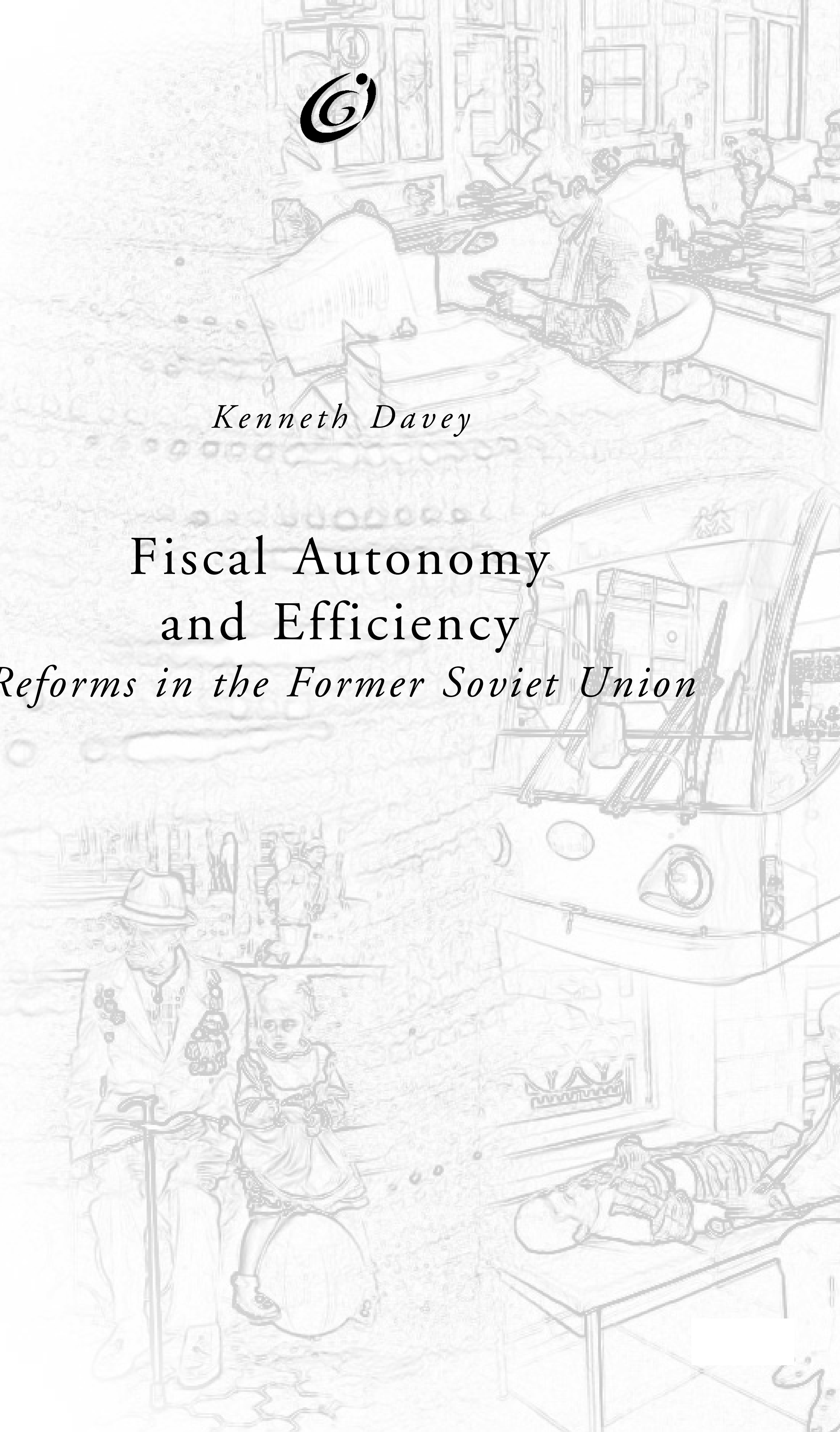

Kenneth Davey

Fiscal Autonomy and Efficiency

Reforms in the Former Soviet Union

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1. INTRODUCTION

This volume combines studies of fiscal decentralization in four countries formerly part of the Soviet Union: Armenia, Georgia, Russia and Ukraine. It describes and compares their diverse approaches and experience in adjusting their public finance systems to the introduction of representative democracy in the lower tiers of government.

