environmental controls—despite the formal provisions of the Law on Local Self-Government.

The initial legislation provided for phasing in the decentralization of some large expenditure items, most notably primary education (through 1993) and water supply and sanitation (through 1992). The
transfer of responsibility for education has been extremely limited. Teachers are still central government employees, and their salaries are fixed at a national level (as are other employment conditions). Municipalities must continue to offer primary education, but they have little discretion over how education resources are utilized.

The rules of the game for decentralization have been vague. (An overview of the administrative status of decentralization is in table 4.1, providing a rough notion of the control that gminy can exercise over the type and quantity of goods or services provided, prices charged, and sources of financing.) Ambiguities in the intergovernmental assignment of responsibilities reduce accountability, limiting the potential benefits of decentralization. (These issues are examined later.)

Still, decentralization has produced remarkable results in many areas, particularly when it has been accompanied by strong incentives for financial responsibility. In public transportation, for instance, cost recovery has increased dramatically, and several different management arrangements have emerged, ranging from more efficient management of municipal enterprises to privatization of bus services. Welfare programs, though legislated largely at the center, are administered by local governments with a degree of effectiveness that could not be achieved.

Table 4.1 Expenditure responsibilities of gminy, Poland, 1994

<table>
<thead>
<tr>
<th>Responsibility</th>
<th>Control</th>
<th>Financing</th>
<th>Central administrative oversight</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Quantity</td>
<td>Price</td>
<td>Local</td>
</tr>
<tr>
<td>Primary education</td>
<td>Exogenous</td>
<td>Center</td>
<td>Largely</td>
</tr>
<tr>
<td>Current expenditures</td>
<td>Gminy</td>
<td>Center</td>
<td>Largely</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>Gminy</td>
<td>Center</td>
<td>Largely</td>
</tr>
<tr>
<td>Local administration</td>
<td>Gminy</td>
<td>Center</td>
<td>Largely</td>
</tr>
<tr>
<td>Housing</td>
<td>Exogenous</td>
<td>Center</td>
<td>Largely</td>
</tr>
<tr>
<td>Current expenditures</td>
<td>Gminy</td>
<td>Exogenous</td>
<td>Largely</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>Gminy</td>
<td>Exogenous</td>
<td>Largely</td>
</tr>
<tr>
<td>Municipal services</td>
<td>Exogenous</td>
<td>Gminy</td>
<td>Largely</td>
</tr>
<tr>
<td>Current expenditures</td>
<td>Exogenous</td>
<td>Gminy</td>
<td>Largely</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td>Exogenous</td>
<td>Gminy</td>
<td>Largely</td>
</tr>
<tr>
<td>Social welfare</td>
<td>Exogenous</td>
<td>Center</td>
<td>Largely</td>
</tr>
</tbody>
</table>

a. "Control" here means preponderance of control. "Exogenous" indicates that for which neither the central nor local government is key, where market conditions may exercise preponderant control over quantity or prices.
b. By the end of 1991, 95 of the almost 2,500 gminy provided primary education under agreements with the Ministry of Education.
c. Primarily water, sewerage, and transportation. Some water and sanitation companies have been placed on a "utility" basis, rendering controls over expenditures and financing "exogenous"; oversight is provided primarily by local governments.

Source: Authors.
by a distant bureaucracy. In water management, local governments have taken several approaches to fulfill new responsibilities and adjust to the drastic reduction in subsidies.

Building the local revenue base. Under the Law on Local Self-Government, local finances were based on a combination of own-source revenues, shared national taxes, and national fiscal transfers (Bell and Regulska 1992).

- **Own-source revenues** included local taxes (with bases determined by the central government), fees, and income from gmina-owned assets. The most important gmina taxes were on real estate, agriculture, motor vehicles, inheritances, and gifts. Gmina councils set the tax rates within limits dictated by the Ministry of Finance. For example, the real estate tax rate was capped by the ministry and applied to a base limited to the property’s physical area (flat tax rate per square meter). Fees charged for administrative and other services, such as housing rents, were also subject to central control, either directly or through voivodships. Sales of gmina commercial properties to private owners were substantial during 1990–91, though they were not well documented in central or local government financial statements. The public viewed the aggressive privatization of gmina assets as a significant breakthrough (Bukowski and Swianiewicz 1992).

- **Shared national taxes** initially reflected the public finance system inherited from the communist regime. The main national taxes shared with gminy were enterprise income taxes (a 5 percent share), enterprise wage taxes (a 33 percent share), and taxes on individual craftsmen and other small businesses (a 50 percent share). Taxes were collected by treasury offices at the voivodship level and distributed among gminy on the basis of origin. Thus, gminy that contained large enterprises or mines were the beneficiaries of large windfall revenues, while neighboring communities—even those that hosted much of the labor force of these same enterprises (and generated most of the demand for local services)—were excluded from these revenue sources. The Act on Local Revenues of December 14, 1990 did not allow for a gmina surcharge, or “piggyback,” on national taxes as a way of increasing local revenues in a transparent manner.

- **Fiscal transfers** budgeted in 1991 were expected to cover the projected gap between a gmina’s total expenditures and its own-source and shared revenues. Transfers were based on central budget data from 1989 and 1990. Transfers were also to finance administrative functions delegated by the voivodship. The Act on Local Revenues stipulated that the total transfer must include...
funds to cover gmina education responsibilities, funds for investment, the equalization block grant, and funds to cover essential current expenditures, based on a complex estimation-of-needs index that considered population size, soil quality, tourism potential, and the presence of facilities such as seaports and airports (Dziennik Ustaw 1990). The Act does not explicitly earmark these general fiscal transfers, although additional transfers may be negotiated for specific purposes, for which earmarking has been the norm. In estimating the total size and allocation of fiscal transfers the Ministry of Finance used a formula that considered intergmina equalization and coverage of essential current and investment expenditures (estimated based on the central plan for 1990). Estimates of gmina own-source revenues did not include the sale of assets or income from rents, sales, and leases. All other estimates were based on data from 1989 adjusted for inflation and new budget needs arising from the substantially expanded responsibilities required by the Law on Local Self-Government. The equalization block grant was intended to compensate for disparities between revenue expected to be generated by a gmina and its expenditure requirements. This element was determined for each gmina by the formula $S = L \times 0.9(0.85B - A)$, where $S$ is the equalization allocation, $L$ is population size, $B$ is the national average of gmina own-source revenues per capita, and $A$ is estimated gmina own-source revenues per capita. To be eligible for the equalization block grant, a gmina’s own-source revenues per capita had to be at least 15 percent below the national average; 1,563 gminy met this condition in 1991.

**Historical origins of revenue sources.** The revenue sources available to local governments in 1991 were mostly derived from the old system of public finance, which was only beginning its process of reform. The 1991 structure for financing local governments is still in place, although, as noted below, revenue bases have changed (figure 4.2).

**Debt and borrowing.** Regarding debt, the Law on Local Self-Government prohibited gminy from running deficits, though it allowed them to include as revenue those items that more appropriately would be considered debt financing. Under this and subsequent regulatory laws, gminy could take out short-term bank loans for liquidity management in amounts not to exceed 5 percent of the expenditures approved for a given year and to be repaid within a year. For longer-term loans to finance investments, interest and principal repayments were not to exceed 5 percent of total annual expenditures. Overall indebtedness was low in 1991, and no local government issued bonds.
Significant reforms in national public finance were initiated in 1992. The enterprise income and wage taxes were replaced with the corporate income tax (5 percent local share) and the personal income tax (15 percent local share). Revenue from both taxes (with bases and rates established by national law) are shared with the local jurisdiction in which the taxes are collected. The personal income tax has a much broader base than the previous wage tax. Also, because the tax is on individuals (at their place of residence) rather than on enterprises, the amount of shared national taxes began to correspond more closely to the number of people living in each community.

The transition from a socialist to a market-based tax system for complementing local finances was made with relative ease. Local governments generated current account savings that supported investment programs on the order of 1 percent of gross domestic product. Except for a few large urban gminy, the level of gmina indebtedness remained low.

The number of gminy that negotiated a takeover of responsibilities for primary education rose from 95 in 1991 to 258 in 1992. Negotiations focused on the money to be transferred, using central planning indices of expenditures per pupil as a baseline. Fiscal transfers increased substantially for these gminy, increasing current expenditures.

Despite success during 1991–92 in eliminating extrabudgetary funds established during the socialist era, new central government funds

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**Figure 4.2 Intergovernmental fiscal flow of funds, Poland, 1991**

![Intergovernmental fiscal flow of funds, Poland, 1991](chart)

Source: Authors.
began to emerge. Substantial parts of these funds would reach local governments as executing agencies. The most significant fund to emerge is the Environment Fund, supported by the newly created ECOBANK. The Environment Fund packages the substantial revenues from pollution fees and fines into attractive, below-market loans to finance environmental improvement projects.

While funding activities with positive environmental impacts is laudable, the sectoral partitioning of intergovernmental financial flows carries risks for intergovernmental fiscal discipline and the accountability of public officials at all levels. This concern is exacerbated by the possibility that special-purpose banks may emerge to promote investments through subsidized financing, thus jeopardizing the development of local government investment financing under conditions of market discipline.

Another important institutional development was the creation of the Office for Public Administration Reform (OPAR) within the Council of Ministers. This was the first clear manifestation in any transition economy in Central or Eastern Europe of the importance of public sector reform, particularly intergovernmental relations, to an efficient transition to a market economy. OPAR was created to coordinate decentralization policy among various sectors and to facilitate the flow of information between levels of government. The need for such coordination during the first two years of local self-government was clear, and OPAR quickly received support from multilateral agencies (the World Bank and the European Union) and several bilateral aid institutions. Although OPAR is a central government entity, it has promoted an extensive outreach program to involve local governments in its analyses and deliberations.

Expansion of decentralization, 1993–94

The basic structure of local government finances did not change substantially from 1992 to 1993. The principal change was modifying the amount and the distribution of fiscal transfers among the gminy. The amount of these transfers was fixed at 12.5 percent of estimated central budget expenditures on housing and communal administration units and on total current expenditures (excluding earmarked funds). The allocation criteria were also modified. The four previous allocation criteria (current expenditures, education, investment, and equalization) were replaced by the following:

- A 40 percent share to all gminy according to the number of children per gmina.
- A 20 percent share to all gminy according to the number of inhabitants.
• A 20 percent share to gminy eligible for an equalization grant (eligibility is determined by the formula $S = L [0.9(0.6B - A)]$, with variables defined as under the 1991 law, but with $A$ and $B$ measured using executed gmina budget data).

• An 18 percent share to all gminy according to the weighted number of inhabitants in each, varying from a weight of 1.0 for people living in gminy with 10,000 inhabitants or less to a weight of 1.25 for populations above 300,000 (the increased weight applies only to the population in excess of the threshold).

• A 2 percent share held in reserve for final adjustments, as determined by the Ministry of Finance. Gminy also could receive earmarked transfers from voivodship budgets based on negotiations with voivodship authorities, primarily for local investments and social welfare measures.

Although any set of criteria for allocating intergovernmental fiscal transfers is subject to criticism, the reforms introduced in 1993 meet some of the important benchmarks used in evaluating fiscal transfer systems. The executed budgets of the gminy indicate that the total amount of fiscal transfers was adequate. The new allocation formula increased the transparency of intergovernmental fiscal transfers and their predictability from both central and local government perspectives.

An important part of the rationale behind the change in criteria for allocating fiscal transfers was the expectation that gminy would assume increasing responsibility for primary education. During 1991–92 transfer of this responsibility was voluntary, depending on each local government's willingness to assume the responsibility under the financing rules of the Ministry of Education. Although full transfer was expected by the end of 1993, only about one-quarter of the gminy (580 gminy) had negotiated agreements by that time. The national administration is currently reconsidering its transfer policy.

Because of the stable and predictable fiscal relations achieved between central and local governments during 1991–93, the local government finance law for 1994 includes expanded local government access to capital markets. Access is being promoted with credit ratings for local government investment programs. Also, the central government may provide guarantees for local borrowing if total local debt service does not exceed 15 percent of programmed local revenues, and if the local government agrees to pledge an acceptable part of its fiscal transfers as collateral for central government guarantees.

Poland's intergovernmental and local finance systems have made considerable progress. Local self-government and democratic processes seem well consolidated. But there is considerable political debate about reforms in the structure of subnational government. These include
redrawing the boundaries of voivodships and possibly giving them more political and financial autonomy. Restoration of powiat governments also is under discussion.

Jurisdictional fragmentation of local service areas and financing bases remains an issue, primarily in Poland's large urban areas. The urban area of the capital, Warsaw, is broken into seven gminy, loosely united under an urban government umbrella. Urban agglomerations (spilling over several gminy) are not legally defined, but gminy may form associations to provide services or infrastructure on a broader scale. Recently, urban mass transport and urban roads authorities were established in Warsaw.

Ambiguities also remain regarding implementation of local responsibilities for service delivery and financing, and about the potential for further decentralization. One example relates to financing the investments of Warsaw's subway system, the Metro. In accordance with the Law on Local Self-Government, the Metro is no longer classified as an investment of the central government. But the central budget has, since 1993, provided more than $60 million in subsidies to the Metro's investment program, far exceeding Warsaw's own contribution. The transition trend is clear, however, when these amounts are compared with Metro investment financing in 1992, when the city contributed about $3 million, and the central budget $40 million. These transition measures are consistent with those in other market-based democracies that have chosen to reform through "disjointed incrementalism" rather than through "master planning" (Lindblom 1968).

Recent political developments

Following the October 1993 parliamentary elections, a coalition of former communists (under the umbrella of the Democratic Alliance of the left) and the Peasant Party formed a government that commands a large parliamentary majority. The consequences for the decentralization agenda are not yet clear. There are important philosophical differences between the two partners, with the former communists favoring a stronger devolution of expenditures to local governments than the rural-based Peasant Party. Functional responsibility for reform has been assigned to the Peasant Party, which has greatly slowed design and implementation of the powiat level of government.

Legislation to reform the electoral law for local governments was vetoed by President Walesa in early 1994, and local elections were held on June 19, 1994. Electoral turnout, at 28 percent in urban areas and 38 percent in rural districts, was disappointing compared with an overall turnout of 42 percent in 1990. Although no clear winners emerged from these elections, the center and right coalition did not permit a replication at the local
level of the dominance achieved in Parliament by the Democratic Alliance and Peasant Party coalition. Clashes between these coalitions involve fundamental differences regarding local government reforms. The left supports maintaining the status quo, while the center and right coalition calls for greater devolution of power to local governments (including the proposed powiat structure) as fundamental parts of democratic reform.

**Local governments in action**

Gminy have now been self-governing bodies for over four years. Detailed budget execution data are available for 1991–92, with estimates for 1993, allowing analysis of expenditure and revenue patterns during this time.

*Local governments and the macroeconomy: Overall budget execution*

Despite their new responsibilities, gminy as a whole have generally complied with the Law on Local Self-Government’s requirement of a balanced budget (table 4.2). A slight surplus in 1991 was followed by a moderate deficit in 1992–93. These deficits were largely covered by the 1991 surplus carryover. In purely macroeconomic terms, the gminy appear to be a success: local autonomy has not created pressures for increasing the deficit, but rather has kept local spending within resource constraints, unlike in the 1980s. The safeguards and limitations on gmina activity discussed above appear to be having the intended effect.

With expenditures at about 5.9 percent of gross domestic product in 1993, gminy accounted for 12.5 percent of general government expenditures, but about 50 percent of total public investment (which totaled 2.8 percent of gross domestic product). This asymmetry—particularly intriguing in view of the lack of clear mechanisms for financing investment at the local government level—is partly attributable to low overall levels of public investment. Except for other formerly socialist economies, which have a similar pattern of compressing public capital expenditures, Poland’s total public investment is low compared with most OECD and middle-income developing countries. Nevertheless, Poland compares favorably with other countries—particularly unitary states—in local public capital formation.

*Gmina revenues: Dependence on the center*

Since a main objective of decentralization is to bring the delivery and financing of local public services closer to the final user, sound principles of public finance require that user fees and charges be utilized where feasible, that locally based taxes be the first complement to user fees, and that only as a last resort should local services be funded through transfers
Table 4.2 Gmina and general government finances, Poland, 1991–93
(trillions of zloty)

<table>
<thead>
<tr>
<th>Item</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>As a percentage of GDP</td>
<td>Amount</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General government</td>
<td>328.5</td>
<td>39.8</td>
<td>488.4</td>
</tr>
<tr>
<td>Gminy</td>
<td>46.8</td>
<td>5.7</td>
<td>64.4</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>24.7</td>
<td>3.0</td>
<td>28.1</td>
</tr>
<tr>
<td>Nontax revenue</td>
<td>9.3</td>
<td>1.1</td>
<td>16.6</td>
</tr>
<tr>
<td>Transfers from general government</td>
<td>12.8</td>
<td>1.6</td>
<td>19.7</td>
</tr>
<tr>
<td>Expenditure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General government</td>
<td>364.0</td>
<td>44.2</td>
<td>575.2</td>
</tr>
<tr>
<td>Gminy</td>
<td>43.7</td>
<td>5.3</td>
<td>65.1</td>
</tr>
<tr>
<td>Current expenditures</td>
<td>337.9</td>
<td>41.0</td>
<td>540.5</td>
</tr>
<tr>
<td>Gminy</td>
<td>33.9</td>
<td>4.1</td>
<td>48.9</td>
</tr>
<tr>
<td>Capital expenditures</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General government</td>
<td>26.1</td>
<td>3.2</td>
<td>34.7</td>
</tr>
<tr>
<td>Gminy</td>
<td>9.8</td>
<td>1.2</td>
<td>16.2</td>
</tr>
<tr>
<td>Balance</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>General government</td>
<td>-35.5</td>
<td>-4.3</td>
<td>-86.8</td>
</tr>
<tr>
<td>Gminy</td>
<td>3.0</td>
<td>0.4</td>
<td>-0.7</td>
</tr>
<tr>
<td>Memo item</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average exchange rate</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(zloty/U.S. dollar)</td>
<td>10,576</td>
<td>13,626</td>
<td>18,115</td>
</tr>
</tbody>
</table>

Note: General government figures are the consolidated accounts of the state budget, extrabudgetary funds, gmina budgets, and funds from other nonbudgetary entities.

Source: Ministry of Finance, Government of Poland; World Bank estimates.

from the central budget. Data on gmina revenues provide only a partial picture of local finances, because many local public services and goods are delivered by local government-owned enterprises, such as water and sewerage companies and public transportation enterprises, whose revenues (and expenditures) are not reflected in gmina accounts (table 4.3). The only enterprise information available is consolidated data on entities classified as "budgetary enterprises," which enjoy little operational autonomy and automatically remit to the local government any excess of revenues over expenditures. No data are available on local government enterprises incorporated in a different form, which account for most municipal enterprises. Sector-specific studies indicate that direct cost recovery practices have been strengthened by a significant number of gminy, in areas such as water and sewerage and public transportation.2

However, some general conclusions can be drawn about the composition of local revenues. First, taxes to which gminy are entitled under
Table 4.3 Gmina revenues, Poland, 1991–93
(trillions of zloty)

<table>
<thead>
<tr>
<th>Item</th>
<th>1991 Amount</th>
<th>Share (percent)</th>
<th>1992 Amount</th>
<th>Share (percent)</th>
<th>1993 Amount</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shared taxes</td>
<td>12.5</td>
<td>26.7</td>
<td>14.3</td>
<td>22.2</td>
<td>24.5</td>
<td>26.3</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>6.9</td>
<td>14.7</td>
<td>12.6</td>
<td>19.6</td>
<td>21.0</td>
<td>22.6</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>5.6</td>
<td>12.0</td>
<td>1.7</td>
<td>2.6</td>
<td>3.5</td>
<td>3.8</td>
</tr>
<tr>
<td>Own taxes</td>
<td>12.2</td>
<td>26.1</td>
<td>13.8</td>
<td>21.4</td>
<td>23.9</td>
<td>25.7</td>
</tr>
<tr>
<td>Real estate tax</td>
<td>7.6</td>
<td>16.3</td>
<td>10.6</td>
<td>16.4</td>
<td>14.3</td>
<td>15.4</td>
</tr>
<tr>
<td>Other</td>
<td>4.6</td>
<td>9.8</td>
<td>3.2</td>
<td>5.0</td>
<td>9.6</td>
<td>10.4</td>
</tr>
<tr>
<td>Subsidies from treasury</td>
<td>12.8</td>
<td>27.3</td>
<td>19.7</td>
<td>30.6</td>
<td>27.1</td>
<td>29.2</td>
</tr>
<tr>
<td>Directd</td>
<td>6.0</td>
<td>12.8</td>
<td>12.1</td>
<td>18.8</td>
<td>16.1</td>
<td>17.3</td>
</tr>
<tr>
<td>General (equalization)</td>
<td>6.8</td>
<td>14.5</td>
<td>7.6</td>
<td>11.8</td>
<td>11.0</td>
<td>11.9</td>
</tr>
<tr>
<td>Revenues from enterprises</td>
<td>1.2</td>
<td>2.6</td>
<td>1.3</td>
<td>2.0</td>
<td>2.2</td>
<td>2.4</td>
</tr>
<tr>
<td>Stamp duty</td>
<td>2.3</td>
<td>4.9</td>
<td>3.4</td>
<td>5.3</td>
<td>4.9</td>
<td>5.2</td>
</tr>
<tr>
<td>Lease or sale of assets</td>
<td>1.7</td>
<td>3.6</td>
<td>3.8</td>
<td>5.9</td>
<td>2.4</td>
<td>2.6</td>
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<tr>
<td>Interest income</td>
<td>1.4</td>
<td>3.0</td>
<td>1.5</td>
<td>2.4</td>
<td>2.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Other</td>
<td>2.7</td>
<td>5.8</td>
<td>6.6</td>
<td>10.2</td>
<td>5.8</td>
<td>6.2</td>
</tr>
<tr>
<td>Total</td>
<td>46.8</td>
<td>100.0</td>
<td>64.4</td>
<td>100.0</td>
<td>93.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Metro item

Average exchange rate
(zloty/U.S. dollar) 10,576 13,626 18,115

Source: Ministry of Finance, Government of Poland.

National legislation (own-source taxes—mostly the real estate tax—and shared national taxes) fell from 53 percent of total gmina revenues in 1991 to 44 percent in 1992, recovering to 52 percent in 1993. The drop was attributable to the abolition in early 1992 of one of the last remnants of punitive private sector taxation, the small business tax, to which gminy had a 50 percent entitlement, as well as to the budgeting difficulties of the central government, which did not transfer to gminy all the amounts it was obligated to under the law.

At the same time, gminy were clear winners from the personal income tax (PIT) that was introduced that same year. As mentioned, the PIT has a considerably broader base than the old wage tax and the other taxes it replaced. In an intriguing way, PIT reform increased budgetary support to gminy by bringing in some 10.5 million pensioners and public employees who had previously been exempted from income tax. When reform was implemented, nominal wages, salaries, and pensions were raised by the amount needed to leave after-tax wages largely unchanged. This increased gmina wage expenditures, but this burden was more than compensated for by substantial increases in tax revenues. The PIT now accounts for almost one-quarter of gmina revenues. And since the tax is now based on residence of the
taxpayer and not, as before, on location of the enterprise, gminy now receive shared personal income taxes more in line with household demand for local services.

Gminy do not have the authority to impose surcharges on shared national taxes, so revenue from these taxes is essentially beyond their control. More leeway is possible with their own taxes, the largest being the real estate tax. Total own-source revenues declined somewhat in real terms between 1991 and 1992, despite the good performance of the real estate tax. It is difficult to document the reasons for the decline, but the reduction in own-source tax revenues required a substantial increase in subsidies from the treasury, from 27.3 percent to 30.6 percent of gmina revenues. Within overall fiscal transfers, the equalization block grants declined in importance, while the subsidy for directed tasks rose substantially, reflecting the increased number of directed tasks (mostly primary education) taken over by gminy in 1992.

A commonly held view is that the resources given to the gminy for the increasing share of directed tasks have reduced the resources available for other local tasks, particularly in light of the relative declines in equalization grants and local own-source revenues. In addition, anecdotal evidence suggests that resources provided for the directed tasks have been inadequate, necessitating the diversion of other local resources.

More important, perhaps, than tracking down the reason for the decline in own-tax revenues is exploring the potential of substantially greater income from the real estate tax, the largest local own-source revenue. A study by the International City/County Management Association based on a simulation done for Kraków indicates that an ad valorem-based property tax could support 34 to 40 percent of that gmina's budget, compared with 24 percent under the current property tax based on flat rates per area, with caps imposed by the central government (Eckert, West, and Kelly 1993). Such reforms could increase accountability and incentives for local allocative efficiency, while reducing pressure on central revenues.

Gmina expenditures: Changing responsibilities

The spending responsibilities of gminy have changed gradually since 1991 (table 4.4). The two most important central spending items delegated to local administrations appear to be social benefits and primary education. Decentralization of primary education was to be phased in during 1991-93, but education quickly absorbed almost one-fifth of gmina expenditures (table 4.5). The role of the gminy in the provision of social assistance is reflected in the increase in the share of social welfare in the total budget.
Particularly striking is the substantial increase in the share of wages and salaries paid by local administrations. Some of the increase reflects changes outside the control of the gminy, such as higher salaries for teachers—whose share in expenditures almost doubled as more gminy assumed responsibility for education—and the introduction of the

Table 4.4 Gmina expenditures, Poland, 1991–93

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<td>Current expenditures</td>
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<td>77.6</td>
<td>48.9</td>
<td>75.1</td>
<td>71.9</td>
<td>77.1</td>
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<td>Wages and salaries</td>
<td>5.8</td>
<td>13.3</td>
<td>12.6</td>
<td>19.3</td>
<td>18.5</td>
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<tr>
<td>Purchase of goods</td>
<td>3.1</td>
<td>7.1</td>
<td>4.6</td>
<td>7.1</td>
<td>6.3</td>
<td>6.7</td>
</tr>
<tr>
<td>Purchase of services</td>
<td>6.0</td>
<td>13.7</td>
<td>9.1</td>
<td>14.0</td>
<td>14.9</td>
<td>15.9</td>
</tr>
<tr>
<td>Social benefits</td>
<td>2.6</td>
<td>5.9</td>
<td>5.4</td>
<td>8.3</td>
<td>7.8</td>
<td>8.4</td>
</tr>
<tr>
<td>Subsidies</td>
<td>13.6</td>
<td>31.2</td>
<td>16.1</td>
<td>24.7</td>
<td>20.6</td>
<td>22.1</td>
</tr>
<tr>
<td>Housing and municipal</td>
<td>4.4</td>
<td>10.1</td>
<td>1.8</td>
<td>2.7</td>
<td>1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>enterprises</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other subsidies</td>
<td>9.2</td>
<td>21.1</td>
<td>14.3</td>
<td>22.0</td>
<td>19.1</td>
<td>20.5</td>
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<td>Other</td>
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<td>6.4</td>
<td>1.1</td>
<td>1.7</td>
<td>3.8</td>
<td>4.1</td>
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<tr>
<td>Capital expenditures</td>
<td>9.8</td>
<td>22.4</td>
<td>16.2</td>
<td>24.9</td>
<td>21.4</td>
<td>22.9</td>
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<tr>
<td>Total</td>
<td>43.7</td>
<td>100.0</td>
<td>65.1</td>
<td>100.0</td>
<td>93.3</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Memo item
Average exchange rate (zloty/U.S. dollar) 10,576 13,626 18,115

Source: Ministry of Finance, Government of Poland.

Table 4.5 Gmina expenditures by function, Poland, 1991–92

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Productive sectors</td>
<td>6.7</td>
<td>5.9</td>
<td>0.1</td>
<td>0.1</td>
<td>3.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Municipal services</td>
<td>28.0</td>
<td>27.6</td>
<td>0.3</td>
<td>0.4</td>
<td>9.3</td>
<td>9.2</td>
</tr>
<tr>
<td>Housing</td>
<td>7.8</td>
<td>8.2</td>
<td>0.2</td>
<td>0.3</td>
<td>0.4</td>
<td>1.4</td>
</tr>
<tr>
<td>Education</td>
<td>16.0</td>
<td>19.7</td>
<td>2.1</td>
<td>5.7</td>
<td>1.2</td>
<td>2.2</td>
</tr>
<tr>
<td>Culture</td>
<td>3.9</td>
<td>3.8</td>
<td>0.3</td>
<td>0.4</td>
<td>0.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Health</td>
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<td>7.2</td>
<td>2.7</td>
<td>3.6</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Social welfare</td>
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<td>11.1</td>
<td>0.9</td>
<td>1.3</td>
<td>0.3</td>
<td>0.7</td>
</tr>
<tr>
<td>Administration</td>
<td>10.4</td>
<td>11.7</td>
<td>6.1</td>
<td>7.6</td>
<td>2.5</td>
<td>2.6</td>
</tr>
<tr>
<td>Subsidies</td>
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<td>0.0</td>
<td>0.0</td>
<td>0.4</td>
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<tr>
<td>Other</td>
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<td>0.3</td>
<td>0.4</td>
<td>2.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Total</td>
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<td>100.0</td>
<td>13.1</td>
<td>19.7</td>
<td>20.4</td>
<td>21.2</td>
</tr>
</tbody>
</table>

Note: This distribution of expenditures differs from that in table 4.4 because "other" expenditures are defined differently in the data sets that served as each table's source.
personal income tax, from which public employees had previously been exempted. At the same time, public employment increased by about 17 percent, from 77,000 to 90,000 gmina employees. Only a substantial fall in real terms (almost 9 percent) in the average salary of gmina employees (salaries are set at the national level) prevented a greater explosion in personnel remunerations.

It is difficult to gauge how local governments contribute to fiscal soundness, or to enhanced efficiency and equity, through decentralized decisionmaking. A key obstacle to this assessment is the lack of data on revenue from user charges. Expenditure data offer an indirect measurement, however. Under the general heading of subsidies are payments to local entities that require additional revenue to perform their functions. Since greater reliance on user charges is stimulated by local governments, reduced gmina budgetary outlays for general subsidies would indicate increased user charges. There was indeed a dramatic decline in the share of subsidies in gmina expenditures during 1991–92, much of it accounted for by the reduction in subsidies for housing and items covered by the Polish definition of municipal economy, including such communal local services as transport, water, and sewerage (see table 4.4).

The relatively large share of capital expenditures in overall gmina expenditures (about one-quarter) poses a challenge to local administrators, in that no explicit mechanism is in place for financing investment and access to credit is restricted. Over half of gmina investments go to municipal services, which include items ranging from street lighting and

<table>
<thead>
<tr>
<th>Social benefits</th>
<th>Subsidies</th>
<th>Capital expenditures</th>
<th>Other</th>
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<tr>
<td>----------------</td>
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</tr>
<tr>
<td>0.0</td>
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<td>0.2</td>
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<td>0.0</td>
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<td>2.6</td>
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<td>0.0</td>
<td>1.9</td>
<td>1.5</td>
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<tr>
<td>5.8</td>
<td>8.4</td>
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<td>0.7</td>
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<td>0.1</td>
<td>0.1</td>
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<tr>
<td>0.0</td>
<td>0.0</td>
<td>0.7</td>
<td>0.6</td>
</tr>
<tr>
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<td>0.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>5.9</td>
<td>8.4</td>
<td>20.6</td>
<td>22.6</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Government of Poland.
paving to water supply and solid waste disposal. Most of this investment is handled by municipal enterprises, and the available data do not allow for more detailed analysis.

More specific information on the composition of investment has been obtained through a survey of gmina investment behavior (box 4.1). Although not statistically representative, the sample indicates that gminy underinvest in streets (possibly reflecting misclassification of expenditures), spend a large share on investment in environmental sectors (perhaps because of targeted investment funds), and are active in areas still under central jurisdiction, such as schools, hospitals, and telephone networks (perhaps reflecting insufficient funding at the central level).

**Box 4.1 A sample survey of local government investment**

In early 1994 the Council of Minister's Office of Public Administration Reform (OPAR) launched, with World Bank assistance, a detailed survey of investments in a sample of twenty-seven gminy. The sample is not statistically representative (for instance, "municipal economy" accounts for a higher share of total investment in the twenty-seven towns than nationwide), but provides some insights on investment patterns:

- In 1993 the sectors accounting for the bulk of capital spending in the sample gminy were sewage treatment (17 percent), water supply (15 percent), education (14 percent), sewage collection (8 percent), streets (8 percent), land development (8 percent), housing (6 percent), heat supply (5 percent), and urban transit (4 percent). The figure for streets is low, suggesting that surface rehabilitation is either insufficient or counted mainly as a recurrent cost.
- Growth sectors during 1991-93 included sewerage and sewage treatment and transport. The share of heat supply, streets, and water declined. Solid waste investment was small but sample gminy expect it to pick up sharply in 1994.
- The high share of environmental services (water and sanitation) may reflect not only local priorities but a greater availability of soft loans for these sectors (avoiding polluter charges is an additional incentive for sewage treatment investment).
- Gmina budget funds are widely used for revenue-earning services, such as water supply. This may reflect slow progress in corporatizing utilities (some are still included in the budget sphere) and insufficient investment contributions from user charges.
- Sample gminy are investing in several sectors for which they still do not have formal responsibility (such as hospitals, schools, and telephone lines), which suggests that they perceive these services to be underprovided by the center.
The difficulty in obtaining aggregate information on investment behavior underscores a general problem of public sector budgeting: although progress has been made in converting antiquated budgeting classifications and procedures inherited from the previous regime (starting with the approval of the organic budget law in 1991), improvements have been more evident at the central than at the local level, where most budgeting departments remain weak.

Assessment: Decentralization or deconcentration?

There are several explanations for local government performance in the first two to three years of self-rule. First, central constraints on gmina operations are in fact partly responsible for their overall satisfactory performance (at least from a macroeconomic perspective), even though the constraints contradict the policy of local autonomy expressed in the Law on Local Self-Government. Gminy cannot run a deficit that is not financed, and the amount of investment financing (for example, from banking sources) is limited. Gminy have little or no control over their most important expenditure categories. Primary education is an assigned task, and teachers' employment conditions are negotiated nationally. Social assistance programs and administration wage rates are also largely determined at the center. Disposal of fixed assets, particularly land and buildings, requires administrative clearance. From this perspective, de facto decentralization, characterized by substantial local autonomy, appears to be limited, and the positive fiscal results to date are not necessarily indicative of a system that matches local beneficiaries with local payers for the provision of local services.

Despite these limitations, the benefits of the decentralization that has taken place should not be underestimated. Interviews with policymakers and users of public services alike suggest that people believe that service quality has improved despite the strict budgetary limits imposed on the gminy. Even if most financial variables are outside the control of the local administrator, there is ample anecdotal evidence indicating that the presence of some degree of accountability for local officials, and their interest in ensuring that gmina employees function in consonance with the objectives of the local administration, may have contributed to a new, user-oriented attitude and facilitated the transition from the bureaucratic culture of the past. The risk exists, however, that enthusiasm for local self-government may wane under tight central controls and limited local autonomy, with decreasing accountability of local officials to their constituents.
Current policy issues and proposals for change

Two policy issues are currently in the forefront of public discussion in Poland. The first is determining the prospects for further decentralization of state functions, and the appropriate structure and number of government levels. The other is identifying suitable vehicles for providing subnational governments with external financing sources for their investment activities, despite conditions of imperfect capital markets and lack of established creditworthiness. These issues are also of interest for the decentralization agenda of other formerly socialist economies.

Beyond municipalities: Issues and prospects

Decentralization in Poland is widely considered to be unfinished. A relatively large number (forty-nine) of deconcentrated branches of the central administration, the voivodships, remain in existence. The main responsibility of voivodships—in addition to oversight of certain gmina decisions, for example, those involving sale or disposition of assets—is to ensure that all central government expenditures within their jurisdictions are consistent with central government laws and policies. These include social and cultural expenditures such as secondary health care, museums, sports facilities, and the like, as well as investment in and maintenance of physical infrastructure such as regional roads. Voivodships also have significant inputs to national decisions regarding priorities for national expenditure programs (especially investment) as well as considerable discretion in the allocation of national resources within their jurisdictions. These conflicting roles have led to proposals to move voivodships in the direction of fewer, but more autonomous, regional-type governments. In addition, plans are under way to restore about 300 powiat governments.

The proposed powiat reform illustrates some of the principal issues and options for further decentralization of the Polish state. The restoration of powiats was proposed by the Suchocka government in 1993 and is still under discussion. Akin to U.S. counties or French départements, these governments would replace the rejony, which are geographic districts of the voivodship administrations. Presumably, the responsibilities and financing of the gminy would not be affected by the change. In fact, gminy with populations above 100,000 would not be incorporated into powiats but would add powiat functions to those they already have.

The main elements of the powiat proposal are:
- Powiat boundaries would coincide with the boundaries for a group of gminy. Each powiat would contain a minimum of five
gminy, at least one of which would have a population of 10,000 or more. The minimum powiat population would be 50,000.

- The main tasks of powiats would be to set policies and administer secondary and vocational education, health services with intergmina coverage, powiat-level roads, police and fire protection, district cultural institutions, land surveys and property registration, and veterinary supervision. This list is not fixed, and responsibility assignment is receiving close attention, particularly with regard to education and health. Phasing in the transfer of responsibilities is also being considered. If these spending responsibilities are accepted, some 40 to 45 percent of total public expenditures (excluding social security) would be transferred from the central government to subnational governments.

- Powiat councils would be directly elected. The councils would select the powiat executive consisting of seven to nine people, including the governor (starost). The powiat executive would be composed of professionals paid for their public service.

- Overall supervision of powiats would rest with the chair of the Council of Ministers. The voivod would have supervision responsibilities in cases where powiats are delegated voivodship tasks. Regional audit offices would supervise powiat financial management, as is the case with gminy.

Although the 1993 proposal for creation of powiats did not pass, a pilot program was set up in 1994 (box 4.2). This program is limited to the forty-six gminy with populations greater than 100,000, representing about one-third of Poland’s population.

When the pilot powiat program was launched in January 1994, agreements with forty-three gminy were in force. The program involves thirty-five gminy in education activities, thirty-two in health, nineteen in social welfare programs, and thirty in cultural activities. By the latter part of 1994, an assessment of the pilot program should determine whether it will be maintained, expanded, or eliminated.

Is further decentralization desirable? There are two sides to this question. Proponents of further decentralization argue that the reforms initiated in 1990 are incomplete. Over 85 percent of general government expenditure is assigned to the central government, which many consider to be increasingly incapable of carrying out important tasks affecting citizens’ everyday life. The deconcentrated branches of government (particularly the voivodships) are not democratically controlled, but are appointed by a center that may have very different priorities. To these proponents, further decentralization means fully embracing democracy and finally rejecting the communist model.
Box 4.2 Launching the pilot powiat program

Negotiations with each gmina eligible to participate in the pilot powiat program—those with populations above 100,000—were held at the voivodship level in late 1993. Following preliminary agreements, the voivod negotiated with the appropriate central ministries (such as health and culture). An exception was the case of secondary schools, where the central ministry's representative (kurator) within the voivodship negotiated directly with gminy.

A central issue in negotiations was the expectation that central fiscal transfers for new powiat functions would not be sufficient to provide powiat services at desirable levels. It was expected that other gmina revenues would also be used for new powiat services. This is an ambiguous area with potential for conflict, under the pilot program and beyond, if the program continues.

How the pilot program will be funded is not clear. In January 1994 the flow of funds was unchanged. Funds for secondary education in the pilot powiats came directly from the Ministry of Education to each school administration, or to the school administration via the kurator. The gmina (powiat) budget was not in the loop.

Changes in the financial arrangements for the pilot program were discussed as part of negotiations for central budget adjustments. Important issues for financing the powiat pilot program included:

- Regularity of fiscal transfers for decentralized responsibilities.
- Reform in fiscal flows, with funds going from central ministries to voivodships, and then to gmina budgets.
- How to handle the accumulated debt of transferred facilities. Many facilities (such as schools, hospitals, and libraries) are in arrears, mainly

Other observers (including World Bank 1992a) have urged caution in the pace of transfer of spending responsibilities to subnational governments. These observers believe that the lack of local administrative capacity combined with inadequate funding mechanisms may lead to rapid deterioration in local services or to a dramatic increase in demands on central government resources, driven by partisan politics rather than sound fiscal policy. The Law on Local Self-Government implicitly acknowledged this concern by allowing gminy to choose their implementation pace and recognized the concept of gmina associations as an important way of increasing local responsibility.

Full implementation of the powiat system could result in the rapid decentralization of responsibilities in a more complex administrative structure than that now in place. This presents risks that should not be discounted. The relative merits of decentralization and deconcentration may not yet have been adequately considered. Indeed, under current
Local and intergovernmental finances in Poland: An evolving agenda

It is unclear whether real autonomy can be exercised by local governments in many of the expenditure programs that would be devolved to them. For example, the authority of a powiat or gmina to deviate substantially from national education or health policies is quite limited, and likely will remain so. Thus, closer design and control by the users of public services, the bedrock of decentralization, may not be achieved. Also, decentralization of policy decisionmaking may not be appropriate in all areas singled out for transfer to existing or new local governments. Concerns about horizontal equity and minimum national standards may be justified in a number of important areas like education, and the complexities of the administration and funding of health services may require uniform national guidelines. In both cases, decentralized administration, rather than decentralized policymaking, might be appropriate. These issues do not appear to have been carefully studied before the political momentum for decentralization was allowed to build.
Furthermore, proponents of the powiat reform have not fully explored whether alternate models might be more appropriate to the tasks envisioned for devolution, such as a system of democratically elected regional governments as successors to a reduced number of voivodships. Restoring a pre–World War II model might not be the most sensible solution from an economic or even political point of view.

The proposed further decentralization of government is intriguing, but involves questions that, on balance, suggest prudence. The reinstatement of powiats, with responsibilities for big-ticket spending items such as regional health services and secondary education, does not appear to have been thoroughly considered. The current proposals regarding the financing of these added expenditures involve replicating transfers from the central government to match current outlays in the individual powiat. This hardly seems a recipe for genuine decentralization, which requires individual governments to choose the level and composition of public services. Also unresolved is the relationship between the proposed powiats and the existing voivodships.

Over time, as these basic issues are resolved, the powiat structure may offer significant benefits. Among these could be an enhanced fiscal base for Poland's urban areas, where increasing demand for public goods and services is expected.

Financing local investment

Despite the lack of appropriate funding mechanisms, gminy now account for a large and growing portion of total public investment. The proposed new levels of government might have investment responsibilities as well, making resolution of this issue of even broader relevance.

Generally speaking, gminy do not have access to financial markets (loans to gminy from the commercial banking system totaled just $8 million in 1992). Commercial banks' loan-processing abilities are undeveloped, and they are generally wary of nonguaranteed lending because of uncertainty in the enforcement of collateral collection laws. The lack of established creditworthiness of gminy is also an issue.

In the medium term, a main objective of Poland's decentralization strategy is the achievement of financial self-reliance by gminy and their enterprises. This may result from direct private sector involvement, which may take different forms (ranging from management contracts to asset ownership) and time horizons for implementation. Investment in revenue-earning services (water and sewerage, public transportation, and the like) would be financed from user charges, leveraged with commercial debt. Well-managed urban utilities should also be able to tap the emerging securities markets, issuing shares or bonds that could offer
attractive portfolio diversification opportunities for investors. Private project finance arrangements (such as build-operate-transfer arrangements) may also help diffuse some of the need for public investment in utilities. Investment in non-revenue-earning services would be funded from gmina revenues (including the proceeds of intergovernmental revenue sharing) and commercial debt or municipal bonds, without a need for central government support. Specific-purpose grants from the national government (in addition to revenue-sharing transfers) would be used only for local investments that support national programs or address externalities between local jurisdictions.

In the short term, however, Poland's financial markets remain undeveloped, and domestic banks may be unable to finance the lumpy investments and long maturities associated with infrastructure. The government has initiated reforms to develop a more competitive financial sector, but the full benefits of these reforms may take years to materialize. Another constraint to the emergence of a market for municipal debt is that gminy and their newly created enterprises have yet to develop their financial management systems and to assert their creditworthiness. In the meantime and as a transition measure, there will be a need for national support to help local governments or utilities access alternative financing sources, including external financial markets or multilateral lending institutions. Administering this support will be one of the main tasks of the Municipal Development Agency and of the parallel Municipal Credit Program, both approved for creation in March 1994. As national entities, these organizations should support responsible decentralization of the state, especially during the reform transition period.

The credit program would be especially useful if the central government is interested in ensuring gminy access to external lending sources. Multilateral agencies such as the World Bank and the European Bank for Reconstruction and Development may provide direct loans to a few large cities, but their scale of operations is not suited to the needs of small or medium-size towns. These agencies could reach a broad range of gminy through local government credit-line operations managed by a national intermediary, serving as a transitory mechanism until this function can be taken over by private sector financial entities. Financing from the international financial markets would also be eased because pooling a number of loans to individual gminy would result in a lower aggregate credit risk and reduced transaction costs compared with a situation in which each gmina has direct access to these markets.

Although it may appear to be a departure from sound decentralization principles, a limited, time-bound transition program to help gminy access investment finance, if managed in accordance with clear rules of the game, could help defuse political pressures that might lead to more
risky developments. In the absence of such a program, public demand for better local services could cause reckless deficit financing by gminy. Lobbying by troubled gminy could in turn extract bailouts from the national budget. Another risky option, which has some support in Poland's regions, would be the creation of regional banks, owned by groups or associations of gminy, to finance their investments. The experience of similar banks in Latin America has been disastrous on both investment quality and fiscal grounds, reflecting a basic conflict between their credit assessment function and their ownership.

As a complement to the credit program, the Municipal Development Agency may discharge important advisory functions in support of decentralization. The agency may steer technical assistance and training programs to local government institutions and disseminate models, instruments, and successful experiences in local management (for example, financial management systems, systems for local tax administration, and model contracts and bidding documents for franchising local services to private operators). It may also monitor gmina performance, particularly in financial areas, and attach conditions to credit or grant programs to encourage sound local management. This agency may also coordinate municipal development programs supported by a number of external donors and ensure their consistency with national policies. As the transition period for local government reform winds down and clear rules emerge covering local responsibilities and intergovernmental fiscal relations (and with the development of capital markets capable of responding to the financing of legitimate local investment needs), the agency's role would be gradually reduced to policy monitoring and reporting functions in a mature, decentralized state.

Notes

1. Public investment is defined here as budgetary outlays for capital investment. This may underestimate the total size of investment projects in some cases. In the case of state enterprises, for example, budgetary outlays may be complemented by enterprise funds and enterprise borrowing.

2. See World Bank (1994d) and World Bank (1994g).

3. This distribution of pilot responsibilities is limited to transfer of physical facilities, such as schools, and related staff and equipment. Areas in which the transfer does not involve clear facilities, such as environmental protection, are not covered.
BULGARIA

- County (oblast) centers
- County (oblast) boundaries
- National capital
- International boundaries

County (oblast) names match the county capitals, except where indicated on the map.

- SOFIA
- Burgas
- Varna
- Ruse
- Montana
- Lovech
- Plovdiv
- Khaskovo

KILOMETERS

The boundaries, coats of arms, and other information shown on this map do not reflect, in any manner, the views of the World Bank Group or any judgment on the legal status of any territory or any endorsement of the renunciation of self-determination.
Four challenges face the Bulgarian government in establishing an intergovernmental framework consistent with the principles laid out in chapter 1. First, a vertical structure of government must be developed, including the number of tiers of local government, the possibility of developing special districts, and the degree of fiscal autonomy granted to settlements, the smallest units of government. Second, a clear, operational assignment of expenditure functions among governments must be made. Under the old regime public expenditures were fully centralized even though a considerable share of spending was passed through or formally allocated to local budgets, especially for expenditures on education, health, and culture. Although, by law, municipalities are to have independent budgets, there is little true local autonomy because of current budgetary practices. Third, adequate tax and other revenue authority must be granted to local governments so that they may finance their assigned expenditure responsibilities. Finally, an intergovernmental transfer scheme must be employed that equalizes fiscal capacity across jurisdictions.

Bulgaria’s experience with decentralization is limited. Centralized governments ruled for centuries under the Turkish empire, followed by almost five decades of communist rule. Government institutions were a central conduit for authoritarian rule rather than a vehicle for addressing citizens’ problems. The decision to decentralize government followed a comprehensive liberalization program launched in February 1991; it was mandated in the Constitution (July 1991) and the Law on Self-Government and Local Administration (September 1991). Yet
implementation awaits the enactment of two draft pieces of legislation: a Law on Local Finances and a Law on Administrative and Territorial Division. As a result, there remains a gap between the declared intent to decentralize and the required institutions, laws, and regulations.

In 1992 municipal governments formulated their own budgets for the first time. But central government agencies still consider local governments to be their administrative arms. Moreover, many local officials still look to the center for guidance and solutions to their local finance problems. Decentralization requires not only the proper legal framework, but the determination by local and central authorities to practice this form of government. The latter will take leadership, time, and commitment.

Several factors are likely to slow decentralization in Bulgaria:

- The decentralization process is largely center-driven. Decentralization efforts are seen by many as political reform rather than as a means to increase local autonomy. Residents of ethnically diverse regions traditionally favor a centralized system of government to guarantee their religious freedom and ensure public transfers to their relatively poorer regions. And many are suspicious of decentralizing such services as basic education for fear that, in some regions, a Turk minority will gain control of some services to further a special political agenda.

- Worker unions, particularly teacher unions, also oppose decentralization. Unions believe that they have more bargaining leverage with a single (central) authority. They also fear that local governments under fiscal pressure will divert funds from areas such as education or health.

- There is also public mistrust of the technical capabilities and general competence of local officials. Many Bulgarians already feel that local governments have too much discretion, and administrative reforms characterized by quick changes in direction have created public confusion and skepticism. In addition, many reforms have been introduced with little notice to local officials, thereby fostering the perception of a lack of local competence.

- Finally, there is an element of guilt by association. Decentralization has evolved in the context of a difficult transition, with dwindling resources, overall government retrenchment, and decreases in the quality and quantity of public services. These conditions make it difficult for the public to distinguish between the need for structural reform (fiscal decentralization) and containment of transitional problems (unemployment and price instability).
Bulgaria's vertical government structure

Although Bulgaria has taken some initial steps toward fiscal decentralization, questions remain about its structure and the number and size of subnational units. This uncertainty adds complexity to the process and thus requires some discussion of the development of Bulgaria's governmental structure.

Background

The system of territorial division in Bulgaria changed several times under the communist regime (1945/47-1989). Prior to 1987 local government was administered by intermediate units of district (okruga) government whose budgets were part of the central budget. District governments were responsible for providing municipalities with services of a regional nature, such as roads and hospitals. Districts were led by a council whose members were effectively selected by the party leadership, and who implemented the policies of the central government. District and municipal governments negotiated the distribution of resources within a district, and a large portion of district funds often remained in district capitals. During this period the number of municipal governments fluctuated from a high of 1,389 in the early years to a low of 300 in 1987.

The current territorial administrative division in Bulgaria (as of 1987; see figure 5.1) divides the country into 9 regions (oblasti; see map of Bulgaria, p. 182), 255 municipalities (obshtini), 4,017 mayoralties

**Figure 5.1** Government structure, Bulgaria, 1993

Central government

Obshtini (255 municipalities)

Kmetstva (4,017 mayoralties) and naseleni mesta (5,336 settlements)

Source: Authors.
(kmetstva), and 5,336 settlements (naseleni mesta). The three largest cities are divided into districts (rayoni). The different territorial units are summarized in box 5.1. Regions do not have elected governments or autonomous budgets and serve mainly as deconcentrated agencies of the central government. Regional governors are appointed by the Council of Ministers and assisted by a deputy appointed by the prime minister. The staff of the regional administration is small and has limited responsibilities. Apart from Sofia the average region has a population of 0.9 million, with 30 municipalities and 650 settlements. A third tier of government, the county (okolia), was legislated in the 1991 Law on Local Self-Government, but it has never been made effective.

Municipalities, the first tier of decentralized authority and local autonomy, vary significantly in population and area. The average population of the municipalities is about 28,000 (excluding Sofia). About 77 percent of the municipalities have populations between 5,000 and 50,000, sixteen have more than 100,000, and twenty-one have fewer than 5,000. There is also considerable variation in the level of urbanization and the economic base. Municipalities are principally rural, with agriculture the primary economic activity. They are governed by a democratically elected mayor and municipal council. The mayor manages a core municipal staff, but since many services are still controlled centrally the mayor's staffing authority is uncertain.

Municipalities comprise a number of settlements. The average municipality has about twenty settlements. Settlements take the form of towns, villages, and population settlements such as monasteries, mines, or railway stations, and all settlement land falls within a municipality. Settlements elect mayors but generally do not have autonomous budgets. Most neither collect revenues nor receive funds from the central budget, though some large and medium-size settlements appear to be operating their own budgets. The mayoralties are settlements or associations of settlements that have the right, granted by the municipality, to elect their mayor by popular vote of the residents. The mayoralties have no council. Finally, the Law on Self-Government allows the three Bulgarian cities with populations in excess of 300,000 (Sofia, Plovdiv, and Varna) to be divided into another unit of government, the rayoni, each with its own elected council, but this has not been done.

Subnational government is an important part of the Bulgarian economy. In 1993 the consolidated budget for all subnational units was lev (L) 34.8 billion—about 24 percent of the consolidated government budget and 10 percent of GDP. The relative economic importance of local budgets is not, however, fully reflected in these figures. For example, local investments in 1993 represented half of the planned capital expenditures for the consolidated public sector.
Reform options in government structure

Reform of the vertical structure of government faces three main issues: whether an intermediate level of government clustering several municipalities is needed, whether these needs would be better satisfied by special districts for specific services, and whether additional budget autonomy should be granted to settlements.

### Box 5.1 Territorial division and local self-government

<table>
<thead>
<tr>
<th>Territorial unit</th>
<th>Nature of local self-government or deconcentration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Region (9 oblasti)</td>
<td>No locally elected authorities. A small staff with limited functions is headed by a governor appointed by the Council of Ministers.</td>
</tr>
<tr>
<td>County (110 okolii)</td>
<td>The 1991 Law on Self-Government allows for an indirectly elected council, but plans for implementation have been canceled. The central government has some offices in the okolia.</td>
</tr>
<tr>
<td>Municipality (255 obshtini)</td>
<td>An obshtinski council is democratically elected on the basis of proportional representation. A mayor is directly elected by majority vote of the population. Deputy mayors are nominated by the mayor and elected by the council. The core administrative staff of the obshtina reports to the mayor, but managers of many local services are appointed by the central government.</td>
</tr>
<tr>
<td>Mayoralty (4,017 kmetstva)</td>
<td>A mayor is elected by the population of the kmetstvo. The kmetstvo size and responsibilities vary considerably. Most functions are directed by central or obshtinski authorities.</td>
</tr>
<tr>
<td>Settlement (5,336 naseleni mesta)</td>
<td>Most large naseleni mesta are kmetstva or are grouped together to form kmetstva.</td>
</tr>
<tr>
<td>Urban district (3 rayoni)</td>
<td>The 1991 Law on Self-Government permits the establishment of directly elected councils in the rayoni, but none has been established. The rayoni currently have only mayors, who are appointed by the obshtina mayor.</td>
</tr>
</tbody>
</table>
Intermediate government. Two pieces of legislation have considered re-creating a general-purpose government similar to the districts that existed prior to the 1987 reform. The Law on Local Self-Government passed in September 1991 defines (a yet to be organized) system of 110 intermediate governments, which are to be formed by grouping municipalities into districts (okolia). Several drafts of a Law on Administrative and Territorial Division also envision district governments. These drafts differ according to the number of districts they create and the number of municipalities assigned to each district. District government would comprise a council formed by delegates from each municipality in the district and a governor appointed by the central government. Districts thus are conceived as a mix of deconcentrated units and decentralized, autonomous units. There are no financing provisions.

Despite Bulgaria’s small size (8.9 million), the need is apparent for some form of intermediate government with clearly defined responsibilities. Options for covering this need range from general-purpose governments with broad powers to jurisdictions with only a limited service mandate.

With the elimination of district (okruga) functions in the 1987 reform, the provision of regional services is currently a responsibility of the municipalities. This has produced conflicts among local governments. With tightened central budgets, subsidies have been inadequate to compensate municipalities for the provision of services of regional significance, such as the larger hospitals offering advanced services in Stara Zagora. Municipal governments have often been forced to allocate their own funds to maintain adequate service provision. Since residents from other municipalities are entitled to these services, the municipality providing the service has a legitimate complaint about other free-riding jurisdictions. Other municipal services with regional benefits include water systems, roads, environmental protection, and secondary and college education.

There are four issues the central government must consider before it creates intermediate governments. First, the proposed districts essentially duplicate, on a smaller scale, existing regional governments. Second, none of the proposals for territorial reform in Bulgaria includes provisions for local involvement in the process; rather, the central government will delineate the boundaries of the new districts even though local participation and consultation on the territorial divisions could provide stability and strengthen the acceptance of the system. Third, the central government should create a broad but explicit assignment of public service responsibility among the different levels of government before the districts are created. The size of districts should be based on the types of public services for which they are responsible, given their
ability to be relatively close to the voters and the extent of benefit spillovers (see chapter 1). The 110 districts proposed may be too many from this perspective. Finally, it should be determined whether the districts will be general-purpose, administering many services, or special-purpose, with one for each type of service. The districts have generally been conceived as general-purpose governments, responsible for providing several public services.

Special districts. The option of special districts is attractive in Bulgaria. The transition provides the opportunity to rationalize the provision of regional services according to economic guidelines, and thereby avoid creating just another layer of general-purpose governments drawn to old district boundaries.

Special-function districts can be simple and flexible. For example, associations of municipalities can fund, regulate, and control executive authorities for water supply, regional hospitals, or other services with regional dimensions. Thus, the boundaries of special districts do not necessarily coincide for the provision of all services. This facilitates exploiting economies of scale and internalizes the benefit spillover of each type of service.

Despite ethnic and historical clustering of municipalities, Bulgaria does not seem to have a grassroots demand for particular configurations of regions and districts. In addition, the concept of special districts is consistent with draft legislation on local finances, since no provisions may be needed for their financing, and with the Law on Local Self-Government, which sees districts as associations of municipalities headed by an appointed executive. An important change would be to give the power to appoint to the municipalities instead of to the central government.

