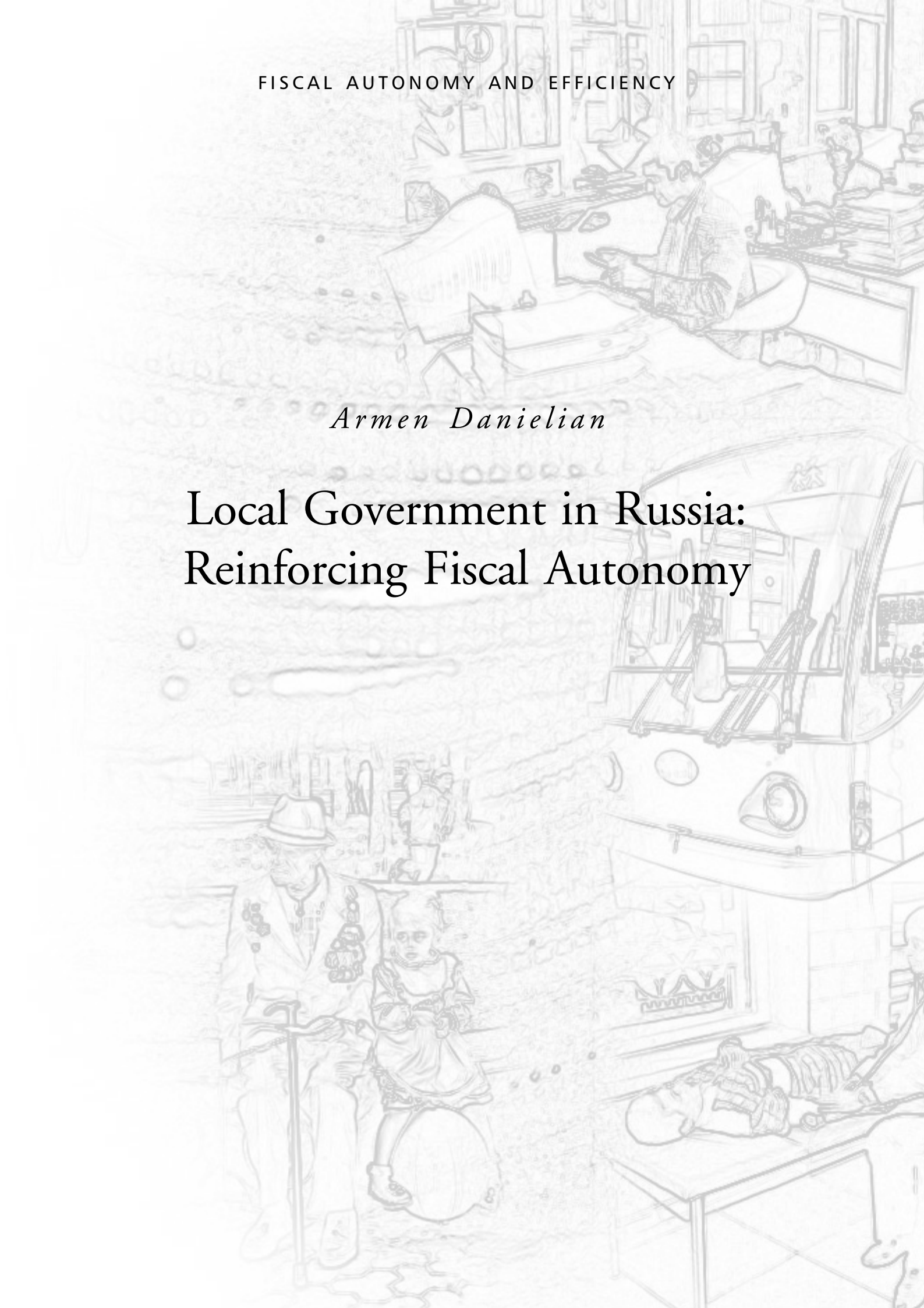


FISCAL AUTONOMY AND EFFICIENCY

*Armen Danielian*

# Local Government in Russia: Reinforcing Fiscal Autonomy





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## 1. INTRODUCTION

The “new history” of local government in Russia dates back to the beginning of the 1990s when the country embarked upon a new political and economic course leading to an open democratic society with an efficient market economy. Realization of the proclaimed political and economic goals called for dismantling the former Soviet-type super-centralized public administration system and making the decentralization of public government one of the most pressing democratic reforms.

As a result of the process of decentralization, local self-government has formally become a very widespread phenomenon. At the moment there are more than 12,000 municipalities in Russia, the majority of which are run by elected governing bodies.

However, even a cursory glance at the way local governments function in present-day Russia reveals their main deficiency: local government institutions are still very weak and their potential for social and economic development are extremely limited.

The weakness of local governments in Russia primarily results from the way inter-governmental fiscal relations are constructed. In fact, they are characterized by two alternative tendencies: decentralization of expenditure obligations and further centralization of revenue sources. Local governments' financial incapacity leads to their asymmetrical dependence upon the higher levels of public government, and sometimes even upon the discretionary decisions of single government officials at the central and regional levels. Therefore, the provision of fiscal autonomy at lower levels of government is one of the vital issues to be addressed for building true democracy and federalism in Russia.

This paper discusses some issues that seem to be relevant to the provision of local government fiscal autonomy in Russia. It addresses general as well as some region-specific questions, empirically based on fiscal relations in the Caucasus Mineral Springs Region (which includes nine municipalities in the southern Russian province).

## 2. LOCAL GOVERNMENT IN POST-SOCIALIST RUSSIA: GENERAL REVIEW

### 2.1 Functions and Role of Local Government in the System of Public Administration in the Russian Federation

Although there is plenty of literature on local government, its role and significance is often underestimated by scholars, government officials, and public opinion. At the same time, one can easily distinguish a number of universal factors that determine the objective necessity of local self-government in a democratic state.

First, local government is a means of optimizing public governance. In this respect, the way that local government institutions are formed in different countries is not significant. Local governments either originated from territorial governments that delegated some of their authority to a central government (USA, Great Britain, Switzerland), or they exist as a result of the upper levels of government delegating authority to the lower levels (France, Germany, Russia). Examples also exist of a combination of both these means (Spain, Mexico, Argentina). In any case, a modern democratic state cannot provide efficient public administration of economic and social processes unless it guarantees the existence of local self-government. These processes are too complicated and diverse to be governed from a single center of power. Decentralization of decision-making results in a more efficient Public Administration. Therefore, a democratic state should delegate to lower levels of government the authority that will be exercised in the most beneficial way with regard to public interests. It calls for the decentralization of decision-making on issues of local significance, which require accurate consideration of local conditions, potentials, means and methods.

Second, local self-government allows individual political rights and freedoms to be realized. The European Charter of Local Self-government is based on the assumption that the citizens' right to participate in public governance could be immediately exercised only through the institutions of local government. Of course, this does not mean that individual political rights cannot be realized by means of state institutions. It implies that large-scale people's participation in public government can be achieved only when governing institutions and procedures are as close to the community as possible.

It should be admitted that decentralization of public government could take place in a democratic as well as totalitarian state. As a complicated system of management, a state (regardless of its political regime or form of rule) always allows its sub-systems (including "vertical" territorial dimension) certain amounts of autonomy. However, decentralization in a totalitarian state can never be consistent and complete, as confirmed by the practice of the Soviet Union and other former socialist countries. Carried out by means of bureaucratic methods, decentralization in non-democratic states is distorted with the inadequately austere restraints imposed on local governments by central governments, such as the tendency toward over-standardization and unification in the spheres of local governments' competence, etc. Decentralization in a democratic state, on the contrary, promotes local communities' participation in decision-making, because relying on the people's awareness of local peculiarities provides more choice and freedom for those living in the localities.

Local self-government varies considerably in countries with different constitutional systems. Even in a single country, there is great diversity over different stages of its history: in regard to local governments' organizational forms, range of authorities, ways of legal protection of their rights, etc. However, in spite of its numerous modifications, there are core features of local government that reveal its essence: *Local Self-government is a power within the range of issues of local significance exercised immediately by the citizenry through elected bodies without central government interference.*

\* \* \*

The adoption of the Constitution in December 1993 signified the first step in the reform of local self-government as a public governance institution in the Russian Federation (RF). The Constitution recognized local self-government as one of the fundamental elements of the constitutional system and affirmed the principles of local self-government, consistent with the internationally recognized principles. In 1999, the Russian Parliament ratified the European Charter of Local Self-government.

The creation of local government institutions in Russia included several stages:

- formation of federal and regional legislation on local self-government;
- formation of territorial basis of Local Self-government;
- formation of the bodies of Local Self-government;
- formation of financial and economic basis for local self-government.

In order to provide for local government reform, a number of governing structures have been established, including:

- a Council on Local Self-government of the Russian Federation;
- a Board of Local Self-government Leaders;
- specialized sub-divisions of federal ministries responsible for local government related issues;
- a specialized department within the President of the Russian Federation Administration.

At this point, the following features characterize the status of local self-government.

#### *Legal Basis of Local Government*

Since 1994, the following federal laws related to local government have been adopted and implemented:

- The General Principles of Local Self-government Organization in the Russian Federation;
- The Foundations of Municipal Service in the Russian Federation;
- The Financial Basis of Local Self-government in the Russian Federation;
- The Provision of Constitutional Rights of the Citizens of the Russian Federation to Elect and Be Elected into the Bodies of Local Self-government;
- The Basic Guarantees of Electoral Rights of the Citizens of the Russian Federation and Their Right to Participate in the Referendum.

The following drafts of federal legal acts have already been fully or partially prepared and are awaiting adoption:

- The Status of the Elected Local Self-government Official in the Russian Federation;
- The General Principles of Vesting Local Self-government Bodies with Special State Authorities in the Russian Federation;
- The Procedures of Transforming the Objects of Federal Property into Municipal Property;
- The State Minimum Social Standards.

The development of a local self-government legal foundation at the regional level has been inconsistent and less dynamic than at the federal level. However, the majority of the 89 regions (federation subjects) have already adopted the basic legal acts regulating local government issues.

The legal foundation for local governments also includes municipalities' charters as their main self-issued legal acts. The charts define specific models of local government organization for each and every municipality. Presently, municipalities keep developing and adopting municipality charters and bringing the earlier adopted charters in line with the Federal Law on the General Principles of Local Self-government Organization in the Russian Federation. Currently, 10,955 municipalities have their charters.

### *Territorial Basis of Local Government*

The existing legislation allows local communities to choose any model of local government territorial organization, taking into consideration local political, cultural, ethnic, geographic, historical and other peculiarities. The legislation prescribes that:

- no settlement, regardless of its population, shall be deprived of the right to establish local self-government;
- municipal territories shall be defined by agreement with the local community;
- municipal borders shall not be changed without local community agreement;
- the local community shall independently decide the issues of establishing, transforming, consolidating and abolishing the municipality.