2. FISCAL DECENTRALIZATION

Fiscal decentralization comprises the financial aspects of devolution to regional and local government. Currently, it is the fashionable term; the alternative descriptions "central-local (or intergovernmental) financial relations" and "fiscal federalism" are often used by European and American writers respectively.

Fiscal decentralization covers two interrelated issues. The first is the division of spending responsibilities and revenue sources between levels of government (national, regional, local, etc.). The second is the amount of discretion given to regional and local governments to determine their expenditures and revenues (both in aggregate and detail).

These combined dimensions have a significant impact on the reality of decentralization in its broader political and administrative sense. How much power and responsibility regional and local governments actually exercise depend substantially on:

1) what range of public services they finance;
2) whether their revenues are commensurate with these responsibilities;
3) how much real choice they have in allocating their budget to individual services;
4) whether they can determine the rates of their taxes and charges (both allowing them to vary their level of spending and making them answerable to the payers).

3. THE COMMON LEGACY

The Soviet system of local finance included some elements of fiscal decentralization. A very wide range of services—both physical and social—was financed from local budgets. These budgets shared the local yields of substantial taxes on land, enterprise and personal incomes, and business transactions. Redistribution between budgets included elements of both horizontal and vertical equalization.

Lacking was democratic accountability in the power structures managing local budgets. Absent too were the financial instruments which reinforce local accountability: local responsibility for levying charges and taxes and determining their rates, a normative basis for tax sharing and equalization, the efficiency and discipline of having to balance budgets and keep them balanced. Instead, rates of taxes and charges were determined centrally; the shares of local taxes, which could be locally retained, or the supplements from higher level budgets were arbitrarily decided and subject to frequent change. Improvements in local tax yields could easily result in an unfavorable adjustment to the sharing in the following year. Financial viability depended on political influence with higher levels, not careful management in the locality.

Each of the four countries has introduced elected structures of local government over the past decade and has had to adjust its public finance system to a new and more democratic system of public administration. It has had to do so in a time of radical economic change and fiscal stress. The financial aspects of decentralization have not been helped by the high degree of territorial fragmentation which has accompanied and characterised the establishment of local government bodies. The large number and varying sizes of local governments have increased administrative overhead costs and deprived the smaller communities of economies of scale in running public services.

4. SPENDING RESPONSIBILITIES

4.1 International Comparison

There is great diversity worldwide between individual states in the scale of the tasks devolved to local government. In most countries, local government is responsible for what are often called "*communal services*": local roads and lighting, water supply and sanitation, waste management, parks and sports facilities, cemeteries, social housing. What varies greatly is the extent of local responsibility for the *social sector*, chiefly comprising education, health and social assistance. In some cases the whole service is funded by the State Budget, while in others the costs are split between levels of government, and in some local budgets meet all costs except central supervision. Cost splitting may be by function (e.g., the State paying for secondary education, hospitals, social benefits, and local government for basic education, primary health care and social services) or by cost factor (e.g., the State providing professional salaries while local government pays all other operating costs).

This varying degree of local budget responsibility for the social sector makes a major difference to the nature and scale of decentralization. Without significant social sector responsibility, local government expenditure is unlikely to exceed 5-6% of GDP. Responsibilities for education, health care or social assistance are likely to double or treble this proportion. This in turn has a major impact on financial self-sufficiency. Major social sector responsibilities are usually combined with a substantial dependence on State grants or tax shares, both because of the limited capacity of revenues which can be assigned to local levy and because of the degree of geographical equality expected in access to these services and, in consequence, the need to equalize financial resources.