Although the voluntary association of municipalities to form special-service districts may not occur, especially given the distrust created by experiences with district governments before the 1987 reform, the central government could create incentives for municipalities to enter these special districts voluntarily, and offer a framework for mediation and conflict resolution in established special districts. Such incentives could include a matching-grant program to encourage cooperation among municipalities in the formation of special authorities. For example, municipalities that agree to build and operate a regional hospital could receive a capital matching grant for hospital construction plus a multiyear grant to cover some of the operating costs. Funding could also require compliance with certain prerequisites for cost sharing among participating jurisdictions, and other conditions ensuring the stability and smooth functioning of the special district. The central government could also encourage contracting between municipalities that have the
proper facilities and those that lack them. Here, the selling jurisdiction would charge fees based on unit costs, and matching grants from the central government would both underwrite part of the costs to the buying jurisdiction and compensate the selling jurisdiction for several years.

Thus, from both a timing and efficiency perspective, Bulgaria should move cautiously, if at all, toward the creation of a third tier of general-purpose government. But circumstances indicate there would be merit in creating special districts to ensure the efficient provision of regional services.

Settlement autonomy. Another reform issue in the vertical structure of decentralized government concerns how much fiscal autonomy to grant to settlements. Increased fiscal autonomy for settlements can take two forms. Some settlements could separate from their municipal governments and establish themselves as municipalities with their own budget and revenue sources. Draft legislation on territorial division and amendments to the Law on Local Self-Government consider this possibility by easing the requirements for establishing municipalities. This process, however, could increase the number of municipalities from the current 255 to more than 800. The second way to increase the fiscal autonomy of settlements is by providing them with more budgetary independence from municipal governments. This could be accomplished, for example, by mandating that municipal governments deliver pass-through funds provided by the central government or other sources, or by assigning settlements their own revenue sources. Settlements could be assigned fees for basic services including sanitation, lighting, and streets.

The choice between allowing the incorporation of settlements as municipalities and maintaining their current status while granting them more budgetary independence involves a tradeoff. Allowing some settlements to incorporate as municipalities would enhance democratic institutions through citizen participation and increase overall efficiency by getting government closer to taxpayers. But increasing the number of municipal governments leads to a growth in bureaucracy and the likely duplication of government services. It also may involve lost economies of scale and increased complexity in policy coordination. One compromise is to allow only settlements that meet certain standards (such as population size or tax base) to incorporate as municipalities.

The optimal size of municipalities is a balance of benefits from increases in efficiency and political accountability against losses in economies of scale, increases in bureaucracy, and more complex coordination. These factors, in turn, depend on other factors such as technology and population density. In Western economies localities with 5,000 to 10,000
inhabitants are often considered adequate to provide self-government. Economies of scale for many local services can be reached at relatively low population sizes, and unit costs of provision can remain at the same level for very different sizes of local jurisdictions. Furthermore, local governments need not directly produce local services. These can be contracted for with the private sector, which can take advantage of economies of scale by servicing many jurisdictions (for instance, garbage collection). Similarly, some jurisdictions can contract with other jurisdictions for the delivery of specific services (such as transportation or fire services).

Additional fiscal autonomy can take several forms. The draft Law on Local Finances provides fiscal autonomy to settlements by assigning specific tax instruments and by mandating they receive a minimum share of the equalization transfers received by municipal governments. This system implies that the central government negotiate with and supervise 5,336 settlements. And unlike municipalities, settlements do not have a democratically elected council; only a mayor is elected. This makes local government less accountable to voters and increases the possibility of abuse. A more common practice is to allow the higher level of government to determine revenue allocation to jurisdictions within its territory. This approach simplifies operations. The provisions in the draft Law on Local Finances are likely motivated by the desire to limit neglect by municipal governments of some of their settlements. Since 1991, however, municipalities have democratically elected councils representing all settlements in the municipality. These democratic institutions should limit potential abuses.

Expenditure assignment

The relative size of the public sector in the economy has decreased rapidly in recent years as a consequence of a tight fiscal policy and severe compression of central government expenditures. The smaller share of GDP represented by public expenditures has affected both central and local budgets, but in relative terms local government expenditures have declined less rapidly. In 1993 central government expenditures on a cash basis amounted to 41 percent of GDP, down from 57 percent in 1990. Local government expenditures in 1993 represented 9.9 percent of GDP, down from 11.7 percent in 1990 (see chapter 1, table 1.1). While the overall compression of expenditure, driven mainly by stabilization concerns, was achieved quickly, clarification of expenditure assignment in the emerging market economy has lagged. Clear specification of which level of government is responsible for functions and activities of the public sector is a starting point for a new role for government in a market economy.
Expenditure assignment in Bulgaria

Appropriate assignment of particular government services varies among countries. The adequacy of any assignment should be judged in terms of how well it achieves the objectives of the decentralization strategy. Without specific assignment of expenditure responsibilities it is not possible to assess the other two components of a system of decentralized government finances: the adequacy of revenue and tax assignments to different types of government and the need for an effective system of intergovernmental transfers. Commonly accepted objectives of fiscal decentralization in developed Western economies include efficient allocation of resources from responsive and accountable local governments and a central government role in promoting the equitable provision of services to citizens in different jurisdictions. In Bulgaria, as in other transition economies, further considerations of the linkages between fiscal decentralization and privatization, distribution, and stabilization also emerge (see below and chapter 1).

The current legal expenditure assignment is summarized in table 5.1. These assignments should not be interpreted as representing fiscal autonomy for local governments. As it operates, the system is a holdover from the communist regime when local budgets were part of the central government budget, and central agencies controlled “economic” activities, leaving local agencies the responsibility for basic social services. Those functions allocated to the central government have a national dimension and include defense, the justice system, foreign relations, and research in health and education. Expenditures with macroeconomic and redistributional implications, such as unemployment compensation, are also a central responsibility. The expenditure responsibilities of municipalities involve services with local benefit areas, such as primary and secondary education, health care, fire protection, and sanitation.

Another way to analyze current expenditure assignment is by examining the share of consolidated total spending in each function represented by municipal governments (table 5.2). Even though both central and local government are involved in most activities, education, health, housing and communal services, and social welfare are fundamentally local government activities when gauged by expenditure levels. Most capital investment in these functions is also the responsibility of local governments. Expenditures on social services represent a large share of municipal budgets—85.3 percent in 1991, 87.5 percent in 1992 (January to June), and 90.4 percent in 1993 (table 5.3).

Evaluation of current assignments. As noted, the current assignment of expenditure responsibilities potentially suffers from the lack of some form
Intergovernmental fiscal relations in Bulgaria

of effective intermediate government. All public services with a regional dimension are assigned either to the central government or, more frequently, to municipalities. Thus, water systems serving several municipalities are run by central government enterprises, while tertiary care hospitals providing services for residents in multiple jurisdictions are often the responsibility of a single municipality. Several subsidies—housing, medicine, heating, transportation—that are now the responsibility of local governments should, given their redistributitional intent, become the responsibility of the central government if it insists these subsidies be maintained. Moreover, there are several policy initiatives under consideration that could have a considerable effect on the assignment of responsibilities. For example, comprehensive reform of the health care system would shift responsibility from municipalities by creating an autonomous national health system. Reforms in social insurance and social safety net programs and in housing could also result in significant changes in the assignment of responsibilities.

In sum, the orderliness depicted in box 5.1 hides the fact that expenditure assignment is in a state of flux and that, under current practices, there is little true local autonomy.

Distribution of public expenditures. There is widespread belief across Bulgaria that public expenditures have not been distributed equally among geographical areas. The general impression is that social and infrastructure expenditures are lower in poor areas of the country. Intraregional inequities are thought to be a major cause of the elimination of districts as an intermediate level of administration, since the capital of the district often received most capital infrastructure and other budget expenditures. The perceived equity with which public funds have been allocated is more than an issue of historical interest. For example, the clauses introduced in recent draft legislation on local finance concerning the revenue autonomy of settlement vis-à-vis municipal government have been inspired in part by the desire to avoid the whimsical behavior of higher-level government in the past.

Determining the patterns of past expenditures is quite complex. In order to account for all government expenditures in different regions it is necessary to go beyond the long-run profile of central (and local government) budgets. Under the planned socialism of the old regime, public funds were systematically used to develop public enterprises in industry and other economic sectors. These public enterprises, in turn, contributed at varying rates to the provision of local public services, and these contributions most often did not appear in an identifiable form in the central or local government budgets.

Unfortunately, the complete data required to analyze budget and enterprise expenditures are unlikely to become available. One way of
Table 5.1 Expenditure assignment, Bulgaria, 1993

<table>
<thead>
<tr>
<th>Category</th>
<th>Central government</th>
<th>Municipality</th>
<th>Settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense</td>
<td>● Entire responsibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Justice/internal security</td>
<td>● Entire responsibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign economic relations</td>
<td>● Entire responsibility</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>● All universities and research institutions</td>
<td>● All expenditures (capital and current) of primary and secondary schools</td>
<td>● Some kindergartens</td>
</tr>
<tr>
<td></td>
<td>• Some technical and vocational schools</td>
<td></td>
<td>• Some technical and vocational schools</td>
</tr>
<tr>
<td>Health</td>
<td>● Research medical institutes</td>
<td>● Tertiary care and psychiatric hospitals</td>
<td>• Some primary health clinics</td>
</tr>
<tr>
<td></td>
<td>• Special service hospitals (cardiology, cancer, and so on)</td>
<td>● Some primary care</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Medicine</td>
<td></td>
</tr>
<tr>
<td>Roads</td>
<td>● Construction of all roads</td>
<td>● Maintenance of third- and fourth-class roads and urban streets</td>
<td>● Maintenance of local networks</td>
</tr>
<tr>
<td></td>
<td>• Maintenance of state highways and any other road linking cities and villages</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public transportation</td>
<td>● Airports</td>
<td>● All modes of city transport</td>
<td>• Equipment for volunteer fire services</td>
</tr>
<tr>
<td></td>
<td>● Railway subsidy</td>
<td>● Subsidy to intervillage bus service within municipalities</td>
<td></td>
</tr>
<tr>
<td>Fire protection</td>
<td></td>
<td>● Most fire protection services</td>
<td></td>
</tr>
<tr>
<td>Libraries</td>
<td>● National library</td>
<td>● Local libraries</td>
<td></td>
</tr>
<tr>
<td>Police services</td>
<td>● National militia and traffic police</td>
<td>● Sofia signed contract with national militia; all other municipalities get free service</td>
<td></td>
</tr>
<tr>
<td>Category</td>
<td>Responsibilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>----------------------------------</td>
<td>----------------------------------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sanitation</td>
<td>Part of garbage collection and street cleaning</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Water and sewerage</td>
<td>State enterprises except for Sofia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public utilities</td>
<td>Electricity subsidy</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Housing</td>
<td>Part of garbage collection and street cleaning</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price subsidies</td>
<td>State enterprises except for Sofia</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Welfare payments</td>
<td>Unemployment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprises in productive sector</td>
<td>State enterprises (including most types of industry)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Environment</td>
<td>Responsible for national environmental issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Enterprises</td>
<td>Responsible for local environmental issues</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Local and municipal enterprises (transport, construction, and other local-economy services)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Note:** An intermediate level of government, regional government, exists between the central government and localities. But since regional governments are agencies of the central government and lack discretion and autonomous budgets, they are not shown in the table as separate from the central government.

Source: Author's research; various Government of Bulgaria documents.
approximating the accumulated impact of government expenditure is to study the distribution of certain types of infrastructure. One such measure is the number of hospital beds per thousand citizens in each Bulgarian municipality for 1989, the most recent year with complete data. This variable includes both infrastructure paid for with budget funds and that built by enterprises. This index was regressed across municipalities on several demographic and socioeconomic characteristics.
of the municipality, including population, density, average household income, and the incidence of infant mortality. Regression results did not indicate any systematic relationship between the number of hospital beds and the municipality characteristics. These findings do not support the view that social infrastructure is distributed unequally across Bulgaria.

Regressions were also run using dependent variables other than total expenditures, including such expenditure subcategories as education, health, and social welfare. After controlling for population and population density across municipalities, total municipal expenditures are not significantly related to income. There was some statistical evidence that per capita social expenditures on education, health, and social welfare tend to be higher in poorer municipalities (as indicated by average regional income and the incidence of infant mortality). These preliminary results also run counter to the assumed significant inequities in the distribution of subnational expenditures.

Ambiguity in the assignment of responsibilities. For several important services including education, health, and social welfare, budgetary authority and responsibility are not clearly divided between central and local governments. These services are financed almost entirely through local government budgets and are considered compulsory, meaning that local governments cannot spend less than the amount set by the central government, but may spend more. Since the level of expenditure and standards of provision are established by the center, local governments act more as deconcentrated agencies of the central government than as autonomous budget units.

<table>
<thead>
<tr>
<th>Education</th>
<th>Health</th>
<th>Social security</th>
<th>Social assistance</th>
<th>Social welfare</th>
<th>Housing and communal services</th>
<th>Recreation and culture</th>
<th>Transport and communication</th>
</tr>
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<tbody>
<tr>
<td>18.507</td>
<td>16.611</td>
<td>31.784</td>
<td>11.879</td>
<td>2.029</td>
<td>4.584</td>
<td>2.767</td>
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<tr>
<td>12.871</td>
<td>11.638</td>
<td>—</td>
<td>2.005</td>
<td>1.627</td>
<td>3.320</td>
<td>1.006</td>
<td>5.92</td>
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<tr>
<td>69.5</td>
<td>70.1</td>
<td>0.0</td>
<td>16.9</td>
<td>80.2</td>
<td>72.4</td>
<td>36.3</td>
<td>11.5</td>
</tr>
<tr>
<td>1.188</td>
<td>978</td>
<td>—</td>
<td>—</td>
<td>59.3</td>
<td>1.610</td>
<td>80.2</td>
<td>1132</td>
</tr>
<tr>
<td>631</td>
<td>635</td>
<td>—</td>
<td>—</td>
<td>30.8</td>
<td>1.610</td>
<td>7.4</td>
<td>592</td>
</tr>
<tr>
<td>53.3</td>
<td>64.9</td>
<td>—</td>
<td>—</td>
<td>51.9</td>
<td>100.0</td>
<td>9.2</td>
<td>52.3</td>
</tr>
</tbody>
</table>

Source: Author's estimates based on data provided by the Ministry of Finance, Government of Bulgaria.
Other areas where there is lack of clarity in expenditure assignment include road maintenance, transportation, the environment, and water and sanitation services. The Law on Local Self-Government transferred the ownership of all infrastructure related to local services to municipal governments. But water, sewerage, and electricity continue to be provided by state enterprises. There are plans to convert the state enterprises to autonomous, self-financing entities. The city of Sofia is a special case because water and sewerage services are provided by municipal enterprises.

Before 1992 the lack of a concrete assignment of expenditure responsibilities had little practical consequence because local government budgets were part of the central government budget. Additional resources were negotiated when there was an unexpected shortfall, and unspent funds were channeled back to the Ministry of Finance. Since 1992 local governments have had autonomous budgets and can theoretically run surpluses not subject to confiscation or extraction by the central government. However, the central government may be tempted to extract surpluses indirectly by shifting expenditure responsibilities “down” to local governments (see chapter 1). Failing to legislate the responsibilities of each government level could lead to significant conflict between the center and local governments. Without specific expenditure assignment, a country runs the risk of having available revenue dictate the expenditure responsibilities of each government level. This can lead to institutional instability and to the inefficient provision of public services. Concrete assignment of responsibilities does not necessarily mean that either the local or the central government has full and exclusive responsibility; in some cases shared (but well-defined) responsibility may be more desirable. For example, the central government may retain the responsibility for curriculum development in primary and secondary education, with all other aspects of education the responsibility of local governments. Of course, even if a service is fully decentralized the government can still influence local government behavior through grants and regulations.

State enterprises. The role played by state and municipal enterprises in the provision of social services further clouds the assignment of responsibilities for social expenditures. These enterprises have played an important role in health, education, infrastructure, and culture. In health care, for example, large state enterprises have provided care facilities, covered operating costs, and in many cases provided free medicine. Medical personnel have typically been paid by the municipality. Enterprise clinics have provided health care for the entire population of a particular area.
Contributions of state enterprises to the provision of local public services are disappearing rapidly since the enterprises are responding to budget austerity, preparing for privatization, or competing with private enterprises. The discontinuation of state enterprise expenditures made on behalf of government is a positive step, but it means that these expenditure responsibilities have to be picked up by central or local budgets. Because most services provided by state enterprises are those that have been traditionally assigned to local government, it would be appropriate for local governments to assume these expenditures. But this means the assignment of taxes to local governments and the computation of transfer needs to take this shift in expenditure responsibility into account.

Assignment of capital expenditure responsibility

Since the democratic reforms substantial capital expenditures in the state sector have been made through local budgets. In 1991, 62.1 percent of the consolidated capital expenditure was local. By 1993 this percentage had declined to 52.8 percent. This high share reflects the priority given to capital investment in the social sectors. Because of the lack of local autonomy, however, the figures are somewhat misleading. Despite the concentration of capital spending on local projects and the fact that municipalities and line ministries are consulted in the process, the responsibility for decisions about public investments remains centralized at the Ministry of Finance.

The criteria used by the Ministry of Finance to select projects give priority to maturation period and sector. Projects that can be finished in one year or that finish incomplete projects from previous years are given first priority. Recent budgets have given investment priority to education, health, and public utility infrastructure.

There are several advantages to decentralizing some capital investment responsibilities. Primary among these is the gains that can accrue from the efficient use of scarce resources if local governments take charge of the planning, financing, and execution of capital projects in sectors and services for which they also have recurrent expenditure responsibility. The reason for the efficiency gain is the information localities have (and that the center lacks when dealing with municipalities) to equate the benefits of the “next” leva of spending with the revenues required to pay for that spending. To the extent that such hard budget constraint decisions are made with the consent of the local citizenry, fiscal accountability is also enhanced (see chapter 1).

In order to achieve efficiency and accountability, decentralization need not always be complete. Rather, arguments can be made for an
intergovernmental solution for those situations where local government officials lack the expertise to discharge their investment decision responsibilities (a situation most likely to arise for small general-purpose governments), or where local investments have significant benefits or scale economies that extend beyond the locality's borders (for example, environmental programs, water and power production). Under such circumstances the central government could share the responsibility for investments through matching-grant programs or similar schemes designed to influence the scope and structure of the investment decision.

Decentralization of the nation's capital budget has further merit to the extent it leads to integration of the investment and capital maintenance process. Under communist centralization, these decisions were separated. Capital investment and replacement was generally determined by the central government with the maintenance responsibility left to local governments. As a result of this dichotomy, local governments would underallocate maintenance funds for infrastructure, and the center would respond by replacing the infrastructure at an early stage. The result was a combination of huge amounts of unfinished capital projects (estimated at L 17 billion in 1992) and deterioration in the completed stock. It will take years to redress this problem.

In addition to sorting out the central-local roles with respect to the decision to invest, improving the capital budget process can also lead to efficiency gains. At present, for example, neither the central nor the local governments employ multiyear planning and budgeting, a technique that would reveal the budgetary implications, current and capital, of capital projects, thereby increasing efficiency in the allocation of scarce investment funds. Given Bulgaria's buildup of unfinished capital projects, such planning would be valuable. Other budgetary techniques, such as multiyear-commitment accounting and tranching of investment projects, could also be effective in dealing with unfinished capital projects.

In addition, an intensive training program for local budget officials in capital budgeting, project evaluation techniques, tendering, contracting, and related subjects will be needed before responsibility for capital investment is transferred to local governments. Shifting capital expenditure responsibilities also requires adjusting the assignment of taxes to allow autonomous financing of these expenditures. Part of the needed funds, particularly for local governments with low tax bases, could come from the equalizing subsidy to be implemented by the central government. The central government could also target matching grants to sectors where local expenditure should be encouraged because of spillover benefits or because of their desirable distributional impact.
Beyond the assignment of responsibilities

If fiscal decentralization is to achieve its intended efficiency goals, it must be accompanied by policies that will ensure local budget discretion and fiscal accountability—the explicit linking of legislative decisions to the decisionmakers. The more responsibility for fiscal decisions is obscured by hidden or complex institutional arrangements, the less accountable (and efficient) the system of public service delivery. In the Bulgarian context, there are five major potential barriers to achieving accountability.

Subordination of local officials. Perhaps the biggest constraint to effective local discretion and accountability is local inexperience with independent fiscal decisionmaking. This is highlighted by the fact that local budget officials have dual subordination: they report to the elected mayor and municipal councils, but they are central government employees. Experience gained from the management of local services in the past was often limited. Local officials frequently were not involved in the management of local services, but acted simply as disbursement intermediaries. Currently, for example, municipalities nominally have the responsibility for hiring teachers, but effectively the directors of schools, who are appointed by the Ministry of Education, make most decisions including the hiring and firing of teachers. This inexperience with decentralized governance means local officials will need to upgrade their skills in areas such as budgeting and accounting.

Contradictory legal framework. There are still significant legal limitations to budgetary discretion. Intergovernmental relations in Bulgaria are framed by contradictory legislation. The Law on Local Self-Government grants unprecedented autonomy to local governments: the power to approve their own budgets, the right to keep surplus funds, and the right to borrow for capital investment projects. But the financial relationship between the central government and the municipalities continues to be regulated by the 1961 Budget Law, which has been the cornerstone of centralized control of municipalities. Although the Budget Law is being updated, the old law has been in force for the past three annual budgets, so local budgetary autonomy has yet to become effective. According to the 1961 Budget Law, several budget categories (education, health, social welfare) are compulsory for local governments. If municipalities wish to receive a subsidy from the central government, they must present evidence to the Ministry of Finance that their budgets will run a deficit if the compulsory expenditures are covered. The evidence is negotiated and then a proposed subsidy is sent to Parliament for approval. But even municipalities that do not receive subsidies from
the central government are subject to compulsory levels of expenditure on education, health, and welfare. Municipalities can, however, add funds to the compulsory level of expenditures, and in 1992 they were allowed to reallocate funds within each compulsory category.

For the future, the government should choose between two models for dealing with compulsory local services. Central government could take back responsibility for the services, providing them in a deconcentrated fashion through central government agents: the national health system is a case in point. Alternatively, full budgetary responsibility for the services could be transferred to local governments. The central government could still regulate and influence the provision of those services, but would respect the budgetary autonomy of local governments by using categorical grants or other transfers to compensate for the delivery of specific services.8

Lack of budgetary certainty. The possibility of central extraction of local surpluses and the unpredictability of revenue sources also detracts from local budgetary autonomy. The Law on Self-Government and Local Administration theoretically allows municipalities to keep any budgetary surpluses. But in practice the Ministry of Finance has been extracting local surpluses indirectly by reducing already budgeted transfers or by reducing the overall level of subsidy or central budget support. This has given municipalities little incentive to increase local revenue mobilization.

Budgetary uncertainty has also reduced local governments' autonomy by limiting their ability to act independently of the Ministry of Finance. Delays in budget approval and central arrears to local governments have heightened this uncertainty. For example, in October 1992 the central government, to contain its deficit, started to withhold 10 percent of all funds that were to be transferred to local governments. In a decentralized system of intergovernmental relations, the center should not rely on local government budgets as cushions to preserve the balance of its own budget (see chapter 1).

Mandates and preemptions. Mandates from the central government have further reduced local budgetary autonomy. Mandates take many forms, but they are essentially orders to local governments to undertake specific expenditures without full compensation. Central determination of local public employee wages are a particularly important source of potential mandates, as was evidenced both in 1992 and again in 1993 when the center mandated increases in teacher salaries but provided late and incomplete central-local reimbursement.

Other mandates have included local maintenance of military schools and horseback-riding facilities, national social insurance benefits, social
assistance payments, and several capital investment projects, such as sewage treatment plants and urban transport electrification to save on imported fuels.

A different sort of mandate is the earmarking of local government funds for specific types of expenditures favored by the central government. A good example is the earmarking of 5 percent of the entire local budget to support “houses of culture.” This rigidity in local budgets has typically meant an overfunding of this activity, with municipalities at times having difficulty spending the assigned funds. The center has also decentralized certain services while reserving the right to set the charges for those services. Local governments have not had the authority to set even the rates for garbage collection or market stall charges. The exception has been public transportation, for which local governments, including Sofia, are free to set tariffs. Local governments have been reluctant to do so, however, for fear of a negative impact on the poor and the old, and because they fear a negative local reaction. Preemptions have also had a negative impact on local fiscal balance. The most significant preemption has been the replacement of the turnover tax, partly a local tax, with a value added tax, which is fully national. Other types of preemptions relate to the fact that local governments need permission from the central government for nearly any modest reform, including hiring, firing, and compensation of personnel.

The central government recently considered draft legislation that would grant the municipalities control over the hiring and firing of local employees. However, not only have these proposals been abandoned, but, in fact, the center is further centralizing the civil service system by adopting a mixed French and Hungarian model that calls for a single national civil service system for all public employees, thereby supplanting the creation of regional or local systems.

Expenditure norms. A related type of mandate is the central expenditure norm, which details capacity and cost specifications and standards to be used in local expenditure formulation. These norms can be of a physical nature, such as the number of blackboards in elementary schools, or of a cost nature, such as how much to spend annually on repairs of particular types of buildings or how much to spend on meals per patient per type of hospital (as in the former Soviet Union). Between 1986 and 1990 norms for current expenditures, maintenance, and equipment and supplies were generally applied throughout the country. Furthermore, each line ministry had its own set of expenditure norms applied to all levels of government and to the municipalities depending on their level of social and economic development. The use of these development norms was officially discontinued in 1990; however, many
municipal governments continue to use the physical norms. Local governments' continued reliance on these norms may stem from an attachment to old rules, or from the desire to pad local budgets to justify a plea of fiscal poverty during grant negotiation time.

Strictly applying norms to the formulation of municipal budgets had significant drawbacks. One of these was that norms lead to disparities in the level of public services provided across municipalities. In Bulgaria norms were intentionally nonuniform across municipalities and were tailored to the existing capacity of public infrastructure rather than to the needs of the population. If a municipality had twice as many hospital beds per 1,000 inhabitants, it also had twice as much funding. The per capita need for public services was assessed separately, without the application of budgetary norms.

The strict application of budgetary norms led to other inefficiencies in public expenditures. Because recurrent budgets were to a large extent formulated on the basis of existing capacity, local governments always had an incentive to keep even inefficient facilities running. For the same reason, public officials added to existing capacity even though existing facilities may not have been operating at full capacity. The relative excess of hospital beds in Bulgaria is a reflection of this perverse set of incentives.

Recently, the government has discussed revamping the old system of norms for budget formulation. However, returning to a system of rigid and detailed norms may not be desirable, even if it is needs-based. The cost of providing services differs throughout the national territory and local governments need the flexibility to formulate budgets to account for local labor market conditions and other specific needs and constraints. Nonetheless, in order to implement an equalization system the Ministry of Finance must develop a methodology and statistical database to quantify each municipality's basic needs.

**Tax assignment and intergovernmental transfers**

Prior to 1992 local governments obtained most of their revenues as fixed shares of the major central government tax revenues and from central government subsidies. The subsidies were made as lump-sum transfers intended to rectify any budgetary shortfalls. Local tax sources and non-tax operating revenues were a much smaller source of local finance. This pro forma revenue assignment to local governments inherited from the old regime gained new meaning with the proclaimed budgetary autonomy granted to local governments in the Law on Self-Government. Under the reforms, local governments with larger tax bases can, in theory, benefit from the application of the existing tax-sharing rates, while the central government, in theory, is not to extract local budget surpluses. In
practice, however, this newly gained formal autonomy has already been undermined by constant changes in the tax-sharing rules. In April 1992 the central government mandated that personal income tax revenue, previously accruing exclusively to local governments, be shared. The central government retained 30 percent of the tax and local government received 70 percent, and the new sharing was made retroactive to 1992. In compensation, in August 1992 it was decided to share 10 percent of the central government’s turnover tax with municipalities; but then in January 1994, the turnover tax was replaced by a value added tax, with no compensation to localities for the loss of the 10 percent in funds. In the meantime (February 1993) the personal income tax share fell from a 70-30 split to 50 percent central and 50 percent local. This change, too, was made retroactive to the first of the year.

Principles of revenue assignment

The principles of revenue assignment among governments typically incorporate concepts of revenue adequacy, efficiency, fairness (equity), and administrative feasibility (see chapter 1). Of course, no revenue assignment scheme can simultaneously satisfy all of these objectives. Well-defined tradeoffs exist between them. For example, an assignment that allows local governments to rely more heavily on their own resources would promote greater efficiency at the local level, although this system would generate large differences in the level of services provided across local jurisdictions. Thus, it is not possible to discuss the best revenue assignment. A country must choose an intergovernmental revenue assignment system by appropriately weighing each of the desirable objectives. Revenue assignments should change as these objectives change, assuming consideration is given to providing local governments with stable and predictable sources of revenue.

An overview of revenue assignment

Local governments in Bulgaria have three main sources of revenues: shared taxes, own revenues, and transfers (table 5.4). The first includes revenue from the company profit tax, personal income tax, and, until January 1994, the turnover tax. Revenues from some excise taxes and customs duties are also shared but contribute smaller amounts. In 1993 shared revenues were L 16.1 billion, representing 46.7 percent of total revenues. Shared revenues were budgeted at L 9.6 billion in 1992 (48.7 percent of total revenues).

Own-revenue sources, which include some local taxes, fees, and other revenues, were L 1.7 billion in 1993, representing 5.0 percent of
Table 5.4 Aggregate municipal budgets, Bulgaria, 1990–93
(millions of leva)

<table>
<thead>
<tr>
<th>Item</th>
<th>1990</th>
<th>Share (percent)</th>
<th>Amount (millions of leva)</th>
<th>1991</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>4,922.8</td>
<td>100.0</td>
<td>15,447.0</td>
<td>100.0</td>
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<td>Own-source revenues</td>
<td>545.3</td>
<td>11.1</td>
<td>680.6</td>
<td>4.4</td>
<td></td>
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<tr>
<td>Fees</td>
<td>139.8</td>
<td>2.8</td>
<td>245.9</td>
<td>1.6</td>
<td></td>
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<tr>
<td>Other revenues</td>
<td>225.5</td>
<td>4.6</td>
<td>300.5</td>
<td>1.9</td>
<td></td>
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<tr>
<td>Property tax and inheritance tax</td>
<td>180.0</td>
<td>3.7</td>
<td>134.2</td>
<td>0.7</td>
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<tr>
<td>Shared revenues</td>
<td>2,507.7</td>
<td>50.9</td>
<td>11,170.5</td>
<td>72.3</td>
<td></td>
</tr>
<tr>
<td>Profit tax</td>
<td>362.8</td>
<td>7.4</td>
<td>4,275.0</td>
<td>27.7</td>
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<tr>
<td>Income tax</td>
<td>1,911.2</td>
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<td>4,977.4</td>
<td>32.2</td>
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</tr>
<tr>
<td>Turnover tax</td>
<td>233.7</td>
<td>4.7</td>
<td>1,247.9</td>
<td>8.1</td>
<td></td>
</tr>
<tr>
<td>Other shared taxes</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transfers</td>
<td>1,869.8</td>
<td>38.0</td>
<td>3,595.9</td>
<td>23.3</td>
<td></td>
</tr>
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<td>Expenditure</td>
<td>5,258.6</td>
<td>100.0</td>
<td>14,507.4</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>4,487.5</td>
<td>85.3</td>
<td>12,873.7</td>
<td>88.7</td>
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<tr>
<td>Wages</td>
<td>1,641.7</td>
<td>31.2</td>
<td>4,326.3</td>
<td>29.8</td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>771.1</td>
<td>14.7</td>
<td>1,651.9</td>
<td>11.4</td>
<td></td>
</tr>
<tr>
<td>Deficit/surplus</td>
<td>-335.8</td>
<td></td>
<td>939.6</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Memo item
Average exchange rate
(leva/U.S. dollar) 2.2 17.8

---

Not available.

Note: Consolidated actual budget data for 1992 were not available. Totals do not add up because some figures have been rounded.

total municipal revenues, a slight increase relative to 1991 (4.8 percent) but a significant decline compared with 1990 (11.1 percent).

Central government subsidies amounted to L 16.7 billion in 1993, or 48 percent of total revenues, and they were budgeted for 1992 at L 9.1 billion, representing 46.2 percent of total revenues. In 1991 transfers from the central government represented 23.3 percent of total revenues, down from 38 percent in 1990.

Revenue from shared taxes. The existing revenue-sharing scheme for the profit tax in Bulgaria is based on both the principle of derivation—the pooled taxes shared are those actually paid in the jurisdiction—and ownership of enterprises. Until 1992 the sharing rates were specified in the respective tax laws.

Municipalities retained the entire company tax profit levied on municipal and private enterprises operating in their jurisdiction, and also levied a 10 percent surtax on state enterprises operating in their jurisdiction. State enterprises paid a regular 40 percent company profit
tax to the central government and a 2 percent surtax earmarked for irrigation and environmental protection. The dual character of this origination and ownership revenue-sharing system has not enhanced the financial autonomy of local governments. The 10 percent surtax on state enterprises was a much more important revenue source for municipalities than the 40 percent levy on municipal and private enterprises. Only 15 percent of the company tax revenues collected by municipalities in the first six months of 1992 came from the levy on municipal and private enterprises. In 1991 this figure was 13 percent. The company profit tax performed relatively poorly as compared with the other major taxes in 1992. This reflects both a shrinking state enterprise tax base and virtually no growth in the taxes paid by private enterprises because of tax holidays, legal avoidance, and tax evasion.

The company profit tax accounted for 21.9 percent of all local revenues in 1992, down from 27.7 percent in 1991. This relatively poor performance continued in 1993 when the profits tax declined to 11.6 percent of total municipal revenues.
Local governments received the entire turnover tax paid by municipal and private enterprises, while state enterprises paid this tax to the central government. The turnover tax was typically applied to a single stage of manufacturing at a rate of 22 percent. The rate, however, varied depending on the type of good, though most businesses paid 22 percent. In 1993 the turnover tax represented 11 percent of total revenues. As noted, this tax was replaced in January 1994 by a national value added tax that is not shared with local governments.

The individual income tax is the single most important source of revenue for local governments. This tax falls on wage and salary income and has progressive rates. The large contribution of the individual tax to total revenues in 1993 is a direct result of inflation-driven wages and salaries without a commensurate tax indexation for inflation. In addition, compliance may not have deteriorated as much as with other taxes because this tax is typically withheld by employers. The relative importance of the individual income tax in the total revenues of local governments has declined from 38.8 percent in 1990 to 21.9 percent in 1993.

Revenue from own sources. Cost recovery charges and user fees continue to represent a small fraction of local government revenues, averaging 2.8 percent of total revenues between 1990 and 1993. This revenue source continues to be relatively unimportant because the fees can only be changed with permission from the central government, which has kept them unchanged for long periods. Bulgaria also has not traditionally employed high user fees. Local governments are authorized to introduce environmental fees, parking fees, and sanitation fees. But sanitation fees, for example, are based on assessed house values, which have been completely outdated for years. Other nontax revenues have fluctuated widely, representing 4.6 percent of total revenues in 1990 and only 1.1 percent in 1993. This is partly a result of the restitution of municipal property to private individuals, limiting the sources of rental income.

Property taxes are the third source of own-source revenues for municipalities. These taxes are fully assigned and have traditionally been administered by local governments. However, local governments have no discretion over rates, assessments, or any other significant aspect of the property tax. Property taxes are levied on the value of land and structures, on the value of transfers as gifts, or on an inheritance. Enterprises pay a property tax of 0.2 percent on the value of the land and structures "initially entered" in the balance sheet of the enterprise. For property owned by individuals, the tax is calculated on the basis of assessed values for land and structures in accordance with officially approved tables dating back to 1952. The tax rate for individual property is also 0.2 percent, although some luxury units are taxed at a rate of 0.3 percent. There is also a
graduated surtax on larger units, with differential rates for Sofia and outside Sofia. Property taxes constituted only 0.7 percent of total revenues in 1991, down from 3.7 percent in 1990. In 1993 property tax collections still represented only 1.2 percent of total local revenues. The experience of other countries suggests that property taxes, if properly designed to include regular ad valorem reassessments, could become a much more important source of local government revenue (see chapter 3).

Central government transfers. Central government transfers make up a substantial portion of local government revenues in Bulgaria. In 1993 central government transfers were L 16.7 billion, accounting for 48 percent of all local government funds. In 1992, L 9.1 billion in transfers were budgeted, representing 46.2 percent of all budgeted revenues. The central government has often delayed transferring funds and subsequently imposed permanent cuts. During the first half of 1992 local governments received only a little more than one-third of the transfers budgeted for the entire year. The lowest share of central government transfers in local budgets was recorded in 1991, when central budget cuts reduced transfers to 23.3 percent of all local revenues. By comparison, central government transfers represented 38 percent of all local government funds in 1990 (see table 5.4).

Prior to 1993 transfers from the central government to the municipalities were determined by subtracting own-source and shared revenue from the minimum required expenditure budget. Beginning in 1990 the Ministry of Finance has calculated the minimum expenditure budgets for each municipality based on the previous year’s budget. In 1992 municipalities prepared their own budgets (often using the old budget norms), which they submitted to the Ministry of Finance for determining the central government subsidy. However, the ministry used its own minimum budget figures to calculate transfers, which on average were two-thirds of those proposed by the municipalities. Dissatisfaction with this procedure led to bargaining among Ministry of Finance officials and those municipalities that disagreed most intensely with the ministry’s estimates. The municipalities provided the ministry with their own estimates of nontax revenues and the ministry used its own estimates of tax revenues, including the shared major taxes: personal income tax, profit tax, and turnover tax. In computing transfers, the ministry still had the freedom to alter the overall estimated revenues, including the forecasts of local nontax revenues.

The approach used through 1992 for the derivation of transfers had three fundamental problems: room remained for the Ministry of Finance to subjectively adjust revenue forecasts and compute expenditure needs; the criteria by which the ministry selected capital projects lacked transparency and decisions were thus subject to ex post negotia-
tions; and local governments were discouraged from raising local revenues, since an increase in local revenues was met by an equal loss in central government transfers.

Beginning in 1993 the Ministry of Finance introduced a more objective formula to determine the level of central government transfers. In its most recent available design, this formula is given by $C = C_1 + C_2 + A + C_3$, where $C$ is the total government transfer, $C_1$ represents a share (85 percent for 1994) of the previous year’s transfer, net of specific capital grants and adjusted for changes in expenditure assignments. $C_2$ is the fraction of the transfer determined by an objective formula employing seventeen weighted variables representing the municipality’s need for public services in different areas (table 5.5). $A$ is an adjustment factor accounting for the relative tax base of municipalities. The last term, $C_3$, is a transfer for capital expenditures, which is distributed at the discretion of the central government.

The adjustment factor, $A$, reflects the tax capacity of the municipality, although municipalities have no discretion over the base or rate of any tax. The adjustment factor is computed using either of the following formulas:

$$A = \left[ - (PCT - TL) \right] N \quad \text{or} \quad A = (BL - PCT) N,$$

Table 5.5 Variables and weights used to determine municipality needs in the equalization formula ($C_2$), Bulgaria, 1994

<table>
<thead>
<tr>
<th>Variable</th>
<th>Relative weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of discharged patients per bed in a unified regional hospital</td>
<td>8.3</td>
</tr>
<tr>
<td>Number of discharged patients per bed in a municipal hospital</td>
<td>4.3</td>
</tr>
<tr>
<td>Beds in pulmonary hospitals</td>
<td>0.5</td>
</tr>
<tr>
<td>Beds in psychiatric hospitals</td>
<td>0.6</td>
</tr>
<tr>
<td>Available places in mother and child care homes</td>
<td>0.7</td>
</tr>
<tr>
<td>Available places in social service homes</td>
<td>3.8</td>
</tr>
<tr>
<td>Number of unemployed</td>
<td>3.0</td>
</tr>
<tr>
<td>Unemployed and single mothers receiving compensation</td>
<td>2.1</td>
</tr>
<tr>
<td>Number of deaths</td>
<td>0.4</td>
</tr>
<tr>
<td>Number of library clubhouses</td>
<td>1.1</td>
</tr>
<tr>
<td>Number of students in secondary general education schools</td>
<td>18.2</td>
</tr>
<tr>
<td>Population</td>
<td>23.0</td>
</tr>
<tr>
<td>Number of settlements on the territory of the municipality</td>
<td>22.0</td>
</tr>
<tr>
<td>Area of the municipalities in square kilometers</td>
<td>3.0</td>
</tr>
<tr>
<td>Number of dwellings in the municipality</td>
<td>3.0</td>
</tr>
<tr>
<td>Settlements of IVth and Vth functional type (poorer settlements)</td>
<td>3.0</td>
</tr>
<tr>
<td>Volume of the subsidy in relation to the overall volume of the municipal budget for 1993</td>
<td>3.0</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

where \( PCT \) is per capita tax revenues in the municipality, including shared taxes, \( TL \) is a top limit for unpenalized per capita tax revenues (1.5 times for 1993)—that is, below this amount, revenues do not trigger a reduction in the transfer, \( BL \) is the bottom limit of per capita tax revenues, which triggers a subsidy, and \( N \) is the population of the municipality. The impact of the adjustment factor is to reduce, and in some cases eliminate, the overall subsidy to municipalities with per capita tax bases considerably higher than the national average. Municipalities with per capita bases much lower than the national average experienced a proportionate increase in the subsidy.

An assessment of the current revenue assignment

Although the system of intergovernmental finances in Bulgaria is in flux, it is useful to assess its strengths and weaknesses in light of the stated objectives for tax assignment.

Revenue adequacy. Are the assigned revenue sources adequate for the current expenditure obligations of local government? Have local revenues grown adequately over time, that is, proportionally to the increase in the need for services? These are difficult questions to answer unambiguously. For example, 22 out of 374 municipalities did not receive central government transfers (subsidies) during the first six months of 1992, and 49 did not receive them in 1991. However, central government transfers are part of the local revenue structure and should not be considered prima facie evidence of the inadequacy of local government revenue sources. A clearer test of revenue adequacy is whether, after taking account of all their revenue sources, local governments incur a deficit in carrying out their minimum budgetary obligations. In 1991 the findings in the field provide a diverse picture, with some municipalities running surpluses or balanced budgets, but a larger number running deficits.

An alternative way to determine whether revenue assignments meet expenditure obligations is to test for the existence of a statistical relationship between common determinants of expenditure needs (such as population and income) and the distribution of assigned tax revenues among municipalities. The lack of a statistically significant relationship between tax revenues and expenditure needs could be interpreted as evidence of inadequate revenue assignment. Several regressions were run of total municipality revenues for 1991 and 1992 on total population, population density, and average household income. The estimation results indicated that municipal revenues are positively related to population and population density. This limited statistical evidence, however, does not enable
us to conclude that expenditure needs are closely matched by the existing revenue assignments. This would require a data-intensive analysis of the costs of providing the services required by local governments, which is well beyond the scope of this work.

Efficiency. The existing revenue assignment receives low marks from an efficiency perspective. Although local governments have been assigned certain taxes, most importantly the property tax, they have no control over the structure of these taxes. Local governments also lack the authority to set most fees and user charges. Furthermore, the system of revenue assignment has become less stable and transparent since 1991. Revenue flows are also unpredictable, since the government has changed the revenue assignment every year. There has also been less stability in the flow of budgeted funds to municipalities, further impairing their ability to plan an efficient use of resources.

Equity. There are some a priori reasons to believe that the present assignment is not equalizing. The importance, albeit decreasing, of shared taxes in local budgets and the fact that these revenues accrue to local governments on a derivation basis imply that the existing revenue assignment system is not very equitable. Relatively richer municipalities will necessarily have more available resources. Furthermore, property taxes, fees, user charges, and revenues from other local sources are all positively correlated with collections from the three main shared taxes.

Most tax assignment schemes give rise to an unequal distribution of tax revenues across local jurisdictions. This is not necessarily undesirable because tax assignment fosters other objectives, such as efficiency. Inequalities in the availability of tax revenues can be offset by a system of transfers. Thus, the equity issue centers on the effectiveness of the central government's transfer system. A priori, there is no presumption that these transfers have been equalizing. Many regions complain of neglect by the center. In addition, until 1993 government transfers were allocated according to a nontransparent and complex process that allowed for subjective decisionmaking. Preliminary regressions for 1991 and 1992 revealed that subsidies increased with the incidence of poverty, as proxied by variables such as infant mortality and average household income. Data limitations, however, make these conclusions very tentative.

Administrative feasibility. The administrative feasibility of the current system is undermined by a local tax administration system that is not well developed. The Bulgarian government should seek to develop a tax administration capacity at the local level to relieve the State Tax Service from having to enforce locally assigned taxes such as taxes on property
and motor vehicles and user fees and charges. The State Tax Service will face challenges enough with enforcement of central taxes.

The scope for reform in revenue assignment and the system of transfers

Several general issues must be considered in reforming the revenue assignment system in Bulgaria. Policymakers must decide whether to reform the existing tax and transfer assignment schemes as well as the role of fees and user charges in local government finance. They must also determine whether to grant a special regime to Sofia, Plodiv, and Varna.

Tax assignment. Local governments can achieve autonomy through direct tax assignment or tax sharing. In pure tax assignment, local governments assume control of particular taxes. This authority may be exclusive (taxes are levied only by local governments), or it may be concurrent (local governments levy their own taxes in addition to tax levied by the central government). In tax sharing as now practiced in Bulgaria, local governments have no control over the tax base or rate but simply receive a fixed portion of the revenues collected by the central government. A special type of tax sharing, which is a hybrid of tax assignment and tax sharing, is to allow local government to levy surcharges ("piggyback") on a national tax. In this case, localities typically employ the same centrally determined base but are free to set tax rates up to a maximum limit.

There are clear advantages to the pure tax assignment option. The pure assignment of taxes to local governments is more likely to yield an increase in efficiency at the local level because of increases in the accountability of local officials to voters and in the fiscal responsibility of taxpayers. In this way, increases in the demand for services can be directly related to increases in local taxes to finance them. This is the main reason for traditionally assigning property taxes to local governments, as is done in Bulgaria. However, the complete assignment of revenue-producing taxes (such as the corporate income tax and the value added tax) to local governments faces major difficulties in the coordination of rates and bases across jurisdictions that would arise from (among other things) having different value added tax rates in different parts of the country.

The individual income tax does not present the same type of problem, and is frequently utilized as a vehicle for tax piggybacking (see chapter 1). The option of the personal income tax surcharge has some tradition in Bulgaria: until the early 1980s there was a local surcharge on wages and salaries that had to be approved by a majority vote of local residents.

When all of these factors are considered, a desirable path for reform of tax assignment in Bulgaria is as follows: Retain the property tax as purely assigned to local government. Develop a tax on motor vehicles
and assign it to local governments. Develop a local administration apparatus to enforce both these local taxes, and, because the two taxes will not give much revenue autonomy to local governments for years to come, adopt a piggyback local personal income tax to be administered together with the national personal income tax. The local personal income tax could have a flat rate set by the local council. The maximum and minimum rates could be set by national law, but this is neither necessary nor, in the interest of local autonomy, desirable.10

User fees. Local governments need to develop their own sources of nontax revenues, particularly service charges and user fees. This source of revenue is largely underutilized in Bulgaria. For example, service fees for transportation and heating still represent only a fraction of the delivery cost. Because these services are similar to those supplied by private markets, it is usually possible to identify and charge a full price to those who benefit directly from particular local public services.

Water supply provides a good example of how user charges might increase efficiency of local service delivery in Bulgaria. The government is planning to devote sizable resources to expand treatment capacity. However, waste estimates are as high as 50 percent in some areas because of leaks, poor construction, the lack of meters, and, more important, low water prices. Evidence from many countries indicates that more realistic fees contribute significantly to conservation. At the same time, higher fees would provide the financial resources needed for the maintenance and rehabilitation of the distribution systems, and the more realistic consumption pattern would give authorities a more accurate reading of the population’s needs.

The most common argument against the use of benefit pricing in transition economies is the impact it might have on low-income households. However, it is possible to target subsidies for needy groups by reducing fares for metered services or by providing monthly transportation passes for the elderly. Even if it is not possible to implement target subsidies, it would still be more efficient to charge full prices for services and support low-income households with direct transfers. In fact, untargeted subsidies maintained with lower fees and user charges can often exacerbate safety net concerns if higher-income groups use a service more intensively.

Because direct charges are not feasible for all types of services, user fees and charges are often transformed into benefit taxes or improvement charges on property for services such as road paving, street lights, or sewerage. These improvement taxes are typically set at a flat rate according to lot size or at an ad valorem rate on the market value of the property, and can be levied as a one-time charge or as an annual charge
paid at the same time as the property tax. Local governments in Bulgaria already use some improvement charges, but they need to be updated.

**Special regimes for large cities.** The establishment of special tax regimes for large cities, particularly Sofia, Plovdiv, and Varna, may be justified because of their special needs and higher demands for certain services. These regimes could enable governments to have more authority to raise external taxes, to levy special taxes such as a tax on hotel services, or to piggyback on the personal income tax. The issue of creating special tax regimes for large cities is not, however, an urgent one. It may be preferable to see whether the reformed local government regime proves to be inadequate for large cities.

**Functions of intergovernmental transfers.** A system of intergovernmental transfers may serve several functions: correcting central versus subnational vertical imbalances, reducing horizontal inequities among rich and poor jurisdictions, influencing subnational fiscal decisions, and, in some transition countries, stimulating local tax effort (see chapter 1).

The intergovernmental transfer system introduced in 1993 is a significant improvement over the previous system. The use of formulas to determine annual transfers promotes efficiency and transparency. The new system also gives the central government considerable flexibility in making discretionary grants to stimulate local government activity.

However, the existing system still does not fulfill some of the functions expected from an equalization grant system. There are three major problems. First, funding is still unpredictable. The adjustment factor \((A)\) in the current formula \(C = C_1 + C_2 + A + C_3\) may cause local governments that received a substantial grant in one period to receive no grant at all or actually pay an adjustment transfer to the central government in the following period. The first component of the grant formula \((C_1)\) is designed to take care of this problem. However, several issues remain unresolved. The definition of \(C_1\) includes only nondiscretionary grants from the previous period. It explicitly excludes other sources of revenues that may be needed, such as in the case of the preemption of turnover tax revenues. Similar cases may emerge in the future with further reforms in the reassignment of taxes. The issue here is whether this type of preempted revenue should be taken into account in the definition of \(C_1\) in order to provide stability and certainty in general funding. An unresolved issue is how quickly the weight given to \(C_1\) should decline over time to phase in a full weight for two objective components of the grant system, \(C_2 + A\). This is an area that calls for caution and evolutionary change after having done the necessary research to quantify the different alternatives by simulating the entire system of local financing (KPMG Peat Marwick 1993).
A second problem of the current design of the grant system is that many of the norms used in the computation of $C_2$ are capacity- rather than needs-oriented. This is true for those criteria based on the number of beds or the number of available places (see table 5.5). This problem is inherited from reliance on past budgetary norms and persists because of the lack of current data. The implementation of a sophisticated system of equalization grants requires a good database. When better data are developed it will be possible to substitute needs-based criteria for capacity-based criteria and reduce the number of criteria used. Several of the current criteria could be substituted for an accurate measure of the percentage of the population that is impoverished.

Finally, the transfer system severely discourages the generation of own-source revenues. The adjustment factor is based on actual revenue collections by local governments rather than on a measure of tax capacity and the relative level of tax effort. This issue is of less importance at the present time because municipalities have little authority to raise tax and even nontax revenues. However, leaving the current adjustment factor $(A)$ as it is will ensure perverse consequences when the system of revenue assignment allows for local discretion in tax effort.

**Borrowing, extrabudgetary funds, and privatization**

All municipalities are legally authorized to borrow from banks and issue bonds to finance investment. However, borrowing to cover current expenditure deficits is prohibited. In general, local governments are not borrowing as such because bank loans are unavailable, financial markets are underdeveloped, and local governments lack experience with issuing bonds. At present, the only borrowing is from the Ministry of Finance. Traditionally, localities have received advances from the ministry, which in turn were subtracted from the allocated transfers as a method of repayment.

Borrowing may become a more important activity in the future, necessarily affecting domestic financial markets. The existing rules adequately address most potential dangers. To guard against excessive crowding in financial markets, local government could be required to get permission from the central government to borrow in excess of preset limits. These limits could be based on the overall budget of the jurisdiction or on the costs of servicing outstanding debt.

Nor are extrabudgetary funds heavily relied on at present to finance local government expenditures; this may be changing, however. Currently, Ministry of Finance officials estimate that available balances represent only 1 to 2 percent of consolidated local budgets. Local government extrabudgetary fund balances were reduced significantly in
1991 because central government cuts forced municipalities to make use of the available extrabudgetary fund surpluses to pay for routine current expenditures. The Budget Law of 1961 requires that all extrabudgetary fund accounts be approved by the Council of Ministers. Municipalities have nonetheless independently opened extrabudgetary fund accounts, which the Ministry of Finance has been unable to monitor closely. The ministry also lacks the means to effectively penalize noncomplying jurisdictions. In 1991 the standard budget reporting forms for local governments contained twenty extrabudgetary fund accounts. Some of these funds originated from past legislation for special programs, such as the housing construction fund or assistance to earthquake victims, and little is known about their sources of revenues and their individual importance. Others have been created recently and, like the fund created by the Law on Land Restitution, are intended to temporarily serve special purposes.

There are good reasons to call for a complete fund inventory and a consolidation of funds either in the regular local government budgets or in the budgets of municipal enterprises. Because they are subject to less scrutiny than the regular budget, extrabudgetary funds may lead local governments to engage in questionable activities. Extrabudgetary accounts gave some autonomy and budgetary flexibility to local governments under the old regime when any unspent monies had to be remitted to the central treasury. However, as local governments gain increasing budgetary autonomy, this justification will have less merit. Aside from earmarking funds for particular activities, this budgetary practice should be generally discouraged.

The process of privatization will also have a significant impact on municipal finances in Bulgaria. Municipal enterprises and joint ventures will define the nature and degree of competition in Bulgaria's new market economy. There are between 800 and 900 municipal enterprises in Bulgaria, most of which are small-scale firms operating in the service sector. As a preliminary step to privatization, many municipalities have transformed their municipal enterprises into limited liability companies, where the municipality holds all shares. Most municipalities have been reluctant to elaborate on their privatization plans, slowing the pace of privatization. Most activities have consisted of restituting assets to previous owners. In addition, privatization has been hindered by uncertainty (for example, fears of a bread shortage if the bakery is privatized), concerns about increased unemployment, and municipal reluctance to give up some nontax revenues (specifically rental income) as a source of revenues.

Municipal ownership of enterprises is an obstacle to rapid conversion to a market economy (see chapter 1). Although some municipal enterprises do deliver local public services, many others are engaged in
purely commercial activities, such as bakeries, restaurants, construction, food processing, retailing, and light industry. Some of these operations are losing money, and are directly or indirectly subsidized by the municipal government. Even those enterprises considered to be "profitable" are subsidized by the municipal government in less obvious ways. To the extent that municipal enterprises compete unfairly with private enterprises, the process of firm creation will be slowed. Furthermore, engaging in these new activities risks having to cover future operating losses and bankruptcy with local finances.

Municipal enterprises that provide public goods should be transformed into autonomous decisionmaking units, supervised by local authorities and self-financed through full-cost recovery fees. Local governments will still need to distinguish between the supervision of services and the delivery of services. Delivery might be provided more cheaply if private enterprises competed for municipal government contracts.

Conclusion

Whereas there has been some initial progress in establishing a new legal framework for fiscal decentralization, not only is that work incomplete, but, in addition, the center has given little attention to implementing what legal reforms it has instituted. Unlike Hungary (see chapters 2 and 3), but like Romania, Bulgaria cannot even be said to be at a policy crossroads. It would be more apt to describe the central government as in a denial stage, hoping that just muddling through will somehow clear up the formidable structural and operational challenges that lie ahead. The three issues that need immediate attention are the assignment of expenditures, the adequacy of local revenues, and the question of an intermediate level of government.

Making local governments responsible for the provision of some public services will increase the efficiency in the public sector. This may be one of the few ways to increase the standard of living of the average Bulgarian citizen without using additional resources. Enhancing the role of local governments will also buttress democratic institutions in the country. Because of the economic and political instability brought on by the transition, the government will be tempted to further centralize, rather than decentralize. Resisting this tendency will become a serious challenge for the central government.

The Bulgarian government has already established the foundations needed for a good revenue assignment system: local own-source revenues, including some taxes, charges, and service fees; revenue sharing of some major taxes; and a system of equalizing intergovernmental transfers. All three components will need to be coordinated into an integrated
revenue-sharing system that is flexible enough to grow and change as Bulgaria develops. In order to do so, the role of user fees and charges must be increased significantly; a surcharge on the national income tax as well as property and motor vehicles taxes should be introduced, with the latter two administered locally; and the system of equalization grants must be designed in a way that will eliminate its bias against mobilization of own-source revenues.

The third issue is whether to create an intermediate level of government and, if so, what form it should take. Bulgaria has experimented with a variety of territorial and administrative organizations; however, all lower units of government were organs of the central government apparatus rather than autonomous bodies with democratically elected officials. Although the country is relatively small, a number of public services require the creation of an intermediate level of government. Bulgaria is well positioned to create special-service districts as alternatives to more bureaucratic and historically controlling general-purpose governments.

Notes

This chapter is based on work done on missions to Bulgaria under the sponsorship of the United States Agency for International Development and the World Bank. The author wishes to thank Robert Ebel for helpful comments. Jamie Boex provided useful research assistance.

1. Most central government agencies had regional delegations that coincided with the territorial division of the districts. This territorial division of decentralized administration still survives today even though the districts no longer exist.

2. The Sofia metropolitan area has a dual status as both an oblast and a municipality (obshtina) and, for the time being, the elected mayor has been fulfilling the duties of the oblast governor. A similar city-county situation prevailed in Budapest prior to the 1991 reforms in Hungary (see chapter 3).

3. The okolii were deconcentrated regional units of the central government until 1959. The first level of the judicial system in Bulgaria is still organized on the basis of this territorial division.

4. The explicit assignment of tax revenues to settlements is at odds with the provision in the Law on Self-Government and Local Administration that eliminates separation of budgets for municipalities and their settlements.

5. The experience in Bulgaria prior to the 1987 territorial division reform, when county governments were seen as arbitrary and passing on few resources to municipalities, may have been in the minds of legislators when they detailed an assignment of tax revenues to settlements. What has changed since 1991 is that municipalities have democratically elected councils with representation from all settlements in the municipality.