The process of forming local governments' territorial basis is developed within the framework of federal and regional legislation: municipal territories are settled in accordance with federal laws, and municipal borders, procedures for establishing, transforming, consolidating and abolishing municipalities are regulated by regional legislation.

As a result, Russia now sees a great diversity in territorial forms of municipalities:

- separate settlement (urban and rural);
- rural districts (selsoviets);
- rayons;
- double layer local government organization (rayon and intra-rayon municipalities, city and intra-city municipalities).

Altogether there are 12,215 municipalities in Russia, including:

- 625 cities;
- 516 urban-type settlements (poseloks);

- 153 city districts and rayons;
- 1,404 rayons;
- 9,314 rural districts;
- 203 rural settlements.

It should be noted that in different parts of Russia (regions, or federation subjects), one would find several types of local self-government organization. Local self-government is carried out:

- at administrative rayons level in six regions;
- at administrative rayons and city levels in 37 regions;
- at administrative rayons, city and rural districts levels in 23 regions;
- at rural districts and urban-type settlements (poseloks) levels in five regions;
- at city rayon and district levels in two regions;
- at city and rural districts levels in eleven regions.

Five regions do not have any well-defined local self-government organizational structure.<sup>1</sup>

### *Local Self-government Bodies*

Current legislation provides that local communities have full jurisdiction over defining the structure of local governing bodies. However, it prescribes only one mandatory restriction in this respect: local government shall include an elected body, preferably in the form of a local legislature (representative body).

In spite of the fact that there is great diversity in the varieties of local government structures, five basic types of local self-government bodies can be distinguished:

- 1) a local legislature and a generally elected local administration head (mayor); the latter also presides over the local legislature;
- 2) a local legislature and a mayor elected by the legislature;
- 3) a local legislature headed by a person who has no right to make decisions on his own and a hired head of the local administration;
- 4) local legislature and a local administration formed out of the legislature's members, who combine representative and executive functions; in this case, the head of the legislature is also the head of the local administration;
- 5) local community assembly (skhod) and local government head (occurs in small rural settlements).

Presently there are:

- 12,045 local legislatures;
- 4,519 local government heads elected from the local legislatures;

- 89 hired heads of local administration;
- generally elected local administration heads (mayors)<sup>2</sup> exist in the remaining municipalities.

### *Local Government Competence (Authority)*

The Federal Law on the General Principles of Local Self-Government Organization in the Russian Federation (1995) treats the term “local self-government” in a broad manner. It stipulates that local self-government is “constitutionally recognized and guaranteed independent and on its own responsibility activity of the population aimed at solution of issues of local significance immediately or through the bodies of local self-government based upon the population’s interests, its historical and other local traditions. As a manifestation of democracy local self-government provides one of fundamental elements of constitutional system of the Russian Federation.”

Article 12 of the Constitution of the Russian Federation (1993) guarantees that local self-government is independent within the range of its authorities.

The authority of local governments include:

- a. local governments’ own authority, i.e., recognized by the state as appurtenant to local government and aimed at tackling matters of local significance and municipal property management, and
- b. special state authority vested in local governments according to the law.

According to Article 6 of the Federal Law on the General Principles of Local Self-Government Organization in the Russian Federation, the following are the main issues of local significance:

- adoption and amendment of municipalities’ charts and control over their fulfillment;
- possession, use and disposition of municipal property;
- local finances, drafting, approval and execution of local budgets, imposing local taxes and levies;
- integral social and economic development of municipalities;
- maintenance and disposition of municipal residential and non-residential housing;
- organization, maintenance and development of municipal primary, secondary and technical schools;
- organization, maintenance and development of municipal health institutions and sanitation;
- organization, maintenance and development of municipal institutions of public order, as well as control over their activities;

- urban planning;
- executing control over land use within the territory of the municipality (irrespective of land ownership and land function);
- control over the use of water resources and minerals of local significance;
- organization, maintenance and development of municipal electricity, gas, water supply facilities, central heating and sewage;
- supplying municipal institutions and population with fuel;
- municipal road construction and maintenance of roads of local significance;
- improvement of the landscape and planting;
- organization of refuse disposal;
- organization of burial services and cemeteries’ maintenance;
- organization and maintenance of municipal archival depositories;
- organization of public transport and provision of telecommunication services;
- creating normal conditions for retail trade and other consume services;
- creating conditions for the normal functioning of municipal culture and leisure institutions;
- safeguarding municipal culture and historic memorials;
- organization and maintenance of municipal information service;
- creating conditions for the normal functioning of municipal mass media institutions;
- providing conditions for the development of sports and physical culture;
- providing social support and promoting employment programs;
- participating in environmental protection actions in the territory of the municipality;
- organization and maintenance of municipal fire service.

Local government functions in present-day Russia are numerous and have great social and economic significance (see Table 5.1.)

Table 5.1  
Functions of Local Government in the Russian Federation

Function	Federal Budget	Regional Budget	Local Budget
<b>EDUCATION</b>			
Pre-school			✓
Primary			✓
Secondary			✓
Technical	✓	✓	✓
Higher	✓	✓	
<b>SOCIAL POLICY</b>			
Retirement homes		✓	
Home-nursing service for the aged and disabled			✓
Special services for the homeless, crises families etc.			✓
Social housing			✓
Subsidies and benefits		✓	✓
<b>HEALTH SERVICE AND SPORTS</b>			
Preventive medicine		✓	
Hospitals	✓	✓	✓
Polyclinics	✓	✓	✓
Sport facilities			✓
<b>CULTURE AND LEISURE</b>			
Theatres	✓	✓	✓
Museums	✓	✓	✓
Libraries			✓
Parks			✓
Clubs and Culture & Leisure Centers			✓
<b>PUBLIC UTILITIES</b>			
Water Supply			✓
Sewage			✓
Electricity			✓
Gas			✓
Central Heating			✓
Refuse Collection			✓
Refuse Disposal			✓
Cemeteries			✓
Street Cleaning			✓
Housing Utilities Subsidies			✓

*Table 5.1 (continued)*  
 Functions of Local Government in the Russian Federation

Function	Federal Budget	Regional Budget	Local Budget
<b>ENVIRONMENT</b>			
Environmental Protection	✓	✓	✓
<b>TRAFFIC AND TRANSPORT</b>			
Roads	✓	✓	✓
Public Lighting			✓
Public Transport		✓	✓
<b>URBAN DEVELOPMENT</b>			
Town Planning			✓
Local Economic Development		✓	✓
Tourism		✓	
<b>ADMINISTRATION</b>			
Authoritative Functions	✓	✓	✓
Other State Administrative Functions	✓	✓	✓
Local Police		✓	✓
Fire Brigades		✓	✓
Civil Defense	✓		

### *Financial and Economic Basis of Local Government*

Local budgets and municipal property provide the financial and economic basis for local self-government in the Russian Federation. The financial (fiscal) basis of local government will be discussed later, though it is worth noting that more than 10,000 municipalities presently have their local budgets.

11,160 municipalities possess municipal property. Municipal property objects include:

- public utilities;
- educational establishments;
- public health institutions;
- cultural institutions;
- sports facilities;
- residential and non-residential housing.

Local government bodies have the right to practice almost any sort of financial and business activities with few exceptions resulting from the necessity to reduce the risks of

municipal property losses and prevent the monopolization of local markets.

*Table 5.2*  
 Municipal Property Structure in the Russian Federation

Municipal Property Objects	Number of Municipalities Having Property Objects at Their Disposal
Municipal Enterprises	4,917
Municipal Educational Establishments	8,729
Municipal Health Institutions	7,916
Municipal Cultural Institutions and Sports Facilities	7,950
Municipal Residential and Non-Residential Housing	8,510

SOURCE: Ministry for Federation and Nationalities Affairs

## 2.2 Major Problems and Challenges of Local Government In Russia

Although local government has already become an integral part of the public administration system in the Russian Federation, it still remains burdened with many complicated problems.

### *Problems with the Local Government Legal Foundation*

The Constitution of the Russian Federation, the Federal Law on General Principles of Local Self-Government Organization in the Russian Federation and a number of other federal laws provide the general basis for the functioning of local government in Russia. However, they do not settle a wide range of specific (but not less important) legal issues related to local government. Some of these issues are regulated by regional and sectoral legislation. In this respect, it should be emphasized that:

- there is not adequate coordination or mutual adjustment among the legal acts regulating local government issues, which belong to different legal branches;
- all of the issues that need legal regulation have not yet been conceived or resolved;
- in many cases, regional governments are either reluctant to pass the necessary laws on local government or adopt legal acts concerned with local government issues that contradict the relevant federal legislation.

### *Problems with the Local Government Territorial Base*

It is obvious that the competition among local and regional governing elites has seriously distorted the process of developing local governments' territorial organization models. The agreement on municipalities' territorial configuration has often been reached either on the basis of a compromise or without regard to the principles of efficiency for local government.

As a result, the territorial organization of local government in a number of regions does not comply with local government's goals and functions.

### *Problems with the Formation of Local Self-Government Bodies*

Though the primary stage of the formation of local government bodies is complete, organizational issues need further consideration and settlement. These issues result from the fact that:

- having defined the general type of organization for local self-government bodies, local governments keep adjusting these models to meet their specific conditions and needs;
- the process of developing organizational models for local government bodies has been greatly influenced by the interests of local elites; this naturally resulted in lower efficiency in governance caused by the over-concentration and undesirable mixture of political and economic power within the same local government bodies.

### *Problems with the Formation of Local Governments' Competence*

On the face of it, the problem of local government competence might seem negligible. However, most of the conflicts between the different tiers of public government in Russia arise from the vagueness of their range of authority as defined in the existing legislation. Inaccurate norms in the Federal Law on General Principles of Local Self-Government Organization in the Russian Federation allows federal and regional governments to interpret the authority of local governments at their own choosing. Therefore, local governments, as the most "vulnerable" layer in the public administration system, get more responsibilities and fewer rights.

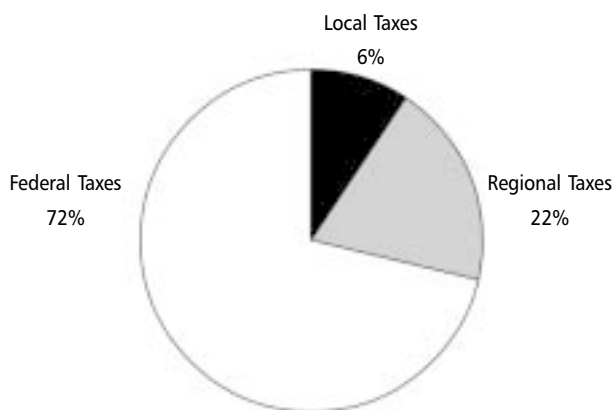
### *The Financial and Economic Problems of Local Government*

The most critical problems for the functioning of local government in Russia are related to its financial and economic foundation.