4.2 The Four States

The Soviet system regarded local bodies as subordinate agencies of the State rather than autonomous entities with their own powers, responsibilities and property. As a result there was much overlap between the competence of the various tiers. This has not been fully resolved although there are current efforts to define the respective tasks of regional (oblast), district (rayon) and local (town/village) levels more precisely. The recent Ukraine Budget Code includes a detailed distinction between the tasks of each level and this is being repeated in draft legislation on local Self-government and local state administration. Draft amendments to the Georgian local government legislation have the same intention.

In all four countries the primary level of local government (city, town or village) has responsibility for a wide range of physical infrastructure and utility services including local roads, waste management, water supply and sanitation, social housing, cemeteries, energy supply, heating, public transport and parks. The exercise of this responsibility is constrained, however, by a number of factors. The enterprises which actually deliver these services are often owned by higher levels of government (or privatised), the rates of consumer charge are usually still controlled by the State, and many of the smaller towns and villages lack the necessary scale economy to provide the service effectively. Nevertheless, these tend to be classified as "original" or "own" local government functions.

Responsibility for the social services differs markedly between the four countries. These include pre-school, primary and secondary education, health care, social benefits and social services. In Armenia these are state responsibilities which local governments may supplement on a voluntary basis. In Ukraine they are State tasks delegated to local government at the level of the city and rayon (i.e., not to the smaller towns and villages subordinated to rayons). In Georgia expenditure on these services is "earmarked"; draft legislation assigns them (as in Ukraine) to the rayons and cities of rayon status. Only in Russia are they recognized as original local government tasks.

The distinctive status of these social sector tasks in Georgia and Ukraine recognizes two characteristics of the social services that distinguish them somewhat from the physical infrastructure tasks. Firstly, they tend to be governed by national standards which are based on an expectation (not always achieved) that citizens have an equal right to receive them, wherever they are located. Secondly, many of the institutions through which these services are delivered (secondary schools, hospitals, residential care homes, for example) have catchment areas which exceed the territories of individual towns and villages.

The studies refer frequently to the problem of "unfunded mandates." These are duties imposed on local governments which exceed their financial capacity. The examples given pertain largely to social services and benefits; the Russian case, for example, refers to the local government duty to provide subsidised housing, utilities, medicines, public transport etc. to 27 categories of people from war veterans to judges. Strictly speaking, if there is a budget gap between overall revenues and overall expenditures, it is not clear which particular costs are uncovered. The fact that social benefits are particularly singled out as "unfunded" indicates the degree of precision with which local budget obligations are defined in this sector, encouraging a perception that local government has very little discretion in fulfilling them.

The studies emphasise the dominance of social expenditures where they form part of local budgets. Education alone constitutes on average 33% of local budgets in Russia.

5. LOCAL TAXATION

The legislation in all four countries recognizes a category of "local taxes," which generally includes taxes on land, property and advertising. (In Russia only property owned by physical, not legal persons is included). Revenue from local taxes is distinguished from shares of state taxes.

The reason for classifying taxes as "local" in the four countries is not entirely clear. There are varying definitions of "local taxation," but it is usually taken to describe taxes which:

(1) accrue to the budgets of the local government in whose area they are collected, and
(2) are subject to some degree of variation by the recipient local government—i.e., the local government has some discretion in deciding how much each person pays, by setting the rate, determining the basis of assessment, granting exemptions, etc.

Neither criterion fits these local taxes precisely. In Russia, for example, local budgets only receive 50% of land tax revenues. In none of the four countries can local governments set the tax rates.

All authors consider local tax revenues to be too low. This raises the question of what constitutes local taxation from an economic rather than legal perspective and how much contribution it should make to local service provision.

Local taxes are only one of three methods by which local governments can derive money from their own territory. The others are:

(1) tax sharing by origin i.e., percentages of federal or regional taxes allocated to the territory where they are collected;
(2) tax base sharing, i.e., where local governments can apply a locally determined surcharge to a federal or regional tax.