6. Housing services deserve special mention. At present, municipal governments are burdened with substantial financial liabilities inherited from the
socialist regime and recent central government policies. Housing construction, which has been the primary responsibility of municipal governments, was financed by a revolving fund, with money generated from the sale of new housing units. Housing prices were liberalized by new legislation in 1990 and 1991. These reforms freed municipalities from many responsibilities pertaining to housing; but they also saddled municipalities with substantial liabilities arising from the acquired rights of many households to buy housing units at guaranteed fixed prices prevailing before the liberalization of housing markets. These prices are a small fraction of the actual cost of building the housing units at current prices. The Compensation Fund for Housing was created by the central government to deal with this issue, but the L 400 million allocated is insufficient for the scale of the problem. In early 1992 the uncovered liability was between L 2.0 billion and L 2.7 billion ($10 million–$14 million). Bulgaria thus faces the choice of either having the center assume the responsibility for providing local governments with the necessary funds to clear these liabilities over time, or leaving the municipalities to deal with the problem.

7. The centralized capital spending decisions at the Ministry of Finance are also reflected in the lack of coordination with the Ministry of Regional Development, Housing, and Construction. Budget officials at the Ministry of Finance who finished the draft capital budget for 1993 were not aware at the time of the five-year Public Investment Plan put together by the Ministry of Regional Development.

8. Partly as a consequence of the compulsory expenditures in local budgets and partly as the result of inertia and tradition, the Ministry of Finance closely monitors budget implementation and remains heavily involved in the budget formulation processes of local governments. For example, the ministry reviews the expenditures and bank balances of all local governments on a biweekly basis, and requires quarterly reports from them. From the center’s perspective, the reporting system serves as a convenient cash management and monitoring tool, which has little to do with improving service delivery. A preferred approach that would address the legitimate need for central monitoring of local fiscal flows and yet promote local budgetary independence would be to audit localities through the independent State Audit Agency, with state subsidies disbursed in preannounced tranches.

9. The coefficient on average household income was positive and in some cases significant. However, income data at the municipal levels were not available and regional data were used instead. This may be a potentially large source of error.

10. Strict piggybacking on the central tax is not required. In Denmark, Sweden, Finland, and Iceland local income taxes are assessed on taxable income as defined for the national income tax, and each municipality chooses its own tax rate. There are no minimum or maximum rates set by the center. The taxes (which yield revenues up to 15 percent of GDP) are centrally collected on behalf of the localities.
Bucharest is a municipality that has district (judet) status. District (judet) names match the district centers, except where indicated on the map.

The boundaries, colors, denominations and any other information shown on this map do not imply, on the part of the World Bank Group, any endorsement of any kind of any territory or any endorsement or acceptance of any boundaries.
Decentralization and local government finance in Romania

Felix A. Jakob

After more than four decades of central control of local affairs, Romania adopted a Constitution in 1991 that mandated local autonomy as a basic principle of governance. Responsibility for managing matters of local interest was devolved to local governments. But in a climate of major macroeconomic adjustment and resulting social and political tensions, implementation of local government reform soon lost momentum. Successive governments hesitated to implement needed reforms of local government finance, public asset ownership, and operation of local utilities. As a result, at the end of 1993 local governments for the most part were still run according to policies and procedures of central control and today remain suspended between new but theoretical constitutional objectives of autonomy and modes of operation rooted in the past.

Background

Romania, with a land area of 238,000 square kilometers and a population of about 23 million, is the second largest country in Eastern Europe. It encompasses four distinct geographical regions: Banat in the west, Moldova in the northeast, Transylvania in the north and center, and Wallachia in the south. About 90 percent of the population is of Romanian descent; Hungarians constitute about 7 percent of the population, and Gypsies are the most important other minority.

Romania's economic resources include fertile agricultural land, extensive forests, large coal and lignite deposits, substantial but shrinking oil and natural gas reserves, and other mineral deposits. Despite the
communist regime's emphasis on industrial development, the country's agrarian roots persist today, with nearly half the population still living in rural areas.

Modern Romania dates from the Treaty of Versailles (1918), which annexed the formerly Austro-Hungarian territories of Transylvania and Banat, as well as the regions of Bessarabia, Northern Bukovina, and Dobrudja, to the kingdom of Romania. In 1940 Romania lost a large part of these gains when Germany forced the return of Transylvania to Hungary. The 1947 peace treaty between the U.S.S.R. and Romania restored Transylvania, but took away Bessarabia (now the Republic of Moldova), Northern Bukovina (now in Ukraine), and Dobrudja (now in Bulgaria).

After World War II and the country's occupation by the Soviet army, the communists formally seized power in 1947. Led by Gheorghe Gheorghiu-Dej, the new regime promoted a policy of economic development inspired by the Soviet model and based on strict autarky, central planning, and heavy investment in industry at the expense of agriculture. After Gheorghiu-Dej's death in 1964, Nicolae Ceaucescu rose to power and eventually became the country's new political leader. Ceaucescu intensified the policies of industrial development and economic self-sufficiency initiated by his predecessor. He also concentrated decisionmaking among members of his family and further centralized power. Facing an acute economic crisis in the early 1980s, the regime increased political repression and attempted to solve its problems by compressing and eliminating imports, deferring maintenance investment, and repaying foreign debt ahead of schedule. The regime also initiated such mammoth investments as the "remodeling" of downtown Bucharest and the construction of a presidential palace, the "People's Palace." By the end of the 1980s the economy was exhausted and gross domestic product (GDP) had started to decline.

Following demonstrations in Timisoara in the western part of the country, the Ceaucescu regime was overthrown on December 22, 1989. Elections in May 1990 resulted in the formation of a government headed by Prime Minister Petre Roman. The Roman government was forced to resign after violent demonstrations by mine workers in Bucharest in September 1991; it was succeeded by a government headed by Theodor Stolojan. Elections in September 1992 voted in a more conservative government, currently led by Prime Minister Nicolae Vacaroiu.

Restoring living standards was the primary objective of the new governments that came to power in 1990, beginning with such populist measures as land distribution and the privatization of public housing stock. In 1991 a macroeconomic stabilization program was introduced based on a gradualist approach to structural changes. Price liberalization began in 1991, but its effects were swamped by the government's
unsuccessful efforts to stabilize the exchange rate (the national currency depreciated from 250 lei to the dollar in 1991 to 1,500 lei to the dollar in 1993), contain soaring inflation (which rose from 175 percent in 1991 to 260 percent in 1993), and halt the decline in economic production (GDP fell 35 percent in real terms between 1990 and 1992). Public sector investment was sharply reduced, representing only 7 percent of central government budgetary expenditure in 1992—a dramatic plunge from the 40 percent in pre-1989. To keep the official fiscal deficit at an acceptable level, a growing portion of public sector expenditure was shifted to extrabudgetary accounts. In 1992 the nominal consolidated public sector deficit was 7 percent of GDP, although the official figure was reported as being less than 1 percent (World Bank 1993a).

Lack of financial discipline in state enterprises led to huge inter-enterprise arrears. Attempts to minimize the social costs of adjustment and to avert social unrest led to a rapid and unsustainable growth in consumer subsidies—amounting to about 9 percent of GDP by 1992.

The downward trend bottomed out in 1993. The economy registered positive growth of 1 percent that year, the first growth since 1988. The general government budget was close to balance. These results were achieved by containing public expenditure, eliminating all budgetary consumer subsidies (except for district heating and urban transport, which were reduced), and continuing restrictions on investment. Still, inflation was unchecked, reaching about 260 percent, and unemployment grew to 11 percent by the end of the year.

The system of local government

Before the communist takeover in 1947, Romania had a system of local government comprising municipalities and districts that was largely inspired by the French system of local administration. Both the municipalities (comuna) and the districts (judet) were administratively and financially autonomous and governed by elected councils and officials. Local government responsibilities were broad and included extensive involvement in education, social assistance, and agricultural development. Local-government-owned but financially independent utility companies provided local services. Local government revenues were derived from revenue sharing of national taxes, local taxes, and service charges.

Under communist rule, management of local affairs was entrusted to People’s Councils at the municipal and district level, and territorial administration was organized along the Soviet model of strict central control over subnational “governments.” Even when local authorities had their own resources and enjoyed some decisionmaking autonomy in matters of local interest, they acted primarily as organs of the central government.
1991 reform

After the collapse of the communist regime, following the example of other East European countries, Romania began a process of administrative decentralization. The Constitution adopted in December 1991 stipulated that local public administration was to be based on principles of decentralization and local autonomy in the framework of a unitary and democratic state. The Law on Local Public Administration (Law 69/91) defined the institutional framework of local government, and the Law on Local Elections (Law 70/91) formed the basis for the local elections held in February 1992.

Romania returned to the two-tiered system of local government that existed before 1947, though the territorial subdivisions and geographical terminology inherited from the communist period were left unchanged. Administratively, the country is divided into forty-one districts (see map of Romania, p. 222). These districts form the geographical basis of both the deconcentrated central government administration (prefectură) and the first tier of the local government system (figure 6.1). Districts are divided into 2,948 municipalities,¹ the second tier of local government, comprising 260 urban communities (municipiu and oraș)

Figure 6.1 Structure of Romanian government
Decentralization and local government finance in Romania

and 2,688 rural communities (comună). The Law on Local Public Administration establishes no hierarchical relationship between districts and municipalities. Municipalities deal with strictly local problems, while districts manage matters relating to geographically larger areas and ensure coordination of activities among municipalities.

Local governments are composed of a legislative branch, the municipal or district council, and an executive branch. All local authorities are elected for a term of four years. Mayors and municipal council members are elected directly, while members of district councils are elected by the district’s municipal councils, and the president of the district council is elected by the district council members. No member of a local government can hold a position in central government or at any higher level of central administration. Local authorities cannot be recalled by their constituencies, but they can be dismissed by the central government. Local governments must submit important decisions to their constituencies for a referendum.

Population distribution. Districts have an average population of 500,000. The average population of municipalities (excluding Bucharest) is 6,954. Of the 2,948 municipalities, about 200 have a population over 10,000, but they account for about half the country’s total population of 22.7 million. The other half of the population is scattered throughout small towns and rural municipalities with an average population of about 4,200, including about 14,000 villages and hamlets without a specific administrative status. Although some municipalities may be too small to operate efficiently, there has been no discussion of possible mergers as yet. To the contrary, there have been attempts to break up both districts and municipalities into smaller units for primarily historical and cultural reasons.

Bucharest. Bucharest, Romania’s capital and its largest city (2.2 million inhabitants), enjoys a special status between district and municipality. Unlike Romania’s other districts, the Bucharest district is composed of two independent subunits: the Agricultural Sector Ilfov, which has the status of a regular district and comprises about thirty autonomous municipalities, and the city itself (figure 6.2). The city is set up as a two-level municipal government. The upper level is the Capital Municipality, headed by a general mayor and a general municipal council. The lower level has six administrative sector municipalities with quasi-autonomous local governments. These municipalities have directly elected mayors and local councils, but limited managerial autonomy because of their virtually total financial dependence on the capital municipal budget. The Law on Local Public Administration stated that these arrangements were provisional, but alternate arrangements have not been prepared thus far.
Reform objectives and obstacles

The new legislation on local administration was conceived under the government of Petre Roman. Its objective was to abolish most central control over local governments and restore the autonomy they had enjoyed before 1947. The legislation's intention was apparently to restrict the central government's role to ensuring the constitutionality and legal conformity of local government activities while allowing local governments full autonomy in matters relating to the administration of their jurisdictions.

These initial steps were not followed by efforts to make reform happen, and little attempt was made to amend existing legislation to render it compatible with the Law on Local Public Administration. This has resulted in some confusion about the actual rights and responsibilities of local governments. At the end of 1993 many local governments still had to contend with laws, policies, rules, and procedures of central control that either predated the 1991 reform or that were established during the reform years in ways that have caused them to collide with principles of local autonomy.

Local finances provide an example of the conflict between reform and maintenance of the status quo. The Law on Local Public Administration was to be followed immediately by legislation defining the financial
framework for the exercise of local autonomy. That legislation never progressed beyond preliminary discussions. Instead, the government issued a Local Tax Ordinance (Ordinance 15/92) that provides only for tax rate adjustments and clarifies a few other features of local revenue sources. Financial management and expenditure decisions remain severely restricted by the Law on Public Finance (Law 10/91), which predates the Law on Local Public Administration. The Law on Public Finance mandates strict control of local governments for both revenues and expenditures and requires approval by the Ministry of Finance for all major investments.

All tax collection and cash management operations are executed through, and under the control of, the Ministry of Finance’s treasury department and its local branch offices. Salary levels and employment conditions of local government officials and most staff are set and regulated by the central government. Finally, mandatory levels of expenditure for the health and social assistance sectors were introduced in 1993 in a system that is apparently expected to be extended to other sectors as well in the coming years.

The extent of local autonomy in matters of local government property remains ill-defined. No legal framework has been established to address the division and assignment of former state assets among local governments. Legislation is also needed to settle the ownership status and operating conditions of local public utilities, which have not yet been fully transferred to local governments.

The merits of decentralization have never been openly questioned by the central government or by any political parties, and local government reform has been confirmed repeatedly as a prime objective and integral part of the economic transition strategy. But large segments of the government administration appear to believe that maintaining the status quo or even reinforcing the mechanisms of central control over the local government system is, for the time being, preferable to stronger local government. This lack of enthusiasm for local autonomy is probably an outgrowth of a variety of converging social and political factors.

First, large-scale decentralization is difficult under any circumstances. It would be naïve to expect Romania to be an exception to this rule, especially given the legacy of the Ceaucescu years. And resistance to change may have been strengthened by the changes in the political make-up that occurred in 1992. Local government elections during the spring of 1992 saw the victory of democratic opposition forces in many jurisdictions, particularly in larger cities. In contrast, general elections that fall returned conservative forces to power in the central government. The competing political philosophies that resulted made it difficult to reach rapid consensus on many issues relating to decentralization.
A second important reason for the slow pace of reform may have arisen from fear that local authorities lacked financial discipline or would be unable to resist popular pressure for increased spending—further threatening the central government’s program of macroeconomic stabilization. There is a tendency at all levels of the public sector to assume the central government will cover all expenditures, even if they exceed budgetary authorizations. Whether decentralization had any significant effect on public sector deficits is uncertain. But without tight central control over investment and access to foreign capital, some local governments might have found it difficult to resist offers for questionable business ventures from within and outside the country (see chapter 1).

Finally, national unity remains a matter of great political sensitivity in a country that has seen its territory dismembered and recomposed repeatedly since World War I. Certain groups may fear that local autonomy would fuel separatism or lead to tensions with neighboring countries. There were occasions when some local government officials acted as though Romania were about to become a collection of 3,000 independent republics. This might explain why Romania, unlike some other East European countries, has never seriously considered the creation of an intermediate level of government.

Local government responsibilities

According to the Law on Local Public Administration, Romania’s local governments have a wide array of responsibilities (box 6.1). In practice, few local governments have assumed all these responsibilities, and disparities among jurisdictions are great. The root difficulty is not only the insufficiency of financial resources but also the persistent confusion about the nature and extent of local responsibilities. Local governments still operate under conditions inherited from or inspired by the communist regime that restrict their capacity to perform as units exercising genuine self-administration.

The influence of the past continues for many reasons. The Law on Local Public Administration did not assign new operational responsibilities to local governments, but rather endorsed assignments made in earlier government decisions and perpetuated assignments that existed under the communist regime. The law intended to establish a new legal and institutional framework for local governments to assume these responsibilities. But the law was vague, failing to spell out what these responsibilities would require of local governments and how the responsibilities would be distributed among central, district, and municipal governments.

Many local responsibilities continue to be assumed by the central government or by entities beyond the reach of local governments. For
Box 6.1 Local government responsibilities

**Municipalities**

*Service provision*
- Infrastructure, housing, and transport
  - Water supply, sewerage, and wastewater treatment
  - Maintenance of local streets and traffic management
  - Solid waste collection and disposal
  - Public lighting
  - Maintenance of parks and green spaces
  - Urban heating
  - Management of public housing stock
  - Public transport
- Art, culture, and education
  - Local libraries and museums
  - Theaters and concert halls
  - Kindergartens and basic education
- Social assistance and health
  - Retirement and nursing homes
  - Youth centers
  - Clinics, hospitals, and other health care facilities
  - Programs of social care and assistance
- Public safety and security
  - Disaster prevention and emergency assistance
  - Local police
- Economic activities
  - Management of commercial enterprises
  - Management of markets and fairgrounds

*Regulatory duties*
- Urban development and environment
  - Urban development planning
  - Environmental protection
  - Conservation of historic and cultural monuments
  - Municipal taxation
- Hygiene and sanitary control

**Districts**

*Service provision*
- Maintenance and construction of district roads
- Creation and operation of social, cultural, and health facilities
- Management of district public services
- Management of commercial enterprises

*Regulatory duties*
- Intermunicipal coordination
- Preparation and implementation of economic development plans
- Environmental protection
- Urban and regional planning
- District taxation

*Source:* Law on Local Public Administration (69/91), Government of Romania.
example, the responsibility for most health and social assistance facilities was not transferred until 1993, and local governments are only in charge of maintenance and operational expenditures—salaries, medication, and equipment are still provided by the Ministry of Health. Responsibility for primary and secondary education is retained by the central government, with conditions for transfer under review. All major investments in infrastructure and services are still decided on and funded by the central government. And the provision of local public services, which constitutes the bulk of local government responsibilities, is undertaken by entities over which local governments do not have full control and whose accountability remains ambiguous.

Local public services

The provision of local public services provides a clear illustration of the problems created by the parallel and often conflicting arrangements about legal ownership, regulatory authority, and financial accountability. Until 1989 local public services were delivered by autonomous public service units and typically included housing, district heating, road and street maintenance, water supply and sewage, solid waste collection and disposal, urban and regional public transport, and maintenance of parks, public spaces, and cemeteries. The units operated at the district level, providing services either for the district as a whole (such as road maintenance) or locally through their municipal branches (such as water supply). Services were delivered on a contractual basis according to centrally set tariffs. Based on the Law on the Restructuring of State Enterprises (Law 13/90), these service units were divided in 1990 into about 450 regie autonome that operate at the level of either a single municipality, multiple municipalities, or a district.

The Law on the Restructuring of State Enterprises established that regie autonome have legal autonomy, enjoy full ownership of their assets, are managed by a board representing the central administration and the client local governments, and are independent in their financial management (though overseen by the Ministry of Finance). Conflict arose when the Law on Local Public Administration granted local governments ownership of all assets that "by their nature are of public use or public interest." To resolve ownership disputes the central government issued a legal order (Decision 597/92) in September 1992 confirming the authority of local governments over local regie autonome. Left open was the question of what such responsibility implied, particularly with regard to financial liabilities. One year later, a new ordinance (Ordinance 3/93) affirmed full ownership by the
Decentralization and local government finance in Romania

The regie autonome of assets essential to their operations and reaffirmed the central government's right to set tariffs when deemed necessary. It also installed local governments as the overseeing authority for all financial and administrative management decisions (with limitations as regards tariffs), but made the regie autonome solely responsible for their financial liabilities.

The concept of independently managed, local-government-owned public service enterprises is neither new nor remarkable in Romania. Such enterprises existed until 1947 and are the form under which a substantial part of local services are provided in France (régie municipale) or Germany (Eigenbetrieb). What distinguishes the Romania case is the extent of the persistent confusion about the legal ownership conditions of these regie autonome and the ensuing complications for financial and technical management. Although the regie autonome budgets are approved by the local government under whose authority they operate, they are financially independent of the local government, and their finances are not incorporated into the consolidated local government budget. Local governments pass on subsidies received from the central government for district heating and urban transport operations and pay for other services provided under contractual arrangements. Capital investments for service infrastructure, facilities, and equipment are financed almost exclusively by the central government or exceptionally by local government capital investment budgets.

The regie autonome are supposed to maintain balanced budgets. In the past three years, however, tariff increases were authorized sparingly, forcing the regie autonome to finance their growing deficits through interenterprise arrears. In Brașov, Romania's second-largest city, the accumulated arrears of the regie autonome providing district heating and water supply in 1993 were equal to about 12 percent of the municipal budget. It is estimated that by end-1993 the arrears of the thirty-six most indebted local service regie autonome were about 50 billion lei, about 7 percent of the consolidated local government budget for that year. The total arrears for all local service regie autonome were probably significantly higher. These arrears (which may not include other commercial debts) explain why many local governments, despite their claims on the ownership of the regie autonome and their assets, hesitate to press for the transfer of regie autonome property, since a transfer could force the governments to assume (despite the dispositions of Ordinance 5/93) regie autonome financial liabilities as well. Local governments seem to be waiting for the central government to provide a compensation scheme to alleviate this debt. But the central government, because of the potentially dangerous fiscal effects of such a scheme, is reluctant or unable to do so.
Local finances: The macroeconomic context

Under the unitary system of public finance and budgeting in place until 1989, local government budgets represented about 20 percent of the unified state budget and about 8.5 percent of GDP (World Bank 1992b). Transfers from the state budget accounted for 45 to 50 percent of local revenue. Transfers mostly financed local expenditure needs, determined on the basis of centrally fixed expenditure norms. As a result of the Ceaucescu regime's economic isolation and its efforts to accelerate foreign debt repayment in the 1980s, social expenditures by local governments were reduced significantly or eliminated by the central administration. Between 1986 and 1989 transfers as a source of revenue were eliminated, and local government expenditure as a share of the state budget declined to about 7.5 percent, and as part of GDP to about 3.0 percent.

Except for the reinstatement of budgetary transfers in 1990, the collapse of the communist regime did not bring any immediate changes to the local finance system. Local revenue sources, budgeting, and finance management were left basically unchanged. And since the first local governments were not formed until spring of 1992, preparation of local government budgets continued to be administered by the central administration. In 1993 local budgets were prepared based, for the first time, on local decisionmaking.

In the past three years total local government revenue (budgetary and extrabudgetary combined) has varied relatively little in proportion to central government revenue, ranging between 18.2 and 19.1 percent (table 6.1). As a portion of GDP it averaged about 4.1 percent in 1991 and 1992, and dropped to 3.7 percent in 1993. This stability conceals important changes in the revenue structure. In 1991 about 46 percent of consolidated local revenue consisted of transfers from the central government budget (about the same proportion as in the early 1980s). This share grew to 68 percent in 1992 and 77 percent in 1993 (table 6.2). Local fiscal (tax and nontax) revenue has stagnated at a level far below its presumed potential. Capital revenue, which accounted for one-third of local government revenue in 1991, has dwindled as the stock of salable assets (particularly housing) has been rapidly depleted. Until 1992 housing sale revenues were accounted as extrabudgetary resources. To increase the transparency of budgetary management, extrabudgetary funding for local governments was eliminated in 1993 and incorporated into the central government budget as regular transfers.

Significant changes have also occurred in expenditures (table 6.3; figure 6.3). Overall local government expenditure has remained relatively constant at about 18 percent of central government expenditure. Wage
### Table 6.1 Local government finance, Romania, 1991–93

(billions of current lei)

<table>
<thead>
<tr>
<th>Item</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central government revenue</td>
<td>497</td>
<td>1,364</td>
<td>3,792</td>
</tr>
<tr>
<td>GDP</td>
<td>2,198</td>
<td>5,982</td>
<td>19,737</td>
</tr>
<tr>
<td>Average annual inflation (percent)</td>
<td>175</td>
<td>211</td>
<td>257</td>
</tr>
<tr>
<td>Real GDP growth (percent)</td>
<td>-12.9</td>
<td>-13.6</td>
<td>1.0</td>
</tr>
<tr>
<td>Local revenue as a percentage of central government revenue</td>
<td>18.2</td>
<td>18.2</td>
<td>19.1</td>
</tr>
<tr>
<td>Local revenue as a percentage of GDP</td>
<td>4.1</td>
<td>4.1</td>
<td>3.7</td>
</tr>
<tr>
<td>Local tax revenue as a percentage of GDP</td>
<td>0.8</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>Local capital expenditure as a percentage of central government capital expenditure</td>
<td>31.9</td>
<td>27.9</td>
<td>23.1</td>
</tr>
<tr>
<td>Local capital expenditure as a percentage of GDP</td>
<td>2.2</td>
<td>1.2</td>
<td>0.9</td>
</tr>
<tr>
<td>Memo item</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average exchange rate (lei/U.S. dollar)</td>
<td>76.4</td>
<td>308.0</td>
<td>760.1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Government of Romania; World Bank.

### Table 6.2 Consolidated local government budget, Romania, 1991–93

(billions of current lei)

<table>
<thead>
<tr>
<th>Category</th>
<th>1991</th>
<th></th>
<th>1992</th>
<th></th>
<th>1993</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>Share (percent)</td>
<td>Amount</td>
<td>Share (percent)</td>
<td>Amount</td>
<td>Share (percent)</td>
</tr>
<tr>
<td>Revenue</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own-source</td>
<td>48.8</td>
<td>54</td>
<td>79.7</td>
<td>32</td>
<td>163.9</td>
<td>23</td>
</tr>
<tr>
<td>Direct taxes</td>
<td>16.1</td>
<td>18</td>
<td>28.8</td>
<td>12</td>
<td>92.7</td>
<td>13</td>
</tr>
<tr>
<td>Indirect taxes</td>
<td>1.6</td>
<td>1</td>
<td>2.5</td>
<td>1</td>
<td>28.6</td>
<td>4</td>
</tr>
<tr>
<td>Capital</td>
<td>31.1</td>
<td>35</td>
<td>48.4</td>
<td>19</td>
<td>42.6</td>
<td>6</td>
</tr>
<tr>
<td>Budgetary transfers</td>
<td>41.4</td>
<td>46</td>
<td>168.0</td>
<td>68</td>
<td>560.0</td>
<td>77</td>
</tr>
<tr>
<td>Tax sharing</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>231.8</td>
<td>32</td>
</tr>
<tr>
<td>Subsidies</td>
<td>41.4</td>
<td>46</td>
<td>168.0</td>
<td>68</td>
<td>328.2</td>
<td>45</td>
</tr>
<tr>
<td>Total</td>
<td>90.2</td>
<td>100</td>
<td>247.7</td>
<td>100</td>
<td>723.9</td>
<td>100</td>
</tr>
<tr>
<td>Expenditure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recurrent</td>
<td>23.7</td>
<td>27</td>
<td>67.3</td>
<td>28</td>
<td>333.3</td>
<td>47</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>10.1</td>
<td>11</td>
<td>25.4</td>
<td>11</td>
<td>85.8</td>
<td>12</td>
</tr>
<tr>
<td>Goods and services</td>
<td>13.6</td>
<td>16</td>
<td>41.9</td>
<td>17</td>
<td>247.5</td>
<td>35</td>
</tr>
<tr>
<td>Subsidies to consumers</td>
<td>21.5</td>
<td>24</td>
<td>112.1</td>
<td>46</td>
<td>151.5</td>
<td>22</td>
</tr>
<tr>
<td>Capital</td>
<td>43.1</td>
<td>49</td>
<td>61.8</td>
<td>26</td>
<td>219.3</td>
<td>31</td>
</tr>
<tr>
<td>Total</td>
<td>88.3</td>
<td>100</td>
<td>241.2</td>
<td>100</td>
<td>704.1</td>
<td>100</td>
</tr>
<tr>
<td>Surplus</td>
<td>1.9</td>
<td>6.6</td>
<td>19.8</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

n.a. Not applicable.

a. For 1991 and 1992, includes extrabudgetary housing sale proceeds to make comparison with 1993 meaningful.

b. Government statistics classify tax-sharing revenues as own-source revenues.

Table 6.3 Local government expenditure by category, Romania, 1991–93

<table>
<thead>
<tr>
<th>Category</th>
<th>1991</th>
<th>1992</th>
<th>1993</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure, housing, and transport</td>
<td>81</td>
<td>75</td>
<td>59</td>
</tr>
<tr>
<td>Art and culture</td>
<td>3</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Health and social assistance</td>
<td>1</td>
<td>1</td>
<td>24</td>
</tr>
<tr>
<td>Economic activities</td>
<td>4</td>
<td>4</td>
<td>3</td>
</tr>
<tr>
<td>Administration</td>
<td>10</td>
<td>14</td>
<td>10</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Government of Romania.

Figure 6.3 Composition of local government expenditure, Romania, 1991–93

and salary expenditures have remained at less than 20 percent. Expenditures for goods and services—including payments for the nonsubsidized part of local services provided by regie autonome—tripled between 1991 and 1993. Capital investment, targeted primarily at the completion of public housing developments, was reduced by half during the same period.
This picture of budgetary operations is misleading, however. By law, local government budgets must be balanced. As a result it is common for outstanding payments to be rolled over from one budgetary year to the next. By the end of 1991, the last year for which information is available, such short-term debt was estimated to be about 15 percent of the consolidated local government budget.

Sources of local government revenue

Since 1991 there have been three main sources of local government revenue: own source, transfers from the central government budget, and extrabudgetary funding allocations.

Own-source revenue

With a few exceptions, all local direct taxes and most nontax revenue sources date back to the previous regime and have been adjusted only slightly since 1990 (box 6.2), although work on a major revision was begun in 1993.

Direct tax and nontax revenue represented about 19 percent of total local government revenue in 1991. This share declined to about 13 percent in 1992 (principally because of inflation) and rose again to 17 percent in 1993 (possibly due to more efficient tax collection). Local tax revenue in Romania amounts to less than 1 percent of GDP, less than in most West European countries (where it averages about 4.5 percent of GDP). The overall tax burden, however, is about 35 percent of GDP—comparable to West European standards, which average 40 percent of GDP. Nontax revenue is derived from fees and payments recovered from administrative actions. Its importance as a revenue source is minor: in 1991 and 1992 it represented about 1 percent of local government revenue, and about 4 percent in 1993.

Taxes. Local governments receive own-tax revenues from six major sources:

- The tax on profits and dividends of local regie autonome (Decision 741/90 and Law 12/91) was established in 1990 to rationalize the taxation of these enterprises and facilitate their privatization. Initially the tax was levied according to a highly differentiated and progressive rate schedule. The tax was simplified in 1992, with calculation based on a two-tier system: 30 percent of net profit for profits of less than 1 million lei and 45 percent for profits of more than 1 million lei (after deduction of contributions to workers' participation and development funds). Few of the local
regie autonome are generating any profit. Since the headquarters of the regie are usually located in large municipalities, this tax is of little importance to small municipalities—only two of ninety-eight municipalities in the Suceava district reported revenue from this tax in 1991.

- The tax on privately owned agricultural land was established in 1977 and has survived essentially unchanged. It is levied according to

---

**Box 6.2 Tax and nontax revenue sources**

*Direct taxes*

**Districts**
- Tax on the profits and dividends of regie autonome
- Tax on the use of agricultural land in state ownership
- Tax on corporate-owned vehicles
- Tax on corporate real estate
- Tax on entertainment
- Late payment penalties

**Municipalities**
- Tax on the profits and dividends of municipal-level regie autonome
- Taxes on individuals
  - Tax on private agricultural land
  - Tax on income of individual businesses
  - Tax on private real estate (land and buildings)
  - Tax on private vehicles and other transport
  - Stamp duties on real estate transactions
  - Other taxes (tourism, dog licenses, and so on)

*Nontax revenue sources*

**Districts**
- Levies on after-tax profit of district public service enterprises
- Rental and leasing income
- Fees for driver exams and licenses
- Budgetary surpluses from preceding years

**Municipalities**
- Levies on after-tax profit of municipal public service enterprises
- Fines
- Fees for processing judicial acts
- Budgetary surpluses from preceding years

*Note:* Assignment of revenue sources is as of end-1993.

a. Though technically not a revenue source, budgetary surpluses are considered as such in Romanian legislation. Local governments were not allowed to retain surpluses until 1993.

*Source:* Ministry of Finance, Government of Romania.
a per hectare rate on land used for agricultural activities. Rates are calculated based on different fertility zones and uses (arable land, pasture, orchards, vineyards, and so on). Rates had not been changed since 1977 until 1992, when the Local Tax Ordinance authorized local governments to increase them by 50 percent. The tax was to be replaced by an Agricultural Income Tax approved by the Parliament in the summer of 1994, but implementation has been postponed until 1995.

- **The tax on use of state-owned land** is levied according to a per hectare rate on state-owned land used for purposes other than agriculture or forestry. Such land includes areas used for commercial or residential activities by individuals, private enterprises, or regie autonome. Established in 1991, the tax was revised in the fall of 1993 by Law 69/93.

- **The tax on corporate and privately owned real estate**, established in 1981, is levied on all corporate and privately owned urban land and real estate. Tax rates on privately owned real estate are determined by the “social characteristics” of the property owners and have not changed since 1981. The taxable value of property is based on insurance assessments, sales contracts, and construction costs. Because of the price distortions in this sector, property values are usually significantly underestimated. All buildings owned by public institutions are exempt from this tax, as are housing units purchased from the public housing stock since 1990. A law revising these taxes was adopted by Parliament in the summer of 1994.

- **The tax on individual businesses** is a group of taxes established in 1954. Essentially an income tax on small private enterprises, its rate is progressive, ranging from 10 percent to 40 percent. It will disappear once the global income tax, currently under discussion, is introduced.

- **The tax on vehicles** is levied on all vehicles (and other means of land and water transport) owned by individuals or enterprises, except vehicles used by government institutions and by various categories of exempted beneficiaries (such as war veterans). The tax rate depends on engine capacity and type of vehicle.

Local governments face two major constraints to their revenue authority to assess local taxes and fees. Rates have not been adjusted since the onset of runaway inflation in 1991. Moreover, the central government has granted tax holidays for many areas and effectively eliminated property taxes as a major revenue source for the rest of the decade. Purchasers of public housing stock are excused from the real estate tax for ten years. Under the Law on Land Reform (18/91), recipients of
agricultural property were spared for eight years. The 1992 Local Tax Ordinance authorized local governments to increase local tax levels up to 50 percent over the centrally mandated minimum, but in the absence of an adjustment of the base rates, this measure was insufficient to allow tax revenue to keep pace with inflation.

Capital revenue. Under the communist regime local governments were only authorized to keep the proceeds from the sale of salvaged materials or obsolete equipment. As a revenue source, then, capital revenue was of little importance. This changed in 1990 when the government instituted the privatization of public housing stock and decided that local governments would receive a portion of the proceeds. In 1991, the year in which most of the sales took place, local governments received 50 percent of the proceeds in the form of extrabudgetary funding. These funds were earmarked for investments and represented about one-third of total revenue for the year. In 1992 local governments were allowed to keep all the housing sales proceeds, but revenue from this source dwindled to about 6 percent of total revenue because the stock of salable housing was rapidly depleted.

Whether the sudden availability of substantial investment funding in 1991 was ultimately beneficial is debatable. While a large portion of it was used to complete ongoing projects, particularly housing, it also encouraged many local administrators to start a number of new investment projects. The rapid decrease of housing sale revenue meant these new projects could not be continued and increased the number of unfinished investments left over from the communist regime.

Intergovernmental transfers

The importance of intergovernmental budgetary transfers as a local government revenue source has been growing steadily in the past three years (see table 6.2). In 1991 budgetary transfers represented more than 45 percent of total local government revenue, a share that rose to 68 percent in 1992 and 77 percent in 1993 (figure 6.4).

Transfers from the central government budget include price subsidies for district heating and urban transport services, transfers for capital investment, and shares of national taxes.

Consumer subsidies. Transfers for consumer subsidies compensate local district heating and urban transport regime for the difference between the cost of service operations and the cost charged to the consumer in accordance with the central government’s tariff regulations. In 1991 and 1992 these transfers accounted for 60 to 70 percent of total annual transfers. In May 1993 these subsidies were eliminated entirely for
urban transport (except for the Bucharest subway system) and reduced substantially for district heating. Current data are insufficient to determine whether these subsidies have been totally halted or whether some local governments have stepped in and continued subsidizing operations.

Investment transfers. Until 1992 central government support for local capital investment was channeled almost exclusively through extrabudgetary transfers, either through proceeds of the sale of public housing stock or through other extrabudgetary revenues, such as the Stock Revaluation Fund (whose revenue came from taxation of gains resulting from revaluation of state enterprise inventories). As mentioned, all such extrabudgetary transfers were incorporated into the government budget as regular transfers in 1993 to make the government's budgetary operations more transparent.²

The transfer system has a series of flaws that stem partly from the way the budgetary management process is set up and partly from the design features of the system. Transfers continue to play the role they had under the socialist system of public finance. Their objective is correcting vertical imbalance—the disparity between local expenditure responsibilities and the resources allocated to them. This gap-filling

Figure 6.4 Composition of local government revenue, Romania, 1991–93

![Bar chart showing composition of local government revenue from 1991 to 1993.]

Source: Table 6.2.
function is indicated by the annual adjustments of the central government budget and the resulting changes in own-source revenue and transfers in local government budgets. As shown in annex 6.1 at the end of the chapter, it appears that transfers have no equalizing effects.

Shared taxes. Tax sharing was introduced in 1993 for the national salary tax. The portion reserved for local governments was initially set at 11 percent, but subsequently increased to 17 percent. Although shared tax revenue can technically be viewed as a transfer, in Romania this revenue is distributed to local governments without clear procedures and criteria. Distribution is not based on origination, nor does it follow any explicitly defined formula.

The budgeting process still follows a vertically integrated, centralized resource allocation process. Local governments prepare annual draft budgets based on their anticipated financial needs. These needs are determined according to a series of centrally calculated norms involving physical and other standards. Individual local government budgets are then aggregated at the district level and submitted to the Ministry of Finance. The Ministry of Finance determines the amount of transfers to be made from the central government budget. Districts then apply similar procedures to distribute resources to the municipalities within their jurisdictions. Since the outcome of each level of negotiations is unpredictable, the system, as in the past, encourages local governments to overstate their expenditure needs and understate their revenues.

The role played by districts in the budgetary process is another legacy of the past. According to the Law on Local Public Administration, district governments have no legal oversight of municipalities. In reality, however, the districts have retained much of the role they had under the communist regime. They continue to control municipalities and act as a de facto intermediate level of government. In the 1992 and 1993 budget laws, for instance, districts are not only the intermediary in the negotiation of transfers, but are given explicit authority to determine the distribution of transfers to municipalities within their jurisdiction. While many decisions on transfers are reached by consensus, there have also been cases—especially when the district and municipal governments were led by opposing political groups—where discussions of distribution ended in open dissent, with the district usually prevailing.

Conclusion

In limiting the decisionmaking power of local governments, Romania’s central government may have prevented local-level finance from threatening its program of macroeconomic stabilization. But this was achieved
by perpetuating a system of extensive central control, restraining legitimate local aspirations for managerial autonomy, and compromising decentralization. It can be argued that in Romania in the past few years, any other policy could have led to fiscal anarchy and unforeseeable political and economic consequences. But the time has now come to decide whether maintaining the current framework is politically opportune or whether replacing it with one that provides local authorities the means to act as true local governments provides for a more promising future.

Consensus must be reached on the extent of local decisionmaking autonomy. And these decisions must be supported by the creation of a legal and institutional framework that allows local governments to operate efficiently and to be responsive and accountable to their constituents.

The future of local government in Romania depends on which view of local decisionmaking autonomy is adopted. So far, central government has restricted the power of local decisionmakers. Excessive control can increase demand for autonomy—creating a perilous political climate. Broad consensus on the gradual devolution of autonomy to local governments, and adherence to the principles of autonomy at all levels of government, are of critical importance.

Annex 6.1 A preliminary analysis of intergovernmental transfers

The purpose of this annex is to present simulations of the distributive effects of changing the transfer formula. The analysis was prepared by Richard Bird (University of Toronto) and Heng-Fu Zou (World Bank).

Distribution of transfers

To provide a preliminary assessment of the distribution of the present intergovernmental transfers in Romania, a simple analysis of the relation between per capita own-revenue and per capita transfers across the forty-one districts has been carried out. The dependent variable is per capita transfers (table A6.1) and the explanatory variable is per capita own-revenues.

For 1991 the regression equation is:

\[
PCT_i = 0.711 + 1.237 \times PCOR_i
\]

where \( PCT_i \) is per capita transfer to district \( i \), and \( PCOR_i \) is per capita own-revenue in district \( i \). (\( t \)-statistic is shown in parentheses.)

The equation illustrates a highly significant, positive correlation between own-revenues and government transfers in Romania. In fact,
Table A6.1  Per capita transfers by district, Romania, 1991–92

<table>
<thead>
<tr>
<th>District</th>
<th>1991</th>
<th>1992</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alba</td>
<td>1,420 (89)</td>
<td>2,559 (99)</td>
</tr>
<tr>
<td>Arad</td>
<td>1,632 (103)</td>
<td>2,506 (97)</td>
</tr>
<tr>
<td>Arges</td>
<td>1,098 (69)</td>
<td>1,867 (72)</td>
</tr>
<tr>
<td>Bacau</td>
<td>1,565 (104)</td>
<td>2,635 (102)</td>
</tr>
<tr>
<td>Bihor</td>
<td>1,327 (83)</td>
<td>2,022 (78)</td>
</tr>
<tr>
<td>Bistrita-Nasaud</td>
<td>1,755 (110)</td>
<td>2,916 (113)</td>
</tr>
<tr>
<td>Botosani</td>
<td>1,583 (100)</td>
<td>2,601 (101)</td>
</tr>
<tr>
<td>Braila</td>
<td>1,049 (66)</td>
<td>2,742 (107)</td>
</tr>
<tr>
<td>Brasov</td>
<td>2,590 (163)</td>
<td>2,407 (94)</td>
</tr>
<tr>
<td>Buzau</td>
<td>1,040 (65)</td>
<td>1,597 (62)</td>
</tr>
<tr>
<td>Calarasi</td>
<td>1,205 (76)</td>
<td>1,956 (76)</td>
</tr>
<tr>
<td>Caras-Severin</td>
<td>2,155 (136)</td>
<td>3,457 (134)</td>
</tr>
<tr>
<td>Cluj</td>
<td>1,594 (100)</td>
<td>2,728 (106)</td>
</tr>
<tr>
<td>Constanta</td>
<td>2,585 (163)</td>
<td>3,765 (147)</td>
</tr>
<tr>
<td>Covasna</td>
<td>2,107 (133)</td>
<td>3,570 (139)</td>
</tr>
<tr>
<td>Dâmbovita</td>
<td>1,093 (69)</td>
<td>1,802 (70)</td>
</tr>
<tr>
<td>Dolj</td>
<td>1,380 (87)</td>
<td>2,332 (91)</td>
</tr>
<tr>
<td>Galati</td>
<td>1,284 (81)</td>
<td>1,962 (76)</td>
</tr>
<tr>
<td>Giurgiu</td>
<td>1,093 (69)</td>
<td>1,905 (74)</td>
</tr>
<tr>
<td>Gorj</td>
<td>925 (58)</td>
<td>1,419 (55)</td>
</tr>
<tr>
<td>Harghita</td>
<td>1,468 (92)</td>
<td>2,342 (91)</td>
</tr>
<tr>
<td>Hunedoara</td>
<td>1,608 (101)</td>
<td>2,431 (94)</td>
</tr>
<tr>
<td>Ialomita</td>
<td>1,232 (77)</td>
<td>2,195 (85)</td>
</tr>
<tr>
<td>Iasi</td>
<td>1,905 (120)</td>
<td>2,816 (109)</td>
</tr>
<tr>
<td>Maramures</td>
<td>2,022 (127)</td>
<td>3,196 (124)</td>
</tr>
<tr>
<td>Mehedinti</td>
<td>1,179 (74)</td>
<td>2,198 (85)</td>
</tr>
<tr>
<td>Mures</td>
<td>1,577 (99)</td>
<td>2,568 (100)</td>
</tr>
<tr>
<td>Neamt</td>
<td>1,305 (82)</td>
<td>1,946 (75)</td>
</tr>
<tr>
<td>Olt</td>
<td>1,036 (65)</td>
<td>1,707 (66)</td>
</tr>
<tr>
<td>Prahova</td>
<td>1,178 (74)</td>
<td>1,778 (69)</td>
</tr>
<tr>
<td>Salaj</td>
<td>1,192 (73)</td>
<td>1,884 (73)</td>
</tr>
<tr>
<td>Satu-Mare</td>
<td>2,114 (133)</td>
<td>3,633 (141)</td>
</tr>
<tr>
<td>Sibiu</td>
<td>1,758 (111)</td>
<td>2,999 (117)</td>
</tr>
<tr>
<td>Suceava</td>
<td>1,206 (76)</td>
<td>2,049 (80)</td>
</tr>
<tr>
<td>Telegorman</td>
<td>798 (50)</td>
<td>1,407 (54)</td>
</tr>
<tr>
<td>Timis</td>
<td>2,072 (130)</td>
<td>3,472 (135)</td>
</tr>
<tr>
<td>Tulcea</td>
<td>1,157 (73)</td>
<td>2,861 (111)</td>
</tr>
<tr>
<td>Vaslui</td>
<td>1,956 (123)</td>
<td>3,254 (127)</td>
</tr>
<tr>
<td>Vâlcea</td>
<td>1,534 (96)</td>
<td>2,543 (99)</td>
</tr>
<tr>
<td>Vrancea</td>
<td>1,895 (119)</td>
<td>2,931 (114)</td>
</tr>
<tr>
<td>Bucharest</td>
<td>4,134 (261)</td>
<td>6,029 (233)</td>
</tr>
<tr>
<td>National mean</td>
<td>1,583 (100)</td>
<td>2,561 (100)</td>
</tr>
</tbody>
</table>

Note: Index is shown in parentheses; national average is 100.
Source: Ministry of Economy and Finance; Government of Romania.
one extra thousand lei of own-revenues is associated with 1,237 lei of transfers. A similar result emerges for the 1992 budget:

\[ PCT_i = 1.54 + 1.405 \times [PCOR_i] \quad i = 41 \text{ districts} \]  
\[ (2.68) \]

Even if Bucharest, by far the richest district, is excluded, the positive correlation still exists for 1992:

\[ PCT_i = 1.905 + 0.797 \times [PCOR_i] \quad i = 40 \text{ districts} \]  
\[ (1.85) \]

At least in this limited sense, intergovernmental transfers in Romania have not been used to correct fiscal inequity across districts.

Another important feature of intergovernmental transfers is their larger standard deviation relative to that of per capita own-revenue. In 1991 the average amount of transfers was 1,583 lei, with a standard deviation of 0.59. In 1992 the average was 2,561 lei, with the standard deviation increasing to 0.823. The standard deviation for per capita own-revenues across counties was only 0.245. Not only is a “poor” (in terms of own-revenues) district unlikely to get more fiscal help from the central government than a “rich” district, but intergovernmental transfers actually increase interdistrict revenue variations.

Although in the end the extent to which any transfers are “equalizing” is inevitably a political issue, it is critical to have an adequate quantitative base to be able both to design equalization features properly (for instance, with respect to matching grants) and, especially, to assess their probable effects. To illustrate the sort of work that needs to be done—but in no sense to replace it—a few simple experiments have been conducted with the limited available data.

One option, for example, might be to adopt a pure derivation system, under which each locality receives a given percentage of the central taxes derived from its jurisdiction. Assuming that roughly the 1991 level of transfers was made, about 10 percent of central taxes would then be distributed to local governments (table A6.2, fourth column). In a second experiment the same amount of transfers is distributed on the basis of population (table A6.2, third column): this might be considered a rough proxy for a pure “needs” system. As might be expected, equal per capita transfers would be considerably more equalizing than either the derivation-based transfers or the actual distribution of transfers.

There is also a third approach that includes some equal per capita transfers and a capacity element. Unfortunately, available data are inadequate to enable us to estimate “capacity” in any meaningful sense, but if we assume—perhaps mistakenly—that local fiscal capacity is distributed
Table A6.2 Simulated transfer by district, Romania, 1991

(lei)

<table>
<thead>
<tr>
<th>District</th>
<th>Existing per capita transfer (1991)</th>
<th>Per capita transfer based on population</th>
<th>Per capita transfer based on derivation</th>
<th>Per capita transfer based on need and capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alba</td>
<td>1,419</td>
<td>1,785</td>
<td>1,364</td>
<td>1,835</td>
</tr>
<tr>
<td>Arad</td>
<td>1,632</td>
<td>1,785</td>
<td>1,513</td>
<td>1,817</td>
</tr>
<tr>
<td>Arges</td>
<td>1,098</td>
<td>1,785</td>
<td>2,022</td>
<td>1,756</td>
</tr>
<tr>
<td>Bacau</td>
<td>1,655</td>
<td>1,785</td>
<td>1,572</td>
<td>1,810</td>
</tr>
<tr>
<td>Bihor</td>
<td>1,326</td>
<td>1,785</td>
<td>1,624</td>
<td>1,804</td>
</tr>
<tr>
<td>Bistrita-Nasaud</td>
<td>1,755</td>
<td>1,785</td>
<td>1,028</td>
<td>1,876</td>
</tr>
<tr>
<td>Botosani</td>
<td>1,583</td>
<td>1,785</td>
<td>712</td>
<td>1,914</td>
</tr>
<tr>
<td>Braila</td>
<td>1,813</td>
<td>1,785</td>
<td>1,504</td>
<td>1,819</td>
</tr>
<tr>
<td>Brasov</td>
<td>1,498</td>
<td>1,785</td>
<td>2,253</td>
<td>1,728</td>
</tr>
<tr>
<td>Buzau</td>
<td>1,039</td>
<td>1,785</td>
<td>1,405</td>
<td>1,830</td>
</tr>
<tr>
<td>Calarasi</td>
<td>413</td>
<td>1,785</td>
<td>766</td>
<td>1,907</td>
</tr>
<tr>
<td>Caras-Severin</td>
<td>2,154</td>
<td>1,785</td>
<td>998</td>
<td>1,879</td>
</tr>
<tr>
<td>Cluj</td>
<td>1,593</td>
<td>1,785</td>
<td>1,803</td>
<td>1,782</td>
</tr>
<tr>
<td>Constanta</td>
<td>1,585</td>
<td>1,785</td>
<td>1,944</td>
<td>1,765</td>
</tr>
<tr>
<td>Covasna</td>
<td>2,107</td>
<td>1,785</td>
<td>2,232</td>
<td>1,731</td>
</tr>
<tr>
<td>Dâmbovita</td>
<td>1,092</td>
<td>1,785</td>
<td>1,503</td>
<td>1,819</td>
</tr>
<tr>
<td>Dolj</td>
<td>1,860</td>
<td>1,785</td>
<td>1,112</td>
<td>1,866</td>
</tr>
<tr>
<td>Galati</td>
<td>1,284</td>
<td>1,785</td>
<td>1,395</td>
<td>1,832</td>
</tr>
<tr>
<td>Giurgiu</td>
<td>1,092</td>
<td>1,785</td>
<td>761</td>
<td>1,908</td>
</tr>
<tr>
<td>Gorj</td>
<td>924</td>
<td>1,785</td>
<td>2,117</td>
<td>1,745</td>
</tr>
</tbody>
</table>

Note: All simulations take the total transfer as given (41,410 million lei in 1991).
a. Based on the formula: Total transfer/national population = 1,785 lei.

In the same way as national tax collections, we can then carry out a third experiment incorporating (crude) measures of both need and capacity, as shown in the last column in table A6.2. To obtain the transfer based on need and capacity, we first take the need as fully represented by the population in each district and provide 2,000 lei per capita on a national basis. That leads to a total transfer greater than the given one (41,410 million lei). To restore equilibrium, we subtract a certain amount of the transfer from each district according to its fiscal capacity. Since we have no data on district GDP, which is a better indicator of fiscal capacity, we approximate the fiscal capacity in each district according to its total tax revenues collected by the center; that is, more district income results in more tax revenue for the center. The formula of this calculation is:

Per capita transfer based on need and capacity in each district = 2,000 - ([2,000 (national population) - the existing total transfer] [center's tax from each district/center's tax from all districts]/[population in each district]).
<table>
<thead>
<tr>
<th>District</th>
<th>Existing per capita transfer (1991)</th>
<th>Per capita transfer based on population</th>
<th>Per capita transfer based on derivation</th>
<th>Per capita transfer based on need and capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Harghita</td>
<td>1,468</td>
<td>1,785</td>
<td>1,210</td>
<td>1,854</td>
</tr>
<tr>
<td>Hunedoara</td>
<td>1,607</td>
<td>1,785</td>
<td>1,568</td>
<td>1,811</td>
</tr>
<tr>
<td>Ialomita</td>
<td>1,232</td>
<td>1,785</td>
<td>1,112</td>
<td>1,866</td>
</tr>
<tr>
<td>Iasi</td>
<td>1,904</td>
<td>1,785</td>
<td>1,372</td>
<td>1,834</td>
</tr>
<tr>
<td>Maramures</td>
<td>2,012</td>
<td>1,785</td>
<td>954</td>
<td>1,885</td>
</tr>
<tr>
<td>Mehedinți</td>
<td>1,179</td>
<td>1,785</td>
<td>1,032</td>
<td>1,875</td>
</tr>
<tr>
<td>Mureș</td>
<td>1,577</td>
<td>1,785</td>
<td>2,903</td>
<td>1,650</td>
</tr>
<tr>
<td>Neamț</td>
<td>1,304</td>
<td>1,785</td>
<td>1,151</td>
<td>1,861</td>
</tr>
<tr>
<td>Olt</td>
<td>1,036</td>
<td>1,785</td>
<td>1,209</td>
<td>1,854</td>
</tr>
<tr>
<td>Prahova</td>
<td>1,178</td>
<td>1,785</td>
<td>2,258</td>
<td>1,728</td>
</tr>
<tr>
<td>Salaj</td>
<td>1,192</td>
<td>1,785</td>
<td>713</td>
<td>1,914</td>
</tr>
<tr>
<td>Satu-Mare</td>
<td>2,113</td>
<td>1,785</td>
<td>1,872</td>
<td>1,774</td>
</tr>
<tr>
<td>Sibiu</td>
<td>1,758</td>
<td>1,785</td>
<td>3,668</td>
<td>1,555</td>
</tr>
<tr>
<td>Suceava</td>
<td>1,206</td>
<td>1,785</td>
<td>1,145</td>
<td>1,862</td>
</tr>
<tr>
<td>Teleorman</td>
<td>797</td>
<td>1,785</td>
<td>1,084</td>
<td>1,869</td>
</tr>
<tr>
<td>Timiș</td>
<td>2,072</td>
<td>1,785</td>
<td>2,146</td>
<td>1,741</td>
</tr>
<tr>
<td>Tulcea</td>
<td>1,157</td>
<td>1,785</td>
<td>1,038</td>
<td>1,875</td>
</tr>
<tr>
<td>Vaslui</td>
<td>1,956</td>
<td>1,785</td>
<td>978</td>
<td>1,882</td>
</tr>
<tr>
<td>Vâlcea</td>
<td>1,334</td>
<td>1,785</td>
<td>1,335</td>
<td>1,839</td>
</tr>
<tr>
<td>Vrancea</td>
<td>1,895</td>
<td>1,785</td>
<td>1,406</td>
<td>1,830</td>
</tr>
<tr>
<td>București</td>
<td>4,134</td>
<td>1,785</td>
<td>3,792</td>
<td>1,543</td>
</tr>
</tbody>
</table>

b. Calculated as follows: (Total transfer/total central tax from all districts) (central tax from each district) = .99 (central tax from each district).

Source: Authors' calculations.

It must be reiterated that the analysis shown in annex table A6.2 is purely illustrative of the sort of analysis that is necessary to devise an appropriate system of intergovernmental transfers for Romania. Such studies should be carried out for local, rather than district, government. Moreover, all the parameters employed need to be defined and measured much more carefully. At the present time, however, there is little point in recommending a more specific transfer design for Romania. In the first place, as discussed in the text, it is not clear that much of a transfer system is required at this time, given the current limited role of local governments. Second, the appropriate design of such a system will require a much clearer specification of objectives (with respect to basic needs, regional redistribution, and the like) than is now possible, as well as much more rigorous simulation analysis of the sort sketched above. What can and should be kept in mind now, however, is the importance of keeping to the general lines set out above if any system of intergovernmental transfers is to help,
rather than hinder, Romania’s attempt to achieve a developed market economy and an efficient public sector.

Notes

1. Although in Romania “municipality” has a specific meaning, the term municipality will, for reasons of language convention, be used in this chapter to denote all municipiu, oraș, and comună local governments. This is all the more legitimate since these distinctions, which are primarily a historical legacy, have little practical meaning today.

2. Prior to the introduction of tax sharing, transfers for the compensation of operational deficits were made to bridge the gap between local governments’ own-source revenues and their expenditures for municipal services other than those delivered by regie autonome, in accordance with the Law on Public Finances, which stipulates that “in the case where local administration units cannot cover all expenditure through their own revenue, transfers can be made from the central government budget [to fill the gap].” These subsidies were allocated using a set of revenue and expenditure criteria defined in the annual budget laws and involved the district as a quasi-intermediate-level government.
Fiscal decentralization and intergovernmental relations in Albania

David Sewell and Christine I. Wallich

Albania was the last country in Central and Eastern Europe to initiate political and fiscal decentralization. Still in its early stages, decentralization is a priority of the current government, which is the first noncommunist government to be elected democratically in the country’s history. The government was elected in March 1992, passed legislation establishing local governments in June 1992, and held the first elections for these local governments in July 1992. The Council of Ministers of the Republic of Albania—the equivalent of the cabinet—met with aid donors and international financial institutions to discuss public administration reform and decentralization in March 1993 (Sewell 1993). At that time, Albania was emerging from some of the most difficult macroeconomic circumstances encountered by any of the transition economies. Successful macroeconomic policy—substantial price stability was achieved by mid-1993—has provided the opportunity to construct a fiscal framework allowing sound long-run financing of central and local governments.

There are several reasons for an interest in decentralization in Albania. First, the desire for empowerment of local government is a reaction to the overcentralization, rigid party control, and tightly regimented behavior that characterized government and society under the communist regime. Second, decentralization represents the public sector equivalent of privatization. Economists typically argue for decentralized market solutions to economic problems, and some of these arguments can be applied to the structure of government. One prominent theory of intergovernmental fiscal relations holds that the lowest possible level of government should carry out government functions—a principle adopted in
the European Union's Maastricht Treaty (see chapter 1). Thus, decentralization in Albania is also the result of an emphasis on increasing efficiency in service provision. Finally, problems in transportation and communications, outlined below, make it difficult to operate a highly centralized government efficiently. Although the center is proceeding cautiously, some deconcentration of power to local officials has already taken place (see chapter 1 for the terminology of the decentralization debate).

Albania is small—its population is less than 3.5 million—and questions might well be raised as to how much decentralization of government is appropriate under these circumstances. The type of extensive decentralization that might be appropriate in a federal state such as Russia, with its many constituent republics, nationalities, and language and ethnic groupings, and its huge expanse of territory, would not be appropriate in a country of Albania's size. Still, efficient service provision requires that local responsibilities be distinct from central responsibilities in some sectors. Many democratic countries with populations in the 3 million–5 million range—Costa Rica is an example—have well-developed local governments based on a logical separation of powers.