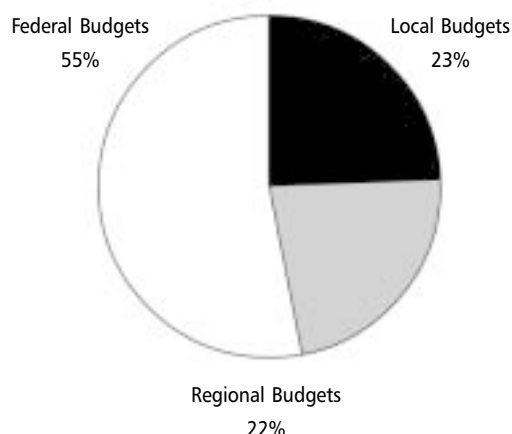
In spite of the fact that legislation provides for the fiscal autonomy of local government, local governments' own revenue (including the so called shared taxes) comprise less than 30% of their total revenue on average. This means that the existing fiscal model encourages large-scale distribution and redistribution processes among levels of public government. At the same time, the mechanism for regulating intergovernmental fiscal relations is not properly defined and suffers from frequent and erratic reform. These reforms, as a rule, result in further decentralization of expenditure responsibilities as well as further centralization of financial resources (see Figures 5.1, 5.2, 5.3).

Under the current fiscal model, local governments do not actually have sustainable sources of revenue to cover their vital expenditure items, nor can they schedule their financial resources and expenses in advance. This dynamic hinders the long-term progressive development of the territories. What makes things even more complicated is the fact that

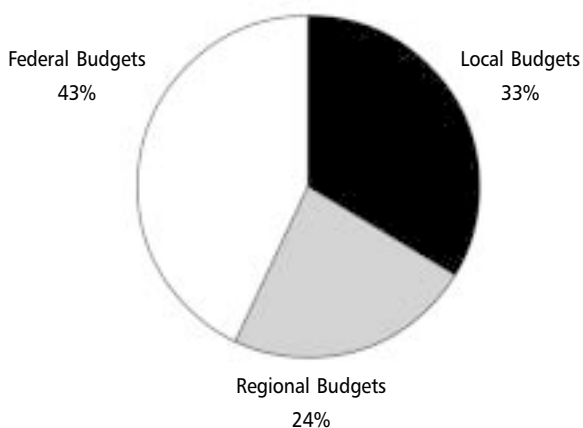
*Figure 5.1*  
The Structure of the Consolidated Budget Revenues in the Russian Federation, 1999



*Figure 5.2*  
The Structure of the Consolidated Budget Expenditures in the Russian Federation, 1993



*Figure 5.3*  
The Structure of the Consolidated Budget Expenditures in the Russian Federation, 1999



the central and regional governments tend to rid themselves of burdensome social mandates by imposing them on local governments without any sort of financial provisions (which, by the way, is a violation of the Budget Code of the Russian Federation).

### 3. FISCAL BASIS OF LOCAL GOVERNMENT IN RUSSIA

#### 3.1 Local Finances: Legislation Review

Local finances are regulated by: the Constitution of the Russian Federation, the Federal Law on the General Principles of Local Self-Government in the Russian Federation, the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation, the Budget Code of the Russian Federation, the Tax Code of the Russian Federation, as well as other federal laws, constitutions, charts, laws of the federation subjects, municipality charters and various local governments' legal acts.

According to the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation (adopted in 1997), municipal finances are characterized as a total sum of financial resources formed and used to satisfy the diverse needs of the local community. Municipal finances include:

- 1) local budget;
- 2) municipal extra-budget funds;
- 3) state and municipal securities owned by a local government;
- 4) other financial resources owned by a local government.

Municipal finances are based on the following principles:

- independence;
- state financial support;
- publicity.

Municipal finances, along with municipal property and federal property objects handed over to the municipalities, provide the economic foundation of local government in Russia.

Federal and federation subject governing bodies take an active part in the development of local finances. They can:

- regulate relations between federation subject budgets and local budgets, as well as between the federal budget and local budgets in connection with the implementation of federal programs;
- participate in tackling matters of local significance through the accomplishment of federal and regional programs;

- distribute the resources allowed for funding federal and regional programs among municipalities and exercise control over the efficiency of utilising these resources;
- develop and introduce the state's minimum social standards;
- render methodological assistance to municipalities related to the formation and execution of local budgets;
- exercise control over local governments' observance of budget and tax legislation;
- provide local governments with the financial resources necessary to accomplish special state functions delegated to local governments;
- recompense local governments for excess expenditures as a result of revenue cuts caused by federal and regional government decisions.

### *Local Budgets*

Local budgets are at the core of municipal finances.

The municipal (local) budget is a centralized financial resource fund; local governments carry out its drafting, approval, and exercise control over its execution independently. Local legislatures are granted the right to set up local taxes, levies and tax exemptions in accordance with federal legislation.

The formation of a local budget is based on uniformed methodology, budget classification, as well as state minimum social standards and social norms provided by federal and regional government bodies. In this sense, local governments' fiscal autonomy is restrained within the frames of federal and regional legislation.

The current legislation does not dictate that municipalities apply a uniform budget structure. However, there is uniformity in the structure of Russia's local budgets, evidently arising from convenience in terms of budget formation, analysis and fiscal control.

#### *Local Budget Structure*

1. Local budgets include three elements:
  - resources allocated for local governments' own responsibilities;
  - resources allocated for special state functions delegated to local governments;
  - resources allotted for funding special federal mandates shifted to local budgets (these are mainly various subsidies and benefits for low-income individuals).
2. Resources allocated for local government functions fall into one of the following categories:

- funds assigned to provide current activities;
  - funds assigned to provide capital expenditures ("investment budget").
3. Funds assigned to provide current activities can be divided into two categories:
    - resources allotted for independently-planned activities;
    - resources which are necessary to provide the state's minimum social standards.
  4. A local budget might incorporate the financial plans of special settlements and city districts that are situated in the territory of the locality but do not enjoy the status of a municipality.

### *Local Budgets' Revenues and Expenditures*

Local budgets are composed of their own and regulatory revenue. The own revenue-generating sources are allotted to local governments on a long-term basis. Regulatory (or shared) revenues are the shares of federal and regional taxes assigned to local budgets for the forthcoming financial year or on a long-term basis (no less than three years) as a means of fiscal equalization.

Local budgets' own revenue include:

- local taxes, levies and fines;
- shares of federal and regional taxes allotted to local governments on a permanent basis;
- income from municipal property privatization;
- part of the income from state (federal and regional) property privatization in case the property objects are situated in the territory of the municipality;
- returns on the municipal property leasing;
- assignments from municipal enterprises' profits;
- fees for natural resources consumption;
- income from holding municipal lotteries;
- national duties (except the one allotted to the federal budget);
- a share of the enterprise property tax;
- personal income tax on individuals engaged in entrepreneurial activities.

Local budgets include the following shares of federal taxes:

- a share of corporate income tax;
- a share of value added tax on home-produced goods;
- a share of personal income tax;
- a share of excise tax on spirits and vodka;
- shares of other excise taxes.

If municipalities fail to provide for their expenditures from the sources mentioned above, then they have the right to claim subsidies and grants from higher-level governments.

Although local governments have sufficiently wide discretion to draft and execute local budgets, the Federal Law on the General Principles of Local Self-Government in the Russian Federation definitely indicates the revenue sources for the provision of certain local government functions as well as permissible ways of spending local budget revenue.

Independently planned activities aimed at tackling issues of local significance are, as a rule, funded from local budgets own sources. If the resources are insufficient, then extra resources from the Municipality Financial Support Fund are extracted. It should also be noted that the act on local government contains a reservation concerning the provision of minimum social standards—implementation of these standards is funded from the shares of federal and regional taxes assigned to the local budgets.

The financial resources necessary for local governments to exercise special state functions are allotted to local budgets from federal and regional budgets, consistent with the level of government that delegated its responsibility to the local government. As local governments execute these functions on a permanent basis, the necessary resources are annually allotted in federal and regional budgets.

The federal Law on the Financial Basis of Local Self-Government in the Russian Federation states that “bodies of local self-government shall be entitled to compensation for the decisions of bodies of state power that result in the loss of revenue or in the increase of expenditures over the amount of the funds transferred to them.”

Federal legislation distinguishes, but is not confined to, the following groups of local government expenditure items:

- expenditures for issues of local significance;
- expenditures for exercising special state functions;
- municipal borrowing interest and redemption costs;
- assignments for the insurance of local officials, municipal property, civil liability and business risks.

### *Municipal Extra-Budget Funds*

Municipalities enjoy the right to form extra-budget funds in order to allocate resources for the direct financing of programs that are of vital importance for the normal functioning and development of a municipality. Therefore, municipal extra-budget funds are purpose-oriented. The law strictly governs the procedures related to forming and using these funds.

Local legislatures are entitled to establish extra-budget funds as well as define and approve regulations concerning their formation, management, organizational structure, etc.

### *Municipal Borrowings and Lending*

Municipalities have the right to establish municipal credit and financial organizations, choose an authorized bank through open competition, issue municipal bonds and housing certificates, lend financial resources to legal entities and individuals, and borrow from banks and other credit organizations.

Municipalities borrow through placing municipal bonds on the market. The Federal Law on the Financial Basis of Local Self-Government in the Russian Federation allows local governments to issue bonds exclusively for the purpose of municipal development programs and projects. The Law also specifies the maximum permissible amount of local government obligations—it shall not exceed 15% of the local budget’s revenue.

The crucial issues of municipal borrowing are regulated by federal legislation. These issues include municipal bond issuing procedures, bond placement as well as buying and selling. Municipal bond obligations are the sole responsibility of local governments.

### *Municipal Order*

The current legislation is binding and allows for the placement of municipal orders through an open competition. Organizational procedures for municipal order placement are determined by local government regulations. Municipal enterprises shall participate in the competition in accordance with the general practice.