Local taxation has three potential advantages. The first is the enhanced discretion and accountability arising from decisions over tax rates; this applies to "local taxes" if the rates are not fixed by law, and to tax surcharging. It does not arise in the case of tax sharing by origin.

The second advantage is the incentive to improve tax administration. This applies to all three types of local taxation, i.e., local taxes, local tax surcharges and tax sharing by origin.

The third potential advantage is their relative certainty and protection from arbitrary decisions by higher levels of government. This cannot be guaranteed to any type of local revenue, since they are all subject to changes in legislation and economic environment. However, they are more stable if they are governed by permanent laws rather than by annual budget laws.

In short, (i) increases in local taxes, (ii) higher origin based shares of national/regional taxes or (iii) local surcharging of federal/regional taxes are all options for improving the local tax base and increasing incentives to local tax administration. But two of these options, increases in local taxes coupled with local responsibility for setting tax rates, and local surcharging of national taxes have the added advantage of increasing local discretion and accountability.

6. TAX SHARING

The Soviet system of local budgets depended substantially on tax sharing. This has remained in force, not only in the four countries but in most of the former communist states.

Taxes can be shared by origin or formula. For example, an allocation of 20% of corporate income tax to local governments could mean that:

(1) (by origin) each local government gets 20% of corporate income tax collected within its territory;
(2) (by formula) 20% of corporate income tax goes into a national pool which is then distributed to individual local governments by formula (population and other factors).

The four countries retain the Soviet system of sharing by *origin*. Its advantages are largely in terms of incentive and political acceptability. On the other hand origin shares will favour wealthier areas and accentuate disparities already existing in the local taxation base. This may be acceptable in financing physical infrastructure where costs are greater in the more productive areas, but it is a less efficient basis for funding education, social assistance or health care where national policy normally demands rough equality of standards. In such cases, origin based sharing needs to be accompanied by an effective system of equalization, a point to which a later section will return.

Sharing by origin can only really be fair if the tax revenue really originates from the territory to whose budget it accrues. This is largely true of taxes on personal income, property and land. It is not the case of corporate income tax if paid to the territory where a company's head office is located, or of an excise or sales tax which is effectively passed on by its payers to consumers located elsewhere.

Quite logically, the most regularly and substantially shared tax in three of the four countries has been that on personal income (PIT). Georgian local budgets retain 85% of PIT; the local share in Russia varies between regions but must not fall below 50%. PIT is part of a local "tax basket" in Ukraine divided 3:1 between cities/rayons and oblasts. Armenian local governments have lost their former 15% share in exchange for 100% of land and property taxes; but, exceptionally, they do not bear major social services costs.

Under the Soviet system local budgets also retained some shares of tax on *corporate profits.* These are generally in decline as a source of local government revenue throughout Europe. There are severe technical difficulties in assigning such receipts to the local government from which the profits truly derive. Corporate profits are highly volatile and the base lacks the stability to support services with such a large component of regularly committed expenses as those of local government. National governments are anxious to restrict taxes on this base to attract inward investment.

Practice over sharing corporate profits tax (CPT) in the four countries is varied and volatile. In Russia local governments can surcharge federal CPT by up to 5%. Georgian local budgets receive 85% of CPT as well as PIT. In Ukraine, however, only the capital city now receives shares of CPT; elsewhere it accrues solely to the State Budget.

In terms of long-term reform, the most favorable feature of the current financing system in Georgia, Russia and Ukraine is the allocation of major shares of PIT to local budgets. Western experience confirms that it is the only tax source that can both be assigned to local budgets without major distortions and meet substantial proportions of the costs of social services like education and health care. It is in any case a logical base of funding for services to people rather than property.

The major disadvantage of the current tax sharing systems in the four countries is their volatility. In each country, authors refer to constant change both in the taxes shared and the percentages awarded to local budgets. The new assignments in Ukraine are part of the Budget Code and not, therefore, subject to change by annual State Budgets. It is to be hoped that this points the way to greater stability.

