Local Government
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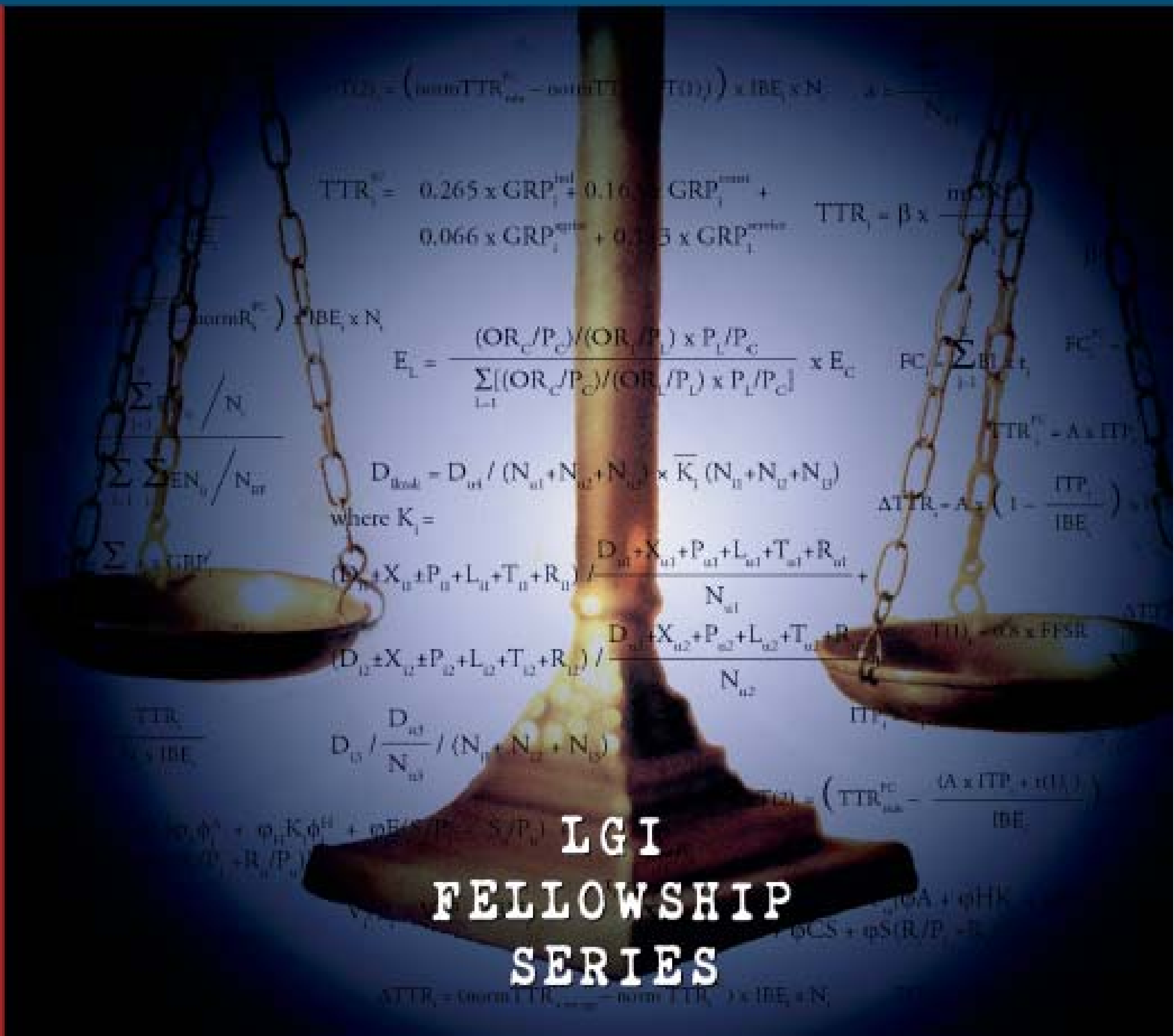
Reform Initiative

DILEMMAS AND COMPROMISES: FISCAL EQUALIZATION IN TRANSITION COUNTRIES

EDITED BY SERGII SLUKHAI

LGI Studies



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LGI
Fellowship
Series

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Preface

The present volume *Dilemmas and Compromises: Fiscal Equalization in Transition Countries* analyzes the equalization system of three post-communist countries: Russia, Romania and Ukraine. Each country displays a fundamentally different model and stage of decentralization:

- Russia and Ukraine are post-Soviet countries that experienced a long break in local self-government activities; Romania, on the other hand, while also a former Communist country, underwent a shorter period under this system and is currently a candidate country to the European Union,
- Romania and Ukraine are unitary countries, while Russia is a federation.

This selection of countries permits generalization of the problems encountered in the following analysis to many other countries undergoing transformation. These three countries have minimal experience or have had a long hiatus in decentralization of public finance. At the same time, there are significant inequalities between local governments, arising from the fact that Communist countries did not conduct their own policies for assisting poorer regions; these inequalities, therefore, have become etrenched. Variations also occur across regions, which is evident in the maps the authors present, as well as across urban and rural self-governments and between capitals and provincial areas.

Further exacerbating the existing inequalities are the problems of insufficient local government revenues and opportunities for transfers from the central budget. Under such conditions, the state treats equalization transfers as an element of its influence over local governments.

For this reason, the authors level their most serious charge at the nebulous system of distribution of equalization transfers, involving negotiations instead of the application of a concrete formula. Further, the "rules of the game" are often changed; instability is the norm.

In fact, a further criticism applies to the entire local government system and not just equalization policy. Unclear divisions of functions among the central government administration and the various tiers of local governments significantly hinder the application of any kind of equalization system. In essence, first the issue of division of competencies should be settled and then the technique of equalization should be improved. This is the long-term recommendation of the authors.

The authors analyze in detail the method of equalization applied in their respective countries. They present both trends in the division of funds (how equalization transfers have changed over time) as well as the effects of applied equalization techniques.

A presentation of the effects of the application of equalization transfers in each country leads to an interesting conclusion: in essence, the methods currently used are not improving the situation of less developed local governments.

Based on this conclusion, the authors propose the introduction or modification of formulas used for calculation of transfers. The authors illustrate their research through simulations of the effects of applying new formulas for local governments and demonstrate the potential improvements: better distribution of funds and equalization of opportunity. Naturally, just as the countries in these studies are different, the proposed solutions are also different. For Romania, it is suggested that it is sufficient to address local government fiscal capacity. Such a solution, not always recommended, is sometimes applied successfully. In Poland, for example, equalization transfers are based exclusively on the fiscal capacity from the previous year. This solution functions properly because local governments are, to a large extent, in a three-tiered self-government system and public services are uniformly divided among local self-governments: in general all must provide residents with access to the same services. Moreover, local governments are readily able to enter into agreements, as well as to transfer functions and funds among themselves.