### *Intergovernmental Fiscal Relations*

Article 9 of the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation stipulates that intergovernmental fiscal relations are based on the following principles:

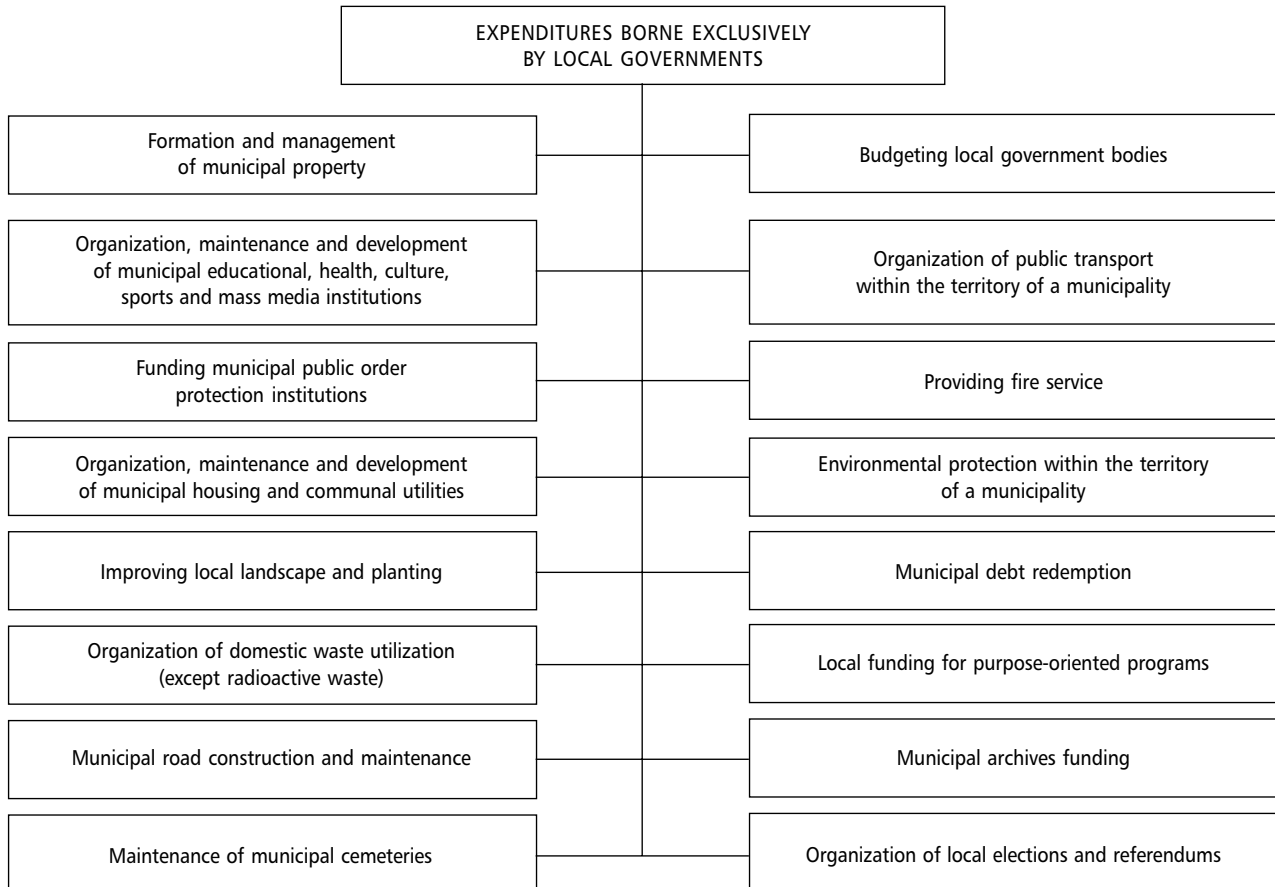
- mutual responsibility;
- using a single methodology for all municipalities with regard for their peculiarities;
- equalization of municipalities’ revenue;
- maximum reduction of counter financial flows;
- local self-government bodies get compensation for the decisions of state bodies that result in the loss of their revenue or in the increase of their expenditure;
- increasing incentives for local governments to raise more revenue;
- publicity of intergovernmental fiscal relations.

### 3.2 Local Budget Expenditures: A Call for Optimization

The structure of local government expenditures is presented below (See Figure 5.4)

In-depth interviews with numerous local government officials have revealed the fact that they identify public utility maintenance and expenditure responsibilities, assigned to them by higher levels of government, as the most problematic issue related to budget expenditures.

*Figure 5.4*  
The Structure of Local Government Expenditures in the Russian Federation



*Table 5.3*  
Local Government Expenditures Caucasus Mineral Springs Region, 2000

Local Government Expenditures	[Thousand Roubles]	[%]	Local Government Expenditures	[Thousand Roubles]	[%]
Education	495,292	33	Culture	27,500	2
Health Care and Protection	335,332	22	Agriculture and Fishing	30,619	2
Public Utilities	269,116	18	Industry and Construction	22,006	1
Public Administration	89,796	6	Public Transport, Roads, Telecommunications	17,515	1
Welfare Policy	69,108	5			
Market Infrastructure	61,652	4	Other	44,887	3
Local Police	41,559	3	<b>Total</b>	150,8768	100

### *Unfunded Mandates*

Local budget expenditures in present-day Russia are heavily burdened with the so-called *unfunded mandates*, when expenditure responsibilities are shifted from higher levels of government to lower levels without adequate financial support. Since 1995, the problem has become a major concern for local governments throughout the Russian Federation.

As a matter of fact, the existing legislation reflects reservations regarding budgets that do not provide sources for covering deficits, stripping such budgets of legal power. Besides, as found in Article 130 of the Budget Code of the Russian Federation, the financial resources required for lower government budgets to carry out special state functions should be separated from all other expenditures in the upper government budget. These financial resources should be considered the revenue of the recipient budget and treated as such.

However, the experiences of intergovernmental fiscal relations in recent years indicate that the related legal norms are being violated.

Most of the unfunded mandates are associated with the provision of various social benefits to a wide range of categories, including:

- allowances for housing fees;
- allowances for utilities fees (gas, electricity, water supply, etc.);
- discounts on home telephone installation and subscription fees;
- free ride on public transport (except taxi);
- free or preferential prices for the provision of medicine, etc.

Before 1992, only nine categories of individuals enjoyed the right of paying lower fees for housing and public utilities use:

- 1) the Heroes of the USSR;
- 2) individuals awarded the Glory Order;
- 3) the Great Patriotic War veterans;
- 4) the Great Patriotic War invalids;
- 5) family members of the Great Patriotic War veterans and invalids;
- 6) individuals awarded the Badge "Honorary Blood-Donor of the USSR";
- 7) qualified specialists working in the rural areas;
- 8) individuals exposed to the radioactive impact as a result of Chernobyl Atomic Station breakdown;
- 9) retired military servicemen and their families.

From 1992 until 1999, the Parliament adopted six acts providing additional allowances for housing and public utili-

ties to eighteen additional categories of individuals (victims of political repressions, underage prisoners of fascist concentration camps during World War II, customs officers, public prosecutors, investigators, judges, policemen, tax policemen, etc.).

The right to a free ride on public transport has 38 categories of individuals (along with those mentioned above, these include members of parliament and their assistants, fire brigade officers, etc.).

Twenty-two categories of individuals enjoy the right to get discounts on home telephone installation and subscription fees; 21 categories of individuals are granted the right to receive medicine at preferential prices or for free.

Most of these social benefits, as set by federal law, are only partially provided because of a lack of financial resources in territorial budgets.

It should be noted that some of these laws do not even specify which level of government is responsible for paying out the benefits. This is the case with the Federal Law on the Additional Social Support Guarantees for Judges and Court of Justice Officers (1996). Other laws give the responsibility of providing benefits to more than one level of government. As seen in the Federal Law on the War Veterans (1995), its funding is assigned to the federal and regional budgets, while the Federal Law on the Rehabilitation of the Political Repressions Victims (1994) is funded jointly by regional and local governments, etc. In the case of the latter, different levels of government are trying to shift the funding responsibility to others, resulting in the inability to implement the given federal law.

The Federal Laws on the Year 2000 Federal Budget and on the Year 2001 Federal Budget contain norms that prohibit stipulating the consolidated budget as a source of funding for public services (i.e., without specifying the budget level). While these two laws are an important start, there is an urgent need to adjust all related legal acts to this principle.

Another serious drawback of the existing legislation on social benefits is the compensation to local budgets for the provision of benefits by upper levels of government. Numerous social benefits prescribed in federal laws do not contain norms that strictly guide compensation procedures. Although the Federal Government arranges these procedures in such cases, they are seldom fulfilled.

Under the current circumstances, local governments are victim to federal legislation inconsistencies as targeted social group representatives (benefits recipients) bring legal action against local governments and generally prevail.

The solution for problems associated with unfunded mandates afflicting local governments includes the following:

- 1) *reassessment of benefit-granting principles*  
Large-scale benefit granting (especially with regard to various service payments) defies principles of social jus-

tice as it takes place against a background of under-financed institutions of public health, education, science and culture as well as the delay of salary payments to public sector employees, etc. Thus, there is a need to cut the number of social benefits and properly arrange the benefit-seeking procedures through the suspension or amendment of some of the laws. As a short-term measure, a federal law should be adopted to reduce benefits by 50% for some targeted categories, and also introduce application procedures for benefit seekers (which is contrary to the present automatic benefit granting).

2) *raising the efficiency of fiscal resource redistribution*

Federal laws on social benefits should provide a more distinct and transparent mechanism for the compensation of local budgets' expenditure increases arising from the necessity to fund federal mandates. It is important to stress that this compensation is a result of federal government indebtedness, and should not be considered a part of the Municipalities Financial Support Funds. This compensation is a source of financial aid allowed for the purposes of fiscal equalization and should be specially allocated in the federal budget.

*Public Utilities Maintenance Expenditures*

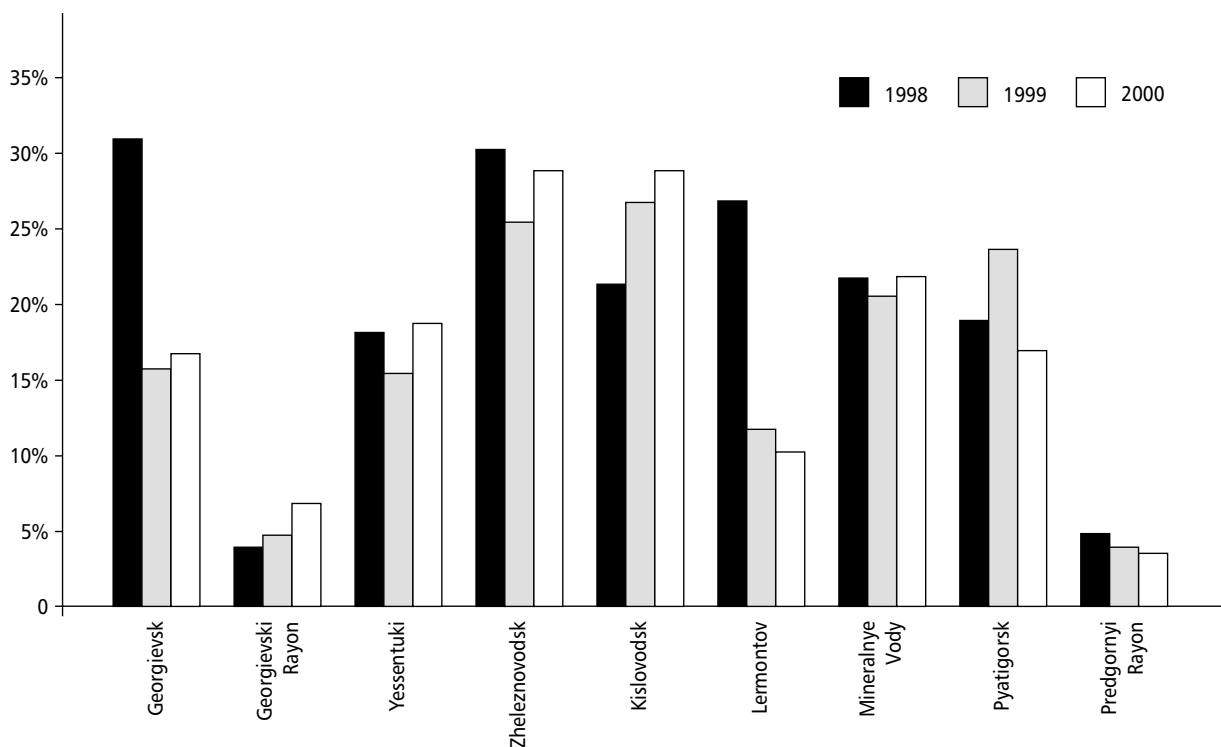
The maintenance expenses for public utilities comprise a considerable part of local budget expenditures (see Figure 5.5). Sometimes this item accounts for more than 50% of a local budget's total expenditures, especially in urban territories.