The other drawback is that tax sharing gives local budgets the yields of revenues which it does not have the responsibility for determining. It is clear that local governments do have influence, though not direct control, over the effectiveness of local tax administration; the Ukrainian report demonstrates the incentive effects of tax sharing in this respect. Converting local sharing of PIT to local surcharging on the Scandinavian model would kill two birds with one stone. It would make local governments accountable for tax decisions, and it would make it much harder for the State to reduce their share of the tax yields.

7. CONSUMER CHARGES

Perhaps the stiffest challenge facing the local finance systems relates to the funding of the local public utilities. The Russian study reports that as much as 50% of some local budgets may be spent on subsidies to the operational and maintenance costs of the utility enterprises.

"Transition" involves bigger changes for this sector than for any other branch of local government finance. This is basically because in a market economy these services fall unmistakably on the private side of the public/private good divide, a distinction unrecognized in the Soviet system. In 1994 Russian consumers paid only 4% of the operational and maintenance costs of the local public utilities, with no contribution at all to capital costs. The generally accepted principle in market economies is that both efficiency and benefit equity justify charging consumers the full cost (including the recovery of capital costs through amortization, depreciation or asset rental). Public subsidy should be restricted to cases where consumers are too poor to afford the full cost of such minimum level of service as may be regarded as essential to the quality of life.

These principles have generally been adopted in the ex-Soviet countries. The 1997 Russian Conception of Public Utilities Sector Reform formulated several goals including:

(1) developing competition in the public utilities market;
(2) increasing the contribution of consumer charges progressively to 100% by 2003;
(3) limiting subsidies to the excess of charges over 25% of household income (the eligible charges being assessed on minimum normative levels of housing space and quality).

These aims are being repeated in the other three countries. Ukraine, for example, also uses 25% of household income as a threshold for housing and communal service subsidy. However, implementation faces many constraints that are common in varying degree to all four countries. These include:

(1) lack of effective municipal control over the utility companies;
(2) difficulty in improving efficiency and severe resistance to the introduction of effective competition;
(3) lack of effective sanctions against non-payment of charges, particularly by commercial users;
(4) the sheer scale of household poverty making it difficult for local budgets to meet the residual entitlement to subsidy; in Armenia, for example, it is calculated that less than half of the households can afford to pay full costs.

Energy costs dominate local public utility expenditure. The control and economics of the energy sector are major issues in each country, involving national policy choices and political struggles. The fundamental problem for local governments is that their legal duty to manage the provision of public utilities and to implement a reformed system of subsidisation is incommensurate with their real political weight. This has, to some extent, been recognized by the Ukraine Budget Code which has converted the funding of housing and communal service benefits into a State Budget subvention, rather than a charge on the local revenue "basket."

8. EQUALIZATION

8.1 The Role of Formulae

As already mentioned, the Soviet system of local finance involved redistribution, but it had no formulaic base and was not systematic, consistent or transparent. It purported to balance local revenues and expenditures, basically by varying local rates of retained revenue shares, but the system of calculation included two major perverse incentives. The calculation of local revenues was based on the previous year's actual performance and actively discouraged local tax effort. Secondly, expenditure was largely assessed according to normative inputs to a given network of institutions and facilities. This disregarded the objective need for the network or the equity of its geographical distribution.

The country studies report reforms to convert equalization systems to a normative basis, the most radical being Ukraine's adoption of a new Budget Code to be implemented in 2002 budgets at all levels. These confront a number of major issues both of policy and technique. It has to be remembered that a conventional principle of intergovernmental transfer formulae is that they should be immune from manipulation by the recipients.

8.2 Revenue Potential

The first challenge is to assess the potential yield of local revenues and to distinguish this from actual levels of tax performance. It is normal to assume standard or average levels of tax rates, leaving local governments to levy higher or lower rates without gain or loss in equalization transfers. This is barely relevant to current circumstances since most local tax revenues are still subject to nationally determined rates. However, differences in local stringency in assessment and collection are still important.