In the case of Russia and Ukraine, where in the past each service had been unevenly distributed, limiting a solution to fiscal capacity only would lead to a deepening of these inequalities. Therefore, it is recommended that local government needs be reconsidered in these countries.

The volume differentiates not only the analytical approach in the existing equalization systems in the three countries, but also proposes concrete changes in the systems. These proposals were based on simulations and forecasts of local government revenues after applying a proposed transfer formula. In contrast to many other such publications, the authors suggest very concrete changes in the equalization system and do not limit themselves to general recommendations for system improvement.

A very important element of this publication is the introduction, which offers a comparative study. The introduction affords the reader the opportunity to become familiar with background information on fiscal equalization, applied measures and techniques, as well as to compare the systems used in the three countries.

Thanks to the introduction, the reader has the opportunity to compare three countries and their experiences and attempts at fiscal decentralization, as well as to understand why certain solutions are successful in one country and not in another.

While the solutions the authors propose themselves require further discussion and development, they do constitute a very concrete proposal for change. I encourage you to read this very interesting work and to develop your own conclusions on fiscal equaliztion.

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DILEMMAS AND COMPROMISES

Sergii Slukhai

Fiscal Equalization in Transition Countries: Searching for the Right Policy

FISCAL EQUALIZATION IN TRANSITION COUNTRIES

Fiscal Equalization in Transition Countries: Searching for the Right Policy

Sergii Slukhai

1. INTRODUCTION

The collection of papers in this volume contains an analysis of fiscal equalization, an important component of intergovernmental fiscal relations, in three post-communist countries: Romania, Russia, and Ukraine. As with many other transition countries, since the late 1980s these countries have been in a process of finding their own path for public sector democratization and construction of a sound public finance management system.

Of course, for these three countries undergoing reforms was not easy: the destruction of Communist regimes led to a weakening of the state, economic chaos, and a deterioration of the public finance system. A fall in GDP, high inflation rates, and growing public arrears are common features of most countries of the former "socialist camp." As it turned out, under such conditions the inherited state mechanism could not properly handle the emerging problems; it was necessary to find ways to make the state cheaper and more effective, thus "to reinvent" a state that would be more consistent with a new (transitional) condition of society.

Generally speaking, in all post-socialist countries the public fiscal systems have the same roots and, at least initially, a similar structure; the intergovernmental equalization systems redistributed large portions of public revenues with the aim of equalizing living conditions throughout the country due to an egalitarian notion of equality. After the start of the transition period, this unique approach to public finance backed by the dominate communist ideology disappeared. For this reason, the comparative study of the equalization techniques as they evolve in different countries could help generate solutions to emerging problems in the intergovernmental equalization field, in both horizontal and vertical dimensions.

The collection of papers below is dedicated to the fiscal equalization policy pursued by the respective national governments from the late 1990s through the early 2000s. Using country-specific practical evi-dence and highlighting current developments, the authors search for possible improvements to current fiscal equalization schemes and aim to develop a set of proposals on how to make them more effective. These proposals are of value not only for Romania, Russia and Ukraine, but also for other transition countries facing similar problems.

The authors of the papers are experts in the field of public finance. Their motivation to participate in LGI's Policy Fellowship Program and to carry out studies of fiscal equalization techniques is grounded in their active participation in past seminars on fiscal decentralization provided at summer university courses sponsored by the Open Society Institute–Budapest.

The contributors were asked to evaluate the following issues: what is the value of equalization and its actual importance in a context of intergovernmental finance in transition; what are the constituent elements of the mechanism of equalization grant allocation; what are the trends in the development of the fiscal equalization mechanism; whether the equalization procedures employed are consistent with the goal of fiscal equalization; whether the extent of equalization is sufficient or not; whether the instruments of equalization are used according to their ability to achieve desired grades of equalization; whether ongoing reforms in the fiscal equalization branch take into account both positive and negative experiences of the past.

Each paper presents a study of a nation's fiscal equalization practice from a different point of view. The case study on Romania is devoted to an analysis of the efficiency of the recently introduced equalization scheme; the case study on Russia presents trends in the evolution of formula-driven equalization approaches on the federal level, with some reflections on its possible introduction at the regional level; while the case study on Ukraine reflects recent developments in intergovernmental finance with special emphasis given to equalizing differentials in service levels between local authorities. The diversity of approaches presented in this volume gives the reader a good reason to think about similar issues arising in her own country.

To understand the developments in fiscal equalization policy in Romania, Russian Federation and Ukraine, one must keep in mind the initially different political and economic factors at play in the respective countries which form the backdrop of ongoing changes in fiscal relations and still affect the intensity of reform activity. All these countries belonged to the former "socialist camp" and share many characteristics, e.g., with respect to political systems, human rights, and traditions of public administration, etc. Their turn to the common way of civic development has had some special characteristics: in Romania it was initiated by the fall of Ceausescu's regime effected by mass protest; the Russian Federation and Ukraine have obtained their true sovereignty in the course of a generally peaceful "divorce" that split the Soviet Union into fifteen independent nations.

In general, in the initial stage of transition, all three countries shared many similarities in public administration inherited from before the regime changes. The inherited similarities were, among others, hierarchic relationships between tiers of government, lack of real fiscal autonomy of local governments, and so on. Many of these features still remain in the present public finance systems.

At the same time, the three countries displayed many differences that could be attributed to historical heritage in structuring the sector of public administration. Romania has a long tradition of relatively large local units of territorial administration. Due to their coexistence in the highly centralized Soviet state over many decades, the Russian Federation and Ukraine have a similar situation in the sector of public administration, although historical background plays its role here. For example, Russia is biased against taking into account the perspectives of many different nations while building its territorial administration; the Ukrainian situation is characterized by an imbalance in the development of self-government units in different parts of the country—traditionally, the municipalities in the west are more independent and accountable to local voters than those in other parts of the country.

It is within this background that the reforms of intergovernmental finance have had their start. Romania and Russia, in 1998, and Ukraine, in 2001, have begun substantial changes by approving new framework legislation. The first results of these reforms are not unconditionally positive; there have been many negative developments and steps backward. The reforms are far from completion in many respects. The mechanisms of equalization are unstable: subject to permanent changes according to the shaky balance of political power between the center and subnational entities. These conditions provide experts with much room to propose alternatives to current equalization policies.