The current situation, in regard to public utilities funding, is rooted in the fact that the legacy of the socialist economy still remains intact in some spheres of Russian economic and social relations. Presently, the consumers of public utility services pay less than 40% of the services' costs (*cf.*: in 1994 they incurred 2-3% of the costs). The rest is covered mainly by local governments in the form of consumer subsidies and grants to communal service producers.

In order to alleviate public expenditures on utility services and make the provision of these services more efficient, the federal government has suggested an overall reform for this sector. The primary goals of the reform are formulated in the Conception of Public Utilities Sector Reform in the Russian Federation. The Conception, approved by Presidential Decree 425 on April 28, 1997, determines the basic issues of the reform, which include:

Figure 5.5

Local Government Expenditures on Public Utilities Maintenance, Caucasus Mineral Springs Region, 1998-2000  
[Total Expenditures—100%]

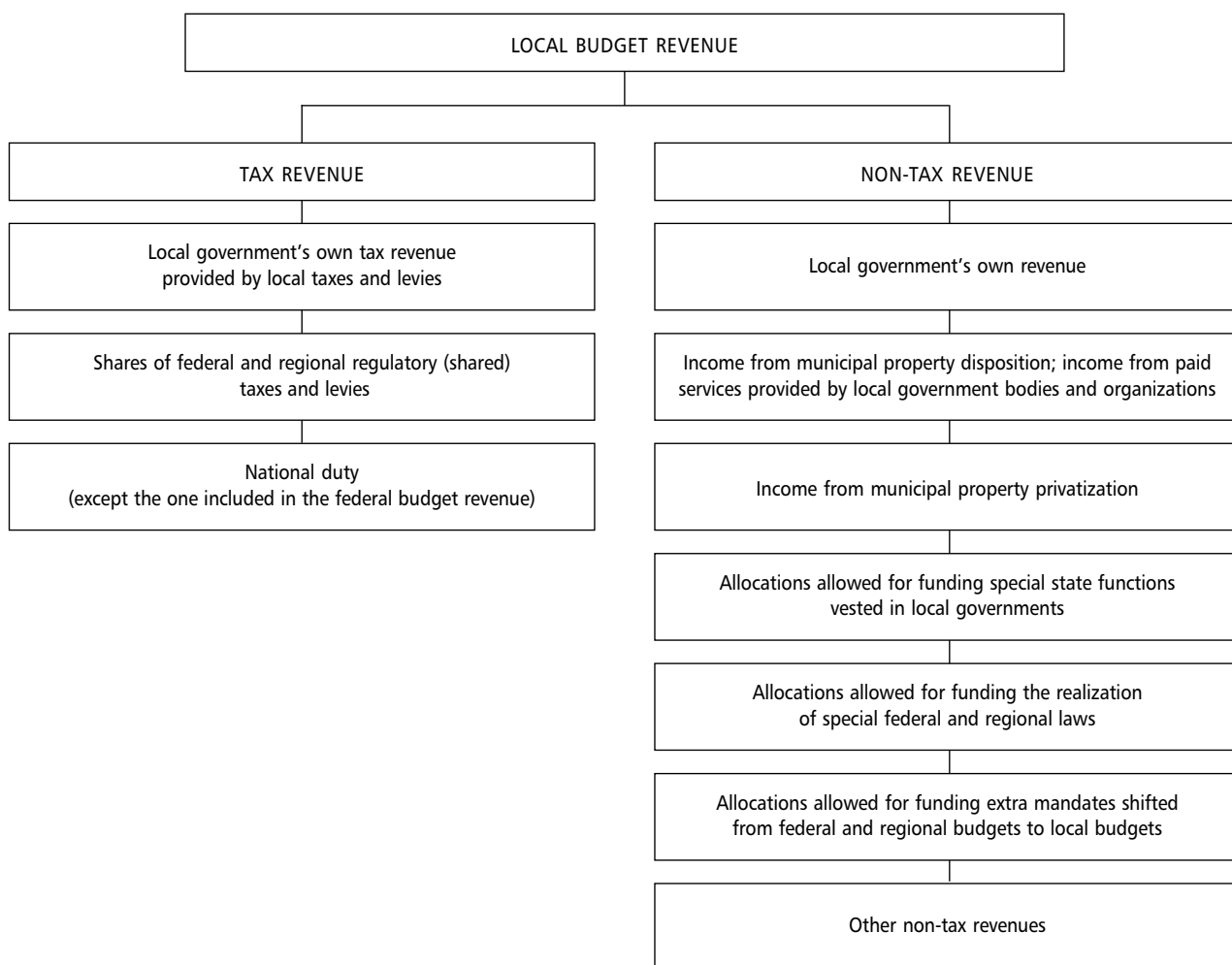


- improving the system of management, maintenance and control of public utilities institutions;
- developing competition in the public utilities services market, which involves:
  - placing municipal orders with private companies providing housing maintenance and public utilities services, and
  - the reorganization of the payment system for communal services on the basis of contracting; applying punitive sanctions on contract violators;
- normalization of the payment system for communal housing and utilities services, which includes:
  - fixing higher rates for housing and communal services for excess consumption of services and living space (over federal standards for social living space norms);
  - differentiating payment rates according to housing location and the quality of accommodation;

- providing targeted social support for those households that are unable to cover the total costs of communal services.

The main impediment to the reform is the ability of people to pay the full charge for their services. Around 40% of the Russian population live below the official poverty line. Thus, the Conception stipulates that the increase in service fees shall be gradual and consistent with real income growth. The Conception implies that the share of costs covered by the population (consumers) shall increase according to a step-by-step schedule: 1997—35%, 1998—50%, 1999—60%, 2000—70%, 2001—80%, 2002—90%, 2003—100%. In addition, the Government set the following maximum permissible shares of aggregated family (household) income spent on public utilities: for the year 1997 – 16%, 1998 – 18%, 1999—19%, 2000—20%, 2001—22%, 2002—23%, 2003—25%. In the case that a family spends a greater

Figure 5.6  
The Structure of Local Budget Revenue



portion of its income for this purpose, the family is granted the right to compensation by the local government.

The public utility reform is being carried out in a very slow and inconsistent manner as a result of the following factors: an unprecedented drop in real income after the 1998 financial crisis, futile government efforts to provide a balance between purely economic goals and social acceptance of reforms, interest groups' resistance, and general public distrust of the reform.

At the moment, consumers cover around 40% of the actual costs of public utility services; the rest is funded from municipal budgets in the form of grants and subsidies.

However, this is just a general assessment of the current situation in the public utilities sector. It should be emphasized that there are regional variations in the progress of public utilities reform. Some of the regions have succeeded in providing higher quality services at lower prices through implementing the measures specified by the Conception; this is primarily due to the development of competition in the public utility services market, promoting transparency on the part of providers and allowing for the optimization of consumers' social support.

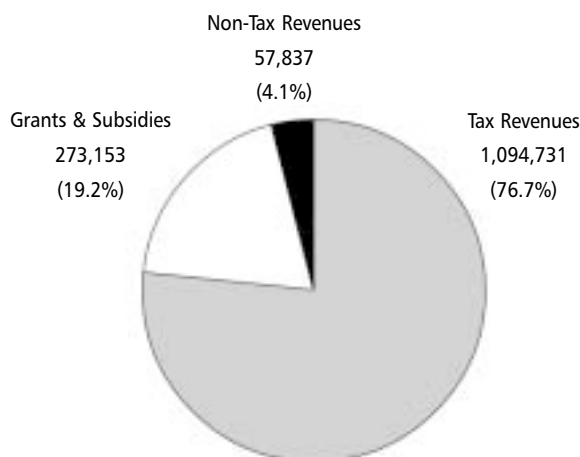
### 3.3 Local Budget Revenues Sources Survey

The structure of local government revenue is presented in Figure 5.6.

Tax revenue comprises the predominant part of local budget revenue (See Figure 5.7).

Figure 5.7

The Structure of Local Government Tax Revenue, Caucasus Mineral Springs Region (9 Municipalities), 2000 [Thousand Roubles, %]



### Local Budgets' Tax Revenue

Article 15 of the Tax Code of the Russian Federation (1999) defines the following local taxes and fees:

- land tax;
- individual property tax;
- advertisement tax;
- inheritance and donations tax.

The current tax reform is aimed at achieving the following goals:

- alleviate the general tax burden;
- make the taxation system more equitable;
- enhance the stability of the taxation system;
- improve tax collection.

Within the framework of tax reform, the tax on the maintenance of local utilities has been abolished since January 1, 2001, even though it accounted for a considerable share of local budget revenue.

The losses resulting from this tax abolition are supposed to be compensated by a share of the corporate income tax assigned to local governments at a rate not greater than 5%.

Actually, the introduction of a "local" corporate income tax, instead of the tax on the maintenance of local utilities, does not adequately compensate local budget losses. On average, local budgets will lose 0.4% of the Russian Federation's consolidated budget tax revenues.<sup>3</sup>

Another important change in the local tax system concerns the inheritance and donations tax, which is expected to shift from the local government level to the federal level.