The ex-Soviet countries are still struggling with this problem. The Russian study reports that equalization transfers are still based on the previous year's collections. The Ukraine Budget Code has been more ambitious; it assesses local revenue potential on averaging assessments over the last three years; it then freezes this calculation for the next three years, so that local governments will make net gains from improvements in tax performance.

8.3 Spending Need

The second challenge is to calculate an objective base for local expenditure needs. Again the Ukraine Budget Code makes a determined attempt to move from the costs of an existing network to client need for service in respect of education, health care, social service, sport and culture. In most cases, population, or its related age group profile, is the basis of calculation. This inevitably raises difficult arguments once the redistributive effects of the new formulae become clear to the losers. How far do per capita health care needs vary according to age composition or environmental circumstances, for example? How far do the higher per pupil costs of rural schools reflect the necessities of population sparsity as opposed to a local preference for village schools?

Needs for physical infrastructure are even harder to assess on a normative need basis. Costs of maintaining one kilometer of road may be capable of standardization with some variation for traffic density etc, but how many kilometers does any given locality need? The Ukrainian Budget Code avoids such complexities by restricting equalisation to the "delegated tasks," i.e., the personal rather than physical services.

8.4 Degrees of Equalization

The objectives of intergovernmental fiscal relations are usually to achieve some degree of horizontal and vertical equalization, i.e.:

(1) (horizontal) some reduction of disparities between the potential revenue bases of individual local governments, and some compensation for the extra costs which individual local governments may face in meeting national standards of service provision;
(2) (vertical) some balance between the resources allocated to each level of government and their relative share of public expenditure responsibilities.

The horizontal objective raises a major choice over the extent of equalization to be achieved. Should the formula redistribution completely level local revenue bases in relation to their spending need? Or should the higher income areas be allowed to retain part of their above-average resources and thereby to afford a higher standard of services?

There is no standard or conventional answer to this question. Some degree of political compromise is usually involved and a number of factors must be borne in mind. The first is the need for some discrimination in the definition of target expenditures. Some areas of expenditure, particularly in respect of education and health care are subject to national standards (even constitutional guarantees) which imply fairly uniform levels of expenditure, with variations related more to differences in local costs than to local revenues; social welfare costs are likely to be higher in the poorer areas, education more costly in rural areas with lower population density.

But the costs of physical infrastructure and utility services are likely to be higher in the more productive areas; there may well be a direct correlation, for example, between the revenues generated from local economic activity and the need to spend on transportation and traffic management.

The Ukraine Budget Code limits the extent of horizontal equalization by distinguishing between "own" and "delegated" tasks and revenues. The redistributive formula equalizes potential local revenues from delegated taxes, chiefly PIT, with normative expenditures on delegated tasks, chiefly education, social assistance, health care, sports and culture. This leaves revenues from land and property taxes, as well as other local fees and charges, to finance the communal and other physical services unequalized. In the cities, these are revenues and expenditures to a common local budget, while in the rural areas, the delegated revenues and tasks pertain to rayon budgets and the "own" revenues and tasks to the constituent towns and village budgets. A similar solution may be in the offing in Georgia where draft legislation assigns responsibility for the personal services to cities and rayons, but the communal and other physical services to towns and villages.

Vertical equalization raises a second and even more critical policy decision that basically concerns the overall capacity of the State Budget. Including normative levels of expenditure in an equalization formula commits the State Budget to meet residual local budget deficits once the capacity of horizontal redistribution has been exhausted. What level of local expenditure, particularly on the personal services, can the State afford to guarantee?

Both the Armenian and Ukrainian equalization formula include an adjusting coefficient, which enables the State to vary the percentage of a formula deficit which its transfers close. In 2001 the Ukraine Government chose to set this coefficient at 1, committing itself to full closure of budget gaps. In 2002, however, the coefficient for net donors will be reduced to a varying extent below one, giving them revenue gains at the expense of the State Budget.

However, the Ukraine Budget Code allows a different route to keeping a realistic rein on State Budget commitments. The spending needs used in equalization formulae can be either absolute or relative, i.e., they can either:

(1) estimate some *absolute* target level of expenditure, regardless of the revenue available, or
(2) compare the *relative* needs of individual local governments to spend a given aggregate amount of revenue.