It should be mentioned that there have been several studies on the evolving intergovernmental fiscal relations in these countries: for example, the World Bank studies on the socialist state transition (Bird, Ebel, and Wallich 1995; Martinez-Vasquez and Boex 2000, 2001; Wetzel 2001); some aspects of fiscal equalization were presented to the international public in the LGI series on local governments in transition countries (Kandeva 2001; Popa and Muntianu 2001); and other publications (Engelschalk 1999; Ieda 2000; Nemec and Wright 1997). But with respect to fiscal equalization issues, Russia receives the most attention because of its great importance for the world economy and its political impact on the post-Soviet rim, and also because its federal nature forces it to implement more or less effective equalization procedures among subjects of the federation.

Taking this fact into account, the proposed study addresses some lacunae in the economic literature concerning important aspects of intergovernmental fiscal relations in Romania and Ukraine, but also in Russia.

The economies of the countries under investigation are in very different stages of development (see Table 1.1), which affects the functioning of the public sector as a whole, state economic policy, and in particular, the shaping of the fiscal equalization issue.

Table 1.1
The Most Important Economic Indicators of Romania, Russia, and Ukraine, 2000

	Romania	Russia	Ukraine
GDP [billion USD]	36.7	251.1	31.8
Surface Area [million sq. km]	0.238	17.1	0.604
Population [millions]	22.4	145.6	49.5
GDP per Capita [USD]	1638	1725	642
Population Density [inhabitants/sq. km]	94.1	8.5	82.0
State Budget Balance [percent of GDP]	–3.0	4.1	–0.6

Source: World Bank 2002.

From the above data, an economist would observe that Russia has a readily evident need for fiscal equalization and extensive state policy in this field. Its vast surface area and sparse population results in greater expenditure differentials and differences in the fiscal endowment of territorial units. The economist's observation would be strengthened by the introduction of a political factor—Russia is a federation, whereas Romania and Ukraine are unitary states. Due to its better economic performance—primarily the result of temporarily favorable international trade conditions—the Russian central fiscus have enough resources not only to repay loans to foreign creditors before they come due, but also to find additional resources to solve intergovernmental financial problems more effectively.

List of Abbreviations

CEE Central and Eastern Europe
CIS Commonwealth of Independent States
fSU former Soviet Union
GDP gross domestic product
HC Hunter's coefficient
LG local government
PIT personal income tax
SNG subnational government

2. SETTING UP A PROBLEM

With regard to public administration, the last decade of the twentieth century is often referred to as a "decade of decentralization" (World Bank 1997); during this period of time many countries of the developing and transition world have launched programs designed to shift the growing share of public functions to lower governmental tiers.

Public administration in transition countries is under reconstruction. The structure and basic principles of fiscal relations between tiers of government should correspond to the new needs of the emerging market economy. Building strong and sound intergovernmental fiscal relations in transition countries requires, to a reasonable extent, incorporation of historical traditions and current realities of the economy, together with the theory on fiscal federalism and worldwide experiences with its implementation.

The empirical evidence shows that there is some kind of trend to decentralization in transition countries, although some asymmetry is likely at play: while the relative size of subnational expenditure responsibilities has soared, their slowly growing revenues remain insufficient to cover functions shifted from above (Table 1.2). This provides national governments with a "good excuse" to subsidize subnational units instead of giving them own revenue sources.

Table 1.2
Dynamics of SNG Share in Combined Public Revenues and Expenditures (transfers excluded) [percent]

Country	Expenditures		Revenues	
	Starting Period	Final Period	Starting Period	Final Period
Armenia, 1995–1999	4.7	4.7	—	—
Azerbaijan, 1994–1999	25.3	23.6	18.9	14.9
Belarus, 1992–1998	30.4	41.0	29.0	36.1
Czech Republic, 1993–1999	21.3	21.9	14.3	19.0
Estonia, 1991–1999	30.3	24.2	26.6	16.7
Georgia, 1995–1999 (1)	17.2	26.1	—	30.6
Hungary, 1988–1998	22.4	25.4	11.9	15.0
Kazakhstan, 1997–1998	29.9	33.4	27.8	29.7
Kyrgyz Republic, 1999	—	30.7	—	17.4
Latvia, 1994–1999	24.1	24.7	19.4	19.9
Lithuania, 1991–1999	24.9	19.3	14.3	21.2
Moldova, 1995–1999	29.5	21.7	31.7	17.7
Poland, 1994–1999	16.6	36.4	12.4	22.1
Romania. 1987–1997	8.1	11.4	7.1	10.3
Russia, 1994–1999	39.2	39.9	41.4	36.2
Slovakia, 1996–1999	8.1	6.8	7.5	5.6
Tajikistan, 1998	—	36.5	—	27.4
Ukraine, 1991–1999 (1)	31.4	45.0	45.8	40.0
Unweighted average	22.7	26.3	22.0	22.3

Source: Own computations based on IMF 1999, 2000.

(1) National financial statistics and country studies published by the World Bank.

The countries in question have demonstrated different trends in expenditure/revenue share development: in Russia, slow growth of subnational expenditure share is accompanied by a sharp decline in respective revenue share; in Ukraine, decentralization of expenditures has not been supported by growth in subnational revenue share; conversely, in Romania, a slight growth of expenditure portion has been accompanied by respective growth in revenues of SNGs. We might conclude then that, within this sample, only in Romania does decentralization occur in a balanced way.

There are numerous reasons why many nations in transition engage in decentralization activity: to increase the efficiency of the public sector in line with W. Oates' "theorem of decentralization" (1972), to diminish the costs of public administration, to reduce horizontal disparities, to encourage democratic institutions at the subnational level, and so on. But sometimes the only reason may be to merely shift the fiscal burden from the central authorities downwards in order to make the central fiscal balance look better.

In many cases, such a policy has caused asymmetric development of intergovernmental fiscal relations, when the soaring spending responsibilities of local authorities has no backup in the form of an own revenue base. Thus, this development led to the growing fiscal dependence of SNGs on national decisions concerning transfer fund allocation. As a matter of fact, the regional and local governments in transition countries have a revenue structure skewed toward external revenue sources, such as shared taxes and governmental grants. This situation was observed in the early 1990s (Bird, Ebel, and Wallich 1995), and has not changed much since then.

Growing local spending responsibilities and rigid revenue endowment led to increasing disparities among regions and communities with respect to their ability to finance their own expenditure programs, making topical the issue of fiscal equalization. It is well known that functional decentralization automatically has to be followed by vertical redistribution of public fiscal resources. But, the vertical redistribution of revenue sources per se is not automatically followed by increased efficiency in the combined public administration sector.

There are some complicating factors that make decentralization a very problematic issue within the context of transition. Inefficiency in decision-making, corruption, and other negative phenomena can also appear at lower levels of public administration, which are especially vulnerable to such phenomenon in light of their institutional weakness and the absence of long-standing traditions at this level.

All these considerations have to be taken into account when reforms of intergovernmental financial relations are undertaken.