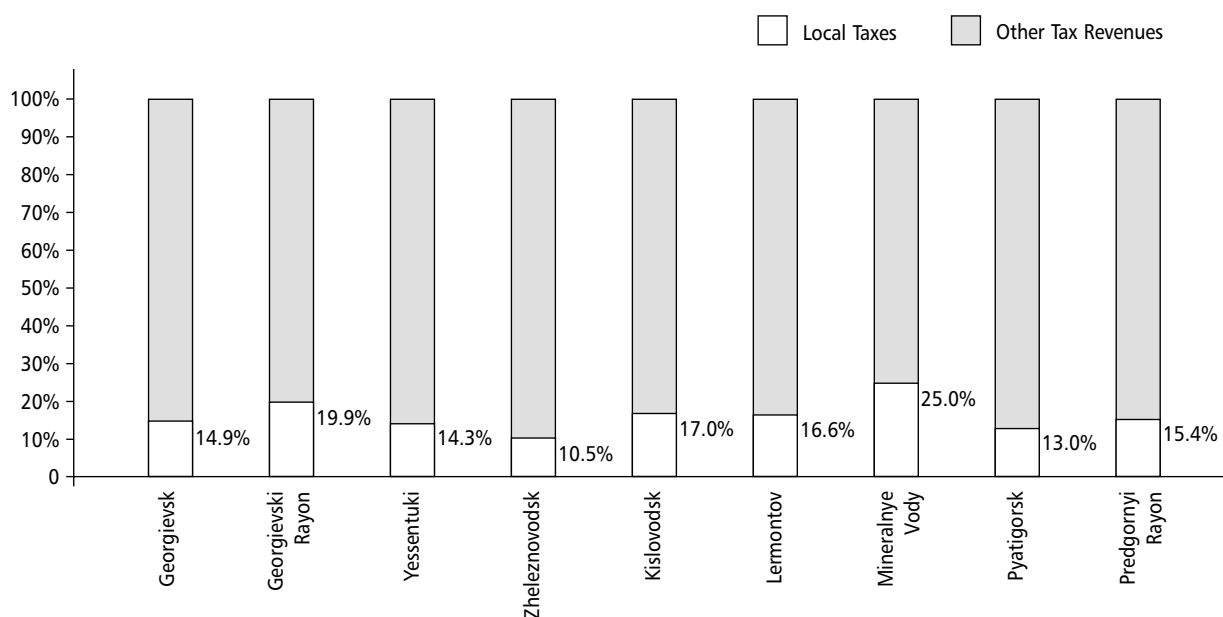
As a result of this reform, local governments will have only three local taxes and one local fee at their disposal:

- land tax;
- individual property tax;
- advertising tax;
- local license fees.

It is necessary to note that the new tax legislation grants regional legislatures, in coordination with local legislatures, the right to introduce a real estate tax instead of the enterprise property tax (which is a regional tax), the individual property tax and the land tax.

Local governments' own taxes comprise a minor part of their total revenue, with the average share of local taxes in local budgets throughout the Russian Federation seldom exceeding 30%.<sup>4</sup> Our own estimates of local taxes in the tax revenue structure of local budgets, with regard to nine municipalities under investigation, confirm this data (see Figure 5.8).

Figure 5.8  
Local Tax Share in Local Budgets' Total Tax Revenue, Caucasus Mineral Springs Region, 2000



The model of tax sharing that is developing within the framework of the current tax reform, with regard to local government fiscal autonomy, needs serious reconceptualization. It would be reasonable to create a clearer and more stable taxation and tax distribution system that follows the principle of matching local government expenditure responsibilities with their own budget revenue.

Tax allocation among the different levels of government (federal, regional and local), with respect to local taxes, should support the following principles:

- local taxes are collected in the territory of the municipality;
- local legislatures have full jurisdiction over the issues of local taxation (they define tax rates, tax bases, etc.);
- proceeds from local taxes (as well as from federal and regional taxes) can be shared among different levels of the budget system. Tax sharing mechanisms could be based on:
  - tax rate sharing (personal income tax, corporate income tax), and
  - sharing of proceeds (land tax).

With the above elements in mind, the existing tax legislation looks rather eclectic.

For example, according to Article 21 of the Federal Law on the Foundations of the Taxation System in the Russian Federation, the land tax is introduced by local legislatures that have the right to define some of its elements and proce-

dures. At the same time, the land tax should be collected throughout the Russian Federation at rates dictated in Article 5 of the Federal Law on Land Payments. In addition, the proceeds from the land tax should be allocated among the different levels of the budget system in accordance with the shares set annually by the federal budget law.

Instead of the tax allocation consequences mentioned above, the tax allocation should result in the increase of incentives for local governments to improve their tax collection efforts and enhance their territories' own revenue-making capacities.

The local tax base of local governments is currently evaluated on the bases of reported data on municipal collections during the previous year. The creation of the local budget for the following year is then based on last year's tax base. The present budgeting model totally ignores growth of the local government's tax base and tax collection efforts. Therefore, local governments are not interested in collecting more taxes; on the contrary, they are motivated to conceal the actual tax base and to indulge in bargaining with higher levels of government for additional grants and subsidies.

It is necessary to implement the principles of shared tax rates and shared tax proceeds in a more consistent manner within the Russian taxation system in order to provide greater incentives for each tier of government (including local governments). This would serve the purposes of improving tax collection and stimulating the development of municipal tax capacities.

It should be noted that some of the taxes are already shared among different levels of the budget system on a per-

manent share-size basis. For instance, tax proceeds from federal subsoil resources are equally shared among federal, regional and local budgets. Regional sales tax proceeds are divided between regional and local governments at the rate of 40% and 60% respectively. Regional single revenue tax proceeds raised from legal entities (organizations) are shared in the following manner: 25% goes to the federal budget, 25% goes to state extra-budget funds and 50% is allocated to regional and local budgets. The same tax proceeds raised from individual entrepreneurs are shared among local budgets (75%) and state extra-budget funds (25%).

It is important to emphasize the fact that the federal legislation setting fixed (permanent) tax shares does not differentiate between the taxes with regard to their status (federal, regional, local) or type (resource, assets or consumption tax).

However, some of the federal tax laws do not provide any fixed shares of taxes assigned to local budgets, such as foreign currency purchase tax; in such cases, the allotment of tax shares to local budgets is determined by the competence of regional governments. Other taxes are shared on the basis of annually set norms by the federal budget law.

The existing mechanism for tax sharing evidently does not promote the normalization of intergovernmental fiscal relations, especially relations between regional (federation subjects) and local tiers of government. In fact, the existing mechanism grants regional officials unlimited discretion over issues related to local finances and makes it impossible for local governments to carry out efficient long-term financial management.

Thus, the optimization of tax revenue allocation among levels of the budget system presupposes *legislative provision of permanent tax shares assigned to local governments*. This will undoubtedly enhance the fiscal autonomy of local governments, providing them with additional revenue-generating sources and reducing counter-redistribution processes within Russia's budget system. It will also contribute to developing stronger incentives and responsibility at each tier of government for improved tax collection and tax capacity. Further, implementation of this measure will enable state government bodies and local self-government to more effectively focus their equalization policy efforts on the territories that *really* have insufficient tax potential.

Clear and transparent rules for the allocation of tax proceeds should also be introduced with regard to the taxes presently servicing the so-called regulatory financial resources. These include the proceeds from taxes that are annually shared among budget system levels in order to provide lower levels of government with additional means (Article 48 of the Budget Code of the Russian Federation).

One of the most important federal regulatory taxes is the value added tax (VAT). The federal budget law annually defines the shares of VAT proceeds that are assigned to fed-

eral and regional levels of government. Regional governments share their portion of the VAT with local governments; according to Article 7 of the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation, no less than 10% of VAT average proceeds raised in the region shall be assigned to local budgets.

Irregular sharing of VAT proceeds among federal and regional governments (see Table 5.4) causes annual fluctuations in local government budget revenues.

*Table 5.4*  
Value Added Tax Sharing in the Russian Federation (1998-2001)

	1998	1999	2000	2001
Federal budget share [%]	75	85	85	100
Regional budget share [%]	25	15	15	0

The federal government promotes the centralization of VAT proceeds from 2001 in terms of alleviating the burden on regional and local budgets from unfunded-mandates. It is argued that 15% of VAT proceeds being concentrated in the so-called Compensation Fund within the federal budget will be used to finance the implementation of three federal "social" laws providing various benefits to several categories of individuals: families with children, war veterans and invalids.

While the federal government's measures aimed at solving the problems of unfunded-mandates might seem reasonable, they contradict the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation as they deprive local governments of a share of the VAT. The same legal collisions exist with respect to other regulatory taxes, including the personal income tax, corporate income tax and others.

*Table 5.5*  
Sharing of Personal Income Tax Proceeds in the Russian Federation (1998-2001)

	1998	1999	2000	2001
Federal budget share [%]	0	0	3	16
Regional budget share [%]	100	100	97	84

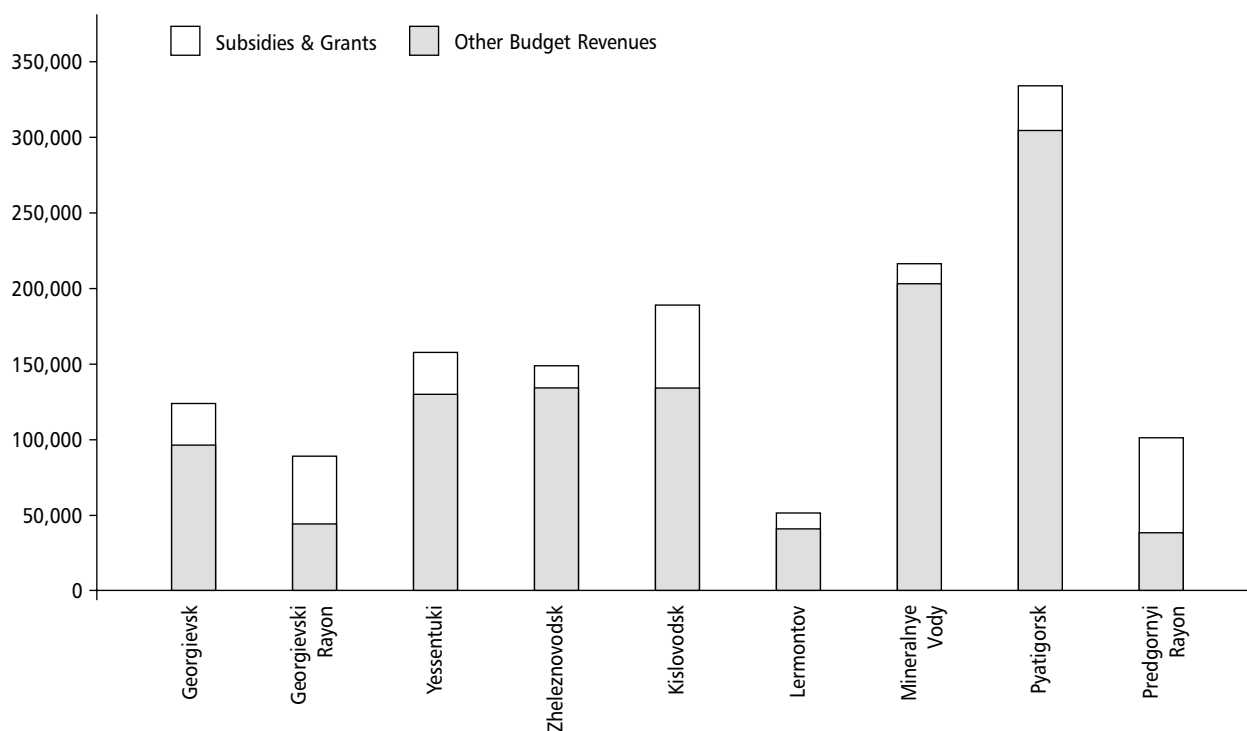
Table 5.6

Local Governments' Own Taxes and Fees Sharing Among Budget System Levels in the Russian Federation, 1999