**National trends and characteristics**

Albania is among the smallest of the Balkan states, with a land area of about 29,000 square kilometers (see map of Albania, p. 250). About 70 percent of the territory is mountainous, and the population lives mostly in rural areas and is engaged in agriculture. The largest city is the capital, Tirana, with a population of 270,000. The average population of the country's forty-seven cities is 28,000. About 65 percent of the population lives outside urban areas, and in 1992 agriculture employed half the labor force and accounted for half of total output.

Albania was the poorest and the most rigidly controlled of all the European command economies. Since 1992 the country has implemented one of the most successful stabilization programs in the region and has liberalized most of its economy. In 1993 Albania had the highest growth rate in Europe (11 percent in 1993), and inflation has been less than 2 percent a month since mid-1993. Virtually all agricultural land has been privatized, state farms have been disbanded, and most small and medium-size enterprises have been privatized.

**Legacy of the past**

During the communist era, Albania was ruled by a vicious dictatorship. Under Enver Hoxha's regime, as many as three out of four families were
touched by police repression, according to some estimates, with family members jailed, exiled internally, or otherwise harassed for political reasons. Former political prisoners now constitute a major political force, and a ministry is devoted to their welfare. So restrictive was the Hoxha regime that it made family planning illegal, banned private automobile ownership, and constitutionally prohibited private ownership of productive assets (Biberaj 1990; Feldman 1993).

The regime also imposed complete central control over the economy and isolated Albania's citizens to an extent unparalleled in any of the command economies. From 1975 until Hoxha's death in 1985, the regime followed a policy of total autarky. The 1976 Constitution adopted this principle of autarky and prohibited any foreign credit, aid, or investment. The extent to which the regime was concerned about threats from abroad is shown by the concrete bunkers that are in almost every field. They are rarely out of sight in the countryside and will be one reminder of the Hoxha regime that will be evident for years.

Albania was and remains the poorest state in Central and Eastern Europe, with an estimated per capita GDP of roughly US$340 in 1993. There are perhaps more graphic indicators of the country's standard of living than even these rather bleak income statistics. For instance, it is estimated that there are only 7.5 square meters of housing per person in Albania. The country with the next-lowest housing stock in Central and Eastern Europe is Romania, which has 15 square meters per person. By way of contrast, Hungary has the largest stock of housing in Central and Eastern Europe, with 26 square meters per person.

Communism's demise in 1991–92 led to economic chaos. For forty-five years the central government had been responsible for allocation and distribution in every sector (Hibbert 1991). When central planning was abolished, no alternative allocation mechanism was in place, resulting in a freefall in economic output. In this respect, the initial process of transition in Albania was similar to that in many other former command economies.

What distinguished Albania from other Central and East European economies where communism collapsed during this period was the breakdown in public order and the destruction of social capital that accompanied the fall of the old regime. More than one-third of the country's schools were damaged or destroyed. Local health centers were also badly damaged, with 24 percent of the centers and 65 percent of local health posts either destroyed or occupied by squatters. The destruction of cooperative and state farm buildings destroyed administrative centers and offices for many rural local governments. The irrigation system that serviced the former network of cooperative farms, which accounted for three-quarters of land under irrigation, was substantially damaged.
Much of the property that was destroyed would be identified as belonging to local communities in many developed countries. Its destruction speaks eloquently of the alienation of the population from the communist regime, the extent to which public services had been delivered jointly with a hated ideology, and the lack of a feeling of local ownership or commitment to activities that used these facilities.

Although Albania was already the poorest country in Central and Eastern Europe before these events, the collapse of central planning and the breakdown in public order led to a decline in output of more than 40 percent in 1990–92. The economic distress drove many away—nearly half a million of Albania's 3.4 million population are estimated to be illegal emigrants in neighboring countries.

The decline in economic output had other macroeconomic consequences. When output fell, so did that of the government’s principal source of revenue—state-owned enterprises. Furthermore, control over most categories of government expenditure almost disappeared. As a result, the fiscal deficit grew to about 42 percent of gross domestic product (GDP) in the first six months of 1992. Money was printed to finance the deficit, and the resulting inflation rate in early 1992 was 14 percent a month. Inflation for all of 1992 was 237 percent.

Restoration of growth and stability

The first democratic noncommunist government in Albania was elected in March 1992. Its priorities were introducing a comprehensive stabilization program and launching structural reforms to establish a market economy. The stabilization program, combined with high per capita foreign aid flows and remittances from the many Albanians who had moved abroad, contributed to a rapid turnaround in inflation and output. Mainly through expenditure reductions, the budget deficit was reduced to 16 percent of GDP in 1993. The resulting fiscal constraint has important implications for the design of Albania's decentralization policies. Albania received substantial assistance in these endeavors. Aid inflows are estimated to have reached US$470 million in 1993, or almost 50 percent of GDP. Remittances from those working abroad totaled $200 million in 1993, or 18 percent of GDP. As a result of the stabilization program, the lek—which had been allowed to float—was stable by the beginning of 1993, and inflation for the year was 31 percent, well below the 1992 rate of 237 percent. By mid-1994 there was evidence of a significant appreciation of the real exchange rate, and inflation had fallen to 18 percent on an annualized basis.

Although measuring from a low economic base, Albania’s 1993 GDP growth of 11 percent was one of the fastest of all the former command economies and the highest in Europe, east or west. Growth in 1994
has been only slightly less, at 7.5 percent. While the recovery originated primarily in agriculture, construction and other private services also expanded substantially. Adjustment was not without costs, particularly for those in the public sector. Real wages there have fallen, and unemployment rose to 26 percent as a result of layoffs in state-owned industrial enterprises. Nevertheless, a recent Eurostat survey (1994) indicated the majority of Albanians felt they were better off than before the reforms, a result that contrasts with the pessimism in some other reforming East European countries.

Sustaining macroeconomic achievements and converting them into long-term growth depends on extensive structural reforms. Thus far, Albania has privatized virtually all agricultural land, and the output response has been substantial. Privatization of trucking and the retail sector has been followed by privatization of small and medium-size enterprises. Remaining challenges include rebuilding the infrastructure required by the private sector, privatizing or restructuring the remaining state enterprises, and reforming the banking system so that credit can be provided more efficiently to the private sector. Albania’s location and inexpensive labor should enable it to expand trade, attract foreign investment, and exploit its natural endowments, particularly for natural resources, tourism, water resources, and agriculture.

Challenges to decentralization

Difficulties in the country’s transportation and communications make it hard for a highly centralized form of government to be efficient. Albania is mountainous and many villages are often inaccessible; about 400 villages with a total population of 1.5 million cannot be reached by motor vehicle for part of the year. There is no telephone service in many municipalities. Thus, not only is Albania poor, but significant regional disparities mean some areas are much better served than others.

Poverty and mismanagement by the former communist regime are reflected in statistics for basic local infrastructure. Of the 250 water supply systems in Albania, only one provides twenty-four-hour service. In Durres, the country’s second-largest city and principal port, about 30 percent of households with a tap get no water at all, and the rest get service for an average of three hours a day. In the past decade four typhoid epidemics in Durres have been traced to water supply contamination. It is estimated that between 50 and 75 percent of drinking water sources nationwide are contaminated. Only 60 percent of primary health care centers have any source of heating, only 40 percent have running water, and just 14 percent have basic laboratory equipment.
Size of local governments

Information on the size of local government units in Albania—districts, municipalities, and rural communes—was collected at the time of the first local government elections in mid-1992 (table 7.1). While the thirty-seven districts had an average population of nearly 100,000, there was considerable dispersion in their size. The addition of ten districts—six of which have an urban population of less than 10,000—in 1991-92 contributed to this dispersion. The forty-seven municipalities also show considerable deviation around their average size of roughly 28,000. The average population of the 309 rural communes in 1992 was about 7,000; they were more homogeneous in size than the other units of local government. Rural communes comprised up to twenty-four villages; the average number of villages per commune was slightly more than nine. Average village population was 764 and there was little variance in size. Population increases since 1992 have affected these numbers; as a result, the number of rural communes was increased to 316 in 1994.

The size of local governments and the degree of urbanization in a country influence the extent to which local governments can capture economies of scale and be viable as independent units. At the district level, Albania's local government units are smaller than those of most of its neighbors in Central and Eastern Europe. But its municipalities and rural communes are larger than those of the equivalent level of local government in other countries in the region, with the exception of Poland and Bulgaria (see chapter 1, table 1.4).

Albania’s decentralization objectives

An appropriate system of local government finances depends on what a country hopes to achieve. Balancing objectives such as efficiency, revenue adequacy, equity, and local government autonomy can be difficult. Excessive central support of local governments can discourage local revenue efforts and reduce local autonomy. The main objectives in designing Albania’s intergovernmental system should be administrative simplicity, effective autonomy in areas for which responsibility is

| Table 7.1 Size of local government units, Albania, 1992 |
|-----------------|-----------------|-----------------|
| Item            | Districts       | Municipalities  | Communes        |
| Number          | 37              | 47              | 309             |
| Population range| 23,789–414,367  | 2,534–270,000   | 1,292–18,791    |
| Average population | 96,118         | 27,801          | 6,963           |
| Standard deviation | 79,434         | 49,622          | 1,723           |

Source: Department of Statistics, Government of Albania.
assigned, consistency with macroeconomic stabilization policy, and sufficient equalization to avoid the emergence or worsening of service differentials—whether or not important functions such as education and health are devolved to local governments. Other priorities might include developing the capacity of local governments to raise more of their own revenues and creating financing mechanisms for infrastructure development (Sewell and Wallich 1994).

Given Albania’s macroeconomic situation, administrative and revenue constraints, and need for more efficient service provision, six general issues should be considered in designing its intergovernmental system. First, administrative constraints, the need for continued macroeconomic controls, and the superior taxing power of the central government suggest that local governments will remain transfer-dependent for some time. Second, Albania should more clearly assign spending responsibilities and grant expenditure discretion to subnational governments in appropriate areas to increase the efficiency of public spending and to improve the accountability of local officials. Quantifying the budgetary implications of these expenditure responsibilities is required to determine both the level of revenue and the revenue elasticity local governments will need. Third, some autonomous taxing power should be assigned to subnational governments to encourage economic efficiency and revenue mobilization. Fourth, a formula grant using transparent indicators should weigh heavily in the system to support equalization of local fiscal capacity. Fifth, greater local pricing discretion should be given to local governments for those functions most appropriately financed by user fees or whose prices are currently controlled by the center. Finally, given the infrastructure backlog, the system should incorporate mechanisms to support public infrastructure development and its appropriate financing by central or local governments.

**The legal and regulatory framework**

The proposed division of responsibilities between levels of government has, to this point, been addressed only by legislation in Albania’s Parliament. An alternative institutional means for determining the division of powers between levels of government is in the formulation of a constitution. Constitutional discussions have been lively in Albania, and one constitutional proposal was rejected by the voters in October 1994. The Constitutional Commission of Parliament has also been considering a draft Constitution that specifies three levels of government: the communes and municipalities, the districts, and the central government; the draft Constitution defines the relationship between these levels and the role of the judiciary in adjudicating disputes among them. Under the
draft Constitution, Albania’s three-tiered intergovernmental system is one in which local governments (districts, communes, and municipalities) have equal power with the center (figure 7.1); in practice, they have almost no fiscal autonomy at present.

Recent legislation

The Law on the Organization and Functioning of Local Government (Law 7572) was passed on June 10, 1992 and was followed by the first local elections of district, municipal, and commune officials in July 1992. Since the elections, problems have arisen from the vagueness of this law, which gave local governments an impressive number of responsibilities but did not specify how these responsibilities were to be financed or the division of labor where local and central government share responsibilities. Such issues need to be clarified to promote the accountability of both central and local governments and to prevent intergovernmental tensions and lapses in service provision.

The government addressed these issues in mid-1993 by establishing an intergovernmental task force on decentralization to draft legislation on the functional responsibilities and financing of local government. This legislation consists of a Law on Local Budgets, amendments to the

Figure 7.1 Government structure, Albania, 1994

Note: According to the draft Constitution, local governments and the central government have equal power. Dotted lines indicate the Ministry of Finance is the principal source of funding for local governments.

Law on the Tax System in the Republic of Albania, and a Law on Asset Ownership of Local Government. These laws address the key dimensions of designing an intergovernmental system: the allocation of functions and their financing. The first two address the financing of local government and deal with transfers from the central government and local own-source revenue. The draft Law on Asset Ownership of Local Government is an indirect attempt to assign spending responsibilities to local governments by allocating ownership of government assets between central and local governments. The Law on Local Budgets was passed on December 22, 1993 (Law 7776). A Property Tax Law was passed in March 1994 (Law 7805) and various amendments have been made to other tax legislation to allow local taxes. At the time of writing (November 1994), the fate of the draft Law on Asset Ownership of Local Government is not clear, except that it has not been passed by Parliament. In the absence of parliamentary action, the government issued a formal decision through the Council of Ministers to identify services that could be delegated to local government in 1995. Ministerial consultations concerning services to be transferred are continuing.

Prefectures

The Law of the Prefectures (Law 7608) was passed on September 22, 1992. The introduction of this law followed the first local government elections in which the opposition parties in Parliament did much better than they had in the national elections in March 1992. In other countries, the prefecture system is the regional arm of the central government. Similarly, the stated objective in the Law of the Prefectures is “to coordinate the activity of the ministries and other central institutions in the administrative territorial units.” In July 1993 the government approved the formation of twelve prefectures with a total of 180 positions.

The functions of the prefectures are something of a mystery. The Law of the Prefectures indicates that they do not have supervisory powers over departments of the central government—any disputes between the prefectures and the departments are to be settled by the Council of Ministers. The Law also specifies that the prefectures and elected local governments are totally independent institutions. But the prefectures are given the right to stay local government bylaws or legislation while the courts decide whether the legislation is constitutional. The Law on Local Budgets indicates that prefectures have no responsibility relating to local government budgets; a copy of local budgets is simply to be forwarded to the relevant prefectures for information. The Law of the Prefectures emphasizes a substantial role for them in internal security: they are to be responsible for civil defense, for example, and for supervising the police.
Expenditure assignment

Public finance theory defines principles for an appropriate division of responsibility between central and decentralized local governments (see chapter 1). Spending responsibilities should be given to the lowest level of government consistent with efficient performance of that service. Where the benefits from a public service are restricted to a particular locality, decentralized supply is appropriate because it allows the services concerned to be provided only to those who benefit from such goods. If these services were to be furnished by a benevolent central government, there would be a tendency to supply uniform amounts in all localities; a less benevolent central government might even choose not to supply services of local importance at all. Many public services are best delivered at the local level, including local roads, public transit, fire protection, general urban services, and water, sewerage, and energy utilities.

On the other hand, the center will be responsible for functions with strictly national benefits (such as defense, foreign affairs, and international trade), functions where economies of scale are important (much of tax administration in a country the size of Albania), and functions with national redistributive or social insurance objectives. The central government may also participate in provision of services with spillover effects such as health or education, perhaps by means of conditional grants, even if delivery of these services is delegated to local governments.

Responsibility for local infrastructure services

The allocation of responsibilities to local governments in Albania parallels the experience of many market economies. The draft Law on Asset Ownership of Local Government proposes transferring significant responsibilities to local governments for local infrastructure, including facilities and equipment for roads, street lighting, water, and sewerage systems, and for local services, including urban transit, firefighting, garbage collection, and local recreational and cultural facilities such as museums, sports stadiums, and parks. Local police powers are the only function commonly undertaken by local governments in market economies that are not under consideration for transfer to local governments in Albania. The proposals also include transferring all local infrastructure services except for electricity. Most of these services are now provided by state enterprises under the Ministry of Construction.

Assigning responsibility for infrastructure services to local government does not mean local government has to provide these services. For example, the central government is considering the privatization of solid waste management services—including street cleaning, solid
waste collection from households, and maintenance of public parks—before transferring responsibility for them to local governments. These services are currently provided by sixty-four state enterprises, but could be provided through performance contracts with the private sector, as in many Organization for Economic Cooperation and Development (OECD) economies.

Water and sewerage systems. Some responsibilities for these functions have already been transferred to local governments. For example, 75 water-borne sewerage systems serve about 30 percent of the population and 250 water systems serve 80 percent of the population. Central government has maintained jurisdiction over all the sewerage works, but it controls only six of the water works. The remaining water works are the responsibility of the municipalities and districts they serve, in the limited sense that local governments are responsible for paying for their operation and maintenance costs from tariff revenues. Investments in the water systems are still controlled centrally, however, with investment priorities determined as part of the public investment program. This may be unavoidable now, but as fiscal accountability increases greater decentralization will be appropriate. Furthermore, water tariffs are subject to a centrally mandated price ceiling without regard to cost recovery or cost differences among areas. These central pricing policies clearly impede efficiency.

Irrigation. Local-level enterprises are partly responsible for irrigation services. Although Albania is rich in water supplies, seasonal irrigation and drainage are necessary for adequate crop growth, particularly in the country’s fertile coastal plain. Some 417,000 hectares, roughly 60 percent of all arable land, were irrigated before 1991. Unfortunately, the irrigation system was one of the pieces of social capital that suffered extensive destruction in the breakdown of public order that accompanied the fall of the communist regime. Destruction and theft, confined mostly to the former cooperative farms that accounted for 74 percent of the total area under irrigation, ruined pumping stations, high-voltage electricity lines, and even the concrete linings of irrigation canals. In addition, operation and maintenance of the irrigation system was based on the network of cooperative and state farms. Privatization of state farms posed institutional problems to undertaking maintenance and collecting user fees from the multitude of newly created small holdings—some 400,000 farms averaging about 1.4 hectares were created by end-1993 as a result of privatization. These factors, along with restrictions on system maintenance because of central budget constraints, reduced irrigation to 31 percent of the previous irrigation “command” area in 1992 and 19 percent in 1993.
These were dramatic developments in an economy where agriculture employs half the labor force. Rehabilitation of the most cost-effective parts of the irrigation system has been a priority for the central government and international lending institutions.

Local authority for irrigation systems has developed in a manner comparable to the formation of many special-purpose districts in OECD countries. There are currently thirty-six district-based water enterprises, though these might eventually be merged into larger organizations covering the country's main river basins. The water enterprises sell water on a wholesale basis to emerging water users associations, which are village-based. Although the irrigation system was based on cooperatives and state farms whose boundaries did not necessarily coincide with those of villages, after privatization of the cooperatives and farms the villages were found to be the only well-functioning local unit in the country. Water users associations are composed of elected village representatives who consolidate water purchases from individual farmers, collect water fees, and enter into contracts with the water enterprises for scheduled deliveries.

Transport. Local governments have no responsibility for marine transport, ports, or railroads, but they are responsible for local roads. Roughly 8,200 kilometers of the national road network of 18,000 kilometers are classified as "local," meaning they connect small urban centers with rural communities. Another 7,800 kilometers of "main" roads connect main cities with one another, and 1,800 kilometers of "economic" roads serve industrial and mining centers. Excluding the economic road network, local roads constitute 51 percent of the national road network but are allocated roughly 30 percent of total road expenditures in the national budget. Most road expenditures have been limited to basic maintenance in recent years. Recommendations for expenditures in the national budget and the allocation of expenditures between main and local roads are made by the National Roads Department. This department also provides technical assistance to local governments and supervises road works that local governments undertake.

Responsibilities for social services

The draft Law on Asset Ownership of Local Government indicates a willingness to have a considerable local government presence in the delivery of social services. Social assistance (ndihme economike) is now a centrally funded program that is managed by local government. Under consideration is the transfer to the municipalities and communes of all facilities for kindergarten, primary, secondary, and vocational schooling,
and of schools for the handicapped. In the health sector, the draft Law on Asset Ownership of Local Government proposes to transfer such facilities as ambulances, pediatric clinics, health centers, and local clinics to municipalities and communes. Hospitals would be devolved to the district level of local government. Efficiency in the health system will be improved by establishing catchment areas that include patients from more than one district for secondary health facilities that can accommodate areas larger than the existing districts. Most district hospitals are being downgraded to offer only basic inpatient care, while a small group will be upgraded to offer comprehensive care to multidistrict catchment areas. Responsibility for public welfare institutions such as orphanages and old-age homes are covered by the Social Assistance Law (Law 7710, adopted on May 18, 1993). Public welfare institutions with district, municipal, or commune responsibilities are transferred to those levels of government, while institutions dealing with multiple districts are administered by the Ministry of Labor and Social Protection.

*Are the proposed expenditure assignments appropriate?*

Each of these responsibility assignments raises issues: Will service provision differentials emerge? How much decentralization is appropriate?

*Capital and recurrent spending.* There are some valid concerns about the proposed transfers. It is not clear whether operating responsibilities will be transferred to local governments—the draft Law on Asset Ownership of Local Government deals only with responsibilities for facilities. Local governments should be responsible for capital expenditures in sectors for which they have recurrent responsibility; problems will arise if operating and capital responsibilities are separated. Nor does the draft law assign responsibility for new capital expenditures. Who will build new schools or hospitals or maintain existing ones? If local governments are to be responsible for such infrastructure, they need to be able to finance it.

*Quality standards.* The possible transfers of responsibility for education and health also raise questions as to whether national standards will be maintained by local governments, for instance, in adherence to national curricula or in hiring credentialed teachers and medical personnel. Since the responsibilities for health and education being considered for devolution to lower governments can only be financed by transfers from the central government, requirements concerning standards should be a condition of such grants. The Law on Local Budgets has provisions for such conditional grants.
Social assistance. Social assistance in Albania is centrally funded but locally managed, providing benefits for families whose income falls below subsistence levels. The program is funded by a quarterly grant to municipalities and communes from the Ministry of Labor and Social Protection. These funds are allocated on the basis of such indicators as the number of disabled or unemployed citizens. While the ministry determines these guidelines, municipalities and communes decide which families receive aid and how much each family receives. Local funding is allocated by administrators who have been trained by the Ministry of Labor and Social Protection and are paid for by the quarterly grant. The efficiency of this design makes the Social Assistance Law a model for delegation of responsibilities and financing of functions from central to local governments. Conditional grants for this purpose are included in the "constituent" budgets of local governments specified in the Law on Local Budgets.

Education. After construction, education is the most deconcentrated ministry (table 7.2). Only a third of the ministry's budget is supervised directly from the center; the rest is managed by employees at the local level. The draft Law on Asset Ownership of Local Government proposes to transfer responsibility for educational facilities to local governments, though no proposals have been made for transferring operating responsibilities. It is uncertain whether local governments will be given full responsibility for primary and secondary education. If underfinanced localities cannot afford to hire qualified teachers or maintain full curricula, educational quality could be affected. It would certainly lead to emerging differentials in service provision unless the center requires standardization of curricula, teacher quality, and other conditions.

Table 7.2 Central government budget: spending by ministries in administrative units at subnational levels, Albania, 1993 (leks)

<table>
<thead>
<tr>
<th>Ministry</th>
<th>District</th>
<th>Share (percent)</th>
<th>Municipality</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ministry of Agriculture and Food</td>
<td>133,700</td>
<td>12</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Ministry of Construction</td>
<td>112,232</td>
<td>3</td>
<td>2,925,620</td>
<td>90</td>
</tr>
<tr>
<td>Ministry of Transport</td>
<td>677,445</td>
<td>28</td>
<td>188,300</td>
<td>8</td>
</tr>
<tr>
<td>Ministry of Education</td>
<td>169,132</td>
<td>5</td>
<td>882,541</td>
<td>23</td>
</tr>
<tr>
<td>Ministry of Health</td>
<td>2,058,000</td>
<td>61</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Other</td>
<td>118,101</td>
<td>16</td>
<td>383,004</td>
<td>51</td>
</tr>
<tr>
<td>Total</td>
<td>3,268,610</td>
<td>22</td>
<td>4,379,465</td>
<td>30</td>
</tr>
</tbody>
</table>

Note: The average exchange rate in 1993 was 100 lek = 1 U.S. dollar.
a. Ministry of Culture, Youth, and Sport and Ministry of Trade and Foreign Economic Relations.
Any transfer of educational responsibilities to local governments should be financed by conditional grants through the constituent sections of local budgets. The Ministry of Education should require that these grants be based on quality assurances, such as requiring credentialed teachers and a national curriculum.

Health. Health spending authority has also been deconcentrated. Sixty-one percent of the Ministry of Health's 1993 budget is controlled by officials working at the district level (table 7.2). New national health strategies call for further deconcentration. The government's strategy paper of April 1993, "A New Policy for Health," called for rationalization of health care delivery, including reducing the number of facilities, improving those that remain, and appointing district health directors, who will be responsible for all public health activities in their districts.

As with education and social assistance, the draft Law on Asset Ownership of Local Government proposes only the transfer of capital responsibilities in health to local governments—no mention is made of recurrent costs. Again, it would seem to be a mistake to separate operating and capital responsibilities. Developments in health and education illustrate the uncertainty about the extent of decentralization and the problems it poses for planning by central and local governments. This uncertainty should be removed.

Revenue assignment and local finance

The key challenge in financing local governments in transition economies is determining the costs of the services they are expected to

<table>
<thead>
<tr>
<th>Commune</th>
<th>Share (percent)</th>
<th>Amount</th>
<th>Share (percent)</th>
<th>Amount</th>
<th>Share (percent)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>976,300</td>
<td>88</td>
<td>1,110,000</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td></td>
<td>0</td>
<td>216,470</td>
<td>7</td>
<td>3,254,322</td>
<td>100</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,525,255</td>
<td>64</td>
<td>2,391,000</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,259,645</td>
<td>34</td>
<td>7,555,870</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1,338,000</td>
<td>39</td>
<td>3,396,000</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>233,621</td>
<td>31</td>
<td>748,124</td>
<td>100</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>5,549,291</td>
<td>38</td>
<td>14,635,316</td>
<td>100</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

provide and designing a system for tax assignments, shared taxes, transfers, and fees that provides revenues sufficient to meet the assigned expenditures. Efficient financing methods for the various functions being assigned to local governments are suggested in table 7.3.

The local financing system under consideration in Albania envisages two sources of funding: transfers from the central government (described in the Law on Local Budgets) and taxes and fees that local governments raise for themselves (described in the various changes to the Law on the Tax System in Albania and other tax laws).

Local budgets

The Law on Local Budgets provides for local budgetary discretion in funding and provision of some local services. According to the law, each local government has two parallel budgets. Constituent local budgets are composed of funds from the central government for delegated programs.

Table 7.3 Efficient financing of functions considered for transfer to local governments, Albania

<table>
<thead>
<tr>
<th>Service</th>
<th>Local taxes</th>
<th>User charges</th>
<th>Central transfers</th>
<th>Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public utilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Water supply</td>
<td>S</td>
<td>P</td>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Sewerage</td>
<td>S</td>
<td>P</td>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Drainage</td>
<td>P</td>
<td>P</td>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Markets and abattoirs</td>
<td>S</td>
<td>P</td>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td>Transportation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Highways and streets</td>
<td>P</td>
<td>P</td>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Public transit</td>
<td>S</td>
<td>P</td>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td>General urban services</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refuse collection</td>
<td>P</td>
<td>P</td>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td>Parks and recreation</td>
<td>P</td>
<td>P</td>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td>Fire protection</td>
<td>P</td>
<td>P</td>
<td></td>
<td>(A)</td>
</tr>
<tr>
<td>General administration</td>
<td>P</td>
<td>P</td>
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<td>Social services</td>
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<td>Education (other than universities)</td>
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<td>Health (other than national facilities)</td>
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<td>Social assistance</td>
<td>P</td>
<td>P</td>
<td></td>
<td>(A)</td>
</tr>
</tbody>
</table>

Notes: P = primary source of finance; S = secondary source of finance. A = borrowing is appropriate for major capital expenditures; (A) = borrowing is appropriate, but likely to account for a small share of total costs.

a. Utilities not being considered for transfer to local governments include electricity and telecommunications.
b. Development charges (special assessments, valorization charges, and so on) are appropriate for these functions, particularly where benefits are well defined within a jurisdiction.
c. Local law enforcement is the principal general urban service not being considered for transfer to local governments.
d. User charges and local taxes will play a smaller role in financing social services for the foreseeable future.

Source: Adapted from Bahl and Linn 1992.
supervised by central ministries but carried out locally. These are strictly conditional grants for performing specific functions and funds are not transferable among programs. Independent local budgets can be used for any purpose determined by local governments. Revenues in the independent budgets are to be derived from local taxes, fees, income from revenues and asset sales of local enterprises, and funding from the central government budget. Revenues in the independent budgets are transferable between uses. The central government contribution to the independent local budgets is essentially an unconditional block grant.

The Law on Local Budgets came into effect in December 1993 and represents an imaginative approach to financing local governments. It should increase accountability and transparency in intergovernmental financial relations and is thus in marked contrast to the individually negotiated transfers that were characteristic of the communist regime.

Local revenue sources

Most of the twenty-two revenue instruments proposed for local governments in draft amendments to the Law on the Tax System in the Republic of Albania are minor service fees, such as for registering mortgages and other legal documents. These fees recover costs incurred in their provision; they are not true revenue-raising instruments.

The central government has not yet decided how much revenue will be given to local governments in addition to that from local taxes assigned in the draft tax law. The required revenues will be substantial, since the proposed taxes will likely yield very little. In many countries most of these local taxes would be considered nuisance taxes—complicated to administer and generating little revenue.

The objective of local autonomy involves local governments having the power to raise their own revenues, being able to set their own tax rates, and being answerable to their electors for these taxing decisions and the level of services they finance. In this respect, there is a positive feature of the amendments to the Law on the Tax System in the Republic of Albania to accommodate local government taxes: in many instances local governments are given a range of rates that can be applied for a particular tax. This element of discretion in local setting of tax rates is to be welcomed. Indeed, it might be emulated in other areas where price or rate fixing by the central government considerably detracts from local government flexibility and discretion.

There is general agreement on the principles that should determine the selection of local taxes. Local governments should levy taxes on immobile bases, preferably in a way that reflects the benefits received from local government services. A good local tax should be visible, have a stable and predictable yield, be easy to administer, and not be exportable.
Property taxes. Most of the criteria of a good local tax support the use of a property tax on immobile property; typically, land and buildings are taxed, and frequently equipment is also. Local property values are closely linked to the infrastructure services that support them, such as street construction, maintenance, and lighting. Property taxes are therefore attractive on benefit grounds and can be equalizing, since people who are better off may have higher-value properties.

The use of property taxes is widespread in OECD countries (see chapter 1). While property taxation has been a principal pillar of local government taxation in English-speaking countries, it is not restricted to them. Of immediate interest to Albania is the fact that local property taxation has recently been introduced in several Mediterranean countries such as Portugal, Spain, and Italy. Italy, Albania’s neighbor and principal aid donor, has long recognized that its local governments are overly transfer-dependent and lack the sources of revenue needed to be autonomous. Italy was scheduled to implement a local property tax with locally established rates in 1994. The Government of Albania also decided to introduce a property tax in 1994 to support local governments. But the country has been unable to attract the assistance needed to introduce a conventional property tax and decided to introduce a more limited version. Under the Property Tax Law passed in March 1994, central government will undertake property valuation, set tax rates, administer the tax, and redistribute 60 percent of the revenues to local governments according to the source of revenue. In rural areas the tax will be assessed on the fertility of land; in urban areas the tax will initially be restricted to building values.

There is little sense in which the new property tax is a local tax, since property value assessment, tax rate setting, and the administration of the tax are performed by central government. The assessment of property values and perhaps even administration of the tax are not essential to its character as a local tax. Higher levels of government often intervene in or even determine local property assessments. This role is justified in Albania if it helps the central government determine comparable property values, leading to equalization among local governments. But local governments must be free to set local tax rates if the property tax is to be a truly local tax. If local governments do not determine tax rates, the property tax is merely another source of local revenue and does not contribute to local accountability or autonomy.

Property tax revenue will vary among municipalities and communes. Most municipalities lack the property tax base of Tirana, where monthly rents were US$1,000 for prime retail locations in early 1993 (at a time when annual GDP per capita was around $300). Similarly, rural communes with prime agricultural land will receive larger revenues.
from the property tax than other rural communes. Equalization grants from the center to local governments may be needed to assist local governments with low-yielding tax bases.

Local vehicle taxes. Automobile taxes are another possible source of local revenue. Private ownership of automobiles was banned in Albania until early 1991, but there is evidence of impressive growth in ownership since then—about 25,000 cars were imported in 1992—and in the social costs of such growth. In 1993 Albania had the highest road accident rate in Europe, with a death rate per vehicle-kilometer about twenty times that of Italy. A local tax on movable property—automobiles and other vehicles—would be a useful proxy for a tax on local road use. At present there are central vehicle taxes—at import, US$400 a car, and annually, $50 a car. Additional local taxes would be appropriate. Furthermore, those fortunate enough to own cars in Albania are much better off than the rest of the population and can well afford to pay this and other taxes on road use (such as import duties for automobiles, licensing fees, and excise taxes on automobile fuels imposed by the central government).

Local income taxes. Local income taxes are the principal source of subnational tax revenues in about half the OECD countries (McMillan 1995). In Scandinavian countries local governments determine their own tax rates as a share of the central government’s income tax base, a process known as “piggybacking.” Subnational governments in other countries, such as the provinces in Canada, also apply surcharges to central income tax bases. Such surcharges or piggybacking arrangements preserve a common tax base, maintain the autonomy of local governments, and increase local accountability.

However, subnational piggybacking on a multilevel consumption tax such as the value added tax would be difficult, if not impossible. Albania’s proposed reliance on a value added tax as the principal source of national tax revenue, combined with the prospective unimportance of income taxes in the immediate future, suggests that local surcharges on a central income tax base or value added tax are not a practical possibility in Albania. The emphasis on the value added tax would also appear to preempt tax room that might otherwise be used for adding local sales tax. It is difficult, however, to imagine local sales or excise taxes or income tax surcharges prevailing as sources of local revenues in Albania, given the small size of the country and its local government units. In the first place, local sales or excise taxes can be avoided by purchasing outside the locality, and as mobility increases between localities in Albania it will be equally difficult to tax labor income differently according to place of residence. Second, it is difficult to imagine that decentralized
administration of these taxes would be optimal given the small size of local governments in Albania.

*Business taxes.* There is also general agreement that local governments should be restricted from tapping some forms of revenue in order to perform their important role in efficient allocation of resources. The principles that should be observed are that local government taxes should not distort the location of factors and that local governments should principally levy taxes on the basis of residence of households. This is one reason it is often argued that natural resource revenues and corporate taxes should be centralized (see also chapters 9 and 10). Natural resource revenues are a case in point of some significance, given that Albania is one of the largest producers of chromium in the world and is an exporter of other minerals as well. And higher property tax rates for businesses than residences, if not justified by differences in service levels, are another example, as are sales taxes applied at other than the retail level, such as the current turnover tax in Albania.

Business taxes used to raise revenues (and not charges for services rendered) are considered undesirable for the above reasons. While it may be attractive for local politicians to try to shift the burden of taxes to nonresidents, such tax exporting artificially cheapens and inflates local provision of services and thereby erodes the efficiency benefits contributed by local governments. To prevent the “exporting” of such taxes to nonresidents, the central government should restrict their use by local government.

*Revenue sharing.* Another approach to increasing local revenues that is common in other countries in transition is sharing central revenues with local governments. Revenue sharing based on the origin of central government taxes—so-called derivation-based sharing—is problematic, however, since it could be counterequalizing. Most revenues are collected in only a few districts—in early 1992 Tirana and Durres collected almost half of all revenues, but accounted for less than 20 percent of Albania’s population (table 7.4). If revenues are to be shared, then sharing revenues according to their district of origin would be inadequate to support national standards in poorer districts, particularly for such services as health, education, and social assistance. Sharing has additional disadvantages. It may not be transparent as a means of indicating to the voter which level of government is imposing the tax burden and thus will inhibit accountability to the voters. Moreover, it can be unilaterally altered by the donor government, as demonstrated by recent experience in countries as diverse as the United States and Hungary. As argued in chapter 1, conditional grants to ensure provision
of minimum standards of specific services and equalization transfers based on fiscal capacity would appear to be preferable to revenue sharing as a means of transferring resources to subnational governments.

User charges, local pricing discretion, and central pricing mandates

In addition to block grants (for constituent budgets) and tax revenues (for independent budgets), local governments derive income from enterprises that now fall or will fall under their responsibility, including public utilities. The central government has retained responsibility for all 75 water-borne sewerage systems and for 6 of the nation’s 250 water systems. Sewerage service, where provided, is free, with provision costs assumed in the national budget. In the case of water works, investment priorities, funding for investment, and tariffs for all 250 systems are set by the central government. Operation and maintenance of local water systems is expected to be financed with revenues from tariffs. But since the tariff has been set at a uniform, nationwide level, it ignores local cost differences in service provision and does not, in most cases, cover costs. This has led to a lack of local commitment to service provision and to deferred maintenance. Furthermore, customers are billed at a flat rate, giving them no incentive to conserve. Local authority to set tariffs and an appropriate pricing policy are essential to improving service and promoting full cost recovery for these utilities.

Irrigation pricing in Albania is based on a simple and effective user pay system that could provide efficient water pricing on a per unit basis. Current pricing levels, however, are insufficient to cover system operation and maintenance costs and to pay for needed rehabilitation investments. As for other utilities, fees are centrally fixed and do not make allowances for different levels of costs for providing water or artificial drainage. Current water charges should be revised to attain full cost recovery and

Table 7.4 Population and revenue in major districts, Albania, 1990 and 1992

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<tbody>
<tr>
<td>Tirana</td>
<td>11.5</td>
<td>24.2</td>
</tr>
<tr>
<td>Durres</td>
<td>7.7</td>
<td>22.7</td>
</tr>
<tr>
<td>Fier</td>
<td>7.7</td>
<td>10.9</td>
</tr>
<tr>
<td>Elbasan</td>
<td>7.6</td>
<td>5.9</td>
</tr>
<tr>
<td>Korce</td>
<td>6.7</td>
<td>5.7</td>
</tr>
<tr>
<td>Other</td>
<td>58.8</td>
<td>30.6</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
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reflect district-based expenditures. The central government should supply the tariff-setting framework and abstain from micromanaging local utility pricing (Sewell and Wallich 1994).

A reduced role for social pricing?

The former command economies used pricing policies as a tool for redistributing income. In Albania many such policies persist, often involving local utilities or affecting local governments. These policies were apparently undertaken either for distributional reasons or in the belief that price ceilings would contribute to macroeconomic stability, but they often have perverse effects. Thus, cross-subsidies in the national water pricing policy are not clearly correlated with the need for income support to those who benefit. It is also unclear why 30 percent of the population receives sewerage services free of charge while the rest of the country has no access to such services. Other effects of misguided pricing policies included subsidized fuel prices for car owners, who are among the better off in Albania. These subsidies were large enough that foreign vehicles entered Albania to buy fuel. In addition, large numbers of electric appliances have been imported since 1992 by affluent citizens, who benefited from electricity that was supplied at one-tenth of its production cost.

Underpricing or cross-subsidizing local services rarely helps the poor more than those with higher incomes. Consumption normally rises with income, making the absolute dollar value of subsidies for "normal" goods greater to the better-off. The distorting effect of such subsidies applies to electricity, household water supply, sewerage systems, and other infrastructure services (World Bank 1994i). The poorest citizens often do not even have access to these services, making the distributional effects of subsidies for them even more questionable. Since such subsidies are not transparent and their effects may not be self-evident, they also violate principles of good governance. More effective instruments such as straightforward income supplements are available to help the poor in principle, even though they are not always that easy to implement in practice (Fitzgerald 1994).

Albania's policies on subsidies and cross-subsidies are changing. In 1993 the government adopted market prices for some fuels and moved prices of others close to cost recovery levels. Automotive fuel prices were raised to European levels in 1993. In March 1994 the government raised tariffs for household electricity sixfold, raised kerosene prices fourfold, and increased tariffs for gas and steam heating four- to sixfold. Prices for wood and coal for heating were also freed.

To compensate for the loss of purchasing power imposed by these increases, the government increased public sector wages and transfers to
households. These expenditures accounted for more than half of the central budget in 1993. This strategy was first applied in raising bread prices, and its success has led the government toward market prices for other goods. Raising prices to cost recovery levels is also part of a strategy to prepare services for privatization.

Transfers and other sources of local government finance

In addition to the assigned revenues and user charges, local governments in Albania receive transfers from the central government, gain revenues from privatization, and, in accordance with the Law on Local Budgets, are permitted to borrow.

Transfers

Since local governments in Albania will be transfer-dependent for some time, the design of central transfers is important. The exact role of central transfers in constituent and independent local budgets is not made explicit in the Law on Local Budgets. Transfers should be transparent, stable, and predictable. Transfer negotiation, typical in a centrally planned economy, is incompatible with local autonomy and accountability. Transfers based on objective criteria embodied in specified formulas are called for to remedy these deficiencies.

Equalization

The objective of revenue equalization programs is not to provide local governments with a guaranteed income, but to achieve goals that benefit individual citizens—such as treating citizens equitably no matter where they live in the country and increasing efficiency in the allocation of resources (Shah 1994; Broadway and Flatters 1982; Economic Council of Canada 1982). Equalization is necessary from this perspective because the fiscal capacities of local governments differ. Localities with high per capita incomes can finance public services with less tax effort than poor localities. Thus, higher rents in Tirana would result in higher per capita revenue from a property tax levied at the same rate throughout Albania. Tirana’s residents would then benefit from both higher per capita incomes and greater net fiscal benefits.

Equalization should be a function of Albania’s planned transfers. Equalization of local revenue capacity could be an explicit objective of central transfers to “independent” local budgets. The extent to which transfers to “constituent” budgets are equalizing will depend on how the underlying central services (education, health, and so on) are
distributed, but equalization should not be the objective of conditional grants for such services.

Privatization revenues

Local governments have recently been transferred ownership of some small and medium-size enterprises. Local governments in many transition economies attempt to augment their small revenue base by extracting monopoly rents from enterprises under their direct control and by becoming entrepreneurial with their newly acquired assets. In general, local governments should not own enterprises, and while there is a tradition of local government ownership of public utilities, even these can be and have been privatized in many countries (see chapter 1). To avoid the problem of local ownership, Albania passed a decree on Measures for the Acceleration of Privatization of Small and Medium Enterprises (Decree 248/93). This dictated that the properties concerned be sold at public auction relatively quickly, and there is evidence that the small and medium-size public enterprises targeted by the decree are moving rapidly into private hands. The decree also specifies that local governments receive 28 percent of the net proceeds of these privatizations.

Local governments must have adequate revenues to finance their assigned functions. If properly funded, local governments are less likely to pursue enterprise ownership. Local government entrepreneurialism and enterprise ownership should be discouraged.

Local government borrowing

To prevent local governments from borrowing to finance current expenditures, the Law on Local Budgets limits local government borrowing to funding for investment. This is fully appropriate. Investment in infrastructure such as local road construction or sewer extensions leads to future benefits and is most appropriately financed by long-term borrowing. Such investments need not be financed out of current local government revenues.

Albania has greater need for rehabilitation and replacement of public sector capital than most transition economies. The breakdown of public order in 1991–92 damaged or destroyed more than a third of the country's schools and about a quarter of all local health centers. If responsibility for these facilities is devolved to local governments, some means of long-term financing for reconstruction and repair will have to be devised.

The development of capital markets in Albania will satisfy local borrowing needs only in the long term. Much capital expenditure on local infrastructure is currently financed by foreign grants or loans at
concessional terms. In the medium term, arrangements need to be developed that permit capital expenditure financing by central or local governments or their utilities. Other countries with similarly weak capital markets have created municipal credit agencies for local governments. Theoretically, these agencies only make loans to creditworthy local governments. Creditworthiness is assessed on the basis of cost recovery plans, anticipated central transfers, or own-revenues. Loans are usually for capital spending on health, education, utilities, or transport and are not extended for capital formation in commercial enterprises that may be owned by municipalities.

The experience with municipal credit agencies has often been disappointing (Dillinger 1992). Accordingly, the Ministry of Finance and Economy may need to approve and supply funds for local government capital projects in the near future in the context of a formal public investment program.

**Intergovernmental coordination**

Intergovernmental relations will require oversight after the current draft legislation is adopted and implemented, particularly in technical and nonpolitical functions. The current role of the Council of Ministers in these respects, coupled with desires to limit the size of the Albanian bureaucracy, makes the Council a suitable and effective location for a continuing intergovernmental coordination function.

This coordinating body could fill several needs. Under the Law on Local Budgets, central contributions to each local government budget are to be presented to Parliament for approval each year. The intergovernmental coordinating body could analyze local government budget submissions and prepare recommendations on these budgets. It could report social, economic, and financial data on local revenues and spending responsibilities to Parliament. The body could provide technical assistance to local governments to build up financial and management skills. It could also help local governments act cooperatively where they have common interests, such as in jointly providing services when this will produce cost savings. Finally, the proposed body could act as arbiter when the interests of local governments conflict.

**Conclusion**

Albania's size must be taken into account in assessing proposals for and progress in decentralization. Functions that might be undertaken by local governments in other countries may be appropriate for the central government in Albania. Still, the basic economic tenets underlying the
argument for decentralization are universal—local governments should provide public services that are of purely local interest and have restricted geographic benefits. The central government in Albania should not be responsible for such activities as local rat catching or filling potholes in village streets. These tasks can be left to local governments so that the central government can devote itself to more appropriate national concerns, such as defense.

The wisdom of decentralizing non-infrastructure social services such as education and health is another matter. Albania is distinguished from other former command economies, however, by its population's fierce hatred of the former, highly centralized communist regime. This must be considered in analyzing whether Albania can afford some forms of decentralization, such as in education. The destruction of schools and hospitals that accompanied the demise of the old regime indicates the need for community involvement in the operation of local facilities and some sense of local ownership of them. Local governments are usually willing to contribute to the financing of such facilities as local schools, even if service provision is the responsibility of higher levels of government. Conditional transfers by the central government can be used to ensure consistent service levels across these key sectors.

Albania's experiences under the Hoxha regime serve as a potent reminder that externality arguments for central involvement in service provision do not ensure that the central government will supply such services. The citizens of Albania's second-largest city, Durres, have suffered through four typhoid epidemics in the past decade because of contaminated water furnished by the central government. Still, efficient local provision will require adequate revenue efforts, appropriate pricing, and a well-designed transfer system—each a major effort.

It is occasionally asked whether local governments have the requisite technical capacities to undertake an expanded role in Albania. The response to this question depends on whether or not the local governance tasks in question are now being performed by the central government. As the example of the Durres water supply under the former communist regime illustrates, some local governance tasks are not being performed at all by the central government. In such cases, the capacity will have to be built up from scratch by local governments. If the central government is now performing these local governance roles, however, it may be possible simply to transfer the personnel involved to local jurisdictions. No additional resources should be required and, indeed, the resources transferred should be more productive in their new and more appropriate location.

One thing is certainly clear: the Government of Albania has not accepted the argument that local governments are incapable of undertaking expanded roles. Important functions (such as those in running
the welfare system) have already been delegated to local governments. Most recently, the government, through a decision of the Council of Ministers, asked ministries in November 1994 to identify further services that should be transferred to local governments in the “independent” local budgets for 1995.

Lack of clarity in draft legislation concerning central and local government responsibilities for major functions, particularly health and education, is a concern. Accountability requires clear lines of responsibility. The draft Law on Asset Ownership of Local Government does not indicate which level of government will be responsible for incremental capital costs and recurrent costs in health and education. The consequences of such muddied lines of responsibility are evident in the provision of municipal water supply. Local authorities are responsible for operations and maintenance and central authorities are responsible for tariff setting and investment. Since tariffs are often insufficient to cover operating and maintenance costs, local authorities lack commitment to service provision and defer maintenance. Continued uncertainty about the extent of fiscal and administrative decentralization poses problems for planning in such fields as health. This uncertainty should be removed.

The appropriate size of administrative units for decentralization and deconcentration should be flexible and need not coincide with the current structure of local government. The creation of ten new districts since 1991 was a response to pressures from local interests who thought their constituencies were being ignored. Such redistricting is not likely to coincide with the optimal size of administrative units, which may fluctuate over time. Instead, function-specific geographic divisions that are comparable to the special-purpose districts in many OECD states could be used. For instance, units for the irrigation network would be more logically based on the main river basins in Albania than on the thirty-seven districts. Such a reorganization would be compatible with decentralized responsibility for demand management among water users associations. Similarly, the Ministry of Health is considering the creation of full-service hospitals for multidistrict areas and is limiting the services provided in existing district hospitals.

The traditional sources of local own-source revenues in many OECD countries are user fees and property taxes, and both can be applied in Albania. The proposed property tax, which returns most of its revenues to municipalities, is a step in the right direction. But while central administration of property assessment is useful for establishing equalization grants, some local freedom to set property tax rates is an essential feature of local autonomy.

Pricing policies for local utilities should not be used as a means of redistributing income, as has been done in the past. The current ceilings
on utility prices, intended to restrain inflation, are also questionable. The better-off have benefited disproportionately from these policies, whether they involve subsidies for automotive fuel or household electricity, the provision of sewerage services without charge to the 30 percent of Albanians who have access to the network, or the household water provided to 80 percent of the population. The government has increased automotive fuel prices to market levels and increased household electricity prices roughly sixfold in 1993–94. Sewer and water charges should be similarly moved to levels that permit full cost recovery.

Centrally mandated uniform pricing for local utilities creates cross-subsidies of dubious merit. It ignores cost differences among locations. Pricing below cost recovery levels is a holdover of central planning and is incompatible with the decentralized management required to respond to local needs. Similarly, the property tax, which is to be the principal revenue source for local government, will have centrally specified rates. Local responsibilities are worthless if local governments are not given the autonomy to raise revenues, set taxes and user fees, and be held accountable to constituents for taxing decisions and service levels. The central government must eventually devolve these functions if local government is to be meaningful in Albania.

Central budget transfers will remain the dominant source of financing for many functions for some time. Where there are externalities, services delivered by local governments should be held to national standards, achievable with appropriate design of conditional grants and transfer payments. Accountability at both levels will be enhanced by transparent transfers. In the constituent and independent local budgets adopted in the Law on Local Budgets, Albania has developed an intergovernmental financing vehicle that increases transparency and accountability in intergovernmental fiscal flows. Increased reliance on local own-source revenue will increase the need for equalization payments to those local governments that have less fiscal capacity.

Albania made a radical break with the past when it introduced elected local governments in July 1992. The better governance associated with autonomous, accountable local governments still lies largely in the future. Despite the difficulties associated with the birth of a new democracy, however, there can be little doubt that Albania is on the path to its goal.
Subnational fiscal decentralization in Ukraine

Jorge Martinez-Vazquez, Charles E. McLure, Jr., and Sally Wallace

Since gaining independence, the Government of Ukraine has made the decentralization of government finances a major objective of its economic policy program. Ukraine is highly centralized, and the successful implementation of a decentralization program remains one of the main challenges facing the new government.

Pressing political and economic concerns, particularly the fear of disintegration and a macroeconomic crisis, have reduced the focus on decentralization. Ethnic tensions in Ukraine are complex, though less severe than in Russia, and threaten fragmentation in this country that has not yet had an opportunity to consolidate its independence. While the western part of the country is ethnically Ukrainian, the eastern and southern parts are ethnically closer to Russia. Centrifugal forces are strongest in the Republic of Crimea, where a majority of the population is of Russian origin.

The lack of an experienced core of bureaucrats and decisionmakers in the capital, Kiev, has also hindered the development of a coherent decentralization policy. The absence of a decisionmaking tradition and personnel trained in economic policy stems from the centralized decisionmaking of the former Soviet regime. It is an obstacle shared by all the former Soviet republics except Russia, and it puts them at a disadvantage with respect to other East European countries.

Political cohesion among the different regions of Ukraine and the consolidation of democracy can be significantly enhanced through effective decentralization. A more accountable intergovernmental system would ameliorate the lack of decisionmaking experience and increase the efficiency of government expenditures.
Basic characteristics and government organization

Although the central government controls most of the country's revenues and expenditures, the subnational government sector is also responsible for a significant share. In 1993 subnational expenditures accounted for about 40 percent of the consolidated government budget.

Geography and basic characteristics

Ukraine was one of the fifteen constituent republics of the former Soviet Union and one of the four founding republics when the Soviet Union was federated in 1922. Its area of 230,000 square miles, extending from the fringes of Central Europe to the Black Sea, is roughly equivalent to that of France (see map of Ukraine, p. 280). Its population of 52.1 million is comparable to that of the United Kingdom.

Highly agricultural, Ukraine is also heavily industrialized as a result of Soviet industrialization policies. It has a significant mineral base, including coal, iron ore (in the Donbass region), and manganese. Some oil deposits are located in western Ukraine.

Ethnically, Ukraine is relatively homogeneous, with the exception of the Crimean Republic, which is majority Russian. About three-quarters of its population are Ukrainians, 17 percent are Russians, and 2 percent are Jews. The balance comprises Belarusians, Moldavians, Bulgars, Hungarians, and other regional minorities.

The institutional framework

Ukraine has a unitary form of government, though it displays some features of a federal state. The government is structured in four tiers. The central government, run by a democratically elected parliament, the Supreme Rada, sits atop the governmental hierarchy. The twenty-four oblasts, the Republic of Crimea, and the cities of Kiev and Sevastopol, which have oblast status, make up the second tier of government (figure 8.1). Each oblast is governed by a legislature, or rada, that theoretically retains the power to formulate the oblast's budget. Decisions of the radas cannot be overturned by the central government, though they can be overturned by a court ruling if they are found to be unconstitutional.

The institutional framework regulating intergovernmental relations is set out in four key pieces of legislation: the Constitution, the Law on Local Self-Government (1992), the Law on the Budgetary System (1991), and the national budget, which is approved annually by Parliament. The national budget establishes sharing rates for the major taxes, and determines intergovernmental transfers and reassignment of expenditure
Subnational fiscal decentralization in Ukraine

Figure 8.1 Government structure, Ukraine, 1994

a. In addition to the twenty-four oblasts, the Republic of Crimea and the cities of Kiev and Sevastopol have oblast status.
b. For example, the city of Vyshnyky is an independent city within the boundaries of Lviv.

Source: Authors.

Responsibilities, if any. According to the Law on Local Self-Government, the oblast radas appoint the head of the oblast executive branch, who in turn appoints the heads of oblast departments. In 1992 the president temporarily assigned a personal representative to head each oblast’s executive branch. The president’s representative was given equal, if not superior, power to the oblast rada. These appointments were terminated after the June 1994 local elections.

The third tier of government is made up of 480 rayons, which govern rural areas, and 139 cities. Both rayons and cities are subordinate to the oblast and have democratically elected local councils or radas. Council members serve on a part-time basis. According to the Law on Local Self-Government, council members elect the chairman of the rada, who also serves as the mayor or head of the executive committee, and appoint the first vice-chairman of the executive committee. For the last two years, however, the central government has appointed the mayor. This changed in the June 1994 local elections, when mayors of the cities were elected for the first time. Other vice-chairmen are nominated by the mayor and approved by the rada. The staff (heads and deputies of departments and division chiefs) is appointed by the mayor.

Unlike most administrative appointments at the oblast, city, and rayon levels, the appointment of the head of the finance department is subject to the approval of the Ministry of Finance. The finance department
is therefore under dual subordination—to the Ministry of Finance and to the subnational government—throughout all tiers of government.

Tax administration at all levels of government is performed by the State Tax Inspectorate, a central government agency. The head of the city or oblast tax administration is employed by the central government, although, under dual subordination, the appointment is approved by the city or oblast rada.

Rural settlements and city districts numbering about 30,000 constitute the fourth tier of government. Settlements comprise small villages and farms of various sizes and are subordinate to rayon authority. On average, a rayon contains twenty settlements. The fourth tier of government in large cities are administrative districts. The city districts have their own administrations that specialize in providing such services as primary education and social assistance. Most settlements and city districts manage their own budgets and elect radas.

This four-tiered governmental system is the general structure nationwide, but there are some exceptions. For example, fully independent smaller cities or independent settlements or villages may be contained within the boundaries of a larger city. The city of Lviv houses the independent city of Vynnyky and two autonomous settlements, Rudno and Bruchovychi.

Although each level of government formulates its own budget, the budget system is still hierarchical. In many ways, the budget system has not changed much from the system used in the former Soviet Union, where the budgets of lower-level governments were nested into the budgets of higher-level governments, proceeding upward to the consolidated budget for the entire Soviet Union. In Ukraine, oblast governments (and those of the Republic of Crimea and the cities of Kiev and Sevastopol) receive their funds from the Ministry of Finance, which determines what share of the major taxes administered by the central government each will receive. Oblasts also negotiate over the amount (if any) of the transfer (subvention) they will receive from (or make to) the central government.

There is no direct fiscal or political relationship between the rayon-level governments and the central government. Oblasts determine the revenues they will share with the rayons and cities subordinate to them. Oblasts also negotiate with rayons and cities the size of the subvention (or exaction) to be transferred. If the fourth tier of government has an autonomous budget, its revenues and transfers are similarly determined through negotiations with the rayon or city government to which it is subordinated. There is no direct link between the fourth-tier governments (the settlements) and the second-tier oblasts. Settlements and city administrative districts that do not have autonomous budgets are funded directly in the city or rayon budget. There is no uniformity in the
lowest level of government. For example, in Lviv five districts have elected radas and executive committees but do not have autonomous budgets. After the June 1994 local elections, Lviv eliminated the radas and kept only the executive committees. In Kiev all districts have freestanding budgets with elected radas and executive committees.

The government’s decentralization policy

The Ukrainian government lacks a clear decentralization strategy. In the past three years government actions have both promoted and retarded the development of fiscally autonomous subnational governments. The fundamental legislation for decentralization is the 1992 Law on Local Self-Government. This law grants subnational governments substantial powers. In theory, the budget of each level of government is fully autonomous from any other level of government. Oblasts, cities, and rayons are entitled to formulate, approve, and execute their budgets without interference from one another or from the center.

The Law on Local Self-Government has several shortcomings. It does not assign clear expenditure responsibilities among the different levels of government, and it lacks a procedure to resolve competency issues when responsibilities are shared by two or more levels of government. It does not establish a system of revenue assignment or revenue sharing among the tiers of government, nor is there a transparent system of equalization or intergovernmental transfers. The role of subnational governments is also not clearly defined. In many ways, subnational governments still function as they did under the communist regime, carrying out duties, such as ownership of commercial enterprises and the majority of the housing stock, that should be transferred to the private sector.

The principle of budgetary independence has been compromised in many ways in actual practice. The Law on the Budgetary System, passed in 1991, still reflects the centralized budgetary practices of the communist regime. It authorizes the central government to determine annually which responsibilities it will assign to or take away from oblast governments. (A similar power is granted to oblast governments with respect to rayons and cities.) In practice, the transfer and reclaiming of responsibilities has proceeded on an ad hoc basis, mostly for the convenience of the central government. The frequent reassignment of responsibilities has been a source of uncertainty and resentment in intergovernmental relations. In addition, the fiscal autonomy of subnational governments has been compromised by central mandates to perform additional services without commensurate increases in funding.