The equalization formulae used in countries like Britain, Netherlands and Sweden are based on the second method, i.e., relative rather than absolute needs. This method has also been adopted in the new Ukrainian Budget Code. For example, under the Ukraine Code an aggregate for education expenditure is determined by the annual state budget process (based on revenue estimates), but then divided between local governments by a formula using objective factors such as pupil numbers, population density, etc. The same applies to other major services like health care. The overall effect is that the pool of local budget expenditure supported by the equalization process is determined from year to year by an estimate of the potential revenues accruing to both State and local budgets.

The Russian Study describes a different though parallel approach to the same problem. Percentages of federal and regional tax receipts are channelled into municipal equalization funds that are then distributed pro rata to normatively calculated deficits. The deficit may be calculated on absolute spending needs, but the extent to which it is closed is then related to forecast receipts of federal/regional taxes.

Both Russian and Ukrainian methods relate equalization commitments to revenue performance. There are two significant differences between them. Firstly, the Russian formula continues to define expenditure need in absolute terms, encouraging the perception that municipalities are being deprived of the full amount of funding attached to their mandates. Secondly, the size of the State Budget transfers in Russia is chosen by relation to proportion of tax yields. In Ukraine the formula disaggregates sectoral allocation totals fixed in central budget negotiation; a sector's share of the overall revenues available is not pre-determined.

9. OVERALL ISSUES: FISCAL DECENTRALIZATION AND ACCOUNTABILITY

The reforms of local public administration in all four countries have been intended, at least formally, to make government accountable to the citizenry at each level.

The need for accountable decision-making has been reinforced by the economic situation in each country. Every ex-Soviet state is struggling to keep public services going in a time of economic contraction. The Georgian study reports that GDP per capita stands at 20% of its level ten years ago. This may overstate the decline in the real economy, but the unreported activity is not taxed. Public budgets suffer not only from economic decline, but also from a massive shift in resources from public to private consumption and from formal to informal employment and production.

To make the most equitable and effective use of shrinking public resources requires a high level of accountability and efficiency. The frequently quoted "unfunded mandates" illustrate severe weakness in accountability, failures to "cut coats according to cloth." Political leaders use decentralization to avoid making the hard decisions to adjust public service standards to the real resources available, and even confer new benefits that cannot be afforded.

It would be idle to expect that administrative and financial systems could adjust quickly to the changes in national identities, political systems and economic fortunes which the ex-Soviet states have experienced over the last decade. The four country studies illustrate varied and some times radical attempts at fiscal reform designed to meet these challenges.

The challenge to promote greater accountability at all levels of government involves a number of steps which are at varying stages of progress in the four countries. One is the clear delineation of functional responsibility of each tier. This is the object of the Ukraine Budget Code and the draft legislation on local government. Draft local government legislation in Georgia has the same aim. Associated with this is delinking the budgets of different tiers, again the result of the Ukraine reform. Local governments should have clearly identified resources and authorities, however limited, free of dependence on, or interference by the intermediate tiers of oblast, rayon, etc.

Resources should be distributed by normative formula, not by political negotiation. Local governments should plan and control their expenditure within known resources without need or opportunity to beg supplements as the year progresses, the key to efficiency and solvency. This is an objective pursued in all four countries. To achieve it, however, requires improvements in financial management as well as intergovernmental relations. Spending departments have to learn the rules of a new game which require keeping within fixed budgets and does not reward over-spending; this demands, in turn, regular flows of information on budget execution from financial departments, who have been used to reporting vertically but not horizontally.

The one feature absent in most reforms is the development of local choice over taxation. Local governments throughout the former Communist bloc are accustomed to a tax sharing system with little accountability for more than administration. Their ambition is for larger tax shares not greater taxing power. This is one major gap in the instruments of local accountability which none of the reforms has so far attempted to fill.

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