Taxes and Fees	Actual Taxes and Fees Distribution Among the Budget System Levels [%]			Taxes and Fees Distribution Among the Budget System Levels According to the Existing Legislation [%]		
	Federal Budget	Regional Budgets	Local Budgets	Federal Budget	Regional Budgets	Local Budgets
Individual Property Tax	0	3	97	0	0	100
Land Tax	20	20	60	30	20	50
Health Resort Fees	0	0	100	0	0	100
Target Fees	0	2	98	0	0	100
Advertisement Tax	0	74	26	0	0	100
Public Utilities Maintenance Tax	0	26	74	0	0	100
License Fees for Retail in Alcohol and Beer	0	21	79	0	0	100
Other License Fees	0	0	100	0	0	100
Other Local Taxes	0	1	99	0	0	100

Figure 5.9

Share of Subsidies and Grants in Local Budgets' Total Revenue, Caucasus Mineral Springs Region, 2000



It should also be noted that sharing of local government own taxes is also irregular and often contradicts the existing legislation (See Table 5.6)

### 3.4 Local Government as a Recipient of Transfers

Under the present conditions, when local governments' own revenues account for a negligible part of their expenditures, the transfers (subsidies and grants) handed over to them by regional (federation subjects) governments become extremely important.

Distribution of financial aid among local governments in Russia is region-specific. As a matter of fact, there is no universal scheme for a transfer policy with respect to local governments.

Until recently, transfers were distributed among municipalities in the majority of the Russian Federation subjects (regions) much like the methods for budget planning practiced in the pre-reform Russia. These methods were based on the unitary approach for treating sub-federal budgets.

After 1994, Russia progressed significantly in the sphere of transfer distribution among federation subjects in terms of making the relevant distribution procedures more objective and transparent. At the same time, the problem has not yet been given any serious consideration at regional level with regard to local budget transfers. The most commonly used method for providing municipalities with financial aid involves attempts by regional governments to cover the gap between the estimated tax and non-tax revenues of a municipality and its "needs." Local and regional governments primarily calculate the size of this gap independently and then both these governments try to reach an agreement on the amount of the transfers. The "adjustment" procedures are extremely tiresome and time-consuming. They create incentives for local governments to understate their revenues and overstate their expenditure claims. It should also be noted that fixing the shares of federal regulatory (shared) taxes allotted to local budgets provides another opportunity for bargaining between regional and local governments.

To forecast their own revenues, local governments use both the estimated parameters of last year's executed budget (adjusted for coefficients provided by the Ministry of Finance and the Ministry of Economic Development and Trade) and informal indices indicating the prospects of business activities in the locality for the coming year.

In search of more objective criteria for local government expenditure estimates, federal and regional authorities are attempting to introduce minimum social expenditure standards for each budget item. However, numerous estimates have demonstrated that local budgets, as a rule, fail to meet

these standards. Besides, the process of working out the standards tends to be too complicated because of the necessity to take into account a wide range of factors and the need to adjust them annually for inflation.<sup>5</sup>

In fact, each regional government has now developed its own scheme for transfer distribution among municipalities within the region. Though these schemes differ from region to region, they have several common features.

As a rule, regional governments form Municipality Financial Support Funds (MFSF) to carry out their transfer policies and draw from various sources to fill these funds. The most common practice for forming a MFSF is based on one of the following strategies:

- using Regional Financial Support Fund (federal transfers addressed to the regions) resources as the only source for MFSFs;
- using the Regional Financial Support Funds alongside assignments from several shared taxes (VAT, corporate income tax, excise taxes, enterprise property tax);
- on the basis of annually fixed assignments from the regional budget.

Apart from the MFSF, some regional governments establish Stabilization Funds to accumulate a certain portion of the regional budget's tax revenue. Stabilization Funds grant financial resources to local governments, enabling them to provide for some of their urgent expenditures (such as public sector employees' salaries, etc.).

In a number of regions, the MFSFs are divided into two parts:

- resources allowed for the equalization of per capita budget sufficiency among municipalities;
- resources allowed for strengthening the incentives of local governments to raise more of their own revenue.

In some of the regions, MFSF resources fall into the following categories:

- resources allocated for current expenditures;
- resources allocated for the purpose of territorial economic and social development.

A crucial issue related to the transfer policy is determining the principles to guide the distribution of transfers among local governments within the region. As it has already been noted, there is no uniformity in the Russian Federation in the way transfers are granted to local governments. Some of the regional governments have developed and introduced their own procedures for determining a local government's

share of the MFSF. The following are examples of such procedures (without specifying the particular regions):

- 1) a local government's share of the MFSF is determined by a ratio of its expenditure-revenue gap to the total amount of this gap throughout the region.
- 2) the procedure of determining local governments' shares of the MFSF has two stages:
  - in the first stage, per capita revenue in the municipalities, where they are a lower than average level throughout the region, are brought up to the average level for the region;
  - if some of the municipalities are unable to cope with their expenditure obligations, they then get more financial resources from the MFSF.
- 3) the procedure of determining local governments' shares of the MFSF has two stages:
  - in the first stage, transfers are granted to the municipalities, which have estimated budget deficits exceeding 50%, in order to reduce their deficits to a level below 50%;
  - during the second stage, the remaining part of the MFSF is divided among the municipalities in proportion to their budget deficits.
- 4) the procedure of determining local governments' shares of the MFSF has two stages:
  - during the first stage, the regional consolidated budget is projected;
  - during the second stage, transfers are granted to the municipalities, which have estimated budget deficits higher than that of the regional budget. The municipality's share is determined by a ratio of its estimated budget deficit to the aggregated deficits of all the municipalities within the region.
- 5) municipalities are grouped according to their populations, industrial potential, availability of large companies-tax-payers, social infrastructure, climate etc. and each group of municipalities is given a coefficient that provides the basis for its transfer.
- 6) regional governments grant transfers to the municipalities to provide equal per capita budget capacity throughout the region regardless of the municipalities' tax potentials.
- 7) transfers are provided so that per capita budget revenues in the municipalities throughout the region are brought to a commensurable level on the basis of the *Budget Expenditures Index*.

## 4. LOCAL GOVERNMENT IN RUSSIA: TOWARDS TRUE FISCAL AUTONOMY

### 4.1 Reassessment of Tax Allocation and Tax-Sharing Patterns Across Government Levels

Local government finance in Russia is characterized by relatively small shares of local governments' own revenues in their total revenues, annual revisions of federal and regional tax shares allotted to local governments, immense redistribution activities of the federal government and other negative tendencies referred to in the previous chapters. This situation calls for a reassessment of the existing tax-sharing patterns across different levels of government with regard to reinforcing the fiscal autonomy of local governments. It seems reasonable to raise the revenue base of local governments through optimizing tax allocation and tax sharing among the different levels of the budget system and through expanding the nomenclature of local taxes.

It is possible to identify several criteria for the optimal tax allocation among different levels of government:

- *stability of tax' returns*: unstable revenue sources that depend more on macroeconomic indicators than on tax-collecting efforts of the territories should be allotted to higher levels of government;
- *economic efficiency*: in order to establish incentives for more efficient tax collection, each level of government should be allotted the taxes over which its tax-collecting efforts would produce maximum effect;
- *equity*: if the tax base is unevenly distributed among the territories, then a higher level of government should be responsible for the tax to allow for redistribution;
- *tax base mobility*: taxes that have territory specific (immobile) tax bases should be allotted to the territories;
- *tax burden exporting*: only those who benefit from public services provided in a certain territory should be responsible for paying for them.

Clear and reasonable tax allocation across different levels of the Russian budget system is a key factor, both for its normal functioning and as a basic precondition for the fiscal autonomy of local governments.

The following is a short description of required changes to intergovernmental fiscal relations to provide a more realistic background for local governments' autonomy in the Russian Federation.

1. At least 10% of proceeds from the *corporate income tax* should be allotted to local governments.

2. 70% of the *personal income tax* should be allotted to local governments. The existing legislation (Article 7 of the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation) stipulates that at least 50% of proceeds from the average regional personal income tax shall be allotted to local governments.
3. A *tax on gambling businesses* should be turned over to localities (now it is a federal tax) due to considerations of economic efficiency.
4. *Excise taxes on alcoholic beverages* and other excise taxes should not be considered as part of local governments' own revenue sources. Their shares should not be allotted to local governments on a permanent or long-term basis, as stipulated in Article 7 of the Federal Law on the Financial Basis of Local Self-Government in the Russian Federation. However, regional governments should be granted the right to assign shares of excise taxes to local governments.
5. Proceeds from the *sales tax* should be shared among regional and local budgets, applying the current ratio of 40:60 respectively.
6. *The Enterprise property tax* should be given a local tax status and be totally assigned to local budgets. Presently, the enterprise property tax is treated as a regional tax and it is shared between regional and local budgets at the rate of 50:50 (according to the Federal Law on the Enterprise Property Tax, 1991). There are several reasons in support of turning the enterprise property tax into a local tax, including stability of tax returns, low tax base mobility and economic efficiency. Another important argument is the fact that companies using the local infrastructure (roads, local public utilities, etc.) should be the primary contributors to local budgets.
7. *The Land tax* should also be purely local. As mentioned in the previous chapter, the land tax is currently shared among federal, regional and local budgets. The actual sharing ratio for the previous years has been 20:20:60, respectively. According to the Federal Law on the Year 2001 Federal Budget, 50% of land tax proceeds are centralized, meaning they go to federal and regional budgets. The arguments in favor of assigning the land tax to local governments are the same as those for the enterprise property tax, with the additional reason that the land tax base is evenly distributed throughout the territories in line with the equity principle.
8. According to Article 15 of the Tax Code of the Russian Federation, the *inheritance and donations tax* is a local tax. However, this tax has an explicit redistributive character and redistribution is the exclusive function of the federal government. Therefore, it would be quite reasonable to assign the inheritance and donations tax to the federal budget. The losses to local budgets resulting from this would be negligible.
9. *The aggregate income tax*—single imputed income tax on specific activities, aggregate income tax on small businesses—is now assigned to regional budgets and should become a local tax. The key reason for reallocation of the aggregate income tax is the fact that as local authorities are interested in the development of this tax base, it would be more efficient to allot it to a lower level of the budget system.

The proposed tax reallocations would improve the position of local governments by allowing their revenues to increase, on average, by 25%. At the same time, regional budgets would lose about 15% of their revenues and the federal budget would lose about 0.5%.