The Law on the Budgetary System also grants subnational governments little ability to mobilize their own resources. The rate and base of
nearly all taxes are set by the central government, as are the maximum levels of fees and charges that subnational governments can implement. The intergovernmental transfers specified under the law are based on the negotiated system of the past regime. The law discourages local tax effort, since one kupon (the provisional Ukrainian currency) in locally raised revenues likely crowds out the same amount in central transfers.

The Law on Local Self-Government and the Law on the Budgetary System contradict one another in several areas. For example, the Law on Local Self-Government specifies that the tax-sharing arrangements between the oblasts and their subordinate rayons and cities should be approved annually by the Supreme Rada. But the Law on the Budgetary System requires that only the oblast rada approve. These contradictions have been resolved in an ad hoc way; for example, the 1994 State Budget Law mandated that the Law on the Budgetary System be followed. The 1994 State Budget Law also contradicted the Law on Local Self-Government by changing personal income and land taxes from taxes fully allocated to the subnational level to regulating revenues shared between central and subnational governments. A regulating revenue is one that is shared between levels of government to regulate the resource flow in a way that provides each level of government with significant revenue. It is characteristic of all intergovernmental fiscal systems in the former Soviet Union, including Russia and Ukraine.

Several other government policies have worked against the decentralization objectives set forth in the Law on Local Self-Government. The appointment of presidential representatives to each oblast, rayon, and city, empowered to veto the decisions of local radas, dealt a serious blow to subnational budgetary autonomy. These appointments were formalized by the 1993 Law on the Representatives of the President of Ukraine, which many observers considered unconstitutional. As pointed out, these appointments were abolished after the June 1994 local elections.

The budgetary autonomy of subnational governments has also been undermined by their finance officials' allegiance to the Ministry of Finance. Although these officials are under dual subordination to both the central and subnational governments, they tend to side with the central government when conflicts arise.

Because of dwindling resources, subnational governments have been under considerable pressure over the past two years to maintain the level of services assigned to them. Financial and institutional constraints have made subnational governments increasingly creative. One common response has been raising the tariffs to industrial users of public services (such as water, sewerage, and garbage collection) to three or four times the estimated cost recovery level. Unlike household tariffs, where cost recovery averages 10 to 12 percent of costs, tariffs for enterprises are not
controlled by the central government. Still, the net revenue gain from these measures is less than the amount of the tariff increase because some of the higher profits tax they generate must be shared with the center. But to the extent that many state enterprises are subsidized by the central government, high tariffs for local services is a roundabout method of transferring funds from the central to subnational governments.

Fiscal pressure led cities to immediately implement sixteen new taxes authorized by the Supreme Rada in 1993. Like most taxes assigned to the subnational level in transition economies, these new taxes will likely have minimal yields. They include taxes on hotel occupancy, market stall rental, parking, apartment occupancy, dog tags, horse racing, advertising, use of city symbols, filming, auctions, lotteries, communal tax, and trading space.

Some cities have responded to financial pressure by being creative in other ways. For example, Lviv eliminated bus stops to transform its traditional urban transport into an express service whose fees are not subject to central government control. Kiev auctioned newly finished housing rather than follow the central rule of offering it to households on a waiting list. The central government has challenged such initiatives in court, and they have been ruled unconstitutional.

Not every development since passage of the Law on Local Self-Government has hindered decentralization. A commitment to decentralization was demonstrated by President Kravchuck’s March 1994 decree transferring to city governments ownership of all state assets in health care, education, social welfare, culture, urban transport, urban roads, housing and communal services, shops, restaurants, and other service facilities. Although the ownership transfer may create additional problems for the cities, the spirit of the decree was to strengthen subnational governments.

Two other measures in 1994 furthered the move toward decentralization. First, five relatively developed oblasts were granted increased financial independence and discretion on an experimental basis, by decree. Another decree sets a goal of achieving 60 percent cost recovery for housing and communal services by 1996. The significance of these measures is discussed later in this chapter.

Delivery of local services and other local activities

Subnational governments, primarily the cities and rayons, are responsible for providing communal services (heating, water and sewerage, gas, electricity), transportation, and housing. Subnational governments and state enterprises provide education, health, and sanitation services. Since independence, subnational governments have also assumed an
increasing role in providing the social safety net. Finally, in the productive sphere, subnational governments continue to manage hotels, restaurants, shops, and other service activities typically run by the private sector in market economies.

Communal services and housing. Communal and housing services are provided by municipal enterprises, which are unincorporated quasi-autonomous units with separate budgets from the local government. Some examples of municipal enterprises include water and sewerage (Vodokanal), heating (Kommunenergo), garbage and sanitation (Spetstrans), electric and bus transport (Electrotrans and Autotrans), and housing maintenance (Zchecks). Communal services, utilities, and housing are heavily subsidized. Recent studies by the State Committee on Housing and Communal Services and the Ministry of Economy estimate that the rate of cost recovery for these services averages 12 percent. These subsidies exert considerable pressure on local budgets and encourage overconsumption and waste. Subsidies for housing and communal services could be nearly 20 percent of GDP, while the cost to households for these services is less than 1 percent of household income. In market economies, costs are between 20 and 30 percent of household income (Lowry 1994).4

The degree of subsidization varies among enterprises. The largest subsidies appear to go to heating and hot water. There is considerable cross-subsidization from enterprises to households. The responsibility for rate setting among the oblast, rayon, and city governments and their subordinate public utility enterprises also varies. Typically, subnational governments regulate the rates to be charged to nonhousehold users while household rates are controlled by the central government.

The pricing of public services is complicated by the fact that all levels of government can give exemptions and preferential treatment to certain public utility customers without directly compensating the enterprise for the lost revenue. The central government controls tariff rates and sets maximum rates for virtually all services. A 1994 Cabinet of Ministers decree calls for tariff increases sufficient to generate 20 percent cost recovery in 1994, 40 percent in 1995, and 60 percent in 1996.

Social services and the role of state enterprises. Subnational governments continue to be major deliverers of social services, including health and education. State enterprises also provide additional services in housing, health, education, infrastructure, and culture. This is a legacy of the past, when the roles of government and enterprise were blurred. In the case of health care, some state enterprises, especially the larger ones, have established and funded primary care facilities and
supplied free medicine. Such clinics provide health care for the entire population of a particular area.

The ability of state enterprises to provide public services has diminished because of their poor economic performance, budget austerity, and the need to prepare for impending privatization and restructuring. Many daycare centers previously supported by state enterprises have been closed because subnational governments are unable to finance them. Data are insufficient to quantify the potential cost the divestiture of public services will impose on local governments.

Subnational governments’ role in provision of the social safety net. Subnational governments in the former Soviet Union administered some of the social safety net programs financed by the central budget. Since independence, the Government of Ukraine has shifted additional financial responsibilities for these programs to subnational governments. The 1994 budget establishes that subnational governments are responsible for three areas in addition to the previously discussed subsidies for housing, communal services, and transport:

- The “social protection of the population,” which includes an allowance for children under sixteen (if they are students, eighteen), an allowance for children for increases in the price of bread, and preferential credit for housing cooperatives.
- The social safety net, which includes retirement homes for the disabled and elderly, an allowance for low-income households and the disabled, an allowance for families with children, and contributions to the pension fund.
- Price subsidies for school lunches and subsidies to construction cooperatives.

Commercial activities. As was the case in the former Soviet Union, subnational governments in Ukraine also own retail shops, restaurants, and other commercial and service enterprises. In the city of Kharkiv, for example, the city government owns more than two-thirds of the retail and consumer service shops, with the remainder owned by state enterprises. This is typical of most local governments.

The assignment of expenditure responsibilities

The relative size of the public sector in the Ukrainian economy has not shrunk as rapidly as in other transition economies. Significant privatization of state and local enterprises has not yet taken place. In the medium term, only those services and activities that private markets cannot supply efficiently—either because of pricing difficulties or
because of positive externalities—and those with desirable redistributive characteristics should remain in the public sector.

While the State Budget Law and several other pieces of legislation address the question of revenue assignment, the question of expenditure assignment has not been explicitly addressed in recent legislation. Expenditure assignment involves two issues: which services the government (and not the private sector) should provide and which level of government should provide which service.

**Current spending assignments**

The current expenditure assignment system is similar to that inherited from the former Soviet Union, with central government agencies specializing in the economic sphere and subnational governments specializing in the social and cultural spheres (table 8.1). The current assignment respects to a large extent the basic principle of assigning expenditure responsibilities according to the benefit area for the public service. Most central government functions are national in scope. They include defense and internal security, the justice system, foreign relations, and research, as well as expenditures with macroeconomic and distributional implications, such as unemployment compensation.

Many of the expenditure responsibilities of oblast governments involve services whose benefit area is regional, such as tertiary hospitals. Many of the expenditure responsibilities assigned to cities and rayons serve the local population, such as primary education, basic health care, and sanitation. Settlements and city districts have more limited responsibilities, concentrated primarily in basic education.

**Expenditure patterns**

Subnational governments are the key providers of education, health, and housing and communal services (table 8.2). They currently contribute 65 percent of all expenditures for the social safety net, a sharp increase from 1993. The largest expenditure categories in Lviv, for instance, are housing and communal services, accounting for 48 percent of total expenditures (half of which are spent on heating), and social services, 33 percent of expenditures (with 31 percent devoted to health services) (see table A8.1 in the annex at the end of the chapter). Because unemployment expenditures are borne by the central government, subnational governments account for a larger share of spending on price subsidies than on social transfer payments. In addition, subnational governments account for about one-third of all spending on public administration. In most other sectors the share of subnational expenditures is relatively modest. In the
so-called economy sector (composed of all industrial and commercial activities normally carried out by the private sector) subnational governments contribute only 2 percent of total expenditures on economy.

Despite the shifting of additional expenditure responsibilities from the center to subnational governments during the past three years, the subnational share of total public sector expenditures is shrinking. The main reason appears to be the increasing expenditures of the central government in the economy sector, which rose from 18 percent of total expenditures in 1993 to 24 percent in 1994.7

The figures in table 8.2 mask the differences in expenditures per capita across oblasts because they include only the public services provided through subnational budgets and exclude those provided by state enterprises. This exclusion is most important in comparisons of existing infrastructure, since under socialism much of the infrastructure, including roads, housing, and communal services, was provided by enterprises, with large, important enterprises able to provide best. The quality of housing, health, kindergarten, and other services available to individuals thus depended more on their place of work than on the public budget. The consensus in Ukraine is that public infrastructure (as currently measured) is distributed quite unevenly as a result of these policies, though no systematic data are available to document these disparities. A regression of total budgetary expenditure per capita on wages per capita across oblasts for 1993 confirms disparities across regions of the country. For each additional 1,000 kupons in wages per capita, expenditure per capita was higher by 26 kupons (box 8.1). These results say nothing about disparities in expenditures per capita within oblasts. Because of the lack of rules governing the allocation of resources within oblasts, such disparities could be as large or larger than those among oblasts.

Problems with current expenditure assignments

The current assignment of expenditure responsibilities has several shortcomings. Subnational governments have been given full responsibility (in other words full financing and full discretion) for maintaining the social safety net with the exception of unemployment insurance. In most market economies the national government assumes financing for this responsibility (though delivery may occur at the subnational level) in order to assist poorer regions, and because pursuing redistribution policies at the regional or local level can be self-defeating. Generous programs attract the poor, while wealthier taxpayers who are heavily taxed migrate to lower-tax areas. Ukraine’s population currently lacks the mobility to make this issue an important one, but it may become important in the future. Since a robust safety net is critical to the success of Ukraine’s reforms, the national
Table 8.1 Expenditureassignmentin Ukraine

r>

Expenditure

Federal

Defense
Justiceandinternalsecurity
Foreigneconomicrelations
Educationa

100percent
100percent
* 100percent
* All university
andresearch * Severalspecialvocational
instituteexpenditures
schools
* Technicians
(secondary * Schoolsfor orphansand
education)
the handicapped
* One technological
institute * Constructionof schools
* Two pedagogical
institutes andother buildings
* Nationalmuseum
* Someoblastmuseums
* Nationaltheater

Cultureandparksb

Health'

Roads

Oblast

Rayon(city)

Settlement
(district)

*

*

*

Teachersalaries

Salaryof supportstaff
andoperationalmaintenanceof primaryschools

Somemuseums
Villageclubs
Zoos
* Musicschools
* All recurrentexpenditures
of all sportandparkfacilities
andallother culturalfacilities
* Medicalresearchinstitutes * Tertiaryhospitals,
I Secondary
hospital
Paramedics
andlocal
psychiatric
hospitals,
veteran operations
clinics
hospitals,
diagnostic
centers, * Primaryhealthclinics
andspecialservicehospitals * Medicine
(cardiology,
etc.)
* Allcapitalexpenditures
in health
* Construction
of allroads * Maintenance
of oblastroads * Maintenance
of rayon
* Maintenance
of com* Maintenance
of federalroads
andcity roads
munalroads
*
*


| Public transportation | • Highways; air and rail transport  
• Subsidies for other facilities  
• Some public transportation facilities (earlier assigned to federal government)  
• Some transportation facilities |
| Fire protection | • Most fire protection services  
• Voluntary, military, and enterprise services possible at this level |
| Libraries | • Most local library services |
| Police services | • National militia  
• Road (traffic) police  
• Local security police  
• Part of garbage collection  
• Some operational expenditures |
| Sanitation (garbage collection) | • Infrastructure capital investment  
• Part of garbage collection |
| Sewerage | • Most operational expenditures  
• Some operational expenditures |
| Public utilities (gas, electricity, water, and heating) | • Capital structures  
• Subsidies to households (not enterprises) |
| Housing | • Building and development  
• Maintenance and small-scale building |
| Social safety net and welfare | • Pension  
• Family allowance, other social protection  
• Child allowance and other social protection |
| Environment | • National environmental issues  
• Chernobyl Fund  
• Local environmental problems (such as forest preservation) |

a. Some schools are being built by collective farms. "Technicians," which are secondary technical schools, are also paid for by some state enterprises. Public enterprises also build schools but typically do not operate them, though they frequently operate kindergarten services.

b. Some enterprises build sports facilities.

c. Some enterprises build hospitals and in some cases also operate them. Social insurance is financed by enterprises, which pay for the health care services of those covered.

d. Prices of services are controlled by the central government.

e. Enterprises have been, and continue to be, important builders of housing. In 1993, 5 percent of all new housing had to be reserved for the military.

f. The pension fund and the unemployment fund are extrabudgetary funds.

Source: Based on authors' fieldwork conducted in 1993-94.
Table 8.2 Consolidated and subnational expenditures by function, Ukraine, 1993 and 1994
(billions of kupon)

<table>
<thead>
<tr>
<th>Function</th>
<th>1993</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total consolidated expenditure</td>
<td>Subnational expenditure</td>
</tr>
<tr>
<td></td>
<td>Amount</td>
<td>(percent)</td>
</tr>
<tr>
<td>Social safety net</td>
<td>22,712</td>
<td>6,300</td>
</tr>
<tr>
<td>Welfare price programs</td>
<td>7,062</td>
<td>381</td>
</tr>
<tr>
<td>Subsidies</td>
<td>14,955</td>
<td>5,315</td>
</tr>
<tr>
<td>Education</td>
<td>5,900</td>
<td>3,682</td>
</tr>
<tr>
<td>Health</td>
<td>4,800</td>
<td>4,325</td>
</tr>
<tr>
<td>Culture</td>
<td>835</td>
<td>393</td>
</tr>
<tr>
<td>Economy</td>
<td>10,852</td>
<td>313</td>
</tr>
<tr>
<td>Capital investment in economy</td>
<td>2,419</td>
<td>717</td>
</tr>
<tr>
<td>Housing and communal services</td>
<td>956</td>
<td>771</td>
</tr>
<tr>
<td>Defense</td>
<td>2,900</td>
<td>12</td>
</tr>
<tr>
<td>Police</td>
<td>1,849</td>
<td>171</td>
</tr>
<tr>
<td>Public administration</td>
<td>803</td>
<td>241</td>
</tr>
<tr>
<td>Total expenditures</td>
<td>59,497</td>
<td>16,947</td>
</tr>
<tr>
<td>Funds transferred to deficit oblasts</td>
<td>586</td>
<td>n.a.</td>
</tr>
<tr>
<td>Funds transferred from surplus oblasts</td>
<td>3,639</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

n.a. Not applicable.

Note: Figures for 1993 have been adjusted for inflation from originally approved budget figures. The official currency of Ukraine is the karbovanet. The exchange rate when introduced in January 1992 was 10 per U.S. dollar in parity with the Russian ruble. Since then there has been considerable devaluation of the currency due to hyperinflation. In July 1994 the exchange rate was 39.970 per U.S. dollar. The average exchange rate in 1993 was 10,161 kupon per U.S. dollar. The karbovanet has never actually been issued. The kupon is serving as the temporary currency.

a. Adjusted for changes in the price level from the originally approved budget figures.
b. Includes all economic activities of a nonpublic nature.
c. Includes expenditures on road maintenance and capital renovation.
d. Includes expenditures for customs and tax inspectorates.

Source: Ministry of Finance, Government of Ukraine.

government should ensure that it is well funded. Leaving full responsibility to subnational governments risks underfunding.

The current fragmentation of responsibilities within the same function also leads to confusion and inefficiency. In the case of basic education, oblast governments build schools, rayon governments pay
Box 8.1 Determinants of subnational public expenditures

There appears to be some consensus in Ukraine that public expenditures in the past were not equally distributed among all geographical areas of the country. The general impression appears to be that social and infrastructure expenditures were lower in poorer areas. There are also questions as to how funds are currently being allocated within the territories of oblasts.

The perceived inequity with which public funds have been allocated is more than an issue of historical interest for Ukraine. Understanding how economic resources were allocated under the previous regime could improve understanding of the relative needs of today's subnational governments. One of the major concerns is addressing the regional disparities in public infrastructure that now exist between different regions in the country. How important those differences are has not been documented adequately. A fair regional distribution of public funds will also be an overriding consideration in developing a sharing formula for transfers.

To account for all government expenditures in different regions one must go beyond the long-run profile of central (and subnational government) budgets. Under the old regime, public funds were systematically used to develop public enterprises in industry and other economic sectors. These public enterprises, in turn, contributed to varying degrees to the provision of local public services, and these contributions most often did not appear in an identifiable form in the central government or oblast government budgets.

Using budget data for expenditures per capita in 1993 seems to confirm that disparities in public expenditures per capita do exist between regions and that higher expenditures per capita are positively correlated with higher levels of per capita income as proxied by wages per capita. For example, the regression of expenditures per capita (in kupons) on wages per capita (in thousands of kupons) gives the following results:

\[
\text{Expenditures per capita} = 36,725 + 25.9 \text{ wages per capita} \\
(5.31) \quad (5.55) \\
R^2 = 0.55 \quad \text{(t-statistics in parentheses)}
\]

These statistical results indicate a mild degree of regressivity in expenditures per capita across oblast. Nothing is said about how expenditures per capita are distributed within each oblast.

Source: Coopers and Lybrand 1993.

teachers’ wages, and city districts and settlements cover the salaries of support staff and maintenance. Furthermore, a disproportionate amount of funds may be spent on salaries at the expense of other operational functions, such as maintenance.
Expenditure responsibilities are not stable or well defined, nor are there rules to resolve conflicts when the responsibilities and interests of different levels of government overlap. This problem is most severe in health, education, and capital investment. The central government has continued to shift expenditure responsibilities to subnational governments on an ad hoc basis, apparently to safeguard its budget. Examples include the social safety net, consumer price subsidies for public utilities and housing, and capital infrastructure. In 1994 additional responsibilities were shifted for housing subsidies, communal services, and pensions for war veterans. Some subnational officials have expressed the view that only those expenditures where cuts are unpopular, and where political problems may result, are being shifted to the subnational governments, regardless of whether or not the assignment is appropriate. These problems also exist in the relations between oblasts and rayon and city districts.

The lack of clearly assigned expenditure responsibilities was not an issue in the former Soviet Union because the budgets of all lower levels of government were integrated with the federal budget, and additional resources could be counted on when there was an unexpected shortfall. Since 1992 all subnational governments have autonomous budgets and can run surpluses not subject to exaction by the central government. Therefore, failing to assign legal expenditure responsibilities and to establish a clear set of rules regulating the sharing of responsibilities will likely become a source of conflict between the tiers of government, with each level accusing the other of jettisoning expenditure responsibilities. The confusion also increases the possibility that some services will be provided at an inefficient level, if at all.

The lack of specific spending assignments makes it virtually impossible to design a tax or revenue assignment system and an accompanying fiscal equalization mechanism. Both will become obsolete each time expenditure assignments are significantly altered. The experience of other economies in transition, particularly Russia, reveals that without well-defined expenditure assignments, a country risks allowing revenue availability to dictate the assignment of responsibilities, rather than the other way around.

The lack of clear spending assignments has also undermined government accountability. The current confusion has made it difficult for local residents to determine which level of government is responsible for the provision of particular services, thereby decreasing government responsiveness to voter preferences.

Finally, the failure to clearly assign expenditure responsibilities means the boundaries between public sector responsibilities and private sector functions remain blurred. Privatization is moving slowly in Ukraine
compared with other formerly socialist economies. State enterprises continue to provide public services that should primarily be the responsibility of government. These burdens are an impediment to their privatization. But subnational governments can ill afford to take over these responsibilities given their current budgetary situation. A result is that privatizing enterprises may not be high on their agenda.

Subnational budgets are also burdened by large subsidies to public utilities and other communal services. In 1993, 90 percent of communal enterprises were owned by subnational governments. The remainder (car repair, elevator maintenance, and similar activities) are scheduled to be transferred to subnational governments by the end of 1994.

**The assignment of revenues**

Subnational governments receive revenues from tax sharing and transfers from the central government and from own-source revenues including local taxes, fees, and charges. The current revenue-sharing arrangements between national and oblast governments and between oblast and local governments are problematic. Some problems are conceptual, others are administrative.

*Fixed and regulating revenues*

The budgetary system of Ukraine, following the Soviet tradition, distinguishes between “fixed” and “regulating” revenues, though this distinction has become blurred. Fixed revenues include those taxes and fees that are assigned exclusively to subnational governments. Localities have no discretion over fixed revenues, because the central government still sets the base and rate of these taxes and fees. In addition to fees and local charges, fixed revenues include the tax on motor vehicles (a fixed annual charge), payment for water used by industries, and taxes on local enterprise profits. Local governments collect all of the company profit tax levied on locally owned enterprises. This tax has the same structure as the national corporate tax on state enterprises whose proceeds are shared equally by the central and subnational governments. The level of revenues earned from locally owned enterprises varies, and is generally not insignificant. For example, about a third of the revenues received by Kiev in 1993 from the tax on company profits came from locally owned enterprises.

As mentioned, local governments have started to implement some of the sixteen additional charges and fees legislated by the Supreme Rada in 1993. Some jurisdictions also charge enterprises a fee per non-resident employee to control population growth. The city of Lviv raised
more than 1.03 billion kupon this way in 1993. Until 1994 the individual income tax and the land tax were considered fixed subnational revenues assigned 100 percent to subnational governments. The 1994 budget considers them as regulating taxes.

Central government taxes that are shared with subnational governments are known as regulating revenues. The sharing rates between the central government and the oblasts (and the Crimean Republic and the cities of Kiev and Sevastopol) are revised annually in the national budget and differ by tax and by oblast (table 8.3). It is not clear whether lower-income oblasts benefited from higher sharing rates and whether this sharing system was equalizing. In Russia it has been shown to be somewhat counterequalizing (see chapter 9). The oblast governments assign a fraction of this sharing rate to their subordinate rayons and cities, which, in turn, do the same for settlements and city districts.

Regulating taxes are all shared on a derivation basis, that is, according to the total collection in each jurisdiction. (For the personal income tax, derivation relates to the place of work rather than residence.) Until 1993 regulating revenues included the value added tax, excise taxes, and the company profit tax. The value added tax is set at a uniform rate of 28 percent. The company profit tax is set at a flat rate of 18 percent on both state enterprises and communal enterprises. This tax, commonly called the income tax in the former Soviet Union, is levied on both profits (net income) and payroll. Excise taxes fall on alcohol, tobacco products, cars, and other luxury items. In 1994 individual income taxes and land taxes were added to the list of regulating revenues. Land taxes are set at a specific rate per square meter, which varies according to location of the property.

**Intergovernmental transfers**

In addition to sharing the regulating revenues, in 1993 the central government provided transfers or subventions to those oblasts whose tax bases, even when given a 100 percent share of all regulating revenues, could not support a budget determined to be the minimum necessary by the Ministry of Finance. Politically important areas, such as the city of Sevastopol and the Crimean Republic (which has declared itself independent and has strong allegiance to Russia), also received subventions in addition to 100 percent shares of regulating taxes (see table A8.2). The same year, some oblast governments, including the city of Kiev, were required to pay an ad hoc exaction to the central government. This practice of subventions and exactions had not been legalized by the 1993 State Budget Law, and it was entirely ad hoc.
Table 8.3 Oblast retention rates for regulating taxes, Ukraine, 1993 (percent)

<table>
<thead>
<tr>
<th>Oblast</th>
<th>Value added tax</th>
<th>Profit tax</th>
<th>Excise tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charkovskaya</td>
<td>27.1</td>
<td>25.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Chernivorskaya</td>
<td>76.5</td>
<td>50.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Chernigovskaya</td>
<td>23.1</td>
<td>50.0</td>
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<td>100.0</td>
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<tr>
<td>Chersonskaya</td>
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</tr>
<tr>
<td>Chmel'nitska</td>
<td>63.6</td>
<td>50.0</td>
<td>100.0</td>
</tr>
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<td>Crimea, Republic of</td>
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<td>100.0</td>
</tr>
<tr>
<td>Dnipropetrovskaya</td>
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<td>Donetskaya</td>
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<td>10.0</td>
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<tr>
<td>Ivano-Frankovskaya</td>
<td>68.9</td>
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<td>50.0</td>
</tr>
<tr>
<td>Kiev (city)</td>
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<td>50.0</td>
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<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Luganskaya</td>
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<td>Lvovskaya</td>
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<td>50.0</td>
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<td>Nikolaevskaya</td>
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<td>50.0</td>
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<td>Odeskaya</td>
<td>62.1</td>
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<td>50.0</td>
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<td>Poltavskaya</td>
<td>41.1</td>
<td>50.0</td>
<td>50.0</td>
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<td>Rovnenskaya</td>
<td>35.6</td>
<td>25.0</td>
<td>10.0</td>
</tr>
<tr>
<td>Sevastopol (city)</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Sumskaya</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Ternopolskaya</td>
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<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Vinnychkaya</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Volynskaya</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Zakarpatskaya</td>
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<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Zapovzhskaya</td>
<td>60.3</td>
<td>50.0</td>
<td>50.0</td>
</tr>
<tr>
<td>Zhitomirskaya</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>


In 1994 the central government introduced uniform sharing rates for all oblasts, preventing any revenue equalization that might have been achieved with variable sharing rates. To mitigate this problem, the central government made additional subventions to twenty oblasts with relatively small tax bases. Four relatively rich oblasts were required to pay exactions (see table A8.3). As before, Kiev will pay an exaction, while Sevastopol and the Republic of Crimea will receive subventions. This new sharing and assignment system leaves subnational governments increasingly reliant on local own-source taxes and subventions.

Revenues from privatization

Until 1994 the Law on Privatization stipulated that all proceeds from privatization would accrue to the central government's Privatization
Fund. The 1994 budget allows subnational governments to retain half of the proceeds from the privatization of locally owned enterprises.

The evolution of tax-sharing rates

Continuing the tradition of the Soviet system, in 1992 and 1993 the government used variable tax-sharing rates to regulate the financing of subnational governments (see table 8.3). Oblast retained shares of excise taxes were set at 10, 50, or 100 percent depending on the oblast. Enterprise profit tax shares were set at 25, 50, or 100 percent. The value added tax was more heavily relied upon as a regulating tax, with nineteen different oblast sharing rates ranging from 23 percent to 100 percent. For 1994 nine of the twenty-seven oblasts that were granted subventions also retained 100 percent of all revenues collected in their jurisdictions. These oblasts generally have below-average per capita wages, though not without exception. Sevastopol, for instance, received a subvention despite the fact that it had the highest per capita revenues of any oblast. While these transfer policies did provide for some equalization, this goal is undermined by the lack of objective rules or principles for determining sharing rates and subventions.

In 1994, for the first time, the central government introduced uniform sharing rates for all oblasts and increased the number of regulating taxes. These oblast shares are, for value added and excise taxes, 20 percent; for company profit and individual income taxes, 50 percent; and for land tax, 70 percent.

Significant differences in tax bases across oblasts discouraged the central government from using a standard sharing rate in the past. This problem was addressed by implementing the subvention and exaction system described above. Despite the significant change in approach to revenue sharing, there is a feeling among subnational government officials that the end result will be the same. As one city finance official put it, “The changes in the 1994 budget represent a different way to achieve the same result in oblast funding. The only difference is that Ministry of Finance officials do not have to answer any longer to angry Supreme Rada deputies complaining about the fact that their oblasts receive a lower sharing rate for some taxes than other oblasts do.” Why? Because oblasts do not exercise fiscal autonomy. Any changes in the revenues they receive as a result of new tax assignments or changes in regulating taxes can (and will likely) be offset by opposite changes in subventions and exactions. If revenue assignment is to have true meaning, then oblasts must be given some control over their budgets and marginal sources of revenue to finance them.
Table 8.4 Trends in the assignment of major revenue sources, Ukraine, 1992-94
(percent)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Central</td>
<td>Subnational</td>
<td>Central</td>
<td>Subnational</td>
</tr>
<tr>
<td>Value added tax</td>
<td>60</td>
<td>40</td>
<td>53</td>
<td>47</td>
</tr>
<tr>
<td>Company profit tax</td>
<td>46</td>
<td>54</td>
<td>45</td>
<td>55</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>0</td>
<td>100</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Excise tax</td>
<td>49</td>
<td>51</td>
<td>46</td>
<td>54</td>
</tr>
<tr>
<td>Land tax</td>
<td>16</td>
<td>84</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>Total revenue</td>
<td>62</td>
<td>38</td>
<td>57</td>
<td>43</td>
</tr>
</tbody>
</table>

a. Actual figures.
b. Budgeted.
c. Budgeted but adjusted for prices and other indicators.
Source: Ministry of Finance, Government of Ukraine.

Trends in revenue assignment to subnational governments

The changes in revenue assignment introduced in 1994 resulted in a loss of funding for the subnational sector as compared with 1993. The subnational government share of each regulating tax decreased in 1994, causing the subnational sector’s share of consolidated government revenues to fall from 41 percent in 1993 to 25 percent in 1994 (table 8.4). This reduction in funding also affected rayon and city governments, settlements, and city districts. In Lviv the sharing rate for the value added tax fell by 5 percentage points, and for land taxes by 10 percentage points; and for the individual income tax the sharing rate fell by 80 percentage points between 1993 and 1994, from 100 percent retention to 20 percent retention (see table A8.4).

Unlike the central government, the oblasts did not administer uniform sharing rates across rayons and cities in 1994. In Kiev relatively poor, low-tax-base districts, such as Vatutin and Dnieper, were given the entire share of taxes assigned by the central government as well as a subvention. In contrast, city districts with a much higher tax base, such as Starokievkiy and Pechersk, were given minimal sharing rates and forced to pay an exaction (see table A8.5).

Major revenue sources for subnational governments

Despite the changes in sharing rates, the value added tax and the company profit tax continue to be the two most important sources of revenue at the subnational level (table 8.5). In 1993 and 1994 these two taxes
Table 8.5 Major sources of subnational government revenue, Ukraine, 1993-94
(billions of kupons)

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>1993(^a)</th>
<th>Share (percent)</th>
<th>Amount</th>
<th>Share (percent)</th>
<th>Amount</th>
<th>Share (percent)</th>
<th>Amount</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added tax</td>
<td>941</td>
<td>26.5</td>
<td>7,501</td>
<td>44.2</td>
<td>17,697</td>
<td>17.8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Company profit tax</td>
<td>746</td>
<td>21.0</td>
<td>7,941</td>
<td>46.8</td>
<td>34,896</td>
<td>35.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal income tax</td>
<td>555</td>
<td>15.6</td>
<td>2,182</td>
<td>12.9</td>
<td>8,350</td>
<td>8.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excise tax</td>
<td>438</td>
<td>12.3</td>
<td>1,204</td>
<td>7.1</td>
<td>5,077</td>
<td>5.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land tax</td>
<td>610</td>
<td>17.1</td>
<td>651</td>
<td>3.8</td>
<td>2,296</td>
<td>2.3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motor vehicle tax</td>
<td>16</td>
<td>0.4</td>
<td>19</td>
<td>0.1</td>
<td>1,853</td>
<td>1.9</td>
<td></td>
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</tr>
<tr>
<td>Timber duty</td>
<td>4</td>
<td>0.1</td>
<td>4</td>
<td>0.0</td>
<td>235</td>
<td>0.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>State duty</td>
<td>7</td>
<td>0.2</td>
<td>57</td>
<td>0.3</td>
<td>236</td>
<td>0.2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Water fee</td>
<td>9</td>
<td>0.3</td>
<td>9</td>
<td>0.0</td>
<td>384</td>
<td>0.4</td>
<td></td>
<td></td>
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<tr>
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<td>825</td>
<td>—</td>
<td>0</td>
<td>0.0</td>
<td>n.a.</td>
<td>n.a.</td>
<td></td>
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<tr>
<td>State enterprise privatization</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>5,046</td>
<td>5.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local taxes and fees</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>10,000</td>
<td>10.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>17</td>
<td>0.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fees and nontax revenues</td>
<td>80</td>
<td>2.2</td>
<td>378</td>
<td>2.2</td>
<td>1,000</td>
<td>1.0</td>
<td></td>
<td></td>
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<tr>
<td>Net transfers from</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>central government(^c)</td>
<td>68</td>
<td>1.9</td>
<td>(-3,054)</td>
<td>(-18.0)</td>
<td>12,515</td>
<td>12.6</td>
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<tr>
<td>Total(^d)</td>
<td>3,557</td>
<td>100.0</td>
<td>16,946</td>
<td>100.0</td>
<td>99,496</td>
<td>100.0</td>
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</tr>
</tbody>
</table>

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\(^a\) Not available.
\(^b\) Not applicable.
\(^c\) Budget adjusted for price increases and other indicators.
\(^d\) Budget.
\(^e\) Only part of the property tax initially budgeted was accounted for in the total. Later on, most of the property tax was never collected and the tax was dropped from the budget.
\(^f\) In 1993 and 1994 many oblasts received a subvention from the central government, but some had to pay the central government.
\(^g\) Includes part of the initially budgeted property tax revenues.
\(^h\) Does not sum to 100 because of property tax discrepancy.

Source: Ministry of Finance, Government of Ukraine.

were budgeted to generate approximately half of all subnational revenues. In the final outcome, value added and company profit tax revenues accounted for 90 percent of 1993 subnational revenues, given that the property tax was not levied and that the central government exacted a gross transfer from the subnational sector of 18 percent of its revenues.

Both the individual income tax and the land tax are significant sources of revenue, though less so than the value added tax and company profit tax. Other local taxes and user fees play a relatively minor role. The 1994 budget forecasts a significant increase in local taxes and fees, though it is not certain that these projections are accurate. The other potentially important source of revenue for subnational governments, proceeds from the privatization of state enterprises, may or may not materialize and is, by nature, transitory.
Problems with the revenue assignment to subnational governments

The revenue assignment system has several major shortcomings. First, the system is unpredictable. The central government has changed the revenue-sharing formula every year and, although it instituted uniform sharing rates across oblasts in 1994, it has not committed itself to following this practice in the future. Moreover, this change was coupled with the reduction or removal of regular and predictable sources of subnational government revenue such as the land tax and individual income tax. Second, the level of revenues has not been stable. Revenue shares have been adjusted erratically, and other actions of the central government, such as the decision not to introduce the property tax in 1993 and to exact negative transfers from some oblast governments, deepened this uncertainty. Third, subnational governments have virtually no fiscal autonomy. The rates and bases of all taxes, local fees, and user charges are controlled by the central government. Tax sharing, a prominent feature of the 1994 budget, is generally inferior to levying subnational surcharges because it fails to give subnational governments fiscal autonomy. This lack of autonomy on the revenue side diminishes the accountability of local officials to local residents and taxpayers and thereby the overall efficiency of the system of intergovernmental relations. Fourth, the role played by fees and user charges is still too low. Some progress is being made, as the central government has declared its intent to improve cost recovery.

Finally, the choice of tax assignments is inappropriate. Land and individual income taxes are good candidates for subnational taxation (see chapter 1). The value added and company profit taxes are better suited as national-level taxes (see below). In the future, Ukraine should reconsider giving some control over taxes, such as individual income and excise taxes, to subnational governments.

Administrative constraints in revenue assignment

Some taxes do not lend themselves to administration by subnational governments, surcharges, or sharing of revenues on an origin basis. The value added tax is a good example. Subnational administration of certain other taxes, such as the enterprise profits tax, while feasible, can lead to chaos in the absence of substantial coordination. Ideally, such taxes should be administered by the central government: surcharges and sharing should be based on uniform application of a formula. If these taxes are administered by subnational governments, strict rules should ensure uniformity across the nation with respect to tax base and administrative practice.
Value added tax. The 1994 budget assigns 20 percent of value added tax (VAT) revenues on a derivation basis to the oblast of origin, meaning VAT revenues accrue to the oblast in which they are collected. The experiences of the European Union, Brazil, which has a state-implemented VAT, and Russia, which, like Ukraine, allots a fraction of VAT revenues to subnational governments, demonstrate that this system is inappropriate. Trade between jurisdictions significantly complicates derivation-based sharing of the VAT.

There are two approaches to levying a VAT: it can be levied on imports with a zero-rate applied to exports (the destination principle) or it can exempt imports and tax exports (the origin principle). The origin principle requires that tax rates be uniform across oblasts to avoid industry migration and to eliminate incentives to falsify the value of traded goods. However, the ability of subnational governments to vary tax rates is crucial for maintaining fiscal autonomy. Ukrainian oblasts are legally given the power to vary the effective rate of the VAT by exempting the enterprise up to the amount of tax to be shared by the oblast. To the extent this power is exercised, it will give rise to problems.

The border controls needed to implement the destination principle impede interoblast trade. In theory, it would be possible to do without internal border controls, relying instead on enterprises’ accounting records. Alternatively, the national government could collect both the VAT and an oblast VAT surcharge. While these approaches warrant further consideration, it is unlikely that Ukraine could implement them at present.

Brazil employs the “restricted origin principle,” taxing interstate trade on an origin basis and international trade on a destination basis. But a disproportionate amount of Brazil’s imports enter the country through the more developed south and a disproportionate amount of its exports leave from the less-developed northeast. As a result, the wealthy south collects most of the compensating VAT revenue on imports and the poor northeast rebates most of the tax on exports.

Ukraine and Russia have encountered some of these problems in assigning a portion of revenues from the national VAT to oblasts and municipalities on the basis of origin of revenues. Asymmetric trade may create a situation in which exporting oblasts are asked to rebate part of the VAT collected before the export stage, commonly in another jurisdiction. Similarly, importing jurisdictions may collect part of the VAT on goods consumed in other jurisdictions (see chapter 9). This is unfair and distortionary.

Enterprise profits tax. The current method of assigning enterprise profit revenue on a derivation basis is also problematic. Ukraine interprets derivation—the oblast of origin—to mean the oblast in which the enter-
enterprise is chartered. This is not a reasonable way to interpret the origin of profits for a multioblast enterprise. Since oblasts only earn revenues from locally chartered enterprises, they have an incentive to discriminate against the enterprises of other oblasts, primarily using nontax policies. This could seriously interfere with the creation of a single Ukrainian market.

Unless prohibited, oblasts will compete with each other to offer low profit tax rates to attract enterprise charters at the expense of other oblasts. This would be a bad result; it would be more efficient for the central government to levy profit taxes than to have them eliminated by tax competition among oblasts. Implementing an origin-based profit tax requires a reasonable means of determining the source of profits.

There are several difficulties with allocating enterprise profits among the jurisdictions in which they operate. First, if the profit taxes of oblasts are not uniform, enterprises have an incentive to shift their accounting profits to the jurisdiction where they are treated most favorably. This can be accomplished by manipulating the notional prices (transfer prices) used to record transactions between affiliated enterprises (or within a single enterprise) operating in several jurisdictions. Even if enterprises do not intentionally manipulate transfer prices, the allocation of profits between (or within) affiliated enterprises, and therefore between jurisdictions, may be arbitrary to some extent, simply because activities in several jurisdictions are closely related to each other. It is thus common to employ standard formulas to apportion the profits of multijurisdictional enterprises.

To summarize, the design and administration of profit taxes should be undertaken by the central government. Subnational surcharges, if any, should be based on a common national formula for profits apportionment. The ability to choose a surcharge rate should provide oblasts with ample fiscal autonomy. Oblasts should not be allowed to legislate and implement their own profit tax independently of one another. Likewise, oblasts should not be allowed to modify the profit tax law of the central government to favor local activities. Surcharging the corporate profits tax, as described, is preferable to Ukraine’s present approach; however, it might be better to develop other local revenue sources, as described below.

Individual income tax. Value added and enterprise profit tax revenues accounted for roughly 41 percent of total revenue in Ukraine’s 1993 consolidated budget. By comparison, the individual income tax accounted for just 7 percent. This is expected to change over time. In Organization for Economic Cooperation and Development (OECD) countries the value added tax (or other general sales tax) constituted 29 percent of total tax revenues, individual income tax 29 percent, social security and payroll taxes 24 percent, and the profits tax just 8 percent.¹¹
The development of a modern individual income tax is important for several reasons. First, taxing individual income at graduated rates will alleviate the income inequalities emerging as Ukraine makes the transition to a market economy. Second, a flat-rate individual income tax levied as a surcharge on the central government income tax can be an important source of revenue for subnational governments.

**Tax administration issues**

The State Tax Inspectorate, a central government agency attached to the Ministry of Finance, administers all taxes (Coopers and Lybrand 1993). The vertical structure of the State Tax Inspectorate reflects the vertical structure of the government. It is composed of 27 oblast offices and more than 700 lower-level offices located in all rayons and cities. The oblast offices are chiefly responsible for supervising the rayon and city offices since it is at this level that most taxes are collected and most tax officials work.

When subnational governments are granted control over their own taxes, as will eventually be likely in a fully developed system of decentralized intergovernmental relations, they will need to develop autonomous local tax administrations, although some taxes (for example, surcharges) will always be best collected by the center. Although it cannot be expected that the central government tax administration will devote as much effort to collecting subnational taxes as to collecting central taxes, it might be better nonetheless for the government to concentrate on strengthening the State Tax Inspectorate before developing autonomous subnational tax administrations. Establishing local tax administrations need not be a simultaneous, countrywide effort. Rather, a flexible approach allowing local governments to either contract the services of the State Tax Inspectorate or develop their own administrations is recommended.

**Budgeting**

Enabling local governments to set their own expenditure priorities is critical if the efficiency gains associated with decentralization are to be realized. Although the Law on Local Self-Government grants local budgetary autonomy, it is rarely practiced by subnational governments.

**The budget process**

The budget system in Ukraine is still rooted in the practices of the communist regime. Under the Soviet system, all important budget decisions were made in Moscow through the planning procedure at Gosplan. At
the subnational level this process meant bargaining with superior authorities for additional funding beyond that mandated by an exhaustive array of budgetary norms.

The old budget process now coexists with the official facade of local budgetary autonomy. Formally, budgets are formulated through two parallel processes—top down and bottom up. First, funding for the lower-level governments is decided on the basis of a "minimum required" or "normal" budget, less a forecast of own-source revenues. Upper-level governments calculate the minimum required budget using the information provided in the budget request submitted by lower-level governments. These calculations are based on the budgetary norms of the past, such as funding per hospital bed, although inflation has reduced much of this procedure to simply multiplying past expenditures by an inflation adjustment coefficient.

Second, the finance department collects budget requests from lower-level governments and all administrative agencies. However, these cannot be finalized until the Ministry of Finance and the oblast finance department finalize their own budgets. The city or rayon administration prioritizes the affordable budget requests. The suggested budget is then forwarded to the local rada for approval by the standing budget committee and by specialized subcommittees. Finally, the budget document must be approved by the full local rada. In 1994 the Supreme Rada and the local radas will readjust the entire budget quarterly to account for inflation.

Subnational governments are required to formulate balanced budgets. The 1994 State Budget Law also establishes that any increases in expenditures proposed by the Supreme Rada or by any local rada must be accompanied by measures to finance them. Any proposal for tax privileges or fiscal incentives must also be accompanied by raising revenues from other sources or cutting expenditures by an equal amount. There is no explicit mechanism to perform, for example, a midyear review to balance the budget when there is a shortfall in anticipated revenues. Given the uncertainty of revenues coming to the local governments through the central governments, the local governments have kept reserves so they can pay for fundamental services when the central government falls in arrears with local governments or when revenues are cut in an unforeseen way. Local governments in many other countries hold this type of precautionary reserve. Budgets are balanced de facto by a cash flow constraint since there is essentially no access to any sort of credit; so local governments' holding of (individually) minor balances should not be taken as an indication of their wealth relative to the central government. To ease this burden, subnational governments may accumulate arrears to state enterprises and other providers. There is no information on the size
of these arrears, though many state enterprises are amassing arrears with subnational governments for the surcharges on public services. The absence of an explicit mechanism to balance the budget once it is executed has led finance officials to distort or rewrite budget priorities deviating from those originally approved by the local rada. There are signs that budget discipline is breaking down and, in the worst cases, there is little relationship between the budget allocation and the actual use of funds.

Oblast's budget surpluses are not extracted by the central government, as was the case under the communist regime. In theory, surplus funds cannot be considered part of a jurisdiction's own resources for the following year's budget. But upper-level governments can extract surpluses of lower-level jurisdictions by lowering their tax-sharing rates or their subvention (or, since 1994, by increasing the exaction) in a subsequent year.

Problems with the budget process

Several features of the budget process limit the budgetary discretion of subnational governments in undesirable ways. In addition to the continued bargaining in the budget process, these limits include the use of spending norms, the proliferation of extrabudgetary funds, and the lack of a budget evaluation system, to name a few.

Continued reliance on budgetary norms. Budget officials continue to rely on budgetary norms similar to those used in the former Soviet Union to formulate local budgets. The norms, set by the central government, detail physical and cost standards for all types of government services. Their use has caused many problems. Typically, norms are based on existing capacity rather than on service needs. This has led to expenditure padding, giving subnational governments incentives to keep inefficient facilities running. Norms also tend to perpetuate existing spending patterns rather than facilitate an examination of the necessity and efficiency of policy measures. In some cases, where underlying population needs have changed, the norms may leave a region underserved. Because they are centrally determined, budgetary norms undermine subnational governments' fiscal autonomy, leading them to be little more than deconcentrated agencies of the national government rather than autonomous budget units. Finally, the reliance on norms suppresses the practice of budgetary review and performance evaluation in Ukraine.

Government mandates. The central government often orders subnational governments to carry out new spending responsibilities or incur expenditures with partial or no compensation. These mandates take
many forms, ranging from the obligation to provide public services with user charges set below costs to the shifting of additional responsibilities in the social safety net area. And they continue to increase. There are mandates on wage levels for subnational government employers and many norms for the construction of schools and hospitals.

Discouragement from raising own-source revenues. The existing budget system discourages subnational governments from raising revenue from those few areas where they have some autonomy to do so. In practice, raising additional revenue from local sources crowds out revenue obtained from central government sources by an equal amount. In 1994 this crowding out took the form of a reduced transfer (or an increased exaction). Prior to 1994 the Ministry of Finance could reduce the sharing rates of one or more of the regulating taxes. Oblast governments continue this practice with respect to rayon and city governments.

Widespread use of extrabudgetary funds. The use of extrabudgetary funds, permitted and encouraged under Ukraine’s budgetary system, is widespread at all levels of government. Their use need only be reported to the respective legislative branch at the end of the fiscal year. In addition, governments are increasingly making off-budget transactions that do not fall into either the regular budget or extrabudgetary fund categories. The Ministry of Finance has no aggregate data on the size of the subnational governments’ extrabudgetary funds. General observation indicates that they vary from 1 or 2 percent to 20 or 25 percent of the local budget.

Subnational governments defend the use of extrabudgetary funds as the most effective means to gain autonomy from higher-level governments. This defense is valid, but it creates a dilemma. Under ideal circumstances, where all levels of government maintain independent budgets, the widespread use of extrabudgetary funds is unjustifiable. Extrabudgetary funds are not subject to the same level of scrutiny as regular budget funds and their use prevents the careful consideration of priorities in allocating public resources. However, the lack of local autonomy makes them attractive in Ukraine’s present circumstances.

Lack of budget evaluation and ex post audit. The budgetary process in Ukraine lacks a method to evaluate whether resources are being used efficiently in the pursuit of stated objectives. Rather, all that is done is to check conformity with budgetary norms ex ante. The system also lacks an ex post audit function that is independent from the executive branch of government. Such a function is found in all OECD countries and in most developing countries. This absence is particularly dangerous given the evidence of budgetary discipline breakdown.
The challenges ahead for Ukraine's subnational governments

Although there has been some movement to increase the autonomy of subnational governments in Ukraine, the process has been hampered by continued reliance on the practices of the centrally controlled Soviet system. Government institutions and the legal system have paid lip service to the necessity of decentralizing, but the infrastructure required to carry it through does not exist.

Opportunities and challenges

The subnational sector, especially the cities, is fertile ground for instituting reforms that have not been undertaken at the national level. Subnational government officials are pressed by the need to deliver services in the face of severe budget cutbacks. They seem to be more aware than officials at the central level that "business as usual" is not a viable option and tend to be more receptive to the introduction of reforms that will increase the overall efficiency of government.

A strengthened and autonomous subnational government can become a bottom-up force for innovation and reform. The financial constraints on subnational governments encourage administrations to mobilize local revenues to the extent that their efforts are not met by revenue-sharing rates and subventions. Financial constraints may also encourage local governments to sell off small-scale enterprises and accelerate the pace of privatization if the right incentives prevail.

The ethnic and political tensions present in some regions of Ukraine may impel the central government to grant subnational governments more autonomy. Allowing taxpayers to have a greater impact on the day-to-day management of their affairs is a direct way to confront regional conflicts and centrifugal tendencies.

Main constraints to decentralization

A number of issues stand in the way of decentralization in Ukraine. Some are particular to former Soviet republics, such as the lack of experienced policy decisionmakers, and others are common to transition economies, such as the need to develop a transparent system of government transfers.

The need to define the boundary lines between the public and private sector. Subnational governments should provide those services that cannot viably be provided by the private sector, namely public goods. The provision of housing and commercial or industrial commodities, still
undertaken by subnational governments, should be transferred to competing private enterprises. Since a high percentage of business enterprises fail in market economies, government involvement in these activities unnecessarily puts local taxpayers at risk. In addition, it deters private entrepreneurs who face unfair competition.

Reducing subsidies for housing and communal services also reduces budgetary pressure at the subnational level and ultimately helps bring the central budget deficit under control. The increase in the rate of cost recovery for communal services should be accompanied by measures to protect the poor and other vulnerable groups. This calls for the conversion of generalized subsidies to targeted subsidies. The Cabinet of Ministers decree of February 1994 outlines a strategy to immediately implement these policies and ultimately to create and oversee autonomous public utility companies. The caveat to reforming the current pricing structure and allowing subnational governments to regulate rates is whether they will actually use their freedom to set rates—or refrain from doing so for political reasons. The more common experience in other formerly socialist economies has been the latter.

As state enterprises appropriately relinquish their social expenditure responsibilities, subnational governments will need to incorporate these additional demands into their budgets. The magnitude of this burden is not known, but a strategy is needed to facilitate the transfer of social expenditure responsibilities from state enterprises to subnational governments. A question that needs to be explored is the extent to which privatization of state enterprises is delayed by their continued responsibility for social services. State enterprises, like private enterprises, should support public services through the tax system, but should not be required to finance or supply them directly.

Initially, state enterprises should separate the costs of providing social services from those of running the enterprise. It would then be possible to begin a transition period where the state enterprises provide some services while receiving partial or full compensation from the government. This intermediate strategy is preferable to one in which enterprises stop funding services when subnational governments are unable, for lack of funds, infrastructure, space, or location, to assume responsibility for their provision.

The need to establish a clear and stable expenditure assignment system. In order to regularize intergovernmental relations it is imperative that a stable assignment of expenditure responsibilities be made between the central government and the oblasts (and between the oblasts and the rayons and cities). Since the unique assignment of expenditure responsibilities to one level of government will not always be possible or desir-
able, an explicit set of rules setting out the procedures for sharing responsibilities and for resolving conflicts of interest must be developed.

Any action taken in this direction must be predicated on careful analysis of the current state of affairs and on an examination of the principles of expenditure assignment and the experience of other countries. Subnational governments should provide those services that mainly benefit their residents. The central government should be responsible for income redistribution and income maintenance, though these services can be administered by "hiring" local governments. The bulk of financing and policy guidelines should come from the central government, with local governments providing additional funding and improved standards. Minimum national targets for redistribution and income maintenance should be the responsibility of the central government. The delivery and implementation of these policies should take advantage of the closer contact and better knowledge local governments have of the groups to whom these policies are addressed. Reformers will need to pay careful attention to the assignment of capital expenditure responsibilities and the provision of the social safety net, two areas that by their size of externalities belong to the center, but that have been disproportionately transferred to subnational governments.

Uncertainty over which level of government is responsible for different types of investment is contributing to the low level of investment in infrastructure. Subnational governments should assume full responsibility for the planning, financing, and execution of all capital projects in their sectors of responsibility. The central government may contribute to these activities by, for example, instituting a matching-grant program.

The Law on Local Self-Government allows subnational governments to cooperate in forming special-service districts. In practice, the central government’s control of service charges has discouraged these associations. However, the State Committee on Housing and Communal Services is promoting a return to this beneficial form of service delivery.

The need to rationalize the assignment of taxes and other revenues. Subnational governments must control local sources of revenue if they are to be responsive to their constituents. Ideally, subnational governments should be given the freedom to legislate and administer the appropriate taxes. However, this scenario is impractical given local administrators’ dearth of experience in tax administration and compliance. Central government administration of most major taxes is likely to prevail in Ukraine for the foreseeable future.

The current system for sharing the value added tax, company profit tax, and individual income tax economizes on administrative resources, but leaves oblasts with no control over tax rates and revenues. Moreover,
the existing method for calculating the origin of value added on interoblast trade is not sustainable in the long run. If feasible, tax surcharges would be superior in this area, since oblasts would retain the ability to set rates. Unfortunately, it is difficult to impose subnational surcharges on the value added tax and it is unlikely that they could be administered in Ukraine. It may be best to simply assign part of the value added tax revenues to a revenue pool to be shared by formula among oblasts.

Assigning the enterprise profits tax to oblasts where enterprises are chartered is conceptually indefensible. There are better alternatives to giving local governments revenue autonomy than a profit tax surcharge—such as property taxes, fees, and excise taxes. But if they are to be used, then the only sensible way to divide the revenues from this tax is to use a formula that reflects the origin of profits, or to allow a surcharge on the profits tax, administered by the central government.

The need for a transparent system of intergovernmental transfers. In Ukraine, as in most other countries, substantial differences exist in tax bases and revenue capacity across subnational jurisdictions. A system of intergovernmental transfers is thus needed to assist poorer jurisdictions in providing an adequate level of public services, to implement government policies at the local level, and to encourage local governments to expand the provision of services that have spillovers to other jurisdictions.

Ukraine does not have a system for determining intergovernmental transfers based on objective criteria. The existing method suffers from lack of transparency, as the minimum required budgets and forecasts of subnational revenues can be easily manipulated. It relies on budgetary norms and is thus capacity-driven rather than needs-driven. It discourages efforts to raise local funds, and it does not stimulate local spending of any kind (for example, matching funds or conditional block transfers for activities with positive externalities extending to other jurisdictions).

The Government of Ukraine will need to reform its system of intergovernmental transfers to accomplish four main objectives. First, transfers should attempt to achieve "vertical balance" in the distribution of funds among the different levels of government. Second, the establishment of an equalization fund, financed by central government revenues including revenues from the value added tax and the company profit tax, should create a horizontally balanced distribution of public services across oblasts. Third, the system of transfers should not discourage subnational governments from raising their own revenues. Finally, some transfers should be used to stimulate local expenditures with significant externalities or with significant national benefits, for example, through matching grants.
The need to reform the budgetary system and process. Several aspects of the budgetary system require urgent reform. These include achieving budgetary independence at all levels of government (in coordination with the reforms in expenditure and revenue assignment and the system of intergovernmental transfers), eliminating all off-budget transactions and integrating all extrabudgetary funds into subnational government budgets, introducing independent ex post budget audits, discontinuing the use of budgetary norms, and making subnational budget officials the employees of the subnational governments.

The need to develop a system of capital financing for subnational governments. Subnational governments have acquired considerable capital investment responsibilities in recent years, although they have devoted, on average, less than 5 percent of their total revenues to capital expenditures. This level—financed from current revenues and subventions—is grossly inadequate. Although subnational governments are permitted to borrow from domestic sources, they tend only to borrow from the central government for cash management purposes.

The Cabinet of Ministers and the Foreign Currency and Credit Council must approve and guarantee any foreign borrowing by oblast governments. Approval is generally granted if the project is self-financing and has a clearly specified repayment schedule. It is less clear whether oblast governments need to approve and guarantee foreign borrowing by city and rayon governments. Some further restrictions may be in order.