Fiscal equalization systems should evolve in conjunction with changes in intergovernmental arrangements. Being "a top" intergovernmental finance, the structure of an equalization system reflects the balance of powers among the main stakeholders in the public sector. The intergovernmental system is therefore very vulnerable to any changes in the political and economic status quo within the country. Thus, the reasons for implementing equalization policy are often not only economic. That is why, strictly speaking, it is misleading to speak here of a "system."

The grant system is an integral part of intergovernmental fiscal relations and as such a primary target of change. The different types of grants include indirect and direct, general and selective, and matching and non-matching. National grant systems have fiscal equalization as one of their main objectives. Thus, as a core instrument of state fiscal assistance policy towards SNGs, the grant system necessarily experiences rather big fluctuations.

All the post-socialist countries make use of some sort of equalization scheme. This practice is still highly influenced by the socialist legacy: post-socialist countries inherited a very unequal territorial allocation of industries along with a weak fiscal basis for local government. Revenue sharing still remains a common instrument of equalization in this part of the world, especially in CIS countries (Table 1.3).

The need for fiscal equalization in transition countries is great because of the territorial inequality in allocation of revenue base. This is largely a result of the decline of the traditional industries that under socialist policy were heavily concentrated in particular regions—and now create consequent horizontal imbalances. It would be plausible to guess that horizontal rather than vertical imbalance is more topical, as is true in most developing countries (Shah 1994, 42). Almost all post-socialist countries have applied instruments of some sort to achieve more equity among jurisdictions, with the exception of those few that have very modest equalization policies (Czech Republic and Slovakia).

It is worth noting that many of the post-socialist countries practice horizontal equalization by use of contributions from subnational units, so in a sense they are playing "Robin Hood." A system of this sort is uncommon in developed nations (though Denmark has a similar fiscal arrangement). Such an approach (with variations concerning degree of equalization, etc.) is still at work in many CIS countries, e.g., Kazakhstan, Russia, Ukraine (until 2001), and amongst CEE countries—in Latvia and Lithuania. Most countries use more advanced equalization techniques which account for both the revenue and expenditure sides of subnational budgets; the exceptions are Estonia and Poland which equalize only the revenue side.

In most countries not all the components of the state grant system are consistent with "optimal" criteria. The most important characteristics of a good transfer system are *objectivity*, *stability*, and *transparency* (Bahl and Linn 1992); while movement towards better systems can be observed in Estonia, Latvia, Lithuania, Kyrgyz Republic, Poland, and Ukraine. In these countries, formula grants are soon going to be the most important source of centralized fiscal support for SNGs despite difficulties faced in the implementation of the new approaches.

By the end of the 1990s, most post-socialist countries had launched reforms in the area of equalization; the core issue had been the implementation or improvement of the formula-based equalization transfers. This is true for Romania, Russia, and Ukraine as well as for the majority of transition countries. Nevertheless, most of these systems remain far from ideal. Less positive features of the equalization policies include instability, incompletion, and the sacrifice of strategic interests for the sake of current political gains. It is for these reasons that the need for shaping fiscal equalization policy analysis is very timely, and proposals concerning its improvement could be very valuable.

3. TRENDS IN INTERGOVERNMENTAL FISCAL RELATIONS

Romania, Russia, and Ukraine have quite different characteristics of intergovernmental finance.

In Romania, the public sector is represented by three levels: national, county, and municipal (cities and villages). Legislation states that there is no direct

Table 1.3

Equalization Schemes Employed in Selected ECA Transition Nations

Country	Equalization Procedure
Armenia	Formula, with respect to per capita incomes and expenditure need indicators, especially geographic characteristics of SNG
Belarus	Formula, with respect to difference between per capita standard expenditure and normative revenues; revenue sharing is also at play
Czech Republic	No clearly defined equalization procedure
Estonia	Formula, with size of population and difference in actual and average per capita revenues as factors
Georgia	Equalization is done through differentiation of conditional grants for basic social needs; there are no transparent procedures for their allocation
Hungary	Equalization is a component of the normative grant which takes into account both the revenue and expenditure sides; also investment grants are involved
Kazakhstan	Formula, with respect to per capita standard revenues and expenditures; funded exclusively through regional contributions
Kyrgyz Republic	Formula, with respect to difference in per capita revenues and expenditures; conditional grants are also employed to equalize difference in delivery of social services
Latvia	Formula, with difference in per capita revenues and expenditures to be equalized; the system is funded mainly through contributions of local governments
Lithuania	Formula, equalization component is included into general grants allocation; the differences in both per capita revenues and expenditure needs are involved; subnational units' contributions are practiced
Moldova	Regional differentiation of tax-sharing rates
Poland	Formula, per capita revenues are equalized up to predetermined grade by use of general subsidy
Romania	Formula, with revenue and expenditure indicators employed
Russia	Formula, the regional level disparities in revenues and expenditures are equalized; the equalization on a sub-regional level is very vague
Slovakia	Indirect equalization through differentiation of sharing rates and addressed grants to small municipalities
Tajikistan	Equalization is undertaken by use of regional sharing rates differentiation and deficit grants allocation
Ukraine	Combination of differentiated sharing rates and equalization grants; formula used since 2001, with respect to difference in expenditure needs and revenue capacity
Uzbekistan	Equalization is undertaken by use of regional sharing rates differentiation and equalization grant allocation

Source: Slukhai 2002a.

subordination between the governmental tiers. On the county level the central government is represented by prefects and branches of line ministries.

In Russia, due to the federal nature of the country, the structure is more complicated: federal, regional, and municipal levels are at play; three to four tiers of public administration are present. Moreover, intergovernmental fiscal relations on a sub-regional level are under the jurisdiction of regional governments. This serves in many cases to erode the common intergovernmental framework because regional governments have introduced their own schemes of intergovernmental fiscal relations that often contradict federal legislation.

In Ukraine, according to national legislation, there are two levels of government—national and local. The local level is represented, on the one hand, by oblast (regional), rayon (county), and cities of oblast significance that all have separate fiscal relations to state government, and on the other hand, by units of the lower level: towns, settlements, urban districts, villages. So, in fact, Ukrainian public administration is structured of four levels. Each territorial unit is guaranteed budgetary independence, however, in practice, this clause of the Ukrainian Constitution is not effectively implemented. The right of territorial governments at regional and rayon levels to execute independent fiscal power is very limited, as executive power of locally elected bodies is increasingly delegated to local state administrations of oblast and rayon levels.

As follows from a look at the administrative structure of each country (Table 1.4), the most effective administration at present is in Romania where the structure of public administration on the subnational level tends toward an integrated type. This corresponds to long-standing traditions of public sector structuring in South Eastern Europe, with its relatively large municipalities and an absence of regional-level territorial administration. Romania and Russia could be treated as countries with limited integration on the local level (Nemec and Wright 1997).