The most significant contribution to the revenue growth in local budgets (16%) would be realized through the reassignment of the enterprise property tax. Due to this measure, the benefits to local governments will exceed their losses by four times, as a result of assigning the excise taxes to regional budgets and the inheritance and donations tax to the federal budget. The total amount of these losses is 3.7% of local budgets' tax revenue. The 70% increase in the share of personal income tax allotted to local governments will lead to their tax revenue growing by 9.4%. The reassignment of the land tax would account for an additional 2.6% growth in local revenue, whereas the tax on gambling businesses would lead to a 0.2% increase. Aggregate income tax reallocation will boost local budget revenue by 0.6%.

The reduction in regional budget revenue is primarily determined by the reassignment of the enterprise property tax to local governments, leading to a loss of about 11% of their tax revenue. Reassigning the personal income tax allotment will result in a decrease of 6.6% of regional tax revenue. As a result of reallocating the proceeds from the land tax, regional budgets will shrink by 1%. However, these losses will be partly compensated by the new pattern of sharing excise taxes, with regional budgets increasing by 2.5%, as well as by the sharing of the aggregate income tax, allowing regional budgets to grow by 0.2%.

The reduction in federal budget revenue, within the framework of the proposed reallocation policies, will result from the assignment of the former federal share of the land tax and aggregate income tax to local governments, each representing 0.3% of total revenue in the federal budget.<sup>6</sup>

The proposed framework for intergovernmental revenue source allocation contributes both to the strengthening of local government fiscal autonomy as well as to providing a more balanced structure to tax revenue allocation in the consolidated budget. In 1999, the proportional distribution of tax revenue from the consolidated budget was respectively 50:27:23 among federal, regional and local levels. In 2001, this proportion became 57:25:18 as a result of VAT centralization and the abolition of the public utilities maintenance

tax. The policy proposals described above are aimed at diminishing the fiscal imbalance among regional and local levels of government with the resulting proportional distribution equaling 57:20:23.

It should also be emphasized that the proposed measures, with minor exceptions, do not affect federal tax revenue.

## 4.2 Improving Transfer and Equalization Policy

As discussed in Sector 2.4, transfer granting with respect to Russian local governments lacks a universal scheme. Each regional government develops and implements its own procedures for distributing equalization transfers among municipalities in its region (federation subject).<sup>7</sup> While developing these procedures, however, regional governments tend to imitate equalization transfer granting as practiced by the federal government with respect to nation-wide equalization.

In order to facilitate more efficient transfer granting for regional governments, the Russian Ministry of Finance, in association with the Center for Fiscal Policy Consulting Group (Moscow) and Georgia State University, suggested in 2000 the “Temporary Methodological Recommendations for Intergovernmental Fiscal Relations Regulation within Federation Subjects.”

The Recommendations explicitly call for the formalization of transfer granting procedures among municipalities within federation subjects and suggest the following:

- (1) a more distinct allocation of federation subject’s consolidated budget revenue among regional (federation subject) and local government levels; the allocation should be based on regional and local government expenditures from the previous year and the existing ratio of regional to local expenditures should be fixed for several years;
- (2) a long-term (at least three year) legislative assignment of basic tax shares to local governments; the rates should be determined so as to provide regional governments with sufficient financial resources enabling them to conduct efficient intra-regional equalization policies;
- (3) determining the total amount of financial resources to be transferred to local budgets from regional budgets in order to cover local deficits arising from the necessity to fund fixed expenditure items;
- (4) determining the amount of financial resources to be handed over to local governments, enabling them to execute special state functions (federal and regional mandates). Local governments should be granted these resources in the form of subventions; the subventions

should not be included into the equalization transfer amount assigned to the local governments.

- (5) the total amount of transfers assigned to local governments should be divided into two parts: (i) resources allotted for equalization purposes; (ii) resources allotted for incentive purposes. The “equalization” activity is aimed at eliminating the gap in per capita budget capacities among local governments within the federation subject (region). The “incentive” activities are geared toward improving local tax collection and developing the local tax base.

It should be noted that the suggested Recommendations are an innovative approach to evaluating local government budget capacity. The evaluation is based on an assessment of a local government’s revenue capacity and its expenditure needs. The indicator for measuring the capacity to generate revenue is different from the amount of taxes actually collected by a local government; it seeks to assess the tax collecting potential of a municipality. The total tax collection potential is comprised of the capacity of individual taxes to be paid to a local budget; the latter is determined on the basis of the average representative tax rates.

Experts at the Ministry of Finance argue that the suggested approach for the local capacity evaluation would provide local governments with stronger incentives for raising the local tax base and would depress the motives for lowering the actual amount of taxes collected by municipalities.

Another important aspect of the intra-regional fiscal equalization problem deals with the proper definition of local expenditure needs. The Recommendations suggest that the needs assessment should take into consideration the number of budgeted service recipients with regard to various local peculiarities that influence the price of a given municipality’s basic service package. In order to evaluate the municipality’s expenditure needs, the Recommendations suggest introducing budget expenditure indices that estimate a wide range of cost factors for services in a given municipality (demography, climate, transport, infrastructure, etc.). Each index should demonstrate how much each factor increases or decreases the cost of a municipal service. The key index for a municipality is defined by the multiplication of individual indices that take into account each factor.

The Recommendations have obviously become one of the first attempts by the federal government to make intra-regional intergovernmental fiscal relations (and especially transfer granting) more transparent, efficient and fair. While some of the measures proposed by the Recommendations are controversial or unrealistic,<sup>8</sup> the Recommendations still retain value. The most valuable feature of this document is its attempt to make the process of transfer granting at the regional level more objective (formula-based) and to eliminate opportu-

nities for costly (in terms of economic efficiency) political bargaining between regional and local levels of government.

### 4.3 Municipal Property: Options for Greater Cost-Efficiency

Along with privatization, Russia has recently experienced large-scale property municipalization. As a result of this process, local governments have become very important property owners with about 40% of public property belonging to municipalities, which represents nearly 16% of the economy's total capital funds.

Municipal property in Russia is characterized by the following traits:

- It is more money-consuming than money-producing. A lion's share of local expenditures (over 60%) goes to property maintenance and operating expenses; the properties account for only 1-2% of local revenues;
- Municipal property is of a very low technological level and is nearly fully depreciated. Municipal service production is absolutely inefficient due to very high costs. Further, municipal property maintenance expenditures are financed through growing creditor indebtedness. This means that municipal property maintenance expenditures are borne by future generations of local communities who will not be able to use these properties because of their deterioration;
- The structure of municipal property returns is not quite satisfactory. The dominant sources of returns include property sale and real estate rent incomes. In addition, municipalities will sometimes receive assignments from municipal unitary enterprise profits. Local governments do not employ the same municipal property management as trusts, concessions or municipal portfolio managers.

Municipal property policy needs serious reassessment. Generally the policy should be aimed at making municipal property more cost-efficient and include the following aspects:

- changing the structure of municipal property,
- working out and implementing new approaches to municipal property management,
- defining new principles of municipal property returns.

The basic requirement for municipal property management is that municipal property should be treated as a capital asset with the potential of generating revenue. One available option is the partial incorporation of municipal property

requiring a serious legislative amendment. Some of the services provided by local governments could be commercialized. Further, local governments should not disregard the opportunity to participate in mixed companies (with private capital) in order to provide local communities with access to profitable businesses (especially those based on natural rent revenues).

### 4.4 SUMMARY

The tendency toward further decentralization of political and economic authority and institutions in the Russian Federation could be characterized as objective and is meant to raise the general level of public administration efficiency. However this process of decentralization is developing spontaneously: it fails to meet true imperatives of economic and social development, it ignores the interests of the regions and local communities, and sometimes it contradicts the norms of the Russian Constitution.

Under the circumstances, one of the most challenging problems facing Russian regional and local authorities is the necessity to provide the equilibrium of intergovernmental fiscal relations. In order to achieve this basic goal, the following measures aimed at fiscal policy modification have to be taken:

- 1) a more adequate coordination between the legal acts regulating local government issues should be provided;
- 2) territorial organization of local government should be brought in line with local government's goals and functions;
- 3) organizational issues of local government bodies' formation need further consideration and settlement;
- 4) a more accurate legal definition of local governments' competence should be provided;
- 5) the solution of the unfunded mandates problem facing local governments calls for: (i) reassessment of benefit-granting policy principles, and (ii) raising the efficiency of fiscal resources redistribution;
- 6) taxation and tax revenue distribution systems should be modified so as to provide the principle of matching local governments' expenditure responsibilities with their own budget revenues;
- 7) the principles of shared tax rates and shared tax proceeds should be implemented in a more consistent manner within the Russian taxation system in order to provide greater incentives for local governments to improve tax collection and stimulate the development of municipalities' tax capacities;
- 8) optimization of tax revenue allocation among budget system levels calls for clear and transparent legislative

provision of permanent tax shares assigned to local governments;

- 9) in order to provide objective criteria for local governments' expenditures estimation, federal and regional authorities should introduce minimum social expenditure standards for each budget item;
- 10) in order to strengthen the local governments' fiscal autonomy and provide more structural balance in the consolidated budget's tax revenue allocation, a new framework for developing intergovernmental revenue source allocation should be proposed;
- 11) the process of transfer granting at the regional level should become more objective (formula-based) in order to eliminate the space for political bargaining between regional and local levels of government;
- 12) the current municipal property related policy needs serious reassessment, allowing the treatment of municipal property as a capital asset with the potential of revenue generation.

## NOTES

- <sup>1</sup> Shirokov A., Niankin V. Segodnya, Zavtra. I Navsegda, *Municipalnaya Vlast*, 2000, Nos. 1-2, p. 41.
- <sup>2</sup> Ibid. p. 42.
- <sup>3</sup> Pronina L.I., *O nalogovykh dokhodakh mestnykh budgetov vo vtoroi chasti Nalogovogo Kodeksa Rossiiskoi Federatsii*, Finansy, 2000, No. 9, p. 22.
- <sup>4</sup> Panskov V., *Municipalnye budgety v sisteme mezhbudgetnykh otnosheniy*, Rossiiskiy ekonomicheskii zhurnal, 1998, Nos. 11-12, p. 66.
- <sup>5</sup> Center for Fiscal Policy (Moscow) Materials.
- <sup>6</sup> Pronina L.I., *O razgranichenii nalogovykh polnomochiy i uvelichenii nalogovykh dokhodov mestnykh budzhetov*, Finansy, 2001, No. 5, p. 33.
- <sup>7</sup> According to legislation intra-regional intergovernmental fiscal relations are regulated by regional governments.
- <sup>8</sup> Pronina L., *Sovershenstvovaniye mezhbudgetnykh otnosheniy—garantiya ukrepleniya mestnogo samoupravleniya*, Finansy, 2000, No. 5.