There is a pressing need to develop sources for subnational governments to finance capital infrastructure projects. Allowing local governments to borrow is a well-accepted principal of public finance in market economies. Borrowing permits long-lived projects to be undertaken that could not be financed out of current revenues. However, there will be a need to regulate subnational government borrowing to prevent public officials from using this source to finance current expenditures and shifting repayment costs to future elected officials. In developed capital markets, financial discipline is imposed by linking the cost of the loan to the risk of default. Many countries limit the borrowing ability of subnational governments by restricting expenditures for debt servicing to a set percentage of the budget. These issues will have to be addressed by the redrafted Law on the Budgetary System.
Annex 8.1 Local budgets and taxes

Table A8.1 City of Lviv budget, Ukraine, 1994
(millions of kupon)

<table>
<thead>
<tr>
<th>Category</th>
<th>Amount</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regulated revenue sources (taxes)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value added</td>
<td>239,670</td>
<td>27.9</td>
</tr>
<tr>
<td>Excise</td>
<td>112,874</td>
<td>13.2</td>
</tr>
<tr>
<td>National businesses and organizations</td>
<td>77,047</td>
<td>9.0</td>
</tr>
<tr>
<td>Land</td>
<td>43,482</td>
<td>5.1</td>
</tr>
<tr>
<td>Personal income</td>
<td>31,175</td>
<td>3.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>504,250</td>
<td>58.7</td>
</tr>
<tr>
<td>Fixed revenue sources</td>
<td></td>
<td></td>
</tr>
<tr>
<td>City fees and collections</td>
<td>145,133</td>
<td>16.9</td>
</tr>
<tr>
<td>Local businesses and organizations</td>
<td>117,886</td>
<td>13.7</td>
</tr>
<tr>
<td>Privatizations</td>
<td>77,736</td>
<td>9.1</td>
</tr>
<tr>
<td>Collections and untaxed revenues</td>
<td>9,217</td>
<td>1.1</td>
</tr>
<tr>
<td>Payments for water</td>
<td>2,586</td>
<td>0.3</td>
</tr>
<tr>
<td>Vehicle tax</td>
<td>1,500</td>
<td>0.2</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>17</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>354,076</td>
<td>41.3</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td>858,326</td>
<td>100.0</td>
</tr>
</tbody>
</table>

| Expenditures                          |        |                 |
| Housing and communal services         |        |                 |
| Heating                               | 208,000| 24.2            |
| Water, gas, and electricity           | 158,886| 18.5            |
| Transportation (buses)                | 45,500 | 5.3             |
| Other                                 | 631    | 0.1             |
| **Total**                             | 413,017| 48.1            |
| Social and cultural facilities        |        |                 |
| Health                                | 263,425| 30.7            |
| Education                             | 14,359 | 1.7             |
| Culture                               | 8,773  | 1.0             |
| Physical education and youth          | 402    | 0.2             |
| **Total**                             | 286,959| 33.4            |
| City services                         |        |                 |
| City maintenance                      | 36,243 | 4.2             |
| Capital repair of residences          | 35,747 | 4.2             |
| Purchase of trolley buses             | 5,160  | 0.6             |
| Other                                 | 3,926  | 0.5             |
| **Total**                             | 81,077 | 9.4             |
| Capital outlays                       |        |                 |
| Administration                        | 12,675 | 1.5             |
| Bylaw enforcement                     | 11,391 | 1.3             |
| Social security                       | 7,744  | 0.9             |
| Road signs                            | 1,500  | 0.2             |
| Contingency                           | 2,000  | 0.2             |
| Other                                 | 9,961  | 1.2             |
| **Total expenditures**                | 858,326| 100.0           |

Note: The exchange rate in July 1994 was 39.970 kupon = 1 U.S. dollar.
Source: City of Lviv, Finance Department.
Table A8.2 Subventions from the central budget to selected oblasts, Ukraine, 1993
(billions of kupons)

<table>
<thead>
<tr>
<th>Oblast</th>
<th>Subvention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zakarpatyne</td>
<td>13.8</td>
</tr>
<tr>
<td>Volyn</td>
<td>12.3</td>
</tr>
<tr>
<td>Kiev (city)</td>
<td>11.7</td>
</tr>
<tr>
<td>Crimea, Republic of</td>
<td>10.3</td>
</tr>
<tr>
<td>Chernivtsi</td>
<td>7.6</td>
</tr>
<tr>
<td>Rivne</td>
<td>4.9</td>
</tr>
<tr>
<td>Sumy</td>
<td>3.5</td>
</tr>
<tr>
<td>Zhitomir</td>
<td>2.4</td>
</tr>
<tr>
<td>Sevastopol (city)</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Note: In 1993 the average exchange rate was 10.161 kupons = 1 U.S. dollar.
Source: Ministry of Finance, Government of Ukraine.

Table A8.3 Oblast subventions and exactions in the 1994 budget, Ukraine
(billions of kupons)

<table>
<thead>
<tr>
<th>Oblast</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Crimea, Republic of</td>
<td>1,657.1</td>
</tr>
<tr>
<td>Vinnitsa</td>
<td>1,197.3</td>
</tr>
<tr>
<td>Zakarpatyne</td>
<td>1,099.7</td>
</tr>
<tr>
<td>Kirovgrad</td>
<td>1,032.5</td>
</tr>
<tr>
<td>Zhitomir</td>
<td>1,080.1</td>
</tr>
<tr>
<td>Ternopol</td>
<td>960.6</td>
</tr>
<tr>
<td>Ivano-Frankiv</td>
<td>940.3</td>
</tr>
<tr>
<td>Volyn</td>
<td>866.2</td>
</tr>
<tr>
<td>Rivne</td>
<td>799.4</td>
</tr>
<tr>
<td>Kherson</td>
<td>787.7</td>
</tr>
<tr>
<td>Chernivtsi</td>
<td>753.4</td>
</tr>
<tr>
<td>Khmelnytsky</td>
<td>716.7</td>
</tr>
<tr>
<td>Sumy</td>
<td>699.3</td>
</tr>
<tr>
<td>Chernigov</td>
<td>494.7</td>
</tr>
<tr>
<td>Ivano-Frankiv</td>
<td>481.5</td>
</tr>
<tr>
<td>Kiev (oblast)</td>
<td>471.6</td>
</tr>
<tr>
<td>Odessa</td>
<td>402.5</td>
</tr>
<tr>
<td>Mykolayiv</td>
<td>358.8</td>
</tr>
<tr>
<td>Kherson</td>
<td>340.6</td>
</tr>
<tr>
<td>Sevastopol (city)</td>
<td>338.0</td>
</tr>
<tr>
<td>Lugansk</td>
<td>282.8</td>
</tr>
<tr>
<td>Exeption</td>
<td>-109.0</td>
</tr>
<tr>
<td>Dnipropetrovsk</td>
<td>-695.2</td>
</tr>
<tr>
<td>Kiev (city)</td>
<td>-758.9</td>
</tr>
<tr>
<td>Poltava</td>
<td>-983.8</td>
</tr>
<tr>
<td>Zaporizhie</td>
<td>-1,472.2</td>
</tr>
</tbody>
</table>

Note: In July 1994 the exchange rate was 39,970 kupons = 1 U.S. dollar.
Source: Ministry of Finance, Government of Ukraine.
Table A8.4 City of Lviv: Revenue-sharing rates from the oblast, Ukraine, 1993–94  
(percent)  

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>1993 from center</th>
<th>1993 from oblast</th>
<th>1994 from center</th>
<th>1994 from oblast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value added tax</td>
<td>39</td>
<td>17</td>
<td>20</td>
<td>13</td>
</tr>
<tr>
<td>Excise tax</td>
<td>50</td>
<td>10</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Company profit tax</td>
<td>50</td>
<td>10</td>
<td>50</td>
<td>10</td>
</tr>
<tr>
<td>Personal income tax</td>
<td>100</td>
<td>100</td>
<td>50</td>
<td>20</td>
</tr>
<tr>
<td>Land tax</td>
<td>100</td>
<td>60</td>
<td>70</td>
<td>70</td>
</tr>
</tbody>
</table>

Source: City of Lviv, Finance Department.

Table A8.5 City of Kiev: Revenue sharing for city districts, Ukraine, 1994  
(percent, except where otherwise specified)  

<table>
<thead>
<tr>
<th>City district</th>
<th>Value added tax</th>
<th>Excise tax</th>
<th>Company profit tax</th>
<th>Personal income tax</th>
<th>Land tax</th>
<th>Subsidy (millions of kuponos)</th>
<th>Exaction (millions of kuponos)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Darnitsa</td>
<td>20</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Dnieper</td>
<td>20</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>70</td>
<td>45,774</td>
<td>0</td>
</tr>
<tr>
<td>Khakov</td>
<td>9.3</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Leningrad</td>
<td>20</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>70</td>
<td>15,362</td>
<td>0</td>
</tr>
<tr>
<td>Minsky</td>
<td>10.3</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Moscow</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>1.0</td>
<td>20</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Pechersk</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>1</td>
<td>0</td>
<td>292,518</td>
</tr>
<tr>
<td>Pochol</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>20</td>
<td>40</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Schevchenko</td>
<td>2</td>
<td>5</td>
<td>5</td>
<td>10</td>
<td>10</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Sovet</td>
<td>5</td>
<td>10</td>
<td>2.9</td>
<td>10</td>
<td>70</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Starokieviy</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>0.5</td>
<td>1</td>
<td>0</td>
<td>26,336</td>
</tr>
<tr>
<td>Vatutin</td>
<td>20</td>
<td>20</td>
<td>50</td>
<td>50</td>
<td>70</td>
<td>74,952</td>
<td>0</td>
</tr>
<tr>
<td>Zaluzhny</td>
<td>2</td>
<td>10</td>
<td>3.6</td>
<td>5.0</td>
<td>30</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Zhovbnyiv</td>
<td>1</td>
<td>20</td>
<td>3.2</td>
<td>5.0</td>
<td>30</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Note: In July 1994 the exchange rate was 39,970 kuponos = 1 U.S. dollar.  
Source: City of Kiev, Finance Department.

Notes

This chapter is based on work done by the authors in several missions to Ukraine under the sponsorship of the United States Agency for International Development and the World Bank. Much of this paper draws from Martinez-Vazquez (1994c), Coopers and Lybrand (1993), and McLure (1993a). The authors wish to thank Yoshine Uchimura and Christine Wallich for helpful comments and guidance.

1. The term "subnational" refers to what is called state and local in the United States and is translated from Russian and Ukrainian as "local." The term "state" is generally used only when referring to fiscal institutions in countries
with federal systems having intermediate governments that are actually called states (or the equivalent in another language), such as the corporate profits taxes levied by American states or the state value added tax in Brazil. In Russia these governments are called oblasts. While “federal” is sometimes used to connote the top level of government, in the Ukrainian context of unitary government “central” is more appropriate.

2. The effective constitution is the Constitution of 1978. It was amended significantly in 1991 and has continued to be amended every year since. A special Constitutional Committee has been established to work out a new constitution, which will then be considered by Parliament.

3. The administrative districts are also known as administrative rayons, not to be confused with the rural rayons at the third tier of government. The administrative districts for Kiev and Sevastopol have rayon status and belong in the third tier of government structure (both cities have oblast status).

4. According to the State Committee on Housing, the rate of cost recovery for heating and hot water is 12 percent, and neither of the services is metered. Cost recovery for gas, used mostly for cooking, is about 3 percent, and consumption is not metered. Cold water consumption is also unmetered, and cost recovery is about 15 percent. Electricity is the only service that is metered. Its cost recovery level is the highest—but still only about 50 percent.

5. This issue has been analyzed for Russia. In the aggregate, such expenditures are estimated to be between 2 and 4 percent of GDP. However, the incidence of the problem was unequal across oblasts in Russia. Oblasts with a heavier concentration of state enterprises were more vulnerable. In some cases, taking over all the public services of state enterprises would have nearly doubled local budgets. See Martinez-Vazquez (1994d).

6. These are aggregate figures for the entire subnational sector. Because oblast governments can reassign responsibilities to cities and rayons and can fund their budgets as they choose, there could be large interoblast variations in the breakdown of expenditures between those two levels of government.

7. This effect is somewhat mitigated by the change in off-budget and on-budget expenditures.

8. By mid-1994 less than 15 percent of the housing stock had been privatized. The 1992 Law on Privatization allows occupants of state- and enterprise-owned housing to assume ownership automatically or by paying for “excess space” beyond the state-determined norm. The slow pace of housing privatization results in part from uncertainty about the additional financial burdens owners will incur (including property tax liabilities) and the fact that tenants may continue renting indefinitely (Lowry 1994).

9. As of end-May 1994 Kiev had not made any payments for its assigned exaction to the Ministry of Finance. The City of Kiev Finance Department estimated that with the reindexation of the budget for inflation and the possible transfer of funds to compensate for its functions as capital city, Kiev may not have to transfer any funds to the Ministry of Finance. Capital city status for Kiev was granted by a 1994 presidential decree. The city is still negotiating with the Ministry of Finance and the Ministry of Economy the compensation package it will be entitled to for performing the functions of the capital city.
10. North-south interstate sales are taxed at 12 percent, while south-north transactions are taxed at 7 percent, giving the northern states preferential treatment. See Longo (1982) and Shah (1994).

11. These figures are not entirely comparable, since the OECD figures are percentages of tax revenues, while the figures for Ukraine are percentages of all revenues. Moreover, Ukrainian taxes are not easily allocated among the categories employed by the OECD. Even so, there is no doubt that Ukraine relies far more heavily on the enterprise profit tax than do OECD countries, and much less on individual income, social security, and payroll taxes.

12. The high inflation of the past two years, particularly in 1993, has caused distortions in the budget process. Subnational governments are penalized when government transfers are delayed. But those oblasts that had borrowed funds from the Ministry of Finance often saw their debts virtually wiped out by inflation. Funds from revenue sharing are not subject to inflation erosion because the funds are received directly from the banks collecting the taxes. Banks are penalized for each day of delay in transferring the funds to the government accounts. The inflation rate in 1994 has moderated considerably—it was 63 percent between January and April.

13. There are exceptions to this general principle. For example, at the central level it is accepted that social insurance and pension funds be kept outside the regular budget to guarantee the integrity of funds and cover future liabilities.
Intergovernmental fiscal relations in the Russian Federation

Roy Bahl and Christine I. Wallich

The Russian Federation is facing a difficult period of economic and political transition. It is attempting to restructure its economic system, protect the well-being of its citizens, stabilize prices and its external balance, and provide public services to support social and economic development. At the same time, it is seeking to establish a system of governance acceptable to regions whose cultural identities, natural resource endowments, and degree of economic development differ widely. The reform program is bold—it includes industry privatization, price liberalization, financial sector modernization, agriculture reform, and tax system reform. These reforms will significantly change the government’s role in the economy, reducing its control over financing and the allocation of resources while strengthening the regulatory and other functions characteristic of governments in market economies.

These reforms have changed the responsibilities of all levels of government—from the federal parliament to the village soviet—including governments’ expenditure responsibilities, revenue needs, and the tax bases available to collect revenues. The Russian Federation also has ambitious plans for fiscal reform and has introduced several changes in the revenue and expenditure system at the federal level. Fiscal reforms will play an important role in the success of Russia’s reform effort. First, sound fiscal policies are critical to a successful stabilization effort. Second, the equity and incentive aspects of tax policy support structural reforms by creating an environment in which the private sector can flourish. Third, expenditure reform has given subnational governments
important new responsibilities for a new, more targeted social safety net and for infrastructure investment.

The Russian Federation is also reconsidering some basic issues in intergovernmental finance: the division of expenditure responsibilities and the assignment of revenues between the federal government and Russia's oblasts (the equivalent of a state). It is considering a system of transfers that will both finance the revenue shortfall of subnational governments and support a more efficient and equitable provision of government services across oblasts. Unlike tax reform, policy changes in intergovernmental relations and subnational finances have just begun and are less well developed. The scope and form these changes take will affect both the political character and the economic stability of the Russian Federation, with significant consequences for the efficiency with which the economy performs.

This chapter discusses the context and evolution of Russia's fiscal system, its expenditures and expenditure assignment policies, the current tax and intergovernmental system, and options for reform. The following chapter (chapter 10) discusses the divisive issue of sharing natural resource tax revenues and the demands being made by certain oblasts for special fiscal treatment within the Russian Federation.

**Intergovernmental fiscal relations: Setting the stage**

The Russian Federation is the largest and one of the most diverse countries in the world, with regions whose cultures, politics, ethnicity, and resource endowments vary widely. This diversity presents a challenge to effective administration, budgetary management, and stabilization and structural policies.

*Basic characteristics of Russia's administrative and federal structure*

The Russian Federation is a three-tiered federal state consisting of eighty-nine provinces or states directly subordinate to the federal government and known as "subjects of federation." These states comprise the oblasts, okrugs, krais, autonomous regions, national regions, metropolitan cities with oblast status (Moscow and St. Petersburg), and, until mid-1992, the autonomous republics (now, merely republics). They are collectively referred to as "oblast level" or "subnational" throughout this chapter. The Russian phrase "subnational administrations" indicates their lack of substantive powers under the previous regime. Below the oblast-level governments are the municipalities and rayons, local governments that are subordinate to the oblast governments (see map of the Russian Federation, facing page 324).
Even when they were still part of the U.S.S.R., and until the constitutional changes of 1994, some republics had their own governments, called Supreme Soviets, which had some degree of autonomy. Immediately after the breakup of the Union, some republics declared independence from the Russian Federation. These declarations have not been recognized by the Parliament of the Russian Federation or by any other country.

The Federation Treaty of 1992 continued the process of defining the relationship between the federal government and the eighty-nine oblast-level units, but did not complete it. The treaty confirmed the greater role of the ethnic republics over their foreign policy and foreign trade relations with the federal government and over their relations with other republics, krais, and oblasts (World Bank 1992c). Traditionally, metropolitan cities, krais, and autonomous okrugs have had more autonomy from the federal government than the other oblasts—but less autonomy than the republics. The republics of Chechenya and Tatarstan refused to sign the treaty, and Chechenya is currently at war with the Federation over its status. Under the new Constitution, all oblasts have equal status, and there is no formal differentiation among the subjects of the Russian Federation, despite pressures to create it (see chapter 10).

All of Russia’s eighty-nine administrative divisions except Moscow and St. Petersburg are further divided into rayons, or districts. The roots of these administrative divisions are in the four-tiered structure of the former Soviet Union, which comprised the Union government, fifteen Union republics, oblasts, and cities or rayons (IMF 1992b). In the Russian system, the central government interacts directly only with oblast-level governments.

Russia’s administrative structure

Each oblast supervises urban and rural areas within its jurisdiction (figure 9.1). All local governments within an oblast report to the oblast government and carry out duties according to oblast regulations. For example, at the end of 1993 the Moscow oblast contained sixty cities with populations ranging from 60,000 to 200,000 and 650 independent rayon, city, and rural settlements. Each oblast has an independent (that is, separate and free-standing) budgetary and administrative status. Although the oblast-level finance departments are by law autonomous and the formal subordination of oblasts’ finance departments to both the central Ministry of Finance and the oblast administration has been eliminated, finance officers are paid by the central government budget. Oblast finance departments may thus feel competing loyalties to the center and to the oblast government and respond to competing realms of authority or, in Russian parlance, “dual leadership” (figure 9.2). While
formally they act as deconcentrated arms of the central administration, incentives to respond to local policy concerns still exist.

Under Russia's new system of budgetary legislation each level of government now prepares its own budget. The system is based largely on sharing of federal taxes (see below). Although federal-oblast tax-sharing rates are in principle fixed by the state Duma (Parliament), in practice they are negotiated with the Ministry of Finance and are designed to give the oblasts sufficient revenue while also providing adequate funding for the federal budget. Thus, the Russian intergovernmental system is not really a system, but a series of ad hoc negotiated arrangements whose effects and incentives are not well understood.

Another unusual characteristic—compared with other systems of federal finance in market economies in which the central government collects most tax revenues and shares them with lower levels—is that revenues in the Russian system are collected at the oblast and rayon level and "shared up" (similar systems exist in other former Soviet republics and in China and Viet Nam). The breakdown of this upward sharing system in 1991, when the Union republics ceased making transfers to the U.S.S.R. budget, contributed to the dissolution of the Union. A similar threat could hang over the Russian Federation unless these issues are resolved (see chapter 10).
Basic characteristics, geography, and nationalities of the Russian Federation

In 1991 Russia's population of some 150 million accounted for 51 percent of the total population of the Soviet Union. The Russian Federation itself includes dozens of ethnic groups. About 82 percent of the population is ethnically Russian. Other major nationalities include Tatars (3.8 percent), Ukrainians (3.0 percent), Belorussians (0.8 percent), and Germans (0.6 percent). Others include Jews, Armenians, and Kazakhs (each 0.4 percent), Bashkirs, Yakuts, Osetians, and Chechens. Many of these nationalities are geographically concentrated, although they do not represent majorities in many of these regions (see chapter 10, map of the non-Russian population in the Russian Federation, facing page 382). Nationality-based administrative units cover about half the geographical territory of the Russian Federation. The European part of the country is relatively densely populated and includes Moscow, with 9 million inhabitants, and St. Petersburg, with 5 million. The Asian part is more sparsely populated, with major urban centers in the Urals and along the Trans-Siberian Railroad.

With an area of 6.5 million square miles spanning eleven time zones (from Kaliningrad on the Baltic Sea to the Bering Straits by Alaska), the Russian Federation covers one-eighth of the world's land surface, making it the largest country in the world. With the exception of the Central Asian deserts, the Russian Federation retains all the major geographical features of the former U.S.S.R. The northernmost part of the country is arctic desert and tundra. Two-fifths of the territory is permafrost. South of the tundra stretch forests (the taiga) and farther south lie the steppes.
Resource endowments across regions

The Russian Federation has vast natural resources (see chapter 10, map of the natural resource endowments of the Russian Federation, facing page 390). Its large mineral deposits include coal, oil, phosphorites, natural gas, potassium salts, and iron ores, as well as gold, diamonds, copper, lead, tin, bauxite, manganese, silver, molybdenum, graphite, nickel, uranium, and rare metals. Some of the most important oil and mineral deposits are located in republics and ethnic regions. For example, a large part of the western Siberian oil fields is in the territory of the Khanti-Mansisk autonomous okrug and the Yamal autonomous okrug. Together these two oblasts produce 80 percent of Russia's oil and gas and 20 percent of the world's supply. Important oil fields are also in Tatarstan. Major diamond deposits are located in the Yakutia Republic, which produces 99 percent of Russia's diamonds and 25 percent of the world's supply.

These resource endowments are reflected in Russian average wage incomes, which vary widely across oblasts. In 1992 the two richest oblasts, Magadansk and Tyumen (which until 1991 contained the oil-producing Khanti-Mansisk autonomous okrug), had average wages exceeding 28,000 rubles, almost ten times that of the poorest, the Dagestan Republic. Budgetary disparities are also significant: per capita expenditures in 1994 range from 83,665 rubles in the diamond-rich Sakha (Yakutia) Republic to 5,077 rubles in the Chechen-Ingush Republic. Differences are also vast in other areas of well-being—education levels, morbidity, housing, access to medical care—and even greater in so-called national economy expenditures such as capital investment and food subsidies. For example, some oblasts spend more than ten times as much as others per capita on education and health and only 40 percent as much as others on national economy expenditures (Le Houerou 1994).

Inflation rates also differ greatly throughout the Russian Federation, implying that money wages and expenditures do not reflect purchasing power. The Chechen-Ingush Republic, one of the poorest localities in money wage terms, suffered the least from inflation in 1992. The highest level of inflation that year was in Primorski krai, where the inflation rate of 1,726 percent was more than twice that of the lowest (Le Houerou 1994). These differentials persist because high transport costs and administrative supply constraints prevent the free movement of goods and services. These high inflation rates and a scarcity of goods and services have led to poverty in many of the resource-rich areas, despite their high nominal wages.
Expenditure assignment

The design of intergovernmental fiscal policy should always begin with the expenditure side. First: Which level of government will deliver which services? Then: What level and kind of government financing are implied? Issues that arise in connection with expenditure assignment in Russia include whether the current division of spending responsibilities matches best principles, the implications of the current movement toward expenditure decentralization for the robustness of the social safety net, and whether the limited budgetary autonomy of subnational governments poses special problems.

Division of expenditure responsibility

The most basic issue associated with expenditure assignment is the division of spending responsibilities. What are the key functions of government, and which level of government should carry out which functions? There is no best system of expenditure assignment or service decentralization. Local preferences, household mobility, economies of scale, spillover effects, and political considerations suggest what will be feasible for a particular country. A well-designed intergovernmental system should be able to adapt to changes in preferences and to changes in the relative importance of efficiency, equity, and stabilization objectives. International experience shows that stable systems of intergovernmental relations are characterized by clearly stated expenditure assignment rules, rather than by the subjective decisions and murky assignments that define the intergovernmental system in Russia (see chapter 1).

How consistent are Russia's spending assignments with principles?

Formally, Russia does not define or allocate legally the expenditure responsibilities of its federal, oblast, and rayon governments. Rather, tradition and inertia have led to "accepted" spending assignments that until recently have been observed as relatively stable over time. Thus, spending responsibilities are established (or reestablished) in each annual budget (or more recently, quarterly budget), which serves as the vehicle by which spending authorities are codified. Since Russia has explicitly assigned revenues between levels of government, this puts the cart before the horse: subnational spending decisions are being revenue-driven, rather than revenues being expenditure-driven.

The traditional assignment of public service activities in Russia to different levels of government is based on the principle of assignment
according to the geographical dimension of benefits. This economic efficiency rule was inherited from the former Soviet Union. Thus, the central government provides public service activities whose benefit area encompasses the entire nation. Public services with a regional dimension, such as universities and tertiary and psychiatric hospitals, are provided by the oblast level of government. Those with a local dimension, such as elementary schools and parks, are provided by rayon and city governments (table 9.1).

Almost all the former U.S.S.R.'s Union-government-level spending functions have been assumed by the Russian Federation. The federal budget is responsible for large and important enterprises (so-called group A), including pipelines, electric power, marine transport, and national environmental problems (such as the Chernobyl accident, which has had major consequences for Russia, although the reactor was located in Ukraine). The federal government is also responsible for international trade activities and fundamental science. In the social sectors, the federal budget accounts for a small share of financing for universities and other higher-level learning institutions, specialized health care facilities, and cultural affairs including museums, in keeping with the principle of minimizing federal involvement when the “benefit zone” is local or regional.

The oblast level has traditionally been responsible for spending of an interjurisdictional nature covering two or more rayons within the oblast. Examples are river transport, oblast roads, environmental issues at the oblast level, forest preservation, vocational schools, intermediate health care at oblast hospitals, and specialized clinics. Oblasts and republics are also responsible for small and medium-size enterprises such as local light industry and consumer goods. Oblasts are increasingly transferring such enterprises to the rayon level to avoid paying the subsidies needed to support them. The expenditure responsibilities of rayons and townships are concentrated in the social services area. Rayon budgets account for almost 100 percent of basic education expenditures, 85 percent of health expenditures, 80 percent of public utility expenditures, 60 percent of kindergarten services, and 60 percent of housing expenditures (Wallich 1994; Le Houerou 1994).

Although this basic and traditional assignment of spending responsibilities has generally matched assignment according to benefit area, the actual practice in recent times does not. Specific service responsibilities are not clearly assigned to specific levels of government, and no laws govern expenditure responsibilities, a striking contrast to the precision with which revenues have been assigned. This murkiness has led recently to some cases of service provision by more than one level of government or to service provision at the wrong level (see below). In
Table 9.1 Expenditure assignment by level of government, Russian Federation, 1992–93

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>Federal</th>
<th>Oblast</th>
<th>Rayon</th>
<th>Village soviet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense</td>
<td>• 100 percent</td>
<td>• Some military housing</td>
<td>• None</td>
<td>• None</td>
</tr>
<tr>
<td>Justice and internal security</td>
<td>• 100 percent</td>
<td>• None</td>
<td>• None</td>
<td>• None</td>
</tr>
<tr>
<td>Foreign economic relations</td>
<td>• 100 percent</td>
<td>• None</td>
<td>• Wages</td>
<td>• None</td>
</tr>
<tr>
<td>Education*</td>
<td>• All university and research institute expenditures</td>
<td>• Several special vocational schools</td>
<td>• Operation, construction, and maintenance of all primary and secondary schools</td>
<td>• None</td>
</tr>
<tr>
<td>Culture and parks^</td>
<td>• National museums</td>
<td>• Some museums</td>
<td>• Some museums</td>
<td>• None</td>
</tr>
<tr>
<td>Health^</td>
<td>• Medical research institutes</td>
<td>• Tertiary hospitals, psychiatric hospitals, veteran hospitals, diagnostic centers, and special service hospitals (such as cardiology)</td>
<td>• Secondary hospitals</td>
<td>• Paramedics</td>
</tr>
<tr>
<td>Roads^</td>
<td>• Construction of federal roads</td>
<td>• Maintenance of oblast roads</td>
<td>• Maintenance of rayon and city roads</td>
<td></td>
</tr>
<tr>
<td>Public transportation</td>
<td>• Previously interjurisdictional highways and air and rail transport</td>
<td>• Most public transportation facilities</td>
<td>• Some transportation facilities, including subway systems</td>
<td></td>
</tr>
<tr>
<td>Fire protection*</td>
<td>• None</td>
<td>• Most fire protection services</td>
<td>• Voluntary, military, and enterprise services possible at this level</td>
<td></td>
</tr>
</tbody>
</table>

(Table continues on the following page.)
<table>
<thead>
<tr>
<th>Expenditure</th>
<th>Federal</th>
<th>Oblast</th>
<th>Rayan</th>
<th>Village soviet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Libraries</td>
<td>• Special libraries (such as the Lenin library)</td>
<td>• Special library services</td>
<td>• Most local library services</td>
<td></td>
</tr>
<tr>
<td>Police services</td>
<td>• National militia</td>
<td>• Road (traffic) police</td>
<td>• Local security police</td>
<td>• Part of garbage collection</td>
</tr>
<tr>
<td>Sanitation (garbage collection)</td>
<td>• None</td>
<td>• None</td>
<td>• Part of garbage collection</td>
<td>• Part of garbage collection</td>
</tr>
<tr>
<td>Sewerage</td>
<td>• Infrastructure capital investment</td>
<td>• Most operational expenditures</td>
<td>• Some operational expenditures</td>
<td></td>
</tr>
<tr>
<td>Public utilities (gas, electricity, and water)</td>
<td>• None</td>
<td>• None</td>
<td>• None</td>
<td>• Subsidies to households (not enterprises)</td>
</tr>
<tr>
<td>Housing</td>
<td>• Building and development</td>
<td>• None</td>
<td>• Maintenance and small-scale building</td>
<td>• None</td>
</tr>
<tr>
<td>Price subsidies</td>
<td>• None</td>
<td>• None</td>
<td>• Fuels, mass transport, food (bread, milk), and medicine</td>
<td>• None</td>
</tr>
<tr>
<td>Welfare compensation</td>
<td>• Partly central responsibility</td>
<td>• Partly oblast responsibility</td>
<td>• Managing programs funded by upper-level governments</td>
<td>• None</td>
</tr>
<tr>
<td>Category</td>
<td>Group A enterprises</td>
<td>Group B enterprises</td>
<td>Group C enterprises</td>
<td>Environment issues</td>
</tr>
<tr>
<td>--------------------------</td>
<td>---------------------</td>
<td>---------------------</td>
<td>---------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td>Public enterprises</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>(productive sectors)</td>
<td>Capacity to invest in joint ventures (keeping 50 percent of privatization proceeds if there is rayon subordination)</td>
<td>Capacity to invest in joint ventures (keeping 50 percent of privatization proceeds if there is rayon subordination, and 10 percent if any other subordination)</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Environment</td>
<td>National environmental issues</td>
<td>Local environmental problems (such as forest preservation)</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td>Enterprises</td>
<td>Group A enterprises (such as transport and heavy industry)</td>
<td>Group B enterprises (such as light industry, housing construction, and food industry)</td>
<td>None</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Group C enterprises (such as transport, light industry, agriculture)</td>
<td>If transferred to local level</td>
<td>None</td>
<td></td>
</tr>
</tbody>
</table>

Note: Capital expenditures are included unless otherwise noted.

a. Public enterprises also build schools but typically do not operate them. They frequently operate kindergarten services.
b. Some enterprises build sport facilities.
c. Some enterprises build hospitals and in some cases operate them. Social insurance, financed primarily by enterprises, pays for the health services of those covered.
d. A "special extrabudgetary fund" is financed by an excise tax on oil consumption.
e. Special fire protection services are provided by enterprises, but such provision is declining.
f. Separate user charges do not normally apply for garbage collection.
g. Separate user charges apply for sewerage.
h. Enterprises have been important builders of housing and own nearly half of the housing stock in Russia. The central government has transferred housing to local governments; maintenance is the responsibility of the level of government or enterprises owning them.

addition to traditional public service functions of government, the assignment of responsibilities in Russia includes ownership of certain commercial and industrial enterprises and all the expenditure responsibilities related to ownership, a practice that significantly complicates expenditure assignment.

*Shifting central spending functions downward*

Recent changes in the assignment of expenditure responsibility have violated benefit-area principles in fundamental ways. An important part of social, and most capital, expenditures has been delegated to the subnational level. However, the new revenue-sharing system to the subnational level has not taken these new responsibilities into account. For example, in early 1992 the central government shifted responsibility to the oblast and rayon governments for most price subsidy and income maintenance programs. Previously, these had been administered by the oblasts but financed with transfers from the central government equaling about 5 percent of gross domestic product (GDP). While the direct burden of price subsidies ceases after prices are freed, the underlying problem of financing social protection for those most hurt by economic change does not. The central government has not estimated the cost of financing this social protection, nor has it developed a way to match this cost with each oblast's available revenues.

Until recently the federal level was responsible for approving, financing, and implementing all subnational capital investment. In mid-1992 national investment responsibilities, such as highways, military housing, and airports, as well as those with local significance, were shifted to subnational budgets. It appears that the main rationale for the reassignment was to balance the central government budget and to claw back the apparent surpluses of subnational governments, which were thought to have been created by the introduction of a new revenue-sharing system in early 1992. The shift placed serious budget pressures on some subnational governments, creating the risk that important social expenditures such as health care and education would be crowded out. Although shifting these spending responsibilities down to lower-level governments may have helped the center's short-run budget pressures, it is inconsistent with expenditure assignment principles and will inevitably lead to distortions and a repressed deficit at the subnational level, with needed but postponable spending not undertaken, or with recourse to other quasi-fiscal financing. Realizing some of these problems, the center took back control over expenditures on federal highways and much of military housing in late 1992. Although probably a good move, assigning and reassigning expen-
ditures in this manner creates its own set of problems, especially with regard to predictability of subnational expenditures and their revenue requirements.

A more general issue is the absence of concreteness in assigning spending responsibilities. Both subnational and central governments reap advantages from the continued ambiguity. Subnational governments use their broader responsibilities to bargain for a larger share of revenue, and the federal government has an additional instrument to balance its own budget—jettisoning expenditure responsibilities to lower-level governments. This lack of definition cannot continue if the system of intergovernmental relations in the Russian Federation is to move away from bargaining and toward greater certainty and predictability. If expenditure responsibilities are not clearly assigned, it will be impossible to determine the revenue sufficiency of alternate financing arrangements.

More important, if this trend persists, what important expenditure functions will the central government perform to justify its existence to skeptical regional governments? By eschewing the concrete assignment of responsibilities, the federal government may inadvertently be contributing to its worst fear—the disintegration of the Russian Federation (Martinez-Vazquez 1994b).

Expenditure autonomy

To realize economic efficiency, subnational governments must have discretion in making budget decisions. Even though the Law on Budgetary Rights of Local Self-Governments (June 1993) prescribes full autonomy, the budgetary activities of Russia’s subnational governments are constrained in several ways. Since the central government dictates the center-oblast tax-sharing rates and defines the rate and base of all central and local taxes, subnational governments cannot determine autonomously the aggregate size of their budgets. Thus, there are no truly independent sources of oblast or rayon revenues. Among other constraints are the unfunded central spending mandates that govern many subnational expenditures. For example, the federal government determines wages for all public employees and prescribes the rate of wage increases. The federal government also sets ceilings on several public sector prices, notably tariffs on many forms of public transport and utilities. Pensions and wages for teachers and health providers are also centrally mandated. Rents on housing owned by enterprises and local governments were controlled until mid-1992.

In earlier years subnational government budgetary discretion was constrained by thousands of budgeted capacity norms used to determine
Box 9.1 Health sector expenditure norms in the Russian Federation

Expenditure norms for most expenditure items in the social sphere of the budget exist at each level of government. The norms for the health sector are released by the ministries of finance and health. They include detailed standards for the cost of each part of the health care sector’s operations and outlays, including cost standards for the acquisition of beds and uniforms, for physicians’ visits, for the acquisition of medicine, and so on. The standards differ according to the specialization of the hospital or hospital department. The following is an example of the cost standards for one patient’s food ration per day at each of the seventeen types of health institution:

<table>
<thead>
<tr>
<th>Type of patient/hospital</th>
<th>Budgetary norm per capita per day (rubles)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Children</td>
<td>7.00</td>
</tr>
<tr>
<td>Maternity</td>
<td>7.00</td>
</tr>
<tr>
<td>Infants</td>
<td>1.00</td>
</tr>
<tr>
<td>Gynecology</td>
<td>3.60</td>
</tr>
<tr>
<td>Gastroenterology/hematology</td>
<td>3.60</td>
</tr>
<tr>
<td>Necrology</td>
<td>5.40</td>
</tr>
<tr>
<td>Leprosy</td>
<td>4.71</td>
</tr>
<tr>
<td>Pneumoconiosis</td>
<td>4.71</td>
</tr>
<tr>
<td>Oncology</td>
<td>3.89</td>
</tr>
<tr>
<td>Endocrinology</td>
<td>3.18</td>
</tr>
<tr>
<td>Burn</td>
<td>4.56</td>
</tr>
<tr>
<td>Tuberculosis</td>
<td>4.71</td>
</tr>
<tr>
<td>Children’s tuberculosis</td>
<td>5.18</td>
</tr>
<tr>
<td>War invalids</td>
<td>6.48</td>
</tr>
<tr>
<td>Daytime inpatient</td>
<td>3.89</td>
</tr>
<tr>
<td>Unpaid blood donors</td>
<td>3.91</td>
</tr>
<tr>
<td>Paid blood donors</td>
<td>1.71</td>
</tr>
</tbody>
</table>

These norms translated minimum physical quantities into ruble amounts and were used to determine the costs of operating existing facilities (box 9.1). For example, norms would determine the ruble amount needed to maintain an existing hospital bed. By 1993 inflation had rendered the expenditure norms useless in determining the required financial outlays. Subnational governments are still bound by salary schedules and some physical mandates on numbers of employees and levels of service, but otherwise have discretion on the mix of expenditures.
Under this system of expenditure norms, the food budget of an Oblast hospital, for example, was calculated using the per capita daily food expenditure norms for each of seventeen different patient/hospital categories—a tuberculosis patient was allotted 4.71 rubles (in 1991) for food, while children and maternity patients received the maximum allowance of 7 rubles, and infants were allotted only 1 ruble a day. Each category's ruble amount (expenditure norm) was then multiplied by the corresponding expected number of patient-days per year to determine the food needs of the ward or specialized hospital. Total hospital budgets were calculated as the sum of the various norm-determined service costs for all patients, which included such things as medicine, physicians' visits, and even linen changings for each class of patient. Thousands of such norms for each spending category were issued by the Ministry of Finance and the specialized ministries under the old system.

Price liberalization since 1992 precluded establishing norms. Rather, physical norms were costed out by asking each locality to estimate the cost of providing each service item for schools, hospitals, and so on. The use of norms had a number of shortcomings. First, they were tailored to the existing capacity of public facilities, not to the actual needs of the population. Areas that were poorly served with infrastructure thus also had smaller recurrent budgets. Second, since the very existence of facilities justified a recurrent budget (based on norms) to maintain them, there was an incentive to keep underused facilities open. Thus, norms contributed to both inequitable and inefficient allocation of recurrent resources.


Improving spending assignments

The concrete and stable assignment of expenditure responsibilities is imperative to a well-functioning system of intergovernmental relations. Without it, the Russian Federation cannot move away from a negotiated form of intergovernmental relations, with all its undesirable consequences. As long as the federal level can change expenditure responsibilities at will, no approach to revenue sharing or assignment will work, and the absence of precise definitions of responsibilities will be a source of tension between the central and Oblast-level governments.
Concrete quantification of expenditure assignments is needed, but the basic analytic background work is incomplete. In addition to being clearly assigned, each function must in principle be priced so the government responsible is able to acquire and manage the funds necessary to provide the service. Ideally, a systematic, data-intensive study is needed to estimate the spending responsibilities of subnational governments and, in turn, their financing requirements. This task requires a function-by-function analysis of expenditure responsibilities based on broad indicators (for example, cost of education can be estimated from the number of students) and an estimate of the financial requirements, including new and recurrent expenditures. An assessment of the yield of alternative revenue assignments against these expenditure needs based on a simulation analysis of alternative assignment possibilities would follow. Such analysis is essential to determining the impact of any transfer of responsibilities, assets, or enterprises, or of any central mandates for wage increases and price ceilings.

Safety net spending. Reassignment of responsibility for social transfers and safety net expenditures should also be considered. Financing social protection for those most hurt by liberalization and economic restructuring will be a challenge, and it is not clear that subnational governments alone should be saddled with this responsibility. Many analysts believe that the decision to transfer responsibilities for social assistance and the safety net to subnational governments was made too quickly. Oblast and rayon governments are not currently well positioned to finance redistributional programs, although they may be able to administer direct transfers if funding is provided.

The adequacy of Russia’s transfer system and safety net is (and will remain) a national priority during the difficult transition ahead and should not be the responsibility of subnational governments alone (Barr 1993; Wallich 1992a, 1994). The central government is in a better position to finance social assistance or welfare subsidies (most likely in the form of cash) for the needy, although administration of the cash-based transfer programs is best done closer to home. Rayon administrations could use some form of targeting—income or means testing—to identify needy recipients. The rayons might continue to administer this social safety net, with reimbursements based on payments made by the federal level through cost reimbursement grants.

Capital investment spending. Capital expenditure assignment also requires reexamination. In principle, the responsibility of subnational governments should be limited to capital investments of a local nature that correspond to their assigned responsibilities for current expendi-
tures, such as for schools, local roads, and other subnational infrastructure. Decentralizing investment responsibilities for capital goods with a local benefit zone to subnational governments can increase efficiency, provided that the subnational governments have adequate funds. Oblasts have a better understanding of the type and level of investment required. Unifying the decisionmaking process for investment and recurrent spending and maintenance also will address the perverse incentives (such as the incentive to neglect maintenance) associated with assigning capital spending to one level and recurrent budgets to another.

Several constraints on the flexibility and discretion of subnational government budget activities impede realizing the gains in efficiency from decentralization. These constraints include the scrutiny, if not the required approval, of the Ministry of Finance, the effective limits placed on subnational spending by the negotiated tax shares, and, for deficit oblasts, the negotiation of agreed expenditure levels and subventions. Also, unfunded mandates from higher to lower levels of government reduce subnational autonomy and can destroy the balance of intergovernmental relations. Unfunded expenditure mandates in the Russian Federation include shifts in social and investment responsibilities and across-the-board wage increases and pension adjustments that are required regardless of the budgetary position of the oblast government. Many would uphold the principle that there should be no mandates without funding (McDowell 1994).

Revenue system and structure

The revenue- and tax-sharing system in place when Russia gained independence in 1991 was an extension of the system that governed intergovernmental relations in the former Soviet Union. Beginning in November 1991 the Russian Federation took over the Union's revenue and expenditure responsibilities and began to pursue sovereign tax policies. Broadly, the Russian system of revenue sharing was characterized by two distinct features. First, unlike in most intergovernmental fiscal systems, in which the center collects and shares national revenue with lower levels of government, revenue in the Russian system is shared upward from rayons to oblasts and then to the federal budget. Upward sharing contributed to the dissolution of the U.S.S.R., as republics stopped making transfers to the state, and a similar vulnerability exists today for the Russian Federation. Second, the system is not a system, but a collection of ad hoc, negotiated, nontransparent agreements whose effects are not well understood. The bargaining inherent in this system makes subnational governments highly dependent on the center and creates considerable uncertainty about their fiscal autonomy and responsibilities.
Subnational revenues and revenue shares

Most subnational government revenues are derived from shared taxes whose rates and bases are set by the federal government. All taxes are shared on a derivation basis, that is, with the jurisdiction in which they were collected. Sharing rates are set by the government and the Duma. Russia's national tax system includes the familiar set of market economy taxes: personal income tax, corporate income tax, value added tax, excise taxes, and taxes on natural resources and trade (box 9.2). Actual data for 1992 and budget estimates for 1993 show that subnational governments obtained more than two-thirds of their revenues from four taxes: personal

Box 9.2 Major taxes in the Russian Federation, 1993

**Personal income tax (PIT).** The PIT is a federal tax withheld by employers that applies to most wage earners. A standard deduction, exemptions for children and other dependents, and several other deductions are allowed. While in principle the PIT incorporates a schedule of rates ranging from 12 percent to 60 percent, it is essentially a flat rate tax: the bracket of 12 percent is wide, applying to annual income of up to 250,000 rubles—more than ten times the prevailing minimum wage. The highest rate—60 percent—applies to earned income that, when the tax was introduced, exceeded the minimum wage by more than 100 times. The self-employed are required to file and pay the PIT quarterly. For the purposes of tax assignment under the Basic Principles law, the PIT is assigned to the locality of the taxpayer's employment, not his residence. In the law, PIT is assigned 100 percent to the oblast level. Oblasts may pass it on to rayons.

**Company income tax (CIT).** This tax was modeled after the corporate tax of industrial countries and is levied at a rate of 35 percent. The law permits oblast-level governments to offer exemptions and preferences on the part of the CIT that accrues to the oblast level. While 100 percent of CIT accrues to the oblast level by law, it is being divided in 1994 between federal and oblast levels, which receive 13 of 35 percentage points and 22 of 35 percentage points, respectively. The CIT has several shortcomings: no adjustments are made to insulate taxable profits from inflation, and depreciation rules do not yet conform to any notion of economic depreciation. There is a move to reform the CIT by replacing it with a tax on the enterprise's income—defined as profits plus wages. This change would seek to discourage excessive wage increases in state enterprises. Special laws deal with the taxation of the net income of the banking and insurance sectors.

**Value added tax (VAT).** The federal VAT was introduced on January 1, 1992 to replace both the classic turnover tax (which was levied on the
income tax, company income tax, value added tax, and excises (table 9.2). 
In 1992 these taxes accounted for about three-quarters of subnational revenue. Subventions and transfers to autonomous regions in 1992 amounted to less than 13 percent of subnational government revenues, a figure lower than many would expect. The remaining 14 percent of subnational revenues came from a number of smaller subnational taxes and fees. Budget estimates for 1993 suggest a similar pattern, though there has been some increase in the reliance on subventions. On average, subnational governments retained about 45 percent of total national tax collections in 1992 (table 9.3). When subventions and transfers are factored in, the subnational share of total national revenues is closer to 60 percent.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Tax Type} & \textbf{Example} \\
\hline
Income tax & Company income tax, value added tax, excises \\
\hline
\end{tabular}
\caption{Examples of Subnational Taxes}
\end{table}

The difference between administratively set retail and wholesale prices) and the 5 percent sales tax that had gone into effect in February 1991. Under the VAT, exports outside the Commonwealth of Independent States are zero rated. Imports from the rest of the world were exempt until 1993. The standard rate is 28 percent, but in February 1992 a 15 percent rate was introduced for retail sales of some foodstuffs. Some oblasts have also made unilateral adjustments (downward) to VAT rates applicable in their territory. VAT is shared between the center and oblasts; in 1994 oblasts receive 25 percent, and the federal level 75 percent.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Tax Type} & \textbf{Example} \\
\hline
Excise taxes & Federal taxes on alcoholic beverages, tobacco products, automobiles, and some luxury goods at rates varying from 14 percent to 90 percent. These rates are expressed as a proportion of the excise-inclusive price. For spirits, for example, the statutory rate of 90 percent means that for every 100 rubles paid by purchasers, 90 rubles are tax and 10 rubles are kept by the producer. The 90 percent rate thus corresponds to an implicit rate of 900 percent on the excise-exclusive price. Excises are not levied on exports outside the Commonwealth of Independent States area, nor on imports. Excises are shared between the federal and subnational governments, with rates identical for all oblasts, but sharing rates depend on the type of commodity. All excise taxes collected from beer, leather, fur, and certain other luxury items are retained locally and go to the oblast government. The excise on vodka is evenly shared by the federal and oblast levels. Motor vehicle excises are a federal revenue. About 60 percent of all excise tax collections are allocated to subnational governments.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Tax Type} & \textbf{Example} \\
\hline
Other taxes & Other legislation imposes taxes on inheritance and gifts, individual property (automobiles and real estate), transfers of bonds, stocks, and other securities, and various small taxes and stamp duties. Most of these are federal taxes.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Tax Type} & \textbf{Example} \\
\hline
Other taxes & Inheritance and gifts, individual property, transfers of bonds, stocks, and other securities.
\hline
\end{tabular}
\caption{Examples of Other Taxes}
\end{table}

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Tax Type} & \textbf{Example} \\
\hline
Source: Ministry of Finance of the Russian Federation.
**Table 9.2 Distribution of subnational government revenues, Russian Federation, 1992–93**

(billions of rubles)

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>1992&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Percentage of total</th>
<th>1993&lt;sup&gt;b&lt;/sup&gt;</th>
<th>Percentage of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>431.3</td>
<td>16.1</td>
<td>1,837</td>
<td>11.5</td>
</tr>
<tr>
<td>Company income tax</td>
<td>920.9</td>
<td>34.5</td>
<td>5,522</td>
<td>34.9</td>
</tr>
<tr>
<td>Value added tax</td>
<td>498.1</td>
<td>18.6</td>
<td>2,614</td>
<td>16.4</td>
</tr>
<tr>
<td>Excise taxes</td>
<td>110.8</td>
<td>4.2</td>
<td>697</td>
<td>4.4</td>
</tr>
<tr>
<td>Land and property tax</td>
<td>108.6</td>
<td>4.1</td>
<td>Included in</td>
<td>n.a.</td>
</tr>
<tr>
<td>Natural resources royalties and payment</td>
<td>104.7</td>
<td>3.9</td>
<td>Included in</td>
<td>n.a.</td>
</tr>
<tr>
<td>Stamp duties and other nontax revenue</td>
<td>—</td>
<td>—</td>
<td>Included in</td>
<td>n.a.</td>
</tr>
<tr>
<td>Revenues from privatization</td>
<td>43.4</td>
<td>1.6</td>
<td>Included in</td>
<td>n.a.</td>
</tr>
<tr>
<td>Other taxes</td>
<td>125.6</td>
<td>4.7</td>
<td>2,385</td>
<td>15.0</td>
</tr>
<tr>
<td>Subventions</td>
<td>142.5</td>
<td>5.3</td>
<td>2,860</td>
<td>18.0</td>
</tr>
<tr>
<td>Transfers to autonomous regions</td>
<td>186.1</td>
<td>7.0</td>
<td>Included in</td>
<td>n.a.</td>
</tr>
<tr>
<td>Total</td>
<td>2,672.3</td>
<td>100.0</td>
<td>15,917</td>
<td>100.0</td>
</tr>
</tbody>
</table>

n.a. Not applicable.
— Not available.

Note: In 1992 the average exchange rate was 196 rubles = 1 U.S. dollar, and in 1993, 933 rubles = 1 U.S. dollar.

<sup>a</sup> Actual.
<sup>b</sup> Budgeted.

Source: Ministry of Finance of the Russian Federation.

**How revenues are shared**

Russia's first attempt at formalizing and legislating revenue sharing was made in 1991 with the Law on the Basic Principles of Taxation, never fully implemented. Since then, revenue shares have been determined in each quarterly Budget Act. In the 1994 formally legislated tax shares (summarized in table 9.4), the personal income tax was fully retained by local governments (rayons), with revenues flowing to the rayon of employment. For 1995, 15.5 percent of the personal income tax revenues will accrue to the federal budget. Revenue yield is strongly sensitive to the current high rates of inflation and resulting changes in tax brackets, personal exemption levels, and wage levels. The tax is administered by the enterprises, who collect it on a withholding basis and keep all employee records.
Table 9.3 Revenue sharing by type of tax, Russian Federation, 1992–93
(percentage of total collections)

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>1992 subnational retention</th>
<th>1993 budgeted subnational retention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>Company income tax</td>
<td>58.8</td>
<td>66.7</td>
</tr>
<tr>
<td>Value added tax</td>
<td>24.9</td>
<td>30.4</td>
</tr>
<tr>
<td>Excise taxes</td>
<td>52.3</td>
<td>61.5</td>
</tr>
<tr>
<td>Foreign trade taxes</td>
<td>1.7</td>
<td>—</td>
</tr>
<tr>
<td>All other taxes</td>
<td>65.2</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>44.7</td>
<td>43.4*</td>
</tr>
</tbody>
</table>

-- Not available.

* This total refers only to excises and the income and value added taxes.
Source: Ministry of Finance of the Russian Federation.

Table 9.4 Federal revenue-sharing rules, Russian Federation, 1994

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>Amount allocated to subnational government</th>
<th>Method of distribution among oblasts</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>100 percent</td>
<td>Derivation, by place of employment</td>
<td>Fully allocated to the rayon level</td>
</tr>
<tr>
<td>Company income tax</td>
<td>Tax rate is up to 38 percent; 13 percentage points belong to the central government</td>
<td>Derivation, by place of employment</td>
<td>Oblast may reduce rate</td>
</tr>
<tr>
<td>Value added tax</td>
<td>25 percent*</td>
<td>Derivation</td>
<td>75 percent accrues to the federal government, of which 22 percent is redistributed to subnational governments for subventions</td>
</tr>
<tr>
<td>Excise on vodka</td>
<td>50 percent</td>
<td>Derivation</td>
<td>Excise on motor vehicles are fully allocated to the federal level</td>
</tr>
<tr>
<td>Other excises</td>
<td>100 percent</td>
<td>Derivation</td>
<td>Distribution largely based on approved deficits and special projects</td>
</tr>
</tbody>
</table>

* The rate varied, with an ad hoc determination of the percentage for each oblast until 1994.
Source: Ministry of Finance of the Russian Federation.
An enterprise income tax of 35 percent is levied on company profits. Oblast-level governments may retain an amount equivalent to 22 percentage points and must turn the remaining 13 percentage points (about 37 percent of revenues) over to the federal government. Oblasts may increase the tax rate to 38 percent or reduce it to 33 percent, but the federal claim must remain at 13 percentage points. Revenues from the enterprise income tax are sensitive to federal decisions about input and output prices, capital consumption allowances, and redefinitions of the tax base. The tax-sharing rates were changed frequently throughout 1992, 1993, and 1994, often quarterly.

The value added tax (VAT) is shared with subnational governments on a derivation basis, but until early 1994 the share of collections that could be retained varied by oblast, with some retaining as much as 100 percent and others as little as 10 percent (table 9.5). On average, oblasts retained about 20 to 30 percent of VAT collections in 1992. These retention rates were established in an ad hoc way and were changed frequently in the past years. In 1993 most oblasts retained 40 to 50 percent of VAT collections, although the subnational sector retained 30 percent as a whole (see table 9.3). In 1994 the VAT sharing rate was a uniform 25 percent for all oblasts, with 75 percent going to the federal budget.

The trend in the tax retentions appears to favor subnational governments when subventions (discussed below) are included, though it is not clear whether the increase has been sufficient to offset increased expenditure responsibilities (Martinez-Vazquez 1993b).

### Table 9.5 Retention rates for the value added tax, Russian Federation, 1992–94

<table>
<thead>
<tr>
<th>Retention rate (percent)</th>
<th>1994</th>
<th>1993</th>
<th>1992, Q2</th>
<th>1992, Q1</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 10</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>14</td>
</tr>
<tr>
<td>11 to 20</td>
<td>0</td>
<td>24</td>
<td>89*</td>
<td>11</td>
</tr>
<tr>
<td>21 to 30</td>
<td>89</td>
<td>2</td>
<td>0</td>
<td>19</td>
</tr>
<tr>
<td>31 to 40</td>
<td>0</td>
<td>3</td>
<td>0</td>
<td>17</td>
</tr>
<tr>
<td>41 to 50</td>
<td>0</td>
<td>60</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>51 to 60</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>4</td>
</tr>
<tr>
<td>61 to 70</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>71 to 80</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>81 to 90</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>91 to 100</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>13</td>
</tr>
<tr>
<td>Total number of oblasts</td>
<td>89</td>
<td>89</td>
<td>89</td>
<td>89</td>
</tr>
<tr>
<td>Median retention rate</td>
<td>25</td>
<td>30</td>
<td>20</td>
<td>30</td>
</tr>
</tbody>
</table>

*All eighty-nine oblasts were given identical value added tax sharing rates during this quarter; 20 percent. Variable sharing rates resumed thereafter.*

Subventions and transfers

Under the system that prevailed until 1992-93, transfers played a minimal role, since the major emphasis was on shared taxes allocated on a derivation basis. At the end of the quarter the Ministry of Finance would provide ex post subventions to oblasts on the basis of its assessment of their needs. Thus, neither the amount nor the distribution of these subventions was formally established beforehand. And there was no entitlement to any transfer.

In a notable move away from the old system, the budget plan for 1994 called for a more objective method of revenue distribution. In principle the bargaining scheme was replaced by a formula-based method of determining subventions for oblasts needing "some support" and oblasts needing "considerable support." Subventions for oblasts needing some support are being granted to those oblasts with per capita revenues below the oblast average revenue level in an amount sufficient to bring them up to the average. To finance both kinds of subventions in 1994, a fund equivalent to about 16 percent of the VAT (22 percent of the federal VAT share, which in turn is 75 percent of total national VAT collections) was set aside. About three-quarters of the fund went to oblasts "needing considerable support" with below-average revenues in 1994. The remaining revenue went to oblasts that could not meet their agreed expenditure needs even after receiving their subventions. The definition of these expenditure needs is negotiated with the Ministry of Finance in the course of budget discussions. So these additional subventions remain negotiable, both in volume and allocation. In practice, some oblasts with above-average "agreed" expenditures and above-average tax ratios are also benefiting. Thus, in 1994 subventions went to fifty-eight oblasts needing "some support" and to twenty-three oblasts needing "considerable support." The 22 percent share of the federal VAT share has proved insufficient; in early 1994 the Ministry of Finance estimated that at least 30 to 35 percent of the federal VAT would be needed; in the 1995 budget 27 percent of federal VAT revenues are slated for the fund (about 20 percent of total VAT collections).

This transfer system has questionable incentive effects on oblasts. First, tax effort is not rewarded since actual revenue collections rather than revenue capacity is used in the formula. (This assumes subnational governments can influence the collections vigor of national taxes such as the VAT, through their influence on local State Tax Service officers.) Second, oblasts, whether falling just below average revenues or well below the average, all benefit by being brought to the same level—the average. Third, providing subventions to oblasts that cannot meet agreed expenditure needs may benefit high-spending oblasts that have
above-average revenues. Designing well-functioning transfer systems is discussed in depth later in the chapter.