From the three countries, Ukraine could be assumed to have the most severe problems, where the municipalities are very small on average with less than two thousand inhabitants per local unit of basic level. Most of these units are too weak to perform legally prescribed activities in public service delivery; there exists therefore a need for reassessment and a following reorganization of administrative-territorial division of the basic level in this country.

According to legislation in all three countries, the local councils should have an independent fiscal base, but the practice of Russia and Ukraine shows that this principle is not universally implemented: about two-thirds of their local authorities of basic level (these are mainly rural communities) cannot execute their full budgetary rights and depend on budgetary

Table 1.4

Number of Subnational Units in Romania, Russia, and Ukraine, by year 2000

Level	**Romania**	**Russia**	**Ukraine**
Regional	—	89	27[a]
County	41	1488[b]	490
Municipality (basic level of local authority)	265 cities, 2,686 rural communes	592 cities, 126 urban districts, 519 urban settlements, 9,000 rural and village communities	451 cities, 122 urban districts, 893 urban settlements, 28,651 villages
Average population of a municipality[c]	7,600	14,400	1,700

[a] Includes 24 oblasts, Autonomous Republic of Crimea, Kiev City, and Sevastopol.

[b] Units of county level in Russia are treated as "municipal units" due to federal legislation. In order to make the data on administrative structure more compatible, for Russia we separated the county level from other municipal units.

[c] In the calculation urban districts are excluded in order to avoid double counting.

decisions of the upper level government (of region or county). One of the explanations for this situation is the following: the size of local government in terms of population (and correspondingly, revenue base) is insufficient to generate enough revenue to finance even mere administrative expenditures. This may provide us with an additional reason to reassess the territorial division of a country in order to obtain more reasonably sized basic territorial units.

This division of units has impact on the structure of public finance. With such weak municipalities in general, the central government concentrates quite a large portion of fiscal resources in the state budget and, in a paternalistic manner, disburses them between lower-level governments.

The picture of the share of subnational government in combined state budget expenditure and GDP presented in Tables 1.5 and 1.6 is likely to show just the opposite: the most decentralized public expenditures are in Russia and then in Ukraine; while the less decentralized are in Romania. These data combine total subnational expenditures of all the levels. In order to make them more compatible, one should extract regional expenditures from the total because Romania has no regional level. Allowing for this, the share of SNGs of county and lower level are for Russia about 8–9 percent of GDP and 28–30 percent of combined public sector expenditures, and, for Ukraine, 9–10 percent of GDP and 25–30 percent of combined public sector expenditures. *This proves that the situation with the allocation of public fiscal resources between governmental levels with respect to the basic level of territorial administration is quite similar in all three countries.*

Apart from current budgetary expenditure distribution, the observed trends in this field are also very important. The growing local government share of GDP in Romania shows that only here do we have a soaring process of decentralization—it received a push in 1998 when the Law on Public Finance was adopted. In Russia and Ukraine, a decline of subnational expenditures as a portion of GDP (about 2.5 times in Russia and 1.5 times in Ukraine) can be seen. This can be understood as a part of a more general process of shrinkage of state responsibilities during the transition period. This shrinkage has gone asymmetric: the relative expenditures of the central government are growing in general at the expense of governments of lower tiers, especially local governments.

We can conclude from the above tables that the *real decentralization process started in these countries only in the mid-1990s*: first in Russia, then in Romania, and finally in Ukraine. The decentralization process was initiated due to new legislation recently adopted in the countries—in 1998 in Romania and Russia, and in 2001 in Ukraine.

Table 1.5

SNG Expenditure Share in GDP [percent]

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001
Romania	3.9	4.1	4.6	5.0	4.1	4.3	4.0	4.9	7.0
Russia	26.1	18.9	15.6	18.0	15.4	12.1	12.6	12.3	10.6*
Ukraine	15.2	15.9	17.5	14.4	14.8	14.6	12.1	9.8	10.6

* First half of 2001.

Table 1.6

SNG Share in Combined Public Budget Expenditures [percent]

Country	1993	1994	1995	1996	1997	1998	1999	2000	2001
Romania	13.0	13.5	14.0	15.3	13.8	14.4	13.4	16.5	23.2
Russia	38.4	48.8	48.7	46.6	51.9	55.2	51.9	54.3	56.4*
Ukraine	39.5	35.3	47.3	43.6	39.8	48.1	35.4	35.3	40.3

* First half of 2001.

Figure 1.1
Subnational Government Share in Public Expenditures in Romania

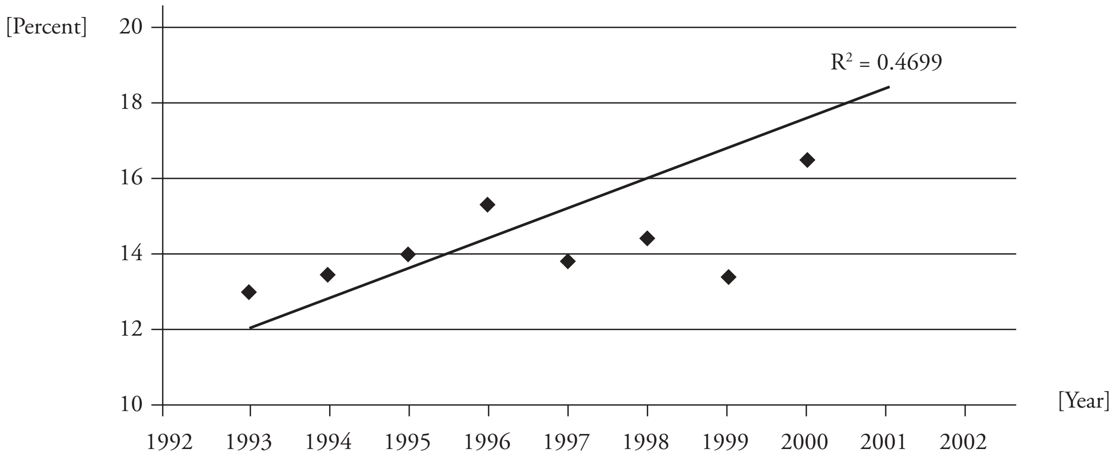


Figure 1.2
Subnational Government Share in Public Expenditures in Russia

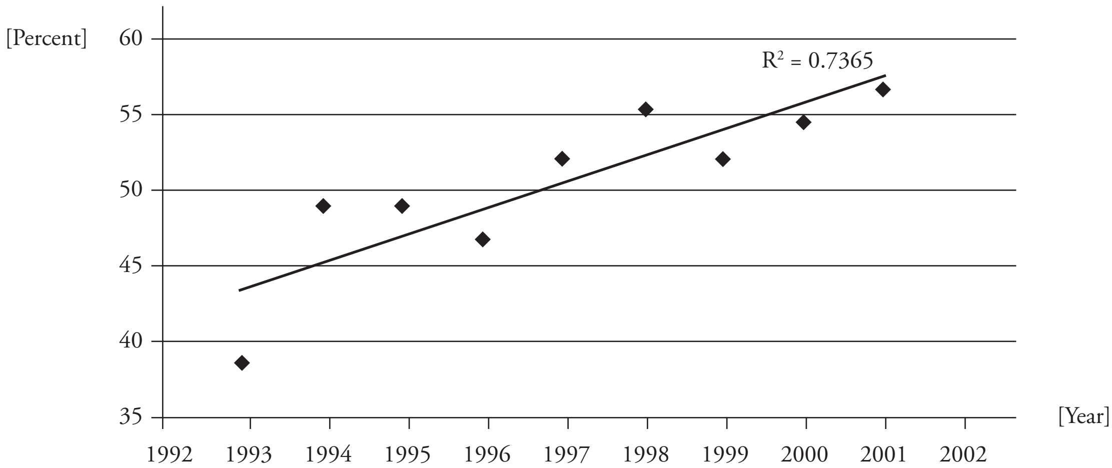
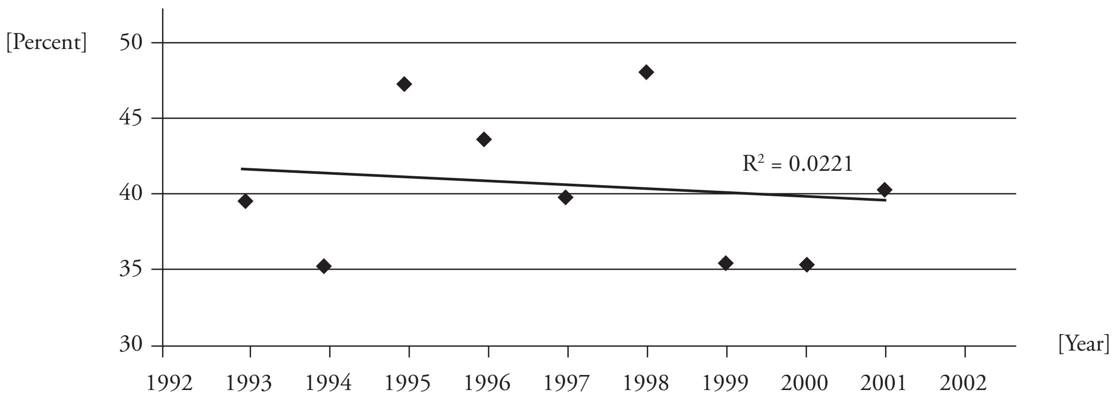


Figure 1.3
Subnational Government Share in Public Expenditures in Ukraine



As Figures 1.1–1.3 suggest, the trends (showed by a solid line) of fiscal decentralization are very important for Romania and Russia. Russia shows a more clearly shaped trend toward decentralization of expenditures than Romania. In contrast, the shaky governmental policy in field of decentralization in Ukraine still demonstrates no clear long-term trend towards decentralization. The dominate form of decentralization is deconcentration—where the central government exercises more responsibilities through local (oblast and rayon) state administrations; giving them more discretion concerning the budget process on the local level, and demonstrating the reluctance of the central government to vest more power in self-government bodies. The first steps toward real fiscal decentralization in Ukraine were undertaken only in 2001, when the implementation of the provisions of the Budget Code began.

It could be asked how the ongoing process of decentralization affects the relative size of the state. One of the dangers of the decentralization process is: while decentralizing certain functions and giving SNGs more discretionary power in fiscal policy, the state would grow both relatively and absolutely, hampering the development of the private sector. The last could be a great danger for a transition economy where the private sector is weak and requires state assistance to get "raised on its feet."

The statistical data on our sample of countries testify that signs of such danger are present. In Romania, the process of expenditure decentralization is accompanied by a growing state. In Russia, the relative size of the state measured by the share of state expenditures of GDP has dropped from 50 percent in 1992 to about 28 percent in 2000. In Ukraine in the first half of the 1990s, the growing SNG share was accompanied by a soaring state size. The process of centralization in the second half of the 1990s was then followed by a stable or diminishing state size, and only since 2000 has there been a trend toward slight decentralization of public expenditures in line with this stabilization of the size of the state.[1] This proves that in the selected countries two hypotheses of decentralization are fitting: the Brennan-Buchanan hypothesis of collusion (Romania and Ukraine) and the Wallis-Oates fiscal decentralization hypothesis (for Russia).[2]

4. VERTICAL AND HORIZONTAL IMBALANCES AND NEED FOR EQUALIZATION

Issues of vertical and horizontal imbalances and their effective equalization are very relevant for most post-socialist countries. Vertical equalization aims to obtain sufficient capacity to finance public services at any level of government: national, regional, and local. It can be achieved both through the assignment of revenue sources and the distribution of responsibilities for public service delivery among the governmental levels. The formation of national policy in this field depends on the degree of democratization of society. In the case of initially highly centralized countries (i.e., all countries surveyed), this policy depends on the readiness of the center to offer real autonomy to SNGs and to grant them real discretion in decision-making on the territory of their own jurisdiction. All three countries have made steps in this direction, but there is still a lot of unsolved reforms remaining.

Intergovernmental horizontal fiscal equalization aims at diminishing the gap between the obligation of SNGs to deliver public services within their jurisdictions and their capacity to fund such services. Theoretically speaking, there are pros and contras to horizontal equalization policy. A contra-argument relates to the efficiency issue: interregional equalization may hamper efficient allocation of resources throughout the national (regional) territory and hinder economic growth because it delivers wrong incentives to economic entities concerning resource allocation. It also diminishes incentives for SNGs to generate revenues. A pro-argument delivers a notion of equity: the national government has to guarantee a certain minimal level of public services throughout the national territory regardless of SNGs' fiscal ability. The well-shaped equalization policy will find the right compromise between efficiency and equity in order to grant fairness and efficiency simultaneously.

For the issue of vertical imbalance, it is important that the correspondence between expenditure responsibilities and the fiscal resources available to each level of government be measured in some way. One means of measurement is based on the computation of coefficients of imbalance proposed by J. Hunter (1977). These coefficients (HC) are calculated in the following way:

$$\text{Coefficient \#1} = 1 - \frac{\text{revenue sharing + untied (equalizing) and other transfers}}{\textit{total expenditures}}$$

$$\text{Coefficient \#2} = 1 - \frac{\text{untied (equalizing) and other transfers}}{\textit{total expenditures}}$$

These coefficients can have values between 0 and 1. Thus, HC #1 values which are closer to 0 indicate larger vertical imbalance because SNG total expenditures are covered mostly by external sources; HC #2 values which are closer to 0 indicate high dependence of expenditure financing on direct transfers from the central government. Table 1.7 presents the HC values for our three countries.

These data show that Romania has the worst vertical imbalance; the role of direct transfers in covering the vertical gap in all three countries is quite modest. However, HC #1 does not reflect the role of real own revenues of SNGs; the truth is that the vertical imbalance is remedied mainly through ceded national taxes that could be considered as "own" revenue sources only with much caution (see Bailey 1999).

SNG units are now seeking fiscal endowments which corresponds to the shifting of expenditure responsibilities to lower tiers and the vesting of more functions in local governments of basic and intermediate levels that occurred in the last decade. This requires allotting more revenue sources to local units. In accordance with a theory of fiscal federalism, the more spending responsibilities the SNGs receive, the more own revenue sources they should control. But as is the case with many post-socialist countries, the central government is not in a position to relax its control over fiscal flows in the public sector.[3] The three countries under analysis are not exempt from this rule.

Table 1.8 presents the most important "own" revenue sources for SNGs in Romania, Russia, and Ukraine.

There is some confusion with the term "own revenue" in these countries. In contrast to the common Western understanding—according to which local revenues are those over which SNGs have a high degree of discretion, e.g., determining tax base and rate, tax exemptions, etc. (Bailey 1999)—some revenues that may not be taken as "own" are in practice treated as such for SNGs. Examples are PIT and land

Table 1.7

Hunter's Coefficients of Vertical Imbalance for Respective Countries

	Romania, 2001	Russia, 2001	Ukraine, 2000
Coefficient # 1	0.22	0.324	0.609
Coefficient # 2	—	0.833	0.742

Table 1.8

Most Important Own Revenues of SNGs.

Revenue Type	Romania	Russia	Ukraine
Taxes on Income and Profit	No	R: Tax on imputed earnings	No
Taxes on Property	L: Land tax; building tax; vehicle tax	R: Enterprise property tax; forest tax L: Individual property tax; tax on gifts and inheritance	No

Legend: R—regional government, C—county government, L—local government.

tax in Russia; ceded national taxes (PIT and land tax) and national taxes with long-term sharing rates in Ukraine. In fact, the extremely limited discretion of governments regarding these taxes is reason enough to exclude ceded taxes and shared revenues from the definition of "own" fiscal resources for SNGs.

Further confusion derives from the understanding of regional and local revenues in these countries. It is worth mentioning that most of these so-called local revenue sources could be considered as quasi-own because the central government executes control over all important elements of the SNG "own-revenue" system: the central government legislates the taxes, determines tax bases and tax rates (the common practice is capping or imposing minimal rates for the majority of local taxes), and administers the local tax collection (in case of Ukraine only). Of course, *such an arrangement undermines local fiscal autonomy and seriously damages the accountability of local administrators to voters; this, in turn, is no good for SNG financial management*.

Own revenues do however play a role in subnational finance, though so far only a minor one; most revenues are still ceded national taxes, shared national taxes, and state grants. As Table 1.9 suggests, the own revenue share was more significant in the case of Romania and Russia, than in Ukraine where the greater portion of SNG revenue sources comes from central government indirect transfers (ceded and shared national taxes).

The lack of fiscal discretion at regional and local governmental levels in both quantitative and qualitative dimensions suggests that the three countries have *a high degree of vertical fiscal imbalance in public finance*: about 80–85 percent of budgetary expenditures in Romania and Russia are covered by external sources; this same figure for Ukraine is on average as high as 95 percent or more.

The massive vertical gap is bridged by the assignment of some national taxes and duties, and tax-sharing. Assigned (ceded) revenues played no significant role in all three countries until recently. The latest changes in Ukrainian legislation portend that the most important assigned taxes (PIT and land tax) will be the dominate sources of SNG financing; in Russia PIT tends to be a ceded tax as well.[4] The other taxes liable to be ceded are duties on usage of natural resources (forest, water, mineral resources) and property taxes (motor vehicle tax in Russia and Ukraine).

Proceeds from assigned national taxes are usually shared between subordinated governmental levels in Romania, Russia, and Ukraine.

The system of tax-sharing is the most important instrument for correction of the vertical imbalance—although it also has other benefits. Because regionally differentiated sharing rates can be applied, tax-sharing can also be employed as an instrument of horizontal equalization (in Ukraine until 2001, currently in Russia).

The mode of usage for shared taxes is varied (for more details please refer to Table 1.10).

In Romania, the tax-sharing system has multiple functions. First, the PIT tax shares are determined to correct the vertical imbalance (fixed sharing rates for central government, counties, and municipalities; annual budget appropriations from the grant fund

Table 1.9
Structure of Revenues of SNGs, by Countries [percent]

	Romania[b], 2001	**Russia[a], 1999**	**Ukraine[a], 1999**
Own revenues	22	16	3
Ceded national taxes	—	9	11[c]
Shared taxes	57	49	56
State grants	16	26	16

[a] Combined regional budgets.

[b] Combined county budgets.

[c] Since 2001, the situation with SNG revenues in Ukraine has changed. The PIT became a ceded tax; so the ceded taxes are now the most important source of subnational revenues.

Table 1.10
The Tax-sharing Systems in Romania, Russia, and Ukraine

	Romania		**Russia**		**Ukraine**		
	Center-County	**County-Municipality**	**Center-region**	**Region-Municipal units**	**Center-regions**	**Region –county, city**	**County-municipality**
Designated revenues	PIT	PIT share	Share of federal budget revenues	Shares of federal and regional taxes	None	PIT, land tax	PIT, land tax
Annual rate fixing	Yes	Yes	PIT	Excise on alcohol	No	No	No
Spatial sharing rate differentiation	No	No	No	For some taxes	No	No	No
Long-term rate fixing	No	No	Excise on alcohol, land tax, natural resources mining tax	Land tax, natural resources mining tax	PIT, land tax	PIT, land tax	PIT, land tax

formed by state portion of PIT for welfare support and supplementary heating and utility price subsidies); second, the state's PIT share is used to cure horizontal imbalances on the county level; third, the VAT share is used to equalize some specific LG expenditures (mostly on primary and secondary education services delivered by municipalities) by use of earmarked grants.

In Russia, the tax-sharing between federal and regional tiers is used solely to bridge vertical imbalance; additionally, on a subnational level it is used to equalize horizontal disparities through the individually negotiated sharing rates.

In Ukraine, after the enactment of the Budget Code, tax-sharing functions as an instrument of vertical equalization in relations between state and regional, county and city of oblast significance authorities, as well as municipalities of lower level (the sharing rates for the PIT and land tax are fixed in legislation for a long term).

In Russia, due to the recent intergovernmental reform agenda, there is no hope of reducing the degree of vertical imbalance. According to federal government plans, the total federal share in public revenues would increase by 2005 from about 50 to 70 percent. There are not many positive developments to be foreseen in this sphere in Romania either: SNGs own revenue share will drop in line with the newly legislated mandated expenditures vested in LGs that are to be compensated through the growing inflow of earmarked grants. In Ukraine, vertical imbalance could be stabilized if the provisions of the Budget Code were strictly implemented that delineate expenditure responsibilities and revenue sources of the different governmental levels.

The status of horizontal imbalance looks quite different in the various countries. In Romania, due to fixed PIT sharing rates and employment of the origin principle, the variation coefficient for local revenues for counties was around 0.5 and for municipalities about 1.0, with great variance between the maximum and minimum per capita revenues (equalization grants excluded). In Russia, the disparity between revenues and expenditures amongst regional units tends to grow with time. The list of needy regions also grows despite the present equalization policy. In Ukraine, the differences between regions and localities in fiscal endowment and service level also remain quite high with a trend toward greater inequity over time.

In Russia, the uneven territorial distribution of capital and natural resources as a factor of emerging equalization policy was combined with a need for regional political and economic elites to have more discretion in fiscal policy. The elected oblast governors and presidents of national republics in Russia are important political actors that represent regional interests and have some influence on the federal center; in contrast, the regional governors in Ukraine are merely creatures of the central executive and are determined to follow the guidance of the Ukrainian President (Ieda 2000). This is a reason why, namely in Russia, we find the first attempts to introduce a formula-based approach to horizontal fiscal equalization on a post-Soviet rim. It also explains why the equalization procedure is elaborated and functions until now only between federal center and regions, without any significant positive steps on a sub-regional tier.

Although the central government gives some guidance to intermediate authorities of how to deal with the fiscal inequality of units on sub-regional and sub-county levels, fiscal inequality is still a problematic issue in all these countries. The intermediate governments avoid creating a transparent and fair procedure for allotting fiscal resources on the territory of their jurisdiction, making municipalities dependent on their will to implement some kind of equalization instrument. The usual practice shows that these governments try to withhold more fiscal resources than they should based on their expenditure needs. This is why the legislated sharing rates for the most important national taxes are below the level prescribed by national legislation. With this practice, intermediate governmental units possess a very important instrument for controlling the behavior of the governmental units of the lower level, securing for administrators of the intermediate level more space for bargaining and informal arrangements.

5. EVOLUTION OF EQUALIZATION INSTRUMENTS

Fiscal equalization practices in different countries show that there are no universal approaches to deal with the problem of interregional and interlocality fiscal disparities (See Table 1.3 above). Each country chooses from a combination of instruments that correspond to the existing state of the public administration sector, revenue and expenditure assignments, and ideology of state formation.

The process of the evolution of equalization mechanisms in respective countries has moved away from Soviet-type equalization based on differentiation of national tax-sharing rates (supplemented by state donations to cover the remaining budget deficit of territorial units after tax-sharing) to a formula-based approach with the use of direct grants.[5]

In Romania, the initial equalization mechanism was completed through discretionary tax-sharing that existed until 1999. Since then the equalization has been done by allocating shares of the central government's portion of PIT to the counties (horizontal equalization grant is allocated to counties, not directly to municipalities; the former can withhold up to 25 percent of grant money for their own use and then must distribute the rest to localities within their jurisdiction), which is supplemented by a special VAT share for conditional grants with an equalization component. In Russia, after the collapse of the Communist regime, fiscal equalization was initially carried out in the obsolete Soviet manner by use of regionally differentiated sharing rates and coverage of remaining fiscal deficits through deficit grants. The fiscal shortages of the first years of the transition period, combined with high inflation rates, brought to life manual administration of intergovernmental fiscal flows. The most important instrument of fiscal equalization was discretionary mutual settlements (which constituted up to 80 percent of grants disbursed in 1993), the role of grants in equalization was then very modest.

The situation has changed gradually since. In 1994 the Federal Fund for Support of Regions was established with the aim to create an appropriate instrument to equalize interregional budgetary disparities. Since 1995 it became the most important source of regional government external funding peaking in its relative value in 1998 (about 75 percent of direct federal fiscal assistance). Essentially, the equalization has been done for *actual* expenditures and revenues of regional budgets that incorporate mighty anti-stimuli for regional budgetary policy. Despite the evolution of some elements of the Russian equalization system (it is likely to become more sophisticated through the time), its essence (to equalize actual revenue and expenditure differentials) remained unchanged until 2001. It is no surprise that most regional units had been eligible for federal untied assistance from this Fund (about 80 percent of regions by now) and that the overall equalization effect is insignificant;

moreover, the differentials after equalization are more significant than before the Fund. The difference in minimum and maximum regional per capita expenditures has risen from 12 times in 1992 to 40 times in 2000; correspondingly, the value of the variation coefficient for regional expenditures for this time period has doubled. The new developments as of 2001 are likely to make the fund allocation procedure more goal-compliant.

In Ukraine, until the late 1990s, the employed instrument of equalization was regional differentiation of sharing rates of some national taxes (the sharing pool has been changed almost every year) supported by state grants with vesting of responsibility for fiscal equalization on the sub-regional level to regional authorities, on the county level—to county authorities. Since 2001, equalization has been carried out only with respect to delegated functions due to the composition of the formula: involving fiscal capacity (measured as SNG average per capita revenues for the last three years multiplied by tax ability coefficient) and expenditure needs (measured on a base of normalized per capita expenditure norms).

A comparison of current equalization techniques practiced in the three countries is provided in Table 1.11.

Based on this information, one of the most important issues that has not been satisfactorily solved until now is *equalization on the basic level of local government*. The state policy towards equalization on this level has undergone no significant change since the turn to a market economy and Western values in state-building. Vesting equalization issues on intermediate governmental levels—in the case of Russia and Ukraine on respective state administrations—cannot be regarded as the best solution.

Although the overall development of fiscal equalization systems could be judged as positive, there are also some countertrends in intergovernmental finance that could worsen the quality of currently problematic equalization procedures. In Romania, there is a trend to relax expenditure needs and to use only fiscal capacity as an indicator of fiscal equalization with growing use of conditional grants to compensate for soaring expenditure disparities. In Russia, the Fund for Fiscal Support of Regions undertook recently the inappropriate role of disbursing specific grants. In Ukraine, the basic approach formulated in the Budget Code has begun to be eroded by implementation of non-justified instruments, such as practicing coefficient of budget performance and tax-sharing arrangements that were not foreseen in budgetary legislation.

Table 1.11

Comparison of Current Equalization Systems

Component	Romania	Russia	Ukraine
Funding Source