Special fiscal regimes

Since independence several oblasts have adopted special fiscal relations with the federal government that are without legal sanction and that violate the revenue-sharing conventions (Litvack 1994; see also chapter 10). In Bashkiria the oblast government has negotiated a single-channel agreement with the federal government under which it retains all revenue from all taxes collected in its territory and transfers a fixed nominal amount each month to the federal budget. This agreement has not been sanctioned by the Parliament. Urmut has a single-channel agreement similar to Bashkiria’s. Since March 1992 Tatarstan, an oil-rich oblast with potentially huge natural resource revenue, has withheld revenue transfers from the Ministry of Finance. About twenty oblasts, at one time or another, have unilaterally decided to determine what proportion of taxes they will share with the center. The refusal to remit what is due to the federal budget is made possible by Russia’s “bottom-up” system of tax administration in which revenues are collected (and withheld) below, and passed on to the oblast and, finally, the federal budgets. Oblast tax departments have the ability, if not the authority, to withhold revenues they collect, and thus to bargain for a better deal.

The proliferation of such regimes poses a danger to the Russian Federation, just as the failure of the Union republics to contribute to the Union budget helped foster the dissolution of the U.S.S.R. in 1991. The Supreme Soviet (Duma) has threatened to apply sanctions to oblasts that pursue either single-channel agreements or unilaterally determined sharing rates. The sanctions would stop all central budgetary expenditure and investments on the territory, withhold the oblasts’ export and import licenses, deny central bank credit, halt material supply from the central supply system, and withhold cash or currency. These measures, whose threat is more apparent than real, reflect the limited tools available to the federal government to influence subnational behavior (see chapter 10).

Tax administration

Until November 1991 the State Tax Service, a department within the Ministry of Finance, was responsible for tax administration. Revenue collection was undertaken by highly decentralized oblast and rayon tax offices supervised by their own oblast finance departments and by finance officers of the federal ministry. No single authority or revenue commissioner was in charge of all tax administration activities. This
dual leadership—with tax officers reporting to both the Ministry of Finance and the subnational government—caused a conflict of interest, and oblast interests often received priority. Why? Because locally owned enterprises generate employment and are a measure of the success of local officials, so local authorities benefit by keeping taxes low and increasing the proportion of earnings retained in enterprises and thus in the local area—a practice local tax officials may be encouraged to permit. Such enterprise-retained earnings could be used for social service expenditures or tapped for donations to local projects.

Since 1991 the State Tax Service has been an autonomous agency with ministerial ranking. It is now in charge of administering all taxes in the Russian Federation through its three-tiered organizational structure: central, oblast, and rayon. Although the dual leadership structure has been formally replaced, conflicts of interest remain, in part for historical reasons. Local State Tax Service officials remain closely tied to local finance departments, and there is no rotation of personnel. Most local State Tax Service officials were part of the local finance office and many are lifelong residents of the community. In some instances, the local oblast administration is responsible for providing local State Tax Service staff with housing, utilities, and other fringe benefits such as food coupons and other noncash allowances, which in the Russian system can provide over half of the total compensation package. Local governments may also contribute wage bonuses to tax officials although the wage itself is paid out by the state. Thus, while strictly speaking local tax administrations are the deconcentrated arm of the central administration, in practice, their loyalties and their ties to the local authorities are strong. Dual subordination, though formally ended, has by no means disappeared, and local tax officers and offices still may respond strongly to local policy concerns. The internal organization of the nationwide State Tax Service must be strengthened to improve resource mobilization and institute a workable intergovernmental system. Without it, the federal budget remains vulnerable. Ultimately, Russia should aim to have a strong, centralized system of tax collection—which, up to now, it has had more in form than in substance. Separate subnational administrations for local taxes may be appropriate in the future.

**Macroeconomic dimensions of subnational finance**

Tax policy, tax administration, and revenue sharing are integral components of the intergovernmental fiscal structure in Russia, and subnational government finance has important consequences for macroeconomic policy. In fact, the current transitional approach to intergovernmental fiscal relations may threaten the success of Russia's macroeconomic
stabilization program. The current system does not explicitly provide funds to meet the expenditure responsibilities that have been shifted down to subnational governments. Thus, subnational governments look for backdoor approaches to create the revenue sufficiency the system does not provide and to balance their budgets. This combination of bottom-up tax administration, increased expenditure responsibility, extra-budgetary funds, and subnational government borrowing through enterprises allows them to do this, but can complicate macroeconomic management and is potentially destabilizing (EBRD 1994; Sachs 1994a, 1994b). Subnational deficits cannot on their own create macroeconomic problems since subnational governments do not print money. But, because subnational governments have little authority to expand their own revenues, deficits are increasingly being financed by credit expansion, with subnational deficits being monetized through central bank loans to local enterprises, banks, and governments. Not only does this put pressure on national budget policy but it also disguises the root of the problem. Advocates of a strong stabilization policy argue that the federal government must regain control over all of these aspects of revenue mobilization and expenditure determination. It must also design a properly functioning intergovernmental system. And monetary and structural reforms will be needed.

Russia's stabilization challenge

Stabilization remains a major challenge. Macroeconomic performance in the Russian Federation has been sluggish over the past few years, with inflation—and sometimes hyperinflation—plaguing the nation, along with falling output and employment. In 1992 inflation was 1,354 percent. It fell to 895 percent in 1993 and subsided slightly in early 1994. The 38 percent drop in GDP since 1991 has reduced government revenues at a time when the government's fiscal responsibilities have expanded, squeezing an already tight budget. In 1992 budget revenues were 31.5 percent of GDP, spending 37.8 percent, and the fiscal deficit 18.2 percent. In 1993 revenues and expenditures fell slightly as a percentage of GDP, to 29.2 percent and 34.8 percent, respectively, and the fiscal deficit remained high at 7.9 percent of GDP. The actual budget deficit was estimated at 10 percent of GDP in 1994, and in 1995 the forecasted budget deficit is 7.8 percent of GDP. This fiscally strained situation both limits and influences the government's options for the design of an intergovernmental fiscal system. The center argues, for example, that it cannot cede control over any of the major tax bases to the subnational level.

The government's current stabilization program implies fiscal austerity at both the central and subnational levels and calls for
implementation of a federally directed program of tax rate adjustments and expenditure cuts. On the revenue side, the value added tax, corporate income tax, and personal income tax were all changed significantly in 1992 and 1993. The 1994 fiscal program called for revisions in the taxation of petroleum products and foreign trade. The 1995 budget proposes lowering the profit tax and the value added tax while increasing the personal income tax. On the expenditure side, continued cuts are planned in investment, producer and consumer subsidies, and operational and maintenance outlays. Priority will be given to certain types of investment and social protection. Social protection expenditures, financed from subnational budgets, are projected to increase significantly during this transition period.

The federal government has the policy tools in principle to design such a program, including the authority to set expenditure and tax levels and to adjust revenue sharing to ensure budgetary balance at the federal level. But it may not have the power to implement such a program. For example, in the past two years some oblast governments have been unwilling to remit the full federal revenue entitlement; others may have dampened tax collection rates by encouraging the local tax administration officials of the State Tax Service to overlook revenue obligations of local enterprises; still others have made the case for significant increases in their subventions and tax-sharing retention rates. Thus, it is not clear to what extent the federal government has been able to control the rate of revenue mobilization and the division of shared revenues.

Revenue-expenditure mismatches

Until recently most cuts in expenditures other than consumer subsidies have affected primarily the federal budget. The central government's strategy has been to push the deficit down by shifting unfunded expenditure responsibilities to subnational governments, hoping that they will cut costs. The shift of financing responsibility for major social expenditures and capital investment to the subnational level suggests that much of the additional expenditure will have to be financed from local sources, worsening the vertical imbalance in the intergovernmental fiscal system and increasing horizontal imbalances between oblasts with a robust revenue base and those without. Other factors heighten the mismatch between revenues and expenditures at the subnational level: federal price controls on local services and rents, the cost of the social safety net and capital investments, pressures from wage and other mandates, and the assumption of the myriad public expenditure responsibilities (for education, health, and housing) now handled by state enterprises.
The success of the macroeconomic reform program depends on how subnational governments respond to this pressure and to what extent the federal government holds to its course. If the center transfers additional resources to the oblasts—for example, by allowing greater subnational revenue retentions or granting larger subventions—so that oblasts can fulfill their new expenditure responsibilities, the enlarged fiscal deficit and its possible monetization could destabilize the economy. If the federal government resists transferring adequate financial resources, subnational governments could address the fiscal squeeze with other solutions that threaten economic reform and stability.

Subnational governments already have developed several coping mechanisms to deal with the restrictive federal policies:

- Spending above allowable limits and accumulating arrears that may come to be monetized.
- Negotiating increased subventions or higher value added tax retention rates with the center, depriving the center of revenues.
- Failing to turn over the federal share of tax revenues, with similar effects.
- Borrowing from locally owned banks (or borrowing through local enterprises, to evade the current ban on local government borrowing), thus possibly monetizing the subnational deficit if these additional credit demands are validated by credit expansion at the central level.
- Relying more on locally owned enterprises to finance infrastructure investments, with the additional credit demand this can imply.
- Protecting the local tax base by supporting local enterprises with trade barriers and purchasing restrictions.
- Pressuring locally owned banks to increase credit to area enterprises, which is in turn monetized.

These mechanisms, when deployed in response to misaligned expenditure and revenue responsibilities, could threaten macroeconomic stability and privatization (Sachs 1994a, 1994b; EBRD 1994). Perversely, economic stabilization efforts pursued through deficit reductions at the federal level are inducing responses at the subnational level that could further destabilize the economy. Moreover, some of these local reactions (such as extrabudgetary funds, arrears, and quasi-fiscal operations of banks) reduce budgetary transparency and make it more difficult for the federal government to monitor subnational fiscal activity. There is a need for new intergovernmental fiscal arrangements that fairly address the needs of each government level, that establish correspondence between expenditures and revenues, and that ensure that the pressures on budgets at the subnational level do not undermine the national stabilization effort. Without adequate own-revenues,
shared taxes, and transfers, and with increased expenditure responsibilities, subnational governments will continue to resort to solutions that could threaten stabilization and overall economic reform.

**Borrowing and extrabudgetary funds**

Budget laws have given subnational governments an unlimited right to borrow funds and to establish and own banks, but the authority to borrow was suspended by the central bank from 1992 until recently. In 1994 a number of oblasts issued local bonds. While the use of credit by subnational governments is currently limited by the absence of suitable financial markets, it is an important aspect of intergovernmental finances and could have major macroeconomic repercussions.

Subnational borrowing is a critical issue in intergovernmental finance. In some industrialized countries, including the United States, state and local governments have substantial discretion to use debt financing. In other countries subnational governments cannot borrow at all. The federal government in Russia may want to limit or prohibit subnational government borrowing for macroeconomic reasons, such as inflation control, spending reduction, and the fear that some oblast-level governments might acquire heavy debts because of highly volatile revenue and expenditure developments. In the long run, oblasts or large cities might be granted some discretion in using debt, such as in bond financing of long-term capital investments (see chapter 1).

Another source of subnational government financing is extrabudgetary revenues, including past unspent funds, voluntary contributions, funds from commodity auctions, tax penalties and other fines, certain nontax revenues, and loans. At the subnational level, the use of extrabudgetary funds has grown rapidly as a result of the increased spending responsibilities that have been passed on to subnational governments. Extrabudgetary funds are attractive to oblasts because they can spend them at their discretion, whereas most budgetary funds are subject to some degree of higher-level approval. Another advantage of these revenues is that they need not be shared with higher levels, giving oblast governments an inducement to shift as much of their revenues as possible from the budgetary to the extrabudgetary category.

The proliferation of extrabudgetary funds at the subnational and national levels presents serious problems for effective budgetary management by the federal government. There are now more than twenty extrabudgetary funds at the national level and an unknown number at the subnational level. The principal national funds are earmarked for social purposes (Pension Fund, Social Insurance Fund, and the like) and for investment (Road Fund, Fuel Fund, Research and Development Fund). The use of extrabudgetary funds reduces the transparency of
consolidated budgetary operations, making it difficult to assess the impact of aggregate fiscal policy as well as its sectoral impacts. Recently, the revenues of federal extrabudgetary funds were estimated at 107 percent of federal budgetary revenues, and 58 percent of consolidated budget revenues (Dubinin 1994), bringing total public revenues up to 48 percent of GDP (from 31 percent). Extrabudgetary funds function as parallel accounting systems, outside the structures of conventional budgetary procedures. The use of these funds is an inefficient budgetary practice from the federal government's point of view because they provide loopholes for public sector operations not approved through proper budgetary channels and thus weaken fiscal policy as a macroeconomic instrument. Moreover, by clouding subnational budgetary aggregates on both spending and revenue sides, extrabudgetary funds can complicate the task of transfer design and equalization policies.

On the other hand, the availability of extrabudgetary funds may improve the efficiency of subnational government spending by allowing greater spending discretion than is allowed them for their budgetary funds, which remain subject to central scrutiny and norms. Indeed, the greater spending discretion that extrabudgetary funds provide is the main attraction for the subnational governments as well as for the central government ministries and agencies that use off-budget accounts to cloud spending priorities and ceilings. However, earmarking via extrabudgetary funds creates its own inefficiencies. Earmarking is in general only justified if the taxpayers are also the beneficiaries, if it ensures the quality of the service or revenue collection, and if it will lead to the appropriate quantity of the service being provided (McCleary 1989).

Because of the macroeconomic disadvantages of loose budgetary control and the informational complications implicit in this practice, there is a reasonable case for discontinuing the extrabudgetary accounts. However, the creation of these funds is within the law, and the practice is now well entrenched. A realistic transitional approach for the central fiscal authorities would be to require subnational governments to disclose information about the sources and uses of extrabudgetary funds while this financial practice is phased out.

Decentralization and privatization

The shifting of ownership and the privatization of enterprises have had a significant effect on subnational government budgets. Because the focus of policymakers and advisers has been directed to the efficiency aspects of the private sector takeover of production, intergovernmental fiscal dimensions of privatization are often overlooked. In Russia the privatization
Process may result in a revenue inflow for local governments from the sale of assets because the government that owns the enterprise recovers the proceeds from the sale of its assets. Dividends, rents, and lease income also accrue to the owning government at the time of divestment. Revenues from privatization accounted for about 1.6 percent of total subnational government receipts in 1992 and account for more now (Le Houerou 1994). There are no guidelines on using revenue from the privatization of public enterprises, but the most common practice is to add the proceeds to general budgetary revenues. However, the privatization process will also result in the transfer of significant expenditure responsibilities from enterprises to local governments. When enterprises are privatized, there is often a need to transfer social assets to local governments, resulting in an increased claim on local government revenues. Thus, the net fiscal impact on local budgets of the privatization and decentralization of enterprise ownerships is far from clear (Bahl and others 1993).

**Asset transfers and entrepreneurial activities of subnational governments**

Oblast and rayon governments are becoming owners of business enterprises, housing, and vacant urban land as such assets are transferred from the central government in the course of decentralization. These asset transfers are a mixed blessing. They are consistent with rhetoric about more subnational autonomy, and they increase subnational government gross wealth. But they may bring subnational governments increased maintenance and subsidy burdens. Many of the enterprises transferred to local governments require an operating subsidy, either because they provide local public goods at subsidized prices or because they are unprofitable.

There are only a few options: increasing user charges to hasten cost recovery, accelerating the privatization of assets (which may also imply absorbing their social assets into the local budget), and bargaining with the center for additional revenues. There do not appear to be hard estimates of the fiscal implications of asset transfers, nor has the federal government required that these estimates be made.

With the endorsement of new laws on local self-government, some subnational governments view their role as not only that of service provider, but also entrepreneur and producer. Localities appear optimistic about their ability to enhance revenue by establishing joint ventures with a domestic or foreign partner, or with another state enterprise, using locally owned assets as the equity share. Typically, these ventures involve purely private, "market"-oriented activities such as industrial products or hotel services.
There are good reasons for local governments in Russia to become involved in new joint ventures. Not only is there a prospect of increased revenues, but profits and dividends from such ventures can be treated as extrabudgetary revenues. There are also important drawbacks to the use of commercial ventures for revenue-raising purposes. First is the inconsistency with the government's goals for privatization. Second is the failure to distinguish between tax revenues and profits from the ownership of industry, which encourages an unhealthy form of intergovernmental mercantilistic rivalry. Local governments may be tempted to protect their enterprises from competition, for example, by prohibiting "imports" from adjacent oblasts. This practice perpetuates bureaucratic management, one of the main targets of the enterprise reform. Finally, the development of government business may have unfavorable fiscal consequences. Expectations of profit sharing in joint ventures can quickly turn into budgetary obligations to cover losses. Public officials tend to be poor business managers, confusing such objectives as income maintenance or retaining jobs with the objective of maximizing profits.

Enterprise provision of social services

Economic restructuring is predicated on government withdrawal from activities that can be more efficiently undertaken by private firms. But privatization also means that government must assume responsibility for some of the government services that were previously delivered by state enterprises (Bahli and others 1993). Enterprises construct and support hospitals, housing, kindergartens, and preschools and make donations to finance public transport systems and to supplement the extrabudgetary funds of subnational governments. Public enterprises also make capital investments in the social sectors that benefit the local population, including building schools and hospital facilities and then transferring their operation to oblast or rayon governments.

Subnational governments have long looked to state enterprises to finance many essential public services. The enterprise contribution was estimated at 40 percent of subnational budgetary outlays in early 1992 (Martinez-Vazquez 1994a). And in some one-company towns, all social infrastructure outlays may be undertaken by the enterprise with no budgetary funding at all. In Vorkuta, a one-company coal-mining town in the far north, nearly all social services, cultural facilities, parks, roads, infrastructure, education, housing, and health services are provided by the local coal enterprise. The rayon budget finances only routine public administration overheads. Currently, enterprises find it difficult to transfer their social spending responsibilities to subnational governments that
lack the resources to assume these new functions. Indeed, the reverse is true: as revenues diminish and their expenditure mandates increase, subnational governments increasingly try to rely on enterprises to provide basic services. Enterprises often have better access to credit than subnational governments do. This adds to pressures for credit creation. The federal government does not appear to have quantified the dimensions of this problem, nor has it planned a solution although experiments are ongoing to shed social assets.

There is another intergovernmental dimension to this issue. The spinoff of enterprises' social expenditures can reduce the need for government subsidies to enterprises or increase an enterprise's disposable after-tax profits. But under the current revenue-sharing system it is not certain that the revenue benefits will accrue to the same level of government that must pick up the added expenditure responsibility. For example, the local government may have to absorb all the added spending if a clinic is off-loaded; however, the incremental enterprise profit taxes go in large measure to the center. Concrete, quantitative analysis of the budgetary implications of this divestiture must be undertaken to determine whether the realignment of these expenditures corresponds with the local government's ability to finance them.

The tax-sharing and transfer system

The system of subnational government financing in the Russian Federation is in transition. In the long run, the intergovernmental fiscal system will almost certainly include some form of tax assignment, probably supported by an equalizing federal grant program. Russia is too heterogeneous, too heavily populated, and too geographically vast to succeed as a highly centralized fiscal federation. In the short time since the dissolution of the U.S.S.R., changes in fiscal federalism have been driven primarily by macroeconomic concerns. The central government has transferred expenditure responsibilities to lower-level governments to lighten its deficit and has made piecemeal tax-sharing adjustments to placate the now-overburdened subnational governments. Indeed, the greater spending discretion that extrabudgetary funds provide is the main attraction for the subnational governments as well as for the central government ministries and agencies that use off-budget accounts to cloud spending priorities and ceilings.

Given the instability in the Russian economy and political system, it is not surprising that the intergovernmental system is beset by problems. Neither the central nor the subnational governments have confidence in the current system, and they are calling for change. Since no single change can benefit both the federal government and all the oblasts—the
system is a zero-sum game unless reforms bring about greater spending efficiency—a compromise solution has been slow to emerge. The place to begin the search for such a compromise is with an understanding of the shortcomings of the current system.

**Correspondence between revenue assignment and expenditure needs**

Russia's current system does not provide correspondence between revenues allocated or assigned to subnational governments and the resources they need to deliver an adequate level of services in their assigned spending functions. Governments worldwide always have a revenue shortage—they are never able to deliver all the services they would like. But the problem with the intergovernmental financing system in Russia goes beyond this chronic revenue problem. The balance between the federal and the subnational government levels is simply not right. From the subnational governments' perspective, the central government has given them expenditure responsibilities without a corresponding revenue share, revenue base, or independent taxing powers. From the federal perspective, the subnational share of revenues has been increasing and now exceeds 60 percent.

One problem is in the system design. Revenues flowing to the subnational sector and to individual oblasts are determined by the size of their taxable base and by sharing rates for each tax. Neither the income tax bases nor the value added tax sharing rate are necessarily related to the amount of financing required to support a normal level of subnational expenditures. If revenue is overassigned to the subnational governments, there is no way to return revenue to the center under the current laws. If revenue is underassigned, there is no legal requirement to systematically compensate for the difference. More generally, the problem is that revenue allocation decisions seem to have been made early on, independent of decisions about expenditure responsibilities. Instead, expenditure responsibilities should be identified first, so that an appropriate revenue allocation system can be designed.

**Tax assignment and tax sharing**

In December 1991 Parliament passed a Law on the Basic Principles of Taxation assigning all of the federal personal and corporate income tax to subnational governments and the value added tax to the federal government (see annex 9.1 at the end of the chapter). This proposal was not well designed in that many important issues were not addressed. Would these revenues be sufficient to meet oblast needs? Would an equalizing
grant mechanism compensate for differences in oblast fiscal capacities? What tax rate-setting authority would subnational governments have? How would taxable profits be determined for enterprises operating in more than one oblast? The Basic Principles law—silent on all these issues—was never implemented, but it did raise a debate over tax assignment as compared with tax sharing.

The Basic Principles law introduced a system that relied only on tax assignment, a major departure from the system existing under the Soviet Union and the current system of sharing the value added tax and the corporate and personal income taxes. Strictly speaking, this was not a system of tax assignment, since it gave subnational governments no control over the rate or the base of assigned taxes. Tax assignment that preferably also gives some autonomy over rate or base to the subnational governments is an important part of the long-term solution. The current setting, however, may not be conducive to the radical change that a system of pure tax assignment would create.

Assigning federal taxes (over which oblasts have no control) to subnational governments leaves their budgets vulnerable to changes in central government economic policies: any changes that the center might make in the rate or base of an assigned tax could have critical, unintended effects on subnational revenue. This has already occurred with the recent changes to the federal personal income tax (100 percent of whose revenues accrue to the subnational level) and the value added tax (which accrues in part to the oblast level). Furthermore, such impacts could vary substantially across oblasts in a way that would be hard to predict. Greater instability of subnational revenue could also result, since the base of any one (assigned) tax is more volatile than the base of the entire (shared) tax system. Thus, tax assignment would make subnational government revenue more volatile. In sum, while tax assignment might appear to reduce the dependence of subnational governments on the center, in the sense that all revenues from an assigned tax would accrue to subnational governments, this independence comes at a heavy price since localities would remain vulnerable to centrally determined changes in the tax base and tax rates and would have no fiscal discretion of their own.

Furthermore, assignment is not compatible with an administrative system in which all revenues are collected by a federal tax administration service. As it becomes more centralized, there will be an incentive for the State Tax Service to be more efficient in collecting federal taxes than local taxes and under a tax assignment system, subnational collections might suffer. If all major taxes are shared with the center, as they are now, no such incentive would exist.
How revenues are allocated across oblasts

Is there some rough justice in the current system of revenue sharing, that is, are revenues implicitly distributed among the oblasts in a systematic way? To try to answer this question, a multiple regression analysis was carried out using actual 1992 data for eighty-eight oblasts, with per capita retained revenues (excluding subventions) as the dependent variable (Bahl and others 1993). The independent variables were chosen to reflect interoblast differences in public service needs and fiscal capacity. Of particular interest was whether some implicit formulas might be used to describe the current distribution of shared tax revenues, and whether the actual distribution of revenues across oblasts is related positively to fiscal capacity or expenditure needs. The proxy measures used to indicate fiscal capacity are:

- Average monthly wage.
- Percentage of the population living in urban areas.
- Population size.

Measures used to describe public services needs are:

- Hospital beds per 10,000 population.
- Percentage of the population over 65 years.
- Infant mortality per 10,000 population.
- Kilometers of roads as a percentage of land area.

Other expenditure needs measures, such as total school-age children, crime rates, and number of handicapped citizens, were not available for many oblasts.

Four results of this analysis stand out (table 9.6). First, about half of the variation in per capita retained revenues can be explained, suggesting that there are other important determinants of per capita revenues accruing to oblasts, or that much of the allocation process is random. Second, oblasts with larger populations retain more revenue on a per capita basis. Third, oblasts with a higher average wage and with higher average wage growth retain significantly more revenue per capita. Finally, there does not appear to be a strong correlation between needs variables and per capita retained revenues: hospital beds, infant mortality rates, and highway density are insignificant determinants of retained revenues. The concentration of elderly population, however, appears to be associated with higher levels of retained revenues.

Together, these results suggest that 1992 revenue distributions were driven in part by the strength of the economic base, that is, wage levels, wage growth, and population size. This finding is consistent with a similar analysis conducted by the World Bank on data for the first half of 1992 (Wallich 1994; Bahl 1994; Bahl and Wallace 1994).
Table 9.6 Determinants of subnational per capita revenues, Russian Federation, 1992
(ordinary least squares estimates)

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>Per capita retained revenue</th>
<th>Per capita subvention</th>
<th>Per capita retained revenue, Cheliabinsk oblast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-20.581</td>
<td>14.461</td>
<td>-1,927.14</td>
</tr>
<tr>
<td></td>
<td>(1.66)</td>
<td>(0.61)</td>
<td>(0.66)</td>
</tr>
<tr>
<td>Population (thousands)</td>
<td>1.40</td>
<td>-0.91</td>
<td>5.50</td>
</tr>
<tr>
<td></td>
<td>(2.67)</td>
<td>(0.76)</td>
<td>(2.82)</td>
</tr>
<tr>
<td>Per capita enterprise profits</td>
<td>..</td>
<td>198.54</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(4.60)</td>
<td></td>
</tr>
<tr>
<td>Average monthly wage</td>
<td>36.45</td>
<td>..</td>
<td>4.69</td>
</tr>
<tr>
<td></td>
<td>(3.98)</td>
<td>(0.80)</td>
<td></td>
</tr>
<tr>
<td>Percentage of population living in urban areas</td>
<td>-115.10</td>
<td>-28.21</td>
<td>37.91</td>
</tr>
<tr>
<td></td>
<td>(1.57)</td>
<td>(0.18)</td>
<td>(3.41)</td>
</tr>
<tr>
<td>1991–92 growth rate in monthly wage</td>
<td>1,373.63</td>
<td>-232.16</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(3.58)</td>
<td>(0.31)</td>
<td></td>
</tr>
<tr>
<td>Percentage of elderly in population</td>
<td>350.22</td>
<td>-1,247.10</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(1.61)</td>
<td>(3.29)</td>
<td></td>
</tr>
<tr>
<td>Infant mortality per 10,000 population</td>
<td>-10.42</td>
<td>-809.27</td>
<td>-4.51</td>
</tr>
<tr>
<td></td>
<td>(0.05)</td>
<td>(2.03)</td>
<td>(0.13)</td>
</tr>
<tr>
<td>Hospital beds per 10,000 population</td>
<td>-41.78</td>
<td>224.35</td>
<td>3.10</td>
</tr>
<tr>
<td></td>
<td>(0.80)</td>
<td>(1.94)</td>
<td>(0.35)</td>
</tr>
<tr>
<td>Highway densityd</td>
<td>17.72</td>
<td>18.19</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(1.26)</td>
<td>(0.60)</td>
<td></td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.51</td>
<td>0.41</td>
<td>0.60</td>
</tr>
<tr>
<td>N</td>
<td>88</td>
<td>88</td>
<td>38e</td>
</tr>
<tr>
<td>F-value</td>
<td>12.646</td>
<td>8.476</td>
<td>12.224</td>
</tr>
</tbody>
</table>

Note: t-statistics are shown in parentheses below regression coefficients.

a. From income, value added, and excise taxes.
b. Including transfers to autonomous regions and loans.
c. Population over 65 years old.
d. Kilometers of highway per square kilometer of land area in the oblast.
e. Cheliabinsk's thirty-eight rayons.

Source: Bahl and Wallace 1994; computed from data supplied by the Ministry of Finance of the Russian Federation, June 1993, and from the Finance Department, Cheliabinsk oblast, June 1993.

How equally are revenues distributed?

The assignment or sharing of taxes to the subnational level on a derivation basis necessarily means that higher-income territories with a larger


### Table 9.7 Selected fiscal measures: variation among the oblasts, Russian Federation, 1992

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Per capita revenue collected</th>
<th>Per capita revenue retained</th>
<th>Retention rate (percent)</th>
<th>Per capita subvention</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>15,055</td>
<td>12,078</td>
<td>49.6</td>
<td>7,495</td>
</tr>
<tr>
<td>Coefficient of variation</td>
<td>87.0</td>
<td>71.2</td>
<td>34.2</td>
<td>227</td>
</tr>
<tr>
<td>Minimum</td>
<td>135</td>
<td>108</td>
<td>38.4</td>
<td>18</td>
</tr>
<tr>
<td>Maximum</td>
<td>88,556</td>
<td>53,634</td>
<td>100.0</td>
<td>126,318</td>
</tr>
<tr>
<td>Simple correlation with money income</td>
<td>0.63</td>
<td>0.59</td>
<td>0.10</td>
<td>0.40</td>
</tr>
</tbody>
</table>

a. The retention rate is the ratio of taxes retained to taxes collected, expressed as a percentage.
b. A coefficient of 0.21 is significant at the 0.05 level.

Source: Bahl and Wallace 1994; computed from data supplied by the Ministry of Finance of the Russian Federation.

The federal government uses three discretionary actions to equalize the distribution of fiscal resources. First, it approves the final budget expenditures of each oblast. Second, it determines the level of subventions that will flow to each oblast, which is partly determined by the approved spending level. Third, it has varied the sharing rates of regulating revenues such as the value added tax to ensure agreed spending levels can be reached (or cannot be superseded; see table 9.5). The value added tax was changed from variable rate sharing in the first quarter to a fixed 20 percent retention in the second quarter, with a return to variable rate sharing by the end of 1992. (A range of these sharing rates was in place until 1994.) The value added tax had the potential for an equalizing effect when it was distributed by the federal government on an ad hoc variable rate basis, but previous studies found no evidence of equalization (Bahl 1994).

How does one measure the success of equalization in the Russian system? Most analysts would agree that the objective is to subsidize oblasts whose fiscal capacity is not sufficient to support adequate levels of expenditures even if the local area makes a reasonable tax effort. In an equalizing system, oblasts with higher levels of expenditure needs and lower levels of fiscal capacity would have a greater tax retention rate.
The dependent variable in this analysis is measured as the ratio of taxes retained to taxes collected. The same general indicators of need and fiscal capacity are used as independent variables to explain the distributional features of the present system.

The multiple regression results for tax retention rates are shown in the first two columns of table 9.8. The variation in the level of retention rates across oblasts cannot be fully explained, suggesting that much of

Table 9.8 Determinants of subnational tax retention rates,
Russian Federation, 1992

(ordinary least squares estimates)

<table>
<thead>
<tr>
<th>Independent variable</th>
<th>Total retention rate, all oblasts (equation 1)</th>
<th>Total retention rate, all oblasts (equation 2)</th>
<th>Total retention rate, Chelyabinsk oblast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>87.00</td>
<td>37.00</td>
<td>11.00</td>
</tr>
<tr>
<td></td>
<td>(5.25)</td>
<td>(1.88)</td>
<td>(1.30)</td>
</tr>
<tr>
<td>Population (millions)</td>
<td>1.40</td>
<td>0.68</td>
<td>-5.00</td>
</tr>
<tr>
<td></td>
<td>(1.42)</td>
<td>(0.73)</td>
<td>(0.99)</td>
</tr>
<tr>
<td>Percentage of population living in urban areas</td>
<td>-0.30</td>
<td>-0.14</td>
<td>0.15</td>
</tr>
<tr>
<td></td>
<td>(1.70)</td>
<td>(0.10)</td>
<td>(4.86)</td>
</tr>
<tr>
<td>Per capita income (thousands)</td>
<td>-0.72</td>
<td>0.51</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(0.50)</td>
<td>(0.40)</td>
<td></td>
</tr>
<tr>
<td>Average monthly wage (thousands)</td>
<td>..</td>
<td>..</td>
<td>3.00</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>(0.22)</td>
</tr>
<tr>
<td>Hospital beds per 10,000 population</td>
<td>..</td>
<td>..</td>
<td>0.07</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.31)</td>
</tr>
<tr>
<td>Infant mortality per 10,000 population</td>
<td>..</td>
<td>..</td>
<td>0.01</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.19)</td>
</tr>
<tr>
<td>Percentage of elderly in populationa</td>
<td>-1.00</td>
<td>-0.20</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(2.70)</td>
<td>(0.33)</td>
<td></td>
</tr>
<tr>
<td>Percentage of workers in industry</td>
<td>0.20</td>
<td>-0.10</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(0.65)</td>
<td>(0.41)</td>
<td></td>
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<tr>
<td>Share of children in second shift in school</td>
<td>0.10</td>
<td>0.40</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td>(0.20)</td>
<td>(1.40)</td>
<td></td>
</tr>
<tr>
<td>Republic dummy variable</td>
<td>..</td>
<td>15.00</td>
<td>..</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(3.10)</td>
<td></td>
</tr>
<tr>
<td>R²</td>
<td>0.15</td>
<td>0.28</td>
<td>0.54</td>
</tr>
<tr>
<td>N</td>
<td>87</td>
<td>87</td>
<td>38b</td>
</tr>
<tr>
<td>F-value</td>
<td>3.523</td>
<td>5.781</td>
<td>9.902</td>
</tr>
</tbody>
</table>

Note: t-statistics are shown in parentheses below regression coefficients.
a. Population over 65 years old.
b. Chelyabinsk's thirty-eight rayons.
Source: Bahl and Wallace 1994; computed from data supplied by the Ministry of Finance of the Russian Federation, June 1993, and from the Finance Department, Chelyabinsk oblast, June 1993.
the process is ad hoc. But there are some systematic relationships. The tax retention rate is significantly higher where there is a lower urbanization rate and a smaller concentration of elderly in the population. The results also indicate that, all things being equal, the autonomous republics (dummy variable, column 2) have a higher retention rate than other oblasts. Perhaps the most significant finding here is that the tax-sharing system did not redistribute resources toward oblasts with a lower per capita income. This tax-sharing system thus cannot be called an equalizing scheme.

If the system in operation in 1992 had an equalizing element, it came from subventions. As the first quarter closed, it became apparent to the Ministry of Finance that some subnational governments would run substantial deficits and would have to be subsidized. For the first quarter of 1992, the size of the subvention was about 99 billion rubles ($5 billion at the then-prevailing rate of exchange, or 0.5 percent of GDP). This subvention was not allocated among oblasts according to a strict formula, but took the form of an ex post deficit-filling grant. The Ministry of Finance set a normed level of expenditures and subtracted revenues retained to define the size of the subvention. By some accounts, the normed expenditure level is last year's amount adjusted by some level of inflation. There was no clawback provision from oblasts that had a surplus. However, the Ministry of Finance reportedly refused to reimburse surplus oblasts for wage increases and other mandated expenditures, and asked them to assume more financial responsibility for capital investments.

The unweighted mean level of subvention among the eighty-eight oblasts studied was about 25 percent of total revenues. (The denominator in this calculation is total revenues including subventions.) The subvention level ranged from zero in some oblasts to over 90 percent of total revenues in others. Were the subventions distributed on an equalizing basis? To test for such a relationship, the relationship between the per capita level of subventions for 1992 and the set of independent variables described above was estimated. The regression results show that about 40 percent of the variation among the eighty-eight oblasts could be explained (see table 9.6, column 2). Per capita subventions are significantly higher in oblasts with greater fiscal capacity, as measured by enterprise profits, suggesting a counterequalizing pattern. There is no evidence that per capita subventions are allocated in greater amounts to oblasts where expenditure needs are greater. In fact, results show that per capita subventions are higher in oblasts with greater hospital capacity, a lower concentration of the elderly, and lower infant mortality rates.

Thus, there is no strong evidence that the 1992 revenue-sharing system is equalizing, even if subventions are taken into account. In fact, the
distribution patterns of the shared taxes and the subventions are similar, and possibly counterequalizing. Simple correlations between oblasts' money income and their retention rates and between money income and subventions are both slightly positive (see table 9.7).

The proposal implemented by the government for 1994 would change value added tax sharing dramatically. Under the new arrangements, value added tax revenues are divided 75 percent federal and 25 percent subnational. Approximately 16 percent of total value added tax collections (22 percent of the federal government's 75 percent share) are placed into a distributable pool to be shared among the lower-spending oblasts on the formula basis described earlier. The formula begins with normed expenditures agreed on with the Ministry of Finance, subtracts revenues, and makes up the difference for each oblast, to provide it with at least the nationwide average for per capita revenues. However, no adjustments are made for cost differentials or for differing expenditure needs.

Revenue effort

Whether the Russian system has stimulated or inhibited revenue mobilization is an open question. The system is centralized and subnational governments cannot change tax rates or the tax base. However, they can offer incentives, encourage more aggressive tax collection, and shift resources from budgetary to extrabudgetary accounts. Subnational governments do not retain all the revenue they collect. The smaller the retention rate, the larger the disincentive to collect taxes. The possibility of subventions is a further deterrent: Why should subnational governments increase their revenue effort if any shortfall will be covered by the federal government? Still, subnational governments do retain a significant percentage of some taxes. Moreover, the 1992 experience shows that oblasts can be successful in negotiating larger retentions on an ad hoc basis.

Do oblasts use their fiscal capacity to varying degrees, creating a wide variation in the effective rates of tax collection? The effective tax rate is measured as the ratio of tax collections to the gross value of industrial output (GVIO). This measure does not fairly compare tax effort variations across oblasts, however, because GVIO alone is not a proper measure of taxable capacity. Even for a given per capita GVIO, an oblast with a higher average wage and a more heavily urbanized population would have a greater tax capacity.

Bahl (1994) took such factors into account in a tax effort regression analysis on 1992 data. The analytic model was based on one developed and extended by the International Monetary Fund. The results showed
that the ratio of tax collections to annual GVIO was significantly higher in oblasts with a higher average wage and a lower per capita GVIO. About half the variation across the sixty-four oblasts for which data were available could be explained.

Based on these results, it was estimated that the variation in tax effort among oblasts ranged from two times the national average to less than half the national average (see table A9.1 at the end of the chapter). The extent to which subnational governments urge tougher enforcement on local tax authorities and better compliance on their enterprises varies widely. Surprisingly, there is no significant correlation between the estimated tax effort ratio and the tax-sharing rate. Whether an oblast with a higher retention rate acts on this incentive to make a significantly greater tax effort cannot be determined from these data.

Options for a new structure: Formula-based sharing

Three considerations underlie any decision about restructuring the Russian Federation's system of central-oblast financing: macroeconomic stabilization, equalization, and subnational fiscal discretion. Fixed and unchangeable solutions that might be delineated in a Constitution should be avoided for the time being because of the difficult structural and political changes now under way. The fiscal needs of the Russian Federation in ten or even five years will be different from what they are now. The reform options discussed here represent a framework for the future that offers both structure and flexibility.

Reform of fiscal federalism in Russia could take three basic directions. It could remain a highly centralized system with the federal government controlling the level of expenditures and revenue mobilization in each oblast, though this is unlikely given the size and diversity of the country and the political pressures for autonomy. At the other extreme is a decentralized tax assignment system, a more likely choice in the long run, but one that would pose significant transition problems. The other alternative is for the government to use the transition period to adopt a flexible system that includes some tax assignment, tax base sharing, formula grants, and derivation-based tax sharing. Such a system could have four components: a common pool of revenue (to be divided between the federal government and the subnational governments), the partial distribution of the subnational share of this pool across oblasts on a derivation basis, the distribution of the remainder of the subnational share among oblasts on the basis of a formula, and greater use of subnational taxes and surcharges. The federal level would also fully reserve some taxes for its own use, such as those on trade and customs duties.
Establishing and sharing the revenue pool

Revenue from the major federal taxes—personal and corporate income taxes, value added tax, and excises—would notionally be available for sharing between the central and local levels. In 1992 these four revenue sources accounted for 80 percent of total taxes. Subnational spending accounted for about half of national outlays. This suggests that a significant fraction of all of these taxes, or all of some of these taxes, must flow in one way or another to subnational governments to achieve vertical balance, since subnational governments account for 50 to 60 percent of total spending. (The exact amounts in the future would depend on the estimated costs of concretely and explicitly assigned central and local expenditure responsibilities.) Direct assignment of some of these taxes to the subnational level might not be feasible, since the center would not give up a major revenue base, in toto, nor cede to the oblasts this degree of control over the allocative dimensions of tax policy. This suggests the need for some form of tax sharing, transfers, and the assignment of the nonmajor tax bases.

The subnational revenue share, once its aggregate volume is determined, would be distributed across oblasts partly on a derivation basis as at present—meaning that taxes would accrue to the budgets of oblasts where they were collected—and partly on a formula grant basis. Decisions about the relative proportions of the subnational revenue share amounts to be distributed on a derivation basis versus the amount to be distributed by formula would depend on political and economic considerations. From an economic perspective, the more revenues that are shared by derivation, the more the system will channel resources into regions with larger taxable bases, giving more revenue to higher-income territories whose growth potential is highest. This approach would reward oblasts that attract industry and deploy budgetary resources to spending and investments that enhance productivity and private sector development. Moreover, derivation-based sharing has the advantage that it builds on Russia’s existing system and is easy to monitor and administer. The larger the proportion of the overall subnational share that is allocated on a formula basis, the more equalizing the overall system may be, depending on the exact design of the formula. The tradeoff between encouraging growth and ensuring equalization is difficult. In one view, the intergovernmental system should place significant weight on the initiatives and fiscal energies of better-off areas, in the interests of higher economic growth. This would argue for channeling a relatively large fraction of revenue to subnational governments on a derivation basis. Another view is that fiscal disparities in Russia, if not addressed, could give rise to unacceptably large disparities in service provision and well-being. Under this view, a
significant fraction of the overall subnational revenue pool would be distributed on an equalizing, formula basis. The choice is not an easy one.

To enhance the transparency and revenue certainty of the system, each of the following could be fixed for a three- or five-year period: the tax shares assigned to the subnational government sector, the relative proportions allocated on a derivation and formula basis, and the distribution formula itself. Many countries have established grants commissions to develop proposals for grant formulas and sharing systems (Bahl and Linn 1992).

One might well ask what is the meaning of transfers in a system where all revenues are collected at the so-called grassroots level and transferred upward. Two elements should be remembered: these are national taxes, collected through the local deconcentrated arms of a national tax service. It is only by convention that localities think of these taxes as “theirs.” Practically speaking, revenues other than those retained on a derivation basis by the oblasts would first flow up; those to be allocated on a formula basis would then flow down.

**Tax sharing on a derivation basis**

Under derivation sharing, a portion of major taxes in the distributable pool would accrue to the oblasts where they are collected, preferably with uniform rates of sharing across all oblasts. If 60 percent of subnational revenues were to be allocated on a derivation basis, all oblasts would receive a percentage from each tax in the revenue pool (the percentage of each tax could vary), with the percentages calculated to exhaust the 60 percent.

This structure would reward oblasts that attract and promote industry by giving them a greater flow of revenue. The uniform sharing rates would remove negotiation from tax-sharing determinations and give subnational governments a more dependable flow of revenue, thereby promoting more efficient budgetary planning. The advantage of this approach for Russia today is its similarity in concept to the existing system. Moreover, derivation sharing can be administered at relatively little cost, and unless the subnational shares in each tax differ widely, it does not give the State Tax Service an incentive to collect one tax more efficiently than another.

The derivation approach to revenue sharing is not without problems. The value added tax does not lend itself easily to derivation sharing, for example. Industrial provinces with a high VAT can have an advantage, and the zero-rating of exports can handicap oblasts whose enterprises sell to foreign markets, since they pay large export rebates. The VAT collected on imports would accrue fully to the port city. These outcomes, neither of
which is sensible, could be dealt with only by means of a complicated set of border tax adjustments as goods crossed from one oblast to another (see the discussion of Ukraine, chapter 8). If these problems are not addressed, derivation sharing of the VAT could lead some oblasts to establish barriers to trade with other oblasts. This problem could be resolved by eliminating the VAT from that part of the revenue pool that is shared on a derivation basis. However, eliminating the VAT would make the common revenue pool more cyclical (the VAT is the most cyclically stable tax), and would require sharing rates of personal and corporate taxes to be set at high levels, possibly affecting State Tax Service collection incentives. On balance, the proper action would be to eliminate the VAT from any derivation sharing as soon as such a move is feasible.

Allocating the corporate tax on a derivation basis is also complex, since the origin of profits must be determined for multilocation enterprises. Are they levied where the headquarters is located? Where the sales took place? Where employment is located? Such determinations will increase the complexity of an already overburdened tax system. The current law allows the corporate income tax to be prorated by employment, but this may require modification. If the corporate income tax is to be shared with subnational governments by derivation, the central government must begin planning for the time when the profits of nationwide firms must be allocated among oblasts.

There are similar complications with excises—the most important being on vodka and cigarettes. Levied presently at the producer level, not the retail level, derivation-based sharing effectively channels these excise taxes to the few oblasts producing excisable goods in Russia's monopolized industrial sector. Thus, while some portion could be shared this way, excises are better suited to formula-based sharing than to derivation sharing at present.

Formula-based revenue sharing

The remainder of the subnational revenue pool would be divided among oblasts on a formula basis. This arrangement would serve the same function as intergovernmental transfers in most countries. Since the revenues assigned to each level of government usually cannot be matched perfectly with their expenditures, transfers are used to supplement own or shared revenues so that subnational expenditures are adequately financed. Depending on the formula, it can be equalizing in the sense that resources are directed toward oblasts where fiscal capacity is relatively low or the level of need is great. This formula would also make revenue receipts for subnational governments more certain, and would help subnational governments plan more efficiently. In Russia
one would envisage formula-based transfers to be channeled via the central budget, although the revenues would first flow upward, as at present, from the inverted system of tax administration.

What indicators should be included in the formula? In Russia the structure of the formula should be kept simple. In most countries that use this arrangement, the formula consists of some estimate of expenditure needs (often simply population), an assessment of revenues potentially available to finance these needs, and rules covering the reach of equalization. A rough construction would be $G = E - R$, where $G$ is the grant, $E$ is the expenditure needs (for example, based on equal per capita needs), and $R$ is the revenue capacity (based on available own-source revenues, not actual revenues). This formula approach is very different from the current Russian approach, which simply seeks to bring all oblasts up to a fraction of average national per capita revenues.

One challenge in this approach is defining expenditure needs for each jurisdiction. Definitions should reflect needs based on population size, composition, or other indicators, as opposed to only the recurrent costs of financing existing facilities (capacity) under the current system since many of these facilities are oversupplied in some areas and absent in others. One approach might be to begin with concrete expenditure norms, and then to cost them out. In Russia this might be accomplished in principle by modifying existing expenditure norms to reflect actual population needs. For example, standardized classroom sizes in rural regions and cities would be multiplied by the standard cost of a teacher, classroom operation, and other factors to derive a cost figure in rubles. Performing this calculation for each expenditure function would itemize and build up the expenditure needs of each jurisdiction. While the precision of this approach has much appeal (it has been successfully applied in Australia and Denmark), it is far too complex. Even such countries as Canada have not felt able to attempt it. In addition, the high rate of inflation in Russia and the need for precise data would probably rule out this method.

A simpler approach would be based on umbrella variables, such as population, density, per capita income, city size, poverty rates, and the centrality of a city, to signify need and allocate budgetary resources accordingly. Other indicators, such as miles of substandard roads and deficiencies in school and hospital space, could also serve. Germany and the United States use such simple models to operate some of their grant programs (Bird 1986b).

The next step is to estimate the revenue capacity of an oblast. If only its actual revenue collections were considered, the oblast could reduce its tax effort to appear poorer and thus receive higher transfers. Subnational revenue capacity in Russia is a function of the size of the subnational tax bases, property and land values, number of vehicles, and number of
businesses. Two approaches to measure fiscal capacity are possible. One estimates the yield of a representative tax system, as done for Canada. Another approach is the regression method, which uses umbrella variables to capture the size of the base (Bird and Slack 1990).

The initial construction of any formula is inherently an arbitrary process. Establishing a grants commission to work on the ongoing design of the overall intergovernment system, to develop a formula on a consensus basis, and to monitor and coordinate ongoing reforms would be one way to address the problem (see chapter 1). Russia's committee of regional, Ministry of Finance, and research experts, appointed in 1994 to investigate reforms of VAT sharing, is in this tradition. Establishing a commission to develop the data (for example, a census of governments) needed to support the ongoing monitoring and redesign of the intergovernmental system would also be a priority consideration.

Enhanced subnational taxes

The fourth dimension of the framework would give subnational governments additional, but limited, independent taxing power. Making subnational governments accountable by giving them both tax and expenditure discretion is a crucial benefit of a decentralized system of fiscal relations. Three promising types of subnational taxing powers are a surcharge on the personal income tax (up to a limit prescribed by the federal government), a tax on land values within urban areas, and a tax on ownership and operation of motor vehicles. Another possible surcharge is on the corporate income tax. This could be more revenue-productive but would raise problems because of interoblast competition; moreover, subnational governments may be unwilling to further increase taxes on local enterprises. Overall, this would be very much a second-best choice.

The advantage of these taxes is that they place the burden on local citizens, thereby increasing the accountability of subnational officials. Moreover, the costs of complying with the taxes would be lower and their revenue potential would be greater than that of the twenty-one minor taxes proposed in the Basic Principles law and now accruing to local governments. While the burden of taxes on individuals is already high in Russia, the distribution of the burden imposed by these three taxes would probably be progressive, making them preferable to other, more regressive taxes. The property and vehicle taxes would require some investment in improved tax administration, and both would have to be collected by the State Tax Service, although the federal level would not share in their revenue. In the long run, subnational governments should probably have even greater revenue discretion, with greater rate- or base-fixing discretion over some major revenue sources.
Arguably, subnational governments currently depend too much on shared central taxes and subventions. In contrast, the twenty-one local taxes currently in place are likely to generate little revenue, strain the limited resources of the State Tax Service, and, most important, divert attention from the more productive revenue alternatives mentioned earlier. Many are nuisance taxes whose compliance costs slow down the workings of the local economy.

**Intraoblast fiscal relations**

A major unanswered issue for Russia is the scope of the intergovernmental system. Laws thus far have been silent on the matter. Should the fiscal structure define tax (and expenditure) assignment only to the oblast level and leave it to the oblast soviet to decide the distribution within its boundaries? Or should the intergovernmental system be structured to prescribe the exact allocation of fiscal resources to oblasts, as well as to cities and rayons? Extending the system to the suboblast level would give the federal government maximum control over the regional distribution of resources, since tax collection and assessment and much of the expenditure delivery and budgeting actually take place below the oblast level. However, local affairs may be handled more efficiently by the oblast than by Moscow, especially in a country as large as Russia. The answers have a great deal to do with whether Russia sees itself as a federation or not.

**Scope of the intergovernmental system**

The oblast soviet, or government, is responsible for the allocation of financial resources among all the rayons and municipalities within the oblast. It determines the share of taxes each rayon and city may retain (and, by implication, the residual that is left for the oblast itself). It may choose to allocate an additional subsidy to rayon governments, thereby determining the spending level of each local government. In making these decisions about intraoblast fiscal relations, the oblast soviet faces some constraints:

- Tax rates and tax bases are fixed by the federal government and cannot be adjusted.
- Some minor taxes and charges are prescribed as fully rayon-level.
- The rayon share of revenue from oil and other natural resources is specifically mandated in the April 1992 Law on Payments for Natural Resources (see chapter 10).

At present, within these constraints, allocation choices rest with the oblast governments, and some have opted to redistribute substantial amounts of revenues away from the urban centers to the less-developed
rayons. It has become a contentious issue, and there have been calls for a federal formula that identifies the share of each local government, either to enhance the position of the rural rayons or to protect the larger revenue base of the cities.

An intraoblast intergovernmental system could in principle operate in three ways: one could create a traditional federalism where taxes are assigned to either the federal or the oblast level and the oblast could then decide on the distribution among the local governments; one could prescribe an exact allocation of fiscal resources to oblasts, cities, and rayons; or one could give general guidelines for distribution within the oblast.

There are several advantages to giving oblasts responsibility for their rayons' fiscal affairs. First, it removes the central government from fiscal decisionmaking concerning the revenue needs of thousands of local governments. Second, it makes oblast and rayon governments more accountable to the local population for fiscal decisions. Third, it is a step toward greater fiscal decentralization in that it brings government closer to the people.

This approach also brings problems, however. The federal government is less able to steer the allocation of resources to areas where it wishes to stimulate economic activity or upgrade services—should this be deemed necessary or desirable. In addition, disparities may be as great within oblasts as they are among oblasts, and the federal and local governments may not share the same equalization goals. Moreover, the federal government may want to use incentives to stimulate local revenue effort, but cannot do so independent of oblast policy because tax administration efficiency is influenced at the local government level.

Disparities among rayons

Wide variations in economic well-being and fiscal capacity exist within each oblast, and oblasts must make difficult decisions about fiscal equalization. The oblast soviet could simply extend the central-oblast revenue-sharing scheme, that is, the derivation principle, but this would exacerbate the economic disparities among its own local governments. For example, within the Riazan oblast, which has thirteen rayons and two cities, per capita expenditures were more than three times larger in the highest-spending locality than in the lowest. In the first half of 1992, per capita expenditures were 50 to 100 percent greater in the cities of Riazan (the oblast capital) and Skopin than they were for the average of all Riazan oblast's rayons. In Cheliabinsk oblast, the per capita retained revenue in the rayons varied by 300 percent from highest to lowest in 1992.

Such disparities have led oblast governments to enact equalization features in their revenue-sharing systems, but some of these efforts have
caused conflicts with better-off rayon governments, who believe they are unduly discriminated against. The situation is made more complex by the many unmet public service needs and poor infrastructure maintenance in even the better-off urban areas. Currently, some oblast governments have opted to use flat-rate tax sharing, which is counterequalizing, along with equalizing subventions.

Intraoblast disparities raise a problem for central government policy: Are variations in population and the average wage greater within oblasts than among oblasts? In the case of Cheliabinsk, this is true for population but not for average wage level. But disparities in per capita revenue collections and in the ratio of collections to income are greater within the oblasts than among them. Fiscal equalization, therefore, is as much an intraoblast as an interoblast issue.

Can federal policy be offset by oblast policy? The multiple regression that was reported in table 9.8 (column 1) shows a bias in the retention rate against urban areas, while the bias in Cheliabinsk oblast (column 3) favors urban communities (Bahl and Wallace 1994). This indicates that the oblast takes more of an interest in revenue stimulation than in equalization, at least with regard to the tax-sharing formulas it designs.

Revenue-raising efforts

The need to equalize may tend to dampen efforts to increase the rate of revenue mobilization. The State Tax Service staff at the local level is closely linked with the local government (rayons and cities), and assessment and collection efforts at the local level may be less successful or less vigorous if the local community knows it will not receive an adequate return from its increased revenue effort.

These issues point to an underlying concern: oblast soviet decisions may not reinforce central government economic policy. Suppose the central government decides to base its economic growth strategy for the next ten years on the development of urban centers and on those industries that require skilled labor and infrastructure. Under the current system, the central government could not implement this strategy easily. The oblast soviet could still choose to direct resources toward rural areas, and could determine the budgetary allocations to education and infrastructure as it pleased. In truly decentralized systems such as Switzerland, the central government loses considerable control over the implementation of such overall economic strategies. While not necessarily a negative thing, it illustrates the complexities of systems with strong local governance.

Bahl and others (1993) analyzed fiscal outcomes in Cheliabinsk oblast. They regressed per capita retained revenues in the oblast against a
set of fiscal capacity and needs variables for thirty-eight suboblast-level governments. Their analysis showed that more than half the variation could be explained and that per capita revenues were significantly higher for local governments with larger populations and greater urban concentrations (see again table 9.6, column 3). Income and needs variables were not significant determinants. Much the same analysis was carried out for the federal level, which showed a similar bias toward oblasts with larger populations, but there was a negative relationship with urbanization (table 9.6, column 1). This evidence may indicate that federal and oblast-level intergovernmental fiscal policies are not in sync. This, of course, is the essence of decentralized decision making, and were Russia to see itself truly as a federation, the differing objectives would be of little concern. However, the central interest over local affairs remains significant.

Options for intraoblast finance

The analysis suggests that federal-subnational fiscal relations should not go below the oblast level. There are two reasons for this. First, this would imply a federal program that purports to equalize, in one effort, among 89 oblasts and more than 2,000 rayons. Second, such an approach would have to apply the same formula to all suboblast equalization nationwide. A better route would be to leave the distribution to each oblast. Moreover, if Russia sees itself as a federation, such center-rayon relations would be inappropriate. In sum, the federal government should concentrate its efforts on finding a proper relationship with its oblasts and regions, and leave intraoblast matters to the subnational councils.

It may be that some “framework law” is appropriate, in which oblasts are required to pass through some proportion of the revenues they receive downward to the rayon or city level, according to some agreed guidelines. One alternative is to specify guidelines, for example, for the minimum amount of the tax sharing that must be passed through to the local governments and by what criteria. Other options could include various center-oblast conditional grant mechanisms. This would seem to be a compromise that reconciles decentralization objectives with the center’s desire for some influence over intraoblast affairs.

Conclusion

The budget for 1994 incorporates some of the reforms discussed in this chapter. Although all taxes are still shared on a derivation basis, the budget calls for formula-based subventions. As mentioned, the subventions will come from a fund made up of 22 percent of the federal government’s share of the value added tax. Subventions accrue to low-revenue
subnational governments based on the amount by which their per capita revenue falls below the average per capita revenue for all subnational governments. This may have a negative impact on the incentives for subnational governments to collect revenue—oblasts with per capita revenues that are just below average and oblasts with per capita revenues that are far below average both end up with the same overall per capita revenue (the average) after the subvention. Since the fund is made up of 22 percent of total federal value added tax collections, there may be some incentive for subnational tax officials to collect the tax effectively. If the value added tax fund is too small, however, they may not get enough. The 1994 budget also allows for some revenue discretion by authorizing a few local taxes to be levied independently.

Nonetheless, the intergovernmental fiscal system in Russia remains in a period of transition. The unstable economy is pushing policymakers in the direction of a more centralized fiscal system better able to support macroeconomic policy, while strong political forces underscore the inevitability of fiscal decentralization. The compromise since 1992 has been to redefine the system continually and in a variety of ways to disguise the centralizing and decentralizing trends.

This analysis points to five general conclusions. The first is that tax structure, tax administration, and revenue sharing are equally important components of the intergovernmental fiscal system: alter any one of the three and the impact of the system may change significantly.

Second, the absence of a concrete, legislated assignment of expenditure responsibilities is the greatest obstacle preventing Russian intergovernmental relations from moving away from the bargaining mode inherited from the old regime. Until expenditure responsibilities are assigned distinctly and explicitly, subnational budgets will be highly unpredictable. Without precision and fixity, it is not possible to design a stable revenue system that adequately finances the subnational sector. Are oblasts expected to finance all capital investments in transport and infrastructure? The decision will determine whether incremental revenues equivalent to 2 percent of GNP need to be channeled to them. The reality of negotiated and shifting expenditure responsibilities and negotiated spending norms is in stark contrast to the explicit tax assignments in the proposed Law on the Basic Principles of Taxation and other recent legislation. By focusing policy efforts exclusively on tax assignment and revenue-sharing mechanisms, the Russian government is putting the cart before the horse.

Third, the shift to a tax assignment system may be inevitable, but the time is not yet right for such a change. Traditions of subnational government finance are not in place to a degree that will allow for the absorption of full local autonomy, and income disparities among oblasts
are so great that decentralization will have to be accompanied by an equalizing grant system. Moreover, there is the problem of tax administration. A tax assignment approach would require separate central and local tax administrations to collect taxes effectively at each level.

Fourth, the net fiscal impact on subnational budgets of the privatization and decentralization of enterprise ownership is unclear. While the sale of assets may lead to revenue inflows, the burden of providing subsidies will now fall on local budgets. In addition, privatization will result in a shift of social spending responsibilities from enterprises to local governments. Both need to be accommodated in the new system's design.

Finally, many of the fiscal tensions between the central government and the oblasts are replicated in the relationship between the oblasts and the rayons. Disparities within oblasts may be as large as the disparities among them. This has policy implications as well. If the oblasts have different goals than the central government, the effectiveness of federal fiscal policy on growth and equalization weakens.

The lack of clarity in the current system does not give the central government true control over fiscal policy, nor does it provide subnational governments with adequate means to meet their increasing expenditure needs. During this time of transition, Russia needs to implement a transparent fiscal system that promotes stability and equalization while permitting the subnational level some discretion. The reforms suggested here are a mix of derivation-based sharing, formula-based sharing, and enhanced assignment of subnational taxes. In 1994 there was a small but promising movement toward such a system. But a clear and precise codification of expenditure assignment is still needed.
Annex 9.1 Tax assignments: Law on the Basic Principles of Taxation

The Basic Principles law, passed in December 1991, was never fully implemented, notably with respect to federal and subnational taxes. However, it governs intergovernmental relations in many important ways.

*Federal taxes*

These taxes accrue fully to the federal level and the federal government has full control over the base and rate of these taxes. They include:

- Value added tax
- Export taxes
- Excises on all items except motor vehicles and alcohol (50 percent local)
- Tax on bank profits
- Tax on insurance profits
- Tax “exchange activities”
- Tax on securities operation
- Customs duties
- The natural resource tax (shared 20/80 or 40/60 by the federal and subnational levels).

*Shared taxes*

The regulating revenues of subnational governments include two federal taxes. Oblast governments have no control over the base or rates of these taxes:

- Personal income tax
- Corporate income tax
- 50 percent of vodka excises and 100 percent of all other excises except motor vehicles

*Subnational taxes*

Subnational governments receive all of revenue from the collection of their own taxes:

- Road fund taxes
- Stamp duty
- Estate duty
- Gift tax and inheritance tax
In addition, there are oblast-level taxes. The center defines the base of these taxes; oblasts have some control over the rate (within a ceiling) and receive all of the revenues:

- Property tax/asset tax on enterprises
- Forestry tax
- Payment for water use

Rayon/local taxes

Rayon and local-level taxes include twenty-one taxes and fees, some of which are best thought of as nuisance taxes. Their base and rate can be set locally, but the law has set maximum rates for most of them:

- Property tax on natural persons
- Land tax
- Business registration fees
- Construction in resort areas
- Resort fee
- Tax on the right to trade
- Special-purpose taxes for such uses as maintenance of the militia
- Tax on advertising
- Tax on the resale of cars and computers
- Tax on owners of dogs
- License fee for the sale of wine and liquor
- License fee for the right to hold auctions
- Fee to move into apartments
- Fee for car parking
- Trademark fee (use of logos)
- Fee to participate in horse races
- Fee on winnings at horse races
- Fee on participating in the “totalizer game” at races
- Fees for commodity exchange transactions
- Fee on filming for cinema and TV
- Fee for cleaning settlements
### Table A9.1 Oblast tax effort and tax capacity, Russian Federation, 1992

<table>
<thead>
<tr>
<th>Oblast</th>
<th>Shared tax collections as a percentage of GVO (1)</th>
<th>Estimated taxable capacity (2)</th>
<th>Tax effort ratio $(1 + 2)$</th>
<th>Tax effort ranking</th>
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### Intergovernmental fiscal relations in the Russian Federation

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GVIO: Gross value of industrial output.
AR: Autonomous republic.

Notes

1. This chapter draws on Wallich (1994).
2. Throughout this chapter, references to the “oblast level” include constituent republics of the Russian Federation, krais, okrugs, regions, and national areas. The term “subnational” refers to all levels below the federal or central level. The “local level” refers to cities and rayons and below.
3. This section draws heavily on Martinez-Vazquez (1994b) and on Wallich (1994). Martinez-Vazquez has also written a series of papers on expenditure assignment and budgeting in Russia that provide information about how the system works and what its failings are. See also Martinez-Vazquez (1994d).
4. In January of 1994 inflation rates were 17.9 percent and in February, 10.7 percent. Inflation in March was notably low at 7.4 percent, compared with an average monthly rate of 21 percent in 1993. (Data are from Goskomstat, IMF, and World Bank.)
5. This is based on Ministry of Finance of the Russian Federation and IMF staff calculations.
6. Subnational deficits can be monetized in the soft budget environment that currently prevails for enterprises, and for banks, whose credit or liquidity demands may be accommodated. Arrears may also be monetized in the course of arrears clearance exercises.
7. The proposed Law on the Basic Principles of the Budget System and Budgetary Process gave subnational governments the right to receive loans from higher-level governments or to receive commercial loans.
9. Bahl and others (1993) compiled an exact list of the services provided and attempted to measure the cost to the enterprise in each case.
11. In Russian terminology a regulating revenue is a revenue shared between government levels to regulate the revenue retained by the lower level and to ensure that the lower level achieves a budget balance.
13. See the annex to chapter 2 for an example in the Hungarian case.
14. The Riazan case study reported here is taken from Bahl (1994), and the Cheliabinsk case study from Bahl and others (1993).
15. Annex 9.1 is based on information from the Ministry of Finance of the Russian Federation.
Special issues in Russian federal finance: Ethnic separatism and natural resources

Charles E. McLure, Jr., Christine I. Wallich, and Jennie I. Litvack

The design of intergovernmental relations in a federation is fundamentally different from its design in a unitary state. Because of the constitutional powers given to the subnational level in a federation, the interaction between levels of government is a two-way street. The constitutional rights and responsibilities of the subnational level are an important factor in the design and ultimate outcome of the intergovernmental system.

By most tests, the Russian Federation is a federation in little more than name. Oblasts have few legal powers and little revenue authority. Since federal transfers represent a small share of gross domestic product (GDP) in Russia, and since the revenue system is not equalizing (see chapter 9), significant disparities between regions have emerged. Oblasts continue to demand more legal and revenue authority despite the new constitutional framework ratified in December 1993, which strengthened the presidency and in effect shifted the balance of power more toward the center. As of early 1995, the Duma (Parliament) continues to review a new law defining intergovernmental fiscal relations. The complex nature of Russia’s federal system substantially complicates the design of its intergovernmental system. Disgruntled oblasts continue to oppose the status quo and to argue for their right to greater autonomy. Although the central government has been strengthened, the risk of secession by disgruntled oblasts persists.

Intergovernmental fiscal relations in Russia are further complicated by some territories’ demands for political autonomy, greater devolution of responsibility for expenditures, or special tax regimes. These demands are
Decentralization of the Socialist State

intimately intertwined with the constitutional debate in Russia, which redefined relations between the oblasts and the federal government and among the oblasts. Equal status was granted for all of Russia’s eighty-nine subjects of federation, or second tier of government, whether republic, oblast, okrug, krai, or autonomous region. But subnational governments were not granted greater powers vis-à-vis the federal government than before. The new laws being drafted on intergovernmental fiscal relations are another opportunity to clarify the relationship between the center and the subnational level. How these powers are defined will influence Russia’s future economic development (Gleason 1990).

In the fiscal area, subnational governments have demanded the retention of greater shares of total revenues and greater fiscal autonomy. These demands have arisen most commonly in three situations. First, areas inhabited by non-Russian ethnic groups are claiming the right to greater autonomy because of their different history and culture (see map on the non-Russian population in the Russian Federation, facing page 382). Second, some areas rich in natural resources feel entitled to special financial arrangements that allow them to derive greater benefits from their resources (see map on the natural resource endowments of the Russian Federation, facing page 390). These natural resource–producing regions note that their development has not benefited from the presence of natural resources; rather, real incomes have remained low and exploitation of resources has caused severe environmental damage. Finally, areas that are currently more developed and that can grow more rapidly may prefer greater fiscal autonomy or special fiscal arrangements to benefit from their stronger economic position. The first two categories overlap where territories, such as Tatarstan or Bashkiria, which are inhabited by ethnic minorities, are also resource-rich.

This chapter outlines two issues in intergovernmental fiscal relations that are peculiar to federations and that are causing distress in Russia today: separatist pressures for greater fiscal sovereignty from increasingly disparate and disgruntled regions, and the sharing of revenues from natural resources—in particular, oil and gas—which will be potentially huge as prices rise to world levels.

Asymmetrical federalism: Dealing with Russia’s separatist oblasts

The intergovernmental system described in chapter 9 represents the uniform fiscal system that, in principle, applies to all oblasts (see Wallich 1994 and Litvack 1994). However, not all of Russia’s oblasts are following
these rules. Since mid-1992 some twenty oblasts (and by September 1993 thirty oblasts) reportedly unilaterally decided to determine what proportion of taxes they will share with the center. The shares would be lower than those negotiated with the Ministry of Finance. Other oblasts have threatened to do the same, essentially on three grounds described below.

**Ethnic separatism**

Separatist sentiments expressed by oblasts that contain ethnic minorities have manifested themselves in disturbing ways. Some oblasts, notably Tatarstan, have declared a state of quasi-independence from the Russian Federation, and Chechenya is at war with the Federation over its status. Some regions insist that a single-channel system be established, with all revenue initially flowing to subnational governments, then taking the form of a negotiated single payment to the federal government. Bashkiria (rich in diamonds and minerals) has already negotiated such an agreement with the Ministry of Finance, though it has not been approved by the Duma. In other cases, where oblasts such as Tatarstan have determined their own sharing rates unilaterally, this approach is implemented in a presumably illegal manner (see chapter 9).

**Resource-rich areas**

Some natural resource-rich areas believe they are entitled to special financial arrangements that permit greater local benefits. They note that the development of their regions has suffered rather than benefited from the presence of natural resources because of severe ecological damage resulting from careless resource exploitation by the central authorities—Soviet, and later Russian. Whether resource-rich regions should receive an extraordinary share of the resource taxes—beyond those required to compensate for environmental degradation—is in part a political question that depends conceptually on the nature of the Russian Federation (whether the collective "we" represents the citizens of the Russian Federation or the citizens of a smaller local jurisdiction). Moreover, the Law on the Rights of Ethnic Minorities (1992) appears to give substantial property rights to the native populations of resource-rich areas. However, it is not obvious which level of government should benefit from resource rents and which should not (assuming issues relating to the claims of native populations have been resolved). Nonetheless, natural resource-rich areas are demanding greater benefits from their resources than they have received in the past. If some response is not given, they may attempt to withdraw from the Federation.
Industrially well-endowed regions

The claims of territories whose industrial bases are large and prosperous are similar to those of resource-rich areas: the socialist regime left an industrial endowment akin to the natural resource endowment. Should the local government or all of the oblasts of Russia benefit from this industrial endowment and the larger tax base it implies? The issue is complicated by the fact that areas with strong industrial bases could use their larger public revenues to good advantage to invest in infrastructure that supports production and thus faster growth. Given the nontransparency of the present intergovernmental system, and the perception that tax sharing works against the better-off oblasts, many rich oblasts think they are subsidizing poorer regions. This perception may encourage the wealthier republics or oblasts to demand special treatment permitting them more benefits from their own endowments.

Replaying the past?

These trends mirror the process of fiscal decentralization that characterized the U.S.S.R. and contributed to its demise in late 1991. The U.S.S.R. budget was dependent, under the inverted tax administration system, on upward tax remittances from the fifteen Union republics—notably Russia, Ukraine, and Kazakhstan, the U.S.S.R.’s three revenue cows. As pressure for fiscal decentralization and regional autonomy became more intense, republics began to retain a share of revenues that was higher than had been agreed upon. These higher retentions became the norm by mid-1991. The Russian Federation respected the principles under the prevailing sharing regime, but agreed to a fixed nominal transfer to the Union budget of only 90 billion rubles. Some 23 billion rubles were remitted in the end. During the course of 1991 transfers from most Union republics dried up, leaving the Union budget without resources.

The fundamental weaknesses of the Soviet system have been inherited by the Russian Federation and the fourteen other independent successor states to the U.S.S.R. In most systems of intergovernmental finance, the central government collects most of the revenues and shares some of them with lower-level governments. In the Soviet system, and now in Russia, revenues are collected by oblasts and shared upward. This upward sharing contributed to the dissolution of the former Soviet Union as the republics ceased their transfers. The Russian Federation faces the same vulnerability if it does not get its fiscal and political house in order. Also, its system is not really a “system,” but a series of bargained, ad hoc federal-oblast agreements, whose overall effects and incentives are not well understood.
The proliferation of single channel or similar regimes could mean the dissolution of the Russian Federation—just as the failure of Union republics to contribute to the Union budget helped bring about the dissolution of the U.S.S.R. Recognizing this, Russia's federal government, supported by the Duma, has threatened to apply sanctions to oblasts using single-channel agreements or unilaterally determined sharing rates. The sanctions would include stopping all central budgetary expenditure and investments on the territory, withholding export and import licenses, denying central bank credit to the oblasts' banks, halting material supply from the central supply system, and withholding cash or currency. These measures have thus far had limited value in influencing subnational behavior, however.

Even without these special regimes, changes in revenue sharing between the Russian Federation and oblasts appear to be consistent with a strengthening of the relative position of subnational governments. Oblasts' value added tax retentions increased from an average of 14 percent in early 1992 to 25 percent in 1994. Their corporate income tax share rose from 17 of the corporate income tax's 32 percentage points in 1992 to 25 percentage points of a 38 percent rate in 1994. Pressure from better-endowed and politically strong oblasts, which might otherwise decide sharing rates unilaterally, and from a legislative branch (the Duma) with populist interests may be responsible for this shift. In response, or in anticipation, the federal level has shifted expenditures downward and reduced subventions. Each of these actions has limits: subventions cannot be reduced below zero, and further downward shifts of expenditures could be politically provocative.

This game of expenditure shifting from the center, and revenue withholding from the oblasts, is politically risky and it may be macroeconomically unsustainable. It reflects the failure of the federal and oblast levels to arrive at a consensus on the design of the new intergovernmental fiscal system, as well as the failure (at the more technical level) to achieve a revenue-expenditure correspondence. If institutionalized, the single-channel approach—including unilateral sharing agreements—could destabilize the federal budget (Sachs 1994a, 1994b; EBRD 1994). At best, it will perpetuate continued negotiations between central and subnational governments. If, as in Bashkiria and Tatarstan, subnational governments negotiate a fixed nominal share for the central government, the single-channel approach will mean a lower federal yield and a procyclical revenue yield, with the center's share eroded by inflation, causing additional stabilization problems.

The experience of China, where such fiscal contracts became the norm, shows how problematical they are (Blejer and Szapary 1989; Bahl and Wallich 1992). Strengthening and centralization of the State Tax
Service would address loose central control over revenue collections. But the political economy dimensions of the single-channel approach and the centrifugal forces that might sweep over the Federation would still have to be addressed.

What then to do? Addressing special areas

Vulnerable to the exercise of fiscal sovereignty by well-endowed, powerful oblasts, Russia's federal government is constrained from strengthening its position by the absence of both a strong tax administration and an efficient intergovernmental system with well-defined rules. Therefore, both areas must be addressed.

Demands for special treatment can be addressed in three ways: through bargained and negotiated ad hoc solutions; through special fiscal regimes; or through the four-dimensional intergovernmental fiscal system described in chapter 9, incorporating a comprehensive distribution formula. A review of how some other countries have managed this complex issue is instructive.

International experience with asymmetrical federalism

Complicating the design of fiscal federalism in many large countries are the demands for autonomy and pressures for political devolution in territories with ethnic minorities. These demands are louder when disputes about the rights to oil and other mineral resources are involved. This conflict raises the issue of granting special fiscal status to some territories. Several decentralized intergovernmental systems allow for special regimes within the unified system. Such regimes may be appropriate when there is significant regional diversity and the uniform fiscal status of all provinces in relation to the federation is not manageable.

The rapid change from a strongly unitary state to a semifederal government structure in Spain in the late 1970s was made partly in response to deeply rooted cultural differences, and was conceived as a way to facilitate the return to democratic rule. As in the Russian Federation today, the issue of regional autonomy was among the most difficult tasks for the designers of Spain's new constitution.

One of the most useful lessons from the Spanish experience is that a nonuniform approach to decentralization and local autonomy can work. Special treatment was granted to territories that claimed special status for historical and cultural reasons. This did not cause problems because their demands for autonomy were not very pronounced, and because their special nature was acknowledged by other regions.
Although most regions of Spain rely on central government transfers of centrally collected taxes for their finances, Navarre and the Basque Provinces acquired the right to levy and collect all taxes themselves, except for customs taxes and excises on tobacco and petroleum products. Authorities in the Basque Provinces and Navarre must make an annual lump-sum payment to the central government from the revenues they collect in compensation for the services provided by the central level. These payments are set for a period of five years, but can be adjusted annually for inflation (Lopez 1990; Sole-Vilanova 1990).

In the Philippines, the Muslim Mindanao and Cordillera regions received more autonomy because of their different religious and cultural heritage. Insurrection and calls for secession led the central government to grant these regions greater autonomy in 1989. Under the Organic Act for Muslim Mindanao significant fiscal powers and responsibilities were devolved to the region, including most expenditure functions. Central approval of expenditure level and composition was eliminated. Only national defense-related functions were retained by the central government. The regional government was given broad taxing powers. It cannot levy income taxes and customs duties but may impose other taxes, levy fees and charges, and share in revenues generated by regional public utilities. The region can keep 60 percent of internal revenue collections, to be divided equally among the regional and provincial governments. Corporations engaged directly in business in an autonomous region pay the regional government a portion of their annual tax on net business income.

In China beginning in the mid-1980s, many provinces were granted special rights and privileges. Fiscal contracting—under which the province delivered a fixed annual revenue quota to the center for five years—allowed these provinces to retain a growing share of the revenues they collected (all the revenues at the margin). The results—in Guangdong and other better-off provinces—are striking (Wong 1991, 1992). This is similar to the system Bashkiria negotiated with the federal government in Russia. The fiscal contracts were negotiated with most of China's better-off provinces, encouraging them to build up a tax base and reap the marginal benefits. While this process was beneficial to provinces with this special regime, it damaged the central government. The fixed nominal contracts kept federal revenues constant, regardless of economic boom or bust, and undermined the use of fiscal policy for macroeconomic stabilization. It also prevented the center from sharing in the revenue growth of the revenue-richest provinces (Bahl and Wallich 1992; BLEJER and Szapary 1989; OI 1993). More recently, China has reversed this trend by successfully negotiating a new revenue-sharing formula with the richer southern provinces. Under the new
arrangements, the central government has given provinces rights to the full proceeds of the personal income tax (a small revenue yield at present, but potentially very significant), while continuing to share the value added tax and the corporate income tax in a manner that guarantees the southern provinces at least the same revenue yield in 1994 and beyond as in 1993 (Wallich 1995, forthcoming).

Possible approaches for Russia

In the past the Russian central government dealt with disgruntled areas in an ad hoc fashion, primarily through intergovernmentally negotiated subventions. This solution is not transparent, and some oblasts perceive that others are striking more favorable deals with the central government, creating a sense of injustice. The current need for transparency, coupled with the general skepticism regarding democratic governance, demands that other systems be considered.

A transparent system that is perceived to treat each oblast fairly and according to uniform standards is the ideal. However, because of Russia's size and the vast differences in service provision among oblasts, such a uniform system is not likely to work. A second-best solution is likely needed that compensates areas that were fiscally starved under the previous regime and that is perceived to address past wrongs. Absent such a system, pressure from below may destroy the Federation. The challenge is to design such a system in a way that new resentments do not emerge, based on privileges in that regime.

Special fiscal regimes. The current trend of disgruntled oblasts deciding unilaterally to implement a single-channel system is potentially threatening to the financial and political viability of the Russian Federation. These developments call into question whether special fiscal status should be granted to some territories within the Russian Federation. As described, some countries provide special regimes within otherwise uniform systems (Gandhi 1983; Gordon 1983). While widespread single-channel systems could threaten the viability of the Russian Federation, insistence on totally uniform fiscal treatment in the face of demands for preferential treatment could lead to the secession of disgruntled groups. The need for special treatment should not be taken lightly, but special fiscal regimes should be granted judiciously. Ideally, special regimes should not exist, absent serious political conflict. Special treatment, once granted, is virtually impossible to reclaim, and demands for special treatment by other areas will spread rapidly, potentially compromising national revenue goals as well as perceived equity.
Flexible comprehensive formulas. Another way to address demands for special fiscal treatment is consistent with the four-dimensional fiscal framework described in chapter 9. Many oblasts, such as those rich in natural resources and industrial areas, resent the perceived cross-subsidies inherent in the current system and want to opt out. (Empirical studies, including those described in chapter 9, show that there was relatively limited equalization, but the perception, engendered by the murkiness of the system, is important [Bahry 1987; Bahl and others 1993].) But if one oblast is granted a special regime, others with comparable economic strength could demand similar status, leaving only the poorer oblasts in the system. As outlined in chapter 9, choosing the relative balance between derivation-based revenue sharing (the present system) and equalizing transfers has both political and economic dimensions. It can be argued that too much emphasis on equalization at this stage may encourage wealthier oblasts to withdraw, diminishing the potential for implementing any equalization. The framework described in chapter 9 for a new intergovernmental system addresses this tension by proposing a clear division of revenue sharing between equalization (the formula-grant component of the divisible pool) and derivation-based sharing. With an independent, objective body such as a grants commission deciding on the size of the relative shares of the two components, the whole nation could understand how the size of the two components was determined. Indeed, the 1993 expert group established by the Ministry of Finance in Russia to design the limited formula-based sharing of the value added tax attests that this approach has some appeal also in the Russian context.

The equalization formula, used cautiously, can also address other demands for special treatment by incorporating economic factors that are assigned greater weights. If the weights are negotiated, however, this will not represent a serious move away from the old bargained system. The same guidelines suggested as appropriate for granting special regimes would also apply: the economic factors chosen and the weights assigned must be clear and justifiable. Some countries have used equalization formulas successfully to support areas with singular needs. For example, the politically sensitive state of Punjab, in India, receives additional government funding from a component of the tax devolution formula that recognizes the economic costs and difficulty of being a border state. Moreover, as part of India's grant formula, "backward" areas are given extra compensation (Bagchi 1991; Rao 1991; Bagchi, Bajaj, and Byrd 1992). In Russia the distribution formula might give heavier weight, and thus more revenues, to areas with large concentrations of ethnic minorities. These areas could assume greater expenditure responsibilities than others, giving them greater autonomy, while retaining
their participation in the common pool. The formula could also be structured to compensate areas rich in natural resources that have suffered from underdevelopment and environmental degradation.

*Advantages of addressing special needs with a formula*

Using a formula to meet special needs of individual regions is an appealing distribution method. Once established, the component parts of such a system permit special treatment where deemed appropriate by policymakers—but on an objective, transparent basis rather than through closed bilateral negotiations. The components can be used to appease disgruntled groups, while the overall formula maintains the transparency necessary to prevent a sense of injustice. Debate and agreement on a formula would avoid debates focused only on outcomes. The perceived fairness of the formula would encourage areas to stay within the system. Disgruntled areas could obtain special treatment from the formula rather than from a special negotiated regime outside the system. Only areas that can demonstrate that public services are far below the median level should be granted special treatment. Formula decisions could be fixed by the aforementioned expert commission for a period of, say, five years, thus insulating them to some extent from annual political pressures (see chapter 1).

As the Russian Federation searches for national definition following the dissolution of the U.S.S.R., the immediate need for political unity may be as great as the need for equity. The government should encourage widespread participation by establishing an intergovernmental fiscal distribution system that does not overemphasize regional equalization, but incorporates special circumstances as needed, within its distribution formula. This would deter oblasts from negotiating individually for special fiscal regimes or deciding unilaterally to opt out of the federal system. Formula-based distribution can promote patience with economic reforms, and pacify disgruntled areas and keep them in the equalization pool as a national identity develops—an important concern given the pace of economic and institutional change in Russia.

The intergovernmental system can also play an important role in defusing the centrifugal forces arising in well-endowed or natural resource-producing regions by addressing them through, and containing them within, the distribution formula. Unless a transparent system of intergovernmental relations based on objective criteria that appear fair to all parties is developed, the risk to the federal system will probably continue. Without rules, subnational governments will bargain for the best possible package and create their own asymmetrical federalism and special regimes. If localities perceive the uniform system of
intergovernmental relations as fair, they may yield their demands for asymmetrical federalism. A formula-based regime that addresses their needs may be able to respond to these demands for special treatment more objectively. Treatment then will be accorded by virtue of the formula, not on the basis of "ad hocery." A flexible system that responds to shorter-term fiscal goals while also promoting nation building is necessary for long-term fiscal health. If more equalization is desired, the proportion of subnational revenues distributed on a formula-grant basis can be increased; if growth of the better-off areas is desired, more revenues can be supplied on a derivation basis. A system that is perceived as fair and transparent, and is developed in the course of an institutional process in which all oblasts have participated, is likely to promote consensus on revenue sharing and a better system of fiscal federalism.

The division of revenues from natural resource taxes

The intergovernmental system has a similarly important role in defusing tensions over natural resources. An equitable, transparent, rules-based intergovernmental arrangement may make it easier to reach consensus on how key natural resource revenues (taxes on oil and gas are the largest single source of federal revenues) should be shared. If resource-producing localities feel they are being treated fairly under the system of intergovernmental relations, they may concede demands for asymmetrical federalism that they would not now surrender. Mineral-rich regions would be less likely to pursue the "what is mine is mine, what is yours is negotiable" approach as their only leverage.

Russia is a resource-rich country that produces a large share of the world's important minerals, including oil, gas, coal, gold, and diamonds. The production of most of these natural resources is geographically concentrated. Oil and gas are concentrated in the Khanti-Mansisk and Yamal autonomous okrugs and in Tatarstan. Together, Yamal and Khanti-Mansisk produce more than 80 percent of Russia's oil and gas; Tatarstan produces much of the remainder. Hard minerals (especially gold and diamonds) are found in the republics of Yakutia and Bashkiria.

These geographically concentrated and potentially large resource revenues make the tax treatment and intergovernmental sharing of these important natural resource revenues—especially from oil and gas, which are the focus of this chapter—especially important. Depending on resource deposits' quality, accessibility, and market price, revenues can be enormous and sustainable for long periods. Deciding who gets these revenues is not easy; there are both political and economic dimensions to the issue. Subnational taxation of these resources could create enormous disparities in the fiscal capacity of different governments. Industrial and
household consumers may react strongly if they feel squeezed by price increases while producing states collect large revenues. Increased awareness of environmental degradation has also heightened interest in the division of revenue. Jurisdictions experiencing such costs want to be compensated for their damages, past as well as present. For these reasons, the questions of which level of government should levy resource taxes and how revenue from major natural resources should be shared among levels of government are especially important and controversial. The focus in this chapter is on oil and gas and the mineral sector: similar arguments may apply to resources such as tourism, forests, and water. However, since the amounts at stake are likely to be less, the consequences of incorrect treatment may be less severe.

The Russian Federation is in a period of nation building. The nature of the Federation is being defined as key details of intergovernmental relations are resolved. This is in marked contrast to the situation in the United States and Canada during the energy crisis of the 1970s, when debate about intergovernmental resource sharing was heated but continuation of the federal system was not at issue. In Russia, with the nature and structure of federalism in flux, the natural resource issue is potentially divisive.

In Russian natural resource revenue sharing is intertwined with special fiscal treatment and ethnic independence. The resource-rich regions of Tatarstan, Khanti-Mansisk, Yamal, Bashkirie, and the Sakhalin Islands, to name a few, are inhabited by ethnically different populations. Allowing resource-rich republics or oblasts to increase their share of revenues at the expense of the federal government could set a precedent, with better-off industrial oblasts and okrugs demanding similar treatment. Given the importance of natural resources in the Russian economy and the fragility of the consensus on the revenue-sharing system, this chain of events could, in the extreme, lead to the fiscal disintegration of the Russian Federation. The authorities are correct in giving priority to this issue.

Taxation of the natural resource sector in the Russian Federation

Natural resources in the Russian Federation are formally the property of the central state, and thus part of the common wealth of Russia. The new constitution (as well as the constitution that preceded it) clearly states that natural resources belong to the nation as a whole and not to any subnational administration and that their exploitation is a matter of federal jurisdiction. The relevant tax laws allow only federal taxation. The natural resource sector is governed by both the general tax regime (personal and corporate taxes, value added tax, and so on) and by other taxes. A royalty tax was introduced in mid-1992 to increase revenues
RUSSIAN FEDERATION

Selected natural resource endowments

- Energy or mineral resources:
  - Coal
  - Manganese
  - Gold
  - Copper
  - Oil
  - Iron ore
  - Gas
  - Nickel
  - Diamonds
  - Chromium

- Superpipe oil fields
- Superpipe gas fields
- Mining centers

- Oblast, krai, or republic boundaries
- Autonomous oblast, okrug, or republic boundaries
- International boundaries

The boundaries, colors, denominations, and any other information shown on this map do not imply, on the part of the World Bank Group, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.
from the natural resource sector. The petroleum sector is also subject to an export tax, an exploration fee, a tax on the reproduction of resources (to address resource depletion), and an excise tax levied at the wellhead. Until 1993 a significant share—40 percent—of the foreign currency earnings derived from the export of oil, gas, and other major minerals had to be surrendered to the central government at 50 percent of the free-market exchange rate. Domestic price controls on oil and gas constitute an additional "tax." For example, with the domestic wholesale price of crude oil set at about 57 percent of the world price in mid-1994, these price controls are equivalent to a tax of 43 percent of potential proceeds from domestic oil sales. Thus, natural resources are one of the most heavily taxed sectors in Russia (table 10.1).

How natural resources should be taxed

Governments have various ways of taxing natural resources. First, they may own natural resources. They will receive compensation from royalties, production sharing, lease payments, and bonus bids, if others exploit the resources, and from dividends, if a state-owned enterprise exploits the resources. Second, governments may use taxes to appropriate resource income, including severance taxes (on either the volume or the value of production), profit taxes, property taxes (on resource reserves), and export duties. Third, governments may use price controls, export restrictions, and other measures to transfer potential income from producing enterprises to consumers of natural resources.

National and subnational governments must agree on a consistent set of rules for taxing natural resources and assigning or sharing taxes. Otherwise, gaps or inconsistencies can discourage appropriate economic behavior.

Table 10.1 Taxes on oil production, Russian Federation, 1994

<table>
<thead>
<tr>
<th>Item</th>
<th>Domestic</th>
<th>Export</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market value (one ton)</td>
<td>214,000</td>
<td>214,000</td>
</tr>
<tr>
<td>Tax implicit in price controls</td>
<td>92,000</td>
<td>n.a.</td>
</tr>
<tr>
<td>Production tax</td>
<td>9,760</td>
<td>9,760</td>
</tr>
<tr>
<td>Export tax of 30 ECUs; of 15 ECUs</td>
<td>n.a.</td>
<td>73,000; 36,500</td>
</tr>
<tr>
<td>Reproduction tax</td>
<td>12,200</td>
<td>21,400</td>
</tr>
<tr>
<td>Income after taxes, before expenses</td>
<td>100,040</td>
<td>109,840</td>
</tr>
<tr>
<td>Aggregate effective tax rate (percent)</td>
<td>53</td>
<td>49.32</td>
</tr>
</tbody>
</table>

n.a. Not applicable.

Note: Assumes an exchange rate of 2,000 rubles to the dollar, a domestic wholesale price of 122,000 rubles per ton, and a foreign price of $1.07 per ton (mid-1994).

Source: Authors' calculations, based on the tax rates prevailing in mid-1994.
Taxes and fees for environmental damage

The Russian Federation does not levy environmental taxes. Charges to compensate for environmental damage should be considered, because enterprises that exploit natural resources should pay taxes tied as closely as possible to the costs of maintaining the infrastructure they use and to the costs of environmental degradation. Exploitation of natural resources typically creates social costs that are not borne by the exploiting enterprise. These include the budgetary costs of publicly provided infrastructure, such as specialized transportation facilities, and the social costs of environmental degradation, including environmental damage from production.

If such taxes are introduced, they should be based on estimates of social costs, including the cost of the transportation infrastructure and the increased health care needs attributable to environmental degradation. Some activities (for example, oil and gas) create more social costs than others (diamonds), making it difficult to quantify the costs of environmental degradation. In some cases, taxes based on the volume, not the value, of production may be a reasonable surrogate for charges tied more precisely to environmental damage. Rents do not bear a close relationship to the social costs of resource exploitation, and therefore should not be the basis for environment taxes. (However, the calculation of economic rents must incorporate such costs; rents do not exist until all such costs are covered.) Such charges would not cover the costs of correcting previous environmental degradation, since costs are not related to current production. Retroactive payments should be covered from general revenues.

How should revenues from environmental taxes be used? Producing regions should be compensated for expenditures associated with resource exploitation. Revenue from taxes, fees, or charges should go to the locality that incurs the environmental costs. Thus, revenue from this source should generally go to the subnational governments in the producing regions.

Taxes on economic rents

The exploitation of natural resources often produces economic rents—the surplus after production costs are met. Rent taxation is desirable for the natural resource sector because it does not affect decisions about investment, timing, output quantity, or production techniques. Most other forms of taxation—including taxation based on output, such as Russia’s severance taxes and royalties, and taxation based on the estimated value of reserves—do affect these decisions and can threaten the optimal exploitation of resources.
The natural resource tax regime in Russia is instead based almost entirely on the total value of production rather than on profits. Taxes and quasi-taxes based on production appropriate more than 49 percent of the market value of exported oil, making it highly unlikely that any but the most productive fields could cover expenses and show a profit, even before the profit tax (see table 10.1). The situation is worse for domestic production, where taxes and quasi-taxes in 1994 took about 53 percent of revenue (until 1992, explicit and implicit taxes accounted for more than 90 percent of revenues). Given these high taxes, production for the domestic market was highly unprofitable.

Although production-oriented taxes and quasi-taxes have been cut significantly since 1992, they still result in effective tax rates of about 50 percent of revenues. In February 1992 the Russian domestic price of crude oil was just 2 percent of the world price. By September the price had increased to 30 percent, and by June 1994 it had reached 57 percent of the world price. Further upward pressure on the domestic price is being generated by a presidential decree that abolished most export quotas and licenses in mid-1994. In addition, the export tax has recently been reduced, making exports more profitable. At its maximum level in mid-1992, the tax was 44 ECUs (European currency units) per ton, in 1993 it was reduced to 30 ECUs per ton, and in 1994 the tax is supposed to be cut to 15 ECUs per ton. The impact of the reduction in this tax on the effective rate of taxation on exported oil can be seen in table 10.1. The cut in the export tax from 30 ECUs to 15 ECUs results in a 17 percent drop in the effective tax rate. As export restrictions and taxes on oil are lifted, profits will increase because of both increased exports and a higher domestic price of oil.

With such heavy reliance on production taxes, resource production that would be economically viable in the absence of taxes is discouraged. The tax regime is especially burdensome on high-cost production while, perversely, the tax on low-cost, high-yield output is relatively small. The Russian tax system is ill-suited to capture economic rents from resource exploitation.

The Russian Federation should develop a system of resource taxation that falls on economic rents, not production. These taxes can capture a portion of resource rents for the fisc, in a neutral way, ensuring that the budget, and not only foreign or domestic enterprises, benefits from resource exploitation (Conrad, Shalizi, and Syme 1990; McLure 1984; McLure and Mieszkowski 1983). Although such a profit-based system would be ideal, experience from other countries suggests that implementing it would be difficult. This section has focused on revenues from oil and gas because of their enormous importance for Russia; still, much of what has been said is just as relevant to revenues from other resources, including hydroelectric power and coal.
Intergovernmental relations and natural resource revenue sharing in Russia

In the Russian intergovernmental system, taxes are assigned to the central or subnational governments, although some designated “regulating taxes” are shared (see chapter 9). The most important dimensions of this regime for the petroleum sector are shown in box 10.1. In addition, the value added tax and corporate and personal income taxes paid by resource-based industries are shared by the federal and subnational governments.

Which government should receive resource revenues and rents?

Who gets the revenues from natural resources is one of the more contentious issues in politics, although not in public finance theory. The general consensus among public finance academic experts is that most revenue from resource taxes should accrue to the federal government although practice differs from this in many countries.

Box 10.1 Rules for sharing oil and gas revenues, Russian Federation

Export tax
100 percent to federal budget by law; in practice, 30 percent shared with oblasts

Production tax (royalty)
Production not in autonomous region/okrug
   40 percent to federal budget
   30 percent to oblast or republic
   30 percent to rayon or city
Production in autonomous region/okrug
   20 percent to federal budget
   20 percent to oblast or republic
   30 percent to okrug
   30 percent to rayon or city
Production from continental shelf
   60 percent to oblast, republic, or okrug
   40 percent to federal budget

Excise tax (18 percent)
100 percent to federal budget by law; in practice, 30 percent shared with producing oblasts

Source: Law on the Subsoil, Russian Federation (1992), and other laws.
The case for federal taxation of resources is threefold. First, revenues from resource rents are volatile, dependent upon output and especially price. A subnational government that depends on revenue from an extractive resource may find its fiscal position dangerously unstable. Assigning unstable revenue sources to subnational governments can complicate macroeconomic management, especially if subnational governments base their spending on their short-term revenue availability (Musgrave 1983; Auerbach and Feldstein 1985).

More important, the uneven geographic distribution of natural resources means that assigning resource rents to subnational governments can create large differences in the fiscal capacities of subnational governments. This would argue for national-level taxation, in spite of the fact that natural resources could be considered an immobile base. During the 1970s the tax capacity of the energy-rich state of Alaska was estimated to be 515 percent that of other U.S. states (Cuciti, Galper, and Lucke 1983, pp. 38–39).

With the unequal distribution of natural resources in the Russian Federation, generous sharing of federal resource revenue with producing oblasts could create large fiscal disparities. An analysis of the regional distribution of production of oil is quite dramatic. Almost 70 percent of 1993 production occurred in Khanti-Mansisk, an oblast with less than 1 percent of Russia’s population; Khanti-Mansisk’s share of production is more than seventy times its share of the population. In per capita terms, the shared revenues that would accrue to some producing oblasts would be enormous, if resource revenues accrued to them. Based on an oil price of 31,000 rubles per ton, Khanti-Mansisk would receive 340,550 rubles per capita in shared taxes in 1993—about three times the minimum annual wage at that time of 96,000 rubles. It would receive 1,087,560 rubles per capita, or ten times the mid-1993 minimum wage, if domestic oil prices were raised to world levels (99,000 rubles per ton, or $110 in this example). Other jurisdictions join Khanti-Mansisk in the list of resource-rich jurisdictions when nonoil natural resources are considered. Thus, in the current environment of decreasing protection of consumers of oil and an increasing domestic price of oil, the share of revenues accruing to resource-rich areas will escalate rapidly if resource revenue is shared with producing oblasts.

Another argument for national-level taxation of natural resources is that cash-rich subnational governments could lower taxes on local residents and businesses, make cash payments to residents, or provide an exceptionally high level of public services and subsidize business activity within the jurisdiction. These responses could distort economic choices,
inducing inefficient inflows of capital or labor that are not justified by the relative factor productivity in the producing locality, thereby reducing national output. As has been written in a similar context, "The case for limiting Alaskan petroleum revenues at the margin is very compelling" (Mieszkowski and Toder 1983).

Arguments for subnational taxation

Subnational governments argue that they should be compensated for the environmental degradation that resource exploitation brings. To ensure both equity and economic efficiency, they argue, subnational governments should receive enough tax revenues or fees to defray these localized costs. While considerable revenues might be needed to compensate for past wrongs, it is unlikely that future degradation could justify allocating the lion’s share of revenues to subnational governments (Hellerstein 1986).

Subnational governments also argue that they are entitled to a share of resource rents. This would enable them to convert resource wealth—the jurisdiction’s heritage—into financial capital. In this way, they would turn oil in the ground into money in the bank. In this view, resource revenue is considered just compensation for "losing forever a one-time harvest" (Link 1978, p. 264).

Finally, there are arguments based on indemnification. An ironic feature in Russia is the poverty in resource-rich areas. Inhabitants of resource-rich regions have not shared in resource wealth as they commonly have in Western market economies. Instead, they are among the poorest members of Russian society. Although wages in the oil sector are high, most are earned by temporary guest-workers from other regions of the former U.S.S.R. who work in the resources sector, but remain nonresident. And higher prices and transport costs in resource-rich regions mean that in real terms, they are not as well off as their money wage might suggest (see chapter 9). In the Russian Federation, people living in oil-rich areas tend to see future payments for natural resources as a form of indemnification for previous abuses under the Soviet system: poverty, environmental degradation, and the despoliation of areas traditionally used by indigenous peoples. Depending on how resource rents are shared, this situation could change as domestic prices are brought in line with world prices.

The political dimension

These considerations are essentially political. Are natural resources part of the nation’s common wealth, or do they belong to the subnational
jurisdiction? If primary allegiance is to the subnational government, as it might be in a confederation, the entitlement argument has some validity. If primary allegiance is to the national government, then the natural resource heritage is considered part of the national common wealth (as perceived in most federations) and its benefits should accrue to the entire nation.

Such political considerations must be recognized if consensus is to be reached on resource revenue sharing. Subnational jurisdictions may be willing to join a federation, or remain part of one, if their natural resource patrimony is protected (Musgrave 1983). This last argument for subnational assignment is a powerful one, and may in the end be the most important in Russia (as it has been in Canada; see below). The executive branch in Moscow lacks the strength of the federal governments of Australia, Canada, or the United States, and it has no obvious recourse when subnational governments refuse to remit tax revenues. This argues for the sharing of natural resource and general revenues according to a system that is fair, transparent, and based on consensus.

Sharing natural resource revenue: International practice

There are a variety of approaches to sharing natural resource revenue. It is generally agreed in the academic literature that, aside from what is necessary to offset the social costs of exploiting natural resources and, arguably, the revenues needed to bring public-service levels in the producing localities up to acceptable levels, revenues from taxes on natural resource rents should be assigned to national governments instead of subnational ones. Both distributional and efficiency reasons support this consensus (Gandhi 1983; McLure 1984).

Not all countries are in accord with the academic view that national taxation is preferable. Throughout the world, industrialized nations with federal systems do not assign taxes on natural resources according to commonly accepted normative considerations, as explained below.

In the United States, natural resources are taxed under federal and state income taxes (levied by about thirty-six of the fifty states), state severance or production taxes, and local property taxes. In addition, Alaska obtains enormous revenues from oil and gas produced on state lands, and Texas obtains some. Both federal and state governments receive royalty payments from natural resources produced on federal lands within their boundaries. During the energy crisis of the 1970s, fiscal disparities resulted from the concentration of natural resources in a few states.

In Canada, the Constitution assigns ownership of natural resources to the provinces, giving them access to royalties and tax revenue. Extreme geographic differences in resource endowments created large
disparities in resource revenue and consequent political upheaval during the 1970s and early 1980s (Courchene and Powell 1992). (Roughly 85 percent of all oil and gas is located in one sparsely settled western province, Alberta.) Given the differences in the fiscal capacities of the various provinces, a transfer system that promotes equalization has been an important part of the Canadian fiscal and intergovernmental landscape. For the federal level the primary source of revenue from oil and gas at present is the corporate income tax, although excises and production taxes have also been important at times. While “efficiency and simplicity considerations point strongly to the need to reallocate resource taxes from the provincial to the federal level,” provincial ownership and control of resources are “undoubtedly one aspect of the federation which is immutable” (Ip and Mintz 1992, p. 86; Boadway 1992, p. 16).

In Australia, the Constitution gives states title to natural resources located within their borders. States can tax these resources despite constitutional prohibitions on the use of both income taxes and indirect taxes. The federal government also has wide-ranging revenue powers, including leasing of offshore drilling rights, an export duty on coal, a levy on natural gas and crude oil, and the company income tax. It collects a 10 percent royalty from offshore minerals and transfers 60 percent of it to the states.

As in the United States and Canada, Australia’s uneven geographic concentration of resources has led to disparities in state revenues from resources. For example, during 1978–79 states raised between $A3 and $A43 per capita (2 to 20 percent of total revenues) from resource taxes. The federal government, by comparison, raised $A137 per capita (9 percent of taxes) from resource taxes. These disparities are less troubling in Australia than in the United States or Canada because generous federal grants to the states offset any resulting inequities.

In Malaysia, the federal government has increasingly depended on revenue from the petroleum sector, which currently accounts for 7 percent of GDP. The Malaysian states ceded all rights to oil and gas resources to the federal government. In compensation, the three oil-producing states receive 50 percent of total royalty payments, or 5 percent of gross production. In 1990 royalty receipts contributed to 11.5 percent of state revenue. Because natural resources are distributed unevenly throughout the country, the revenue capacity of the various states has varied considerably. For example, during 1977–79 per capita revenues from own sources in oil-producing Sarawak were five to six times those of states with the next highest figures. These in turn were well above the national average. The differences are not corrected by the federal grants to states, which are fairly uniform in per capita terms (Ariff 1991).

Finally, in Brazil, 70 percent of revenue from the federal taxation of minerals is shared with the states of origin. Another 20 percent of federal
mineral taxes are shared with municipal governments. Because state governments have important revenue sources of their own, especially the value added tax, transfers from the federal government are relatively unimportant (Shah 1990, 1991).

To conclude, the subnational governments in the industrialized countries cited have considerable latitude to levy taxes on natural resources, despite the geographic unevenness of this tax base. By comparison, tax assignment in the developing countries is apparently more rational—and at least more consistent with theoretical principles (Gandhi 1983). This could simply reflect a tendency among developing countries to exhibit more centralized government finances.

One important reason for the divergence between theory and reality may be that academic analysis of "the tax assignment problem" did not exist when the constitutions of Australia, Canada, and the United States were drafted. The extent and location of resources was also unknown and neither level of government knew the stakes. In newer federations such as Malaysia, the process of bringing the federation together may have required this approach. In Russia, however, the location and value of many resources are fairly well-known and will not be overlooked.

### Natural resource sharing: Options for Russia

The issue of natural resource sharing raises a fundamental question: What is the nature of federalism in the Russian Federation? Careful consideration of five issues should guide Russia as it designs the sharing of natural resources.

**Compensate for social costs.** Subnational jurisdictions, and the ethnic groups whose income from traditional activities may be lost, should be compensated for the financial, social, and environmental costs and losses related to resource extraction.

**Ensure that rents are appropriated by the government budget.** Potential resource rents in the Russia Federation are very large, and there will be many claimants, including consumers, producers, workers and managers, shareholders, foreign investors, related industries, and indigenous peoples, to name just a few. Whether or not there are delays in designing an appropriate natural resource tax regime, these rents will be appropriated, though not necessarily in a fair and economically sensible manner, and almost certainly not for the budget. Once a given distribution of rents is established, it may be difficult to revise the system, since the wealth generated by resource rents can lead to political influence that impedes reform.
Allow only the federal government to tax important resources. In Russia today, some subnational governments are introducing their own natural resource taxes, independently and without central approval. In addition to the problems of equity and inefficiency, multiple and conflicting oblast taxes on natural resources would spell chaos for investors. If subnational governments are to obtain resource revenues from significant natural resources such as oil and gas and other minerals, it should be through sharing, not through their own taxes.

Craft intergovernmental sharing arrangements carefully. Disagreement over the proper intergovernmental division of revenue from natural resources is inevitable. Most analysts agree that tax revenue from natural resource rents should go to national governments, not subnational ones. Nevertheless, political realities in many countries dictate that subnational governments receive at least some preferential benefit from their resources—even where, as in Russia, the ownership of the resources, formally, is national.

The question is also one of the nature and survival of federalism. Is the primary allegiance to the Russian Federation or to a smaller subdivision such as the oblast or republic? Will the federation survive if the federal government insists on taking the lion’s share of resource revenues? Depending on how this question is answered, the division of resource revenue can take many forms. Other countries facing this issue have found there is no single, correct answer.

Adopt a federal or confederal view? If citizens perceive that their primary political allegiance is to the Russian Federation rather than to subnational governments—if, for example, they think of themselves as Russians rather than as Siberians—then the federal government should have primary access to fiscal revenues from important natural resources that are distributed unequally throughout the Federation. This argument is based on equity and economic efficiency—the locational distortions and inequities created by large differences in subnational fiscal resources, which in turn translate into a disparate ability to supply public services, should be minimized. Implicit in this view of equity is that large discrepancies in income and service levels across subnational governments are undesirable and should not be aggravated by allocating resource revenues to these subnational entities.

However, the people of the Russian Federation may see themselves as a confederation, with primary allegiance to the subnational entities. In this case oblasts would want primary access to fiscal revenue from their natural resources. This perspective does not view differences in average incomes across subnational units as a major concern.
A compromise for Russia?

Russia's design of a revenue-sharing scheme does not have to be a question of all or nothing. The fact that in the past natural resource-producing regions have received little from their endowments suggests that compromise can be reached that would be beneficial to both oblasts and the federal budget. This compromise involves sharing revenues between the federal budget and the oblast or okrug. The current 40-60 federal-oblast split (or 20-80 federal-subnational split for an okrug) may, however, disproportionately favor the subnational level and especially resource-rich regions—particularly as prices rise to international levels.

To achieve this compromise, a link between natural resource sharing and the tax sharing system may be essential. Oblasts want tax authority over their natural resources because they perceive revenue sharing and transfers to be unfair. The introduction of a transparent, formula-based grant system could well be the sine qua non of an increased federal share in natural resource revenues. The Australian approach may be relevant to Russia. Disparities inherent in Australia's state taxation of natural resources have been partially offset by an equalizing grant system that helps areas poor in natural resources, because Australia values equalization highly.

The Russian Federation's approach and choices regarding the sharing of natural resource revenues may thus depend on the design of revenue sharing under the general intergovernmental system. Giving the federal level a large share of resource taxation may be palatable to the powerful producing oblasts only if a generous share of the revenues is allocated on the basis of derivation and the formula-based equalization fund includes a special weight on natural resource-producing oblasts.

Another issue is how the federal share would be used. In the context of the unified intergovernmental sharing regime described in chapter 9, the federal share could be devoted entirely to federal budget outlays, given its fiscal constraints. Or it could be channeled in part to the subnational equalization pool, to be shared with the oblast governments according to a formula, allowing nonproducing oblasts to benefit from resource exploitation. Sharing resource revenues among oblasts in this "brotherly" manner might be more acceptable than sharing them between levels of government.

Will the Russian Federation survive if the federal government insists on taking the lion's share of resource revenues? Most academics agree that natural resource taxation should be a federal affair, but that local jurisdictions must be compensated for the costs of environmental damage from production and for the costs of any required social infrastructure. A case can also be made that local jurisdictions should also be
entitled to a share of revenues sufficient to bring schools, hospitals, care for the elderly, roads, and housing up to national standards. In the Russian Federation both points are important because the earlier regime left producing areas environmentally degraded and did not allow the benefits of natural resource revenues to flow to the oblasts. Khanti-Mansisk, Yamal, Tatarstan, Bashkiria, and other resource-rich regions are also arguably among the poorest in Russia in terms of social infrastructure, roads, schools, health facilities, and so on.

Using the revenue from natural resources

Natural resource-rich jurisdictions often have windfall gains or budgetary inflows that far exceed current budgetary outlays or immediate investment opportunities. In Khanti-Mansisk, for example, the okrug government estimated that with world prices for oil, production tax revenues (of which the okrug gets 30 percent) would be 70 billion rubles, or four times the okrug's annual budget for 1992. It will be critical to use these revenues wisely.

At least four options are available for using such windfalls: spending them on current outlays; investing them in a trust or heritage fund; providing grants to local citizens; and reducing the tax burden on local citizens.

Given the budgetary stringency in the current fiscal environment, any resource revenue obtained by the federal level will probably be devoted to current budgetary outlays. It would be unwise for resource-rich okrugs receiving large windfalls to do the same. Although a case can be made for using some revenues to raise public service levels to national standards, raising spending rapidly to a multiple of current budgets implies low productivity outlays. Establishing a trust or heritage fund to convert the nonrenewable natural resource into financial capital is a judicious strategy.

Three alternatives for managing resource revenues in the trust fund are investing in the resource-producing regions, investing throughout the Russian Federation, and investing in financial assets outside Russia. Several producing oblasts favor local investment because it helps to build an industrial base.

The contrasting experiences of Kuwait and Saudi Arabia, which invested primarily in world capital markets, and those of oil-rich developing countries, which borrowed against future oil revenues and invested heavily in resource-based industries, show how important these decisions can be (Gelb and associates 1988). Russia's oblasts should invest for the future. The heritage fund should pursue a strategy of high returns, with investments based on financial criteria alone, wherever the investment is located. There is an essential distinction between trust fund models and
development models of investment. The first, used in Alaska, emphasizes stability, portfolio diversification, and guaranteed return. The second, practiced in Alberta, Canada, considers social criteria in its investment decisions. A developmental fund maintains investments within the region, hoping to stimulate employment or provide local capital.

Both resource-rich subnational governments and native populations need to avoid the seductive but wasteful trap of development funds. Alberta has devoted much of its trust fund to local investments, including investments in petroleum-related activities and resource-based industrialization. Many petroleum-exporting countries have followed similar policies. The rate of return on these local projects is usually low, and little revenue is left for future generations compared with investments where the return is highest. In Russia such high-return investments will generally be outside the local area, and perhaps outside the country. Income from these investments can be used for local purposes, while the principal will continue to grow, ensuring continued funding for the future.

**Conclusion: Dividing the spoils**

The potential resource rents in the Russian Federation are large. There will be many claimants to these rents. All three levels of government, as well as consumers, producers, workers and managers, consuming industries, foreign investors, and indigenous peoples, could claim these rents from natural resources, depending on how economic liberalization moves forward. While natural resources are owned formally by the federal government, recent events have challenged this principle. The Law on Ethnic Minorities under consideration by the Duma gives indigenous populations what amounts to veto power over the development of natural resources in their traditional lands. The native peoples of Khanti-Mansisk already have such power under a presidential decree. Contracts between the enterprise and the tribe are supposed to define compensation and govern resource exploitation.

If the Law on Ethnic Minorities is implemented and enforced, indigenous people would hold one of the most important attributes of ownership—veto power—and would be able to extract much of the resource rents derived from production on their traditional lands. For example, if the native population of Khanti-Mansisk—which is only 54,000 of the oblast's 1.3 million inhabitants—could extract resource rents, they would become extremely wealthy.

The issue of claimants on resource rents is more complex in the Russian Federation than in most market economies. It encompasses such diverse issues as price liberalization, privatization, demonopolization, the regulation of public utilities (such as pipelines), labor relations law,
inadequacies of domestic capital markets, and the liberalization of international trade—in short, most of the issues associated with transition to a market economy as well as issues that are pertinent to the rights of indigenous peoples. The same issues may be relevant in a developed market economy, but they usually do not arise because of the more stable legal and economic setting. Depending on how these issues are handled, there may not be much rent to divide among governmental claimants. If these issues are handled in a way that promotes competition and a market economy, the resource rents should be substantial. And, under almost any scenario, the tax assignment issue will be paramount.

Notes

1. This upward system also applied in the former Yugoslavia, with similar results. China is presently reforming the system to avoid this vulnerability.
2. The legislated sharing rate was 17 percent in the first-quarter 1993 budget, but the rate was reduced to 14 percent when implemented.
3. For a description of the Russian Federation's overall tax system, see Wallich (1992a).
4. For a more detailed discussion of natural resource taxation, see Charles McLure, "The Sharing of Taxes on Natural Resources and the Future of the Russian Federation," in Wallich (1994). The Law on the Subsoil is a royalty arrangement passed in May 1992. It specifies a royalty or severance tax that ranges between 8 and 21 percent of the value of production for oil and gas, depending on the profitability of petroleum fields. The tax base is calculated as the volume of output multiplied by the domestic wholesale value; it was 2,000 rubles per ton of oil in mid-1992. Other taxes include an export tax of 30 ECU (European currency units, worth about $36.50) per ton of oil exported and fees for the reproduction of resources, equivalent to 10 percent of the value of production (in foreign exchange if the output is exported) and earmarked for a fund for petroleum sector investments by state-owned enterprises and selected private enterprises. An exploration fee of 1 to 3 percent of the value of exploration expenditures is being considered, as is a fee for the exploitation of the continental shelf.
5. Such costs include labor payments, interest and other payments for debt, capital depreciation of equipment and supplies, governmental charges for services and facilities, compensation for the environmental damage and other social costs of production, and the return-to-equity capital required to induce investment.
6. Competitive bidding and auctions are other methods for extracting rents, given a sufficient number of independent, noncolluding bidders. See McLure, op. cit.
7. The effective tax rate is the tax rate implicitly defined by price controls, taxes, and quotas. Nominally legislated tax rates are far lower than the actual effective tax rate producers in Russia experience.
8. Based on a production tax of 30 ECUs per ton and oil production of 224 million tons. This estimate attributes all of Tyumen region's oil production to Khanti-Mansisk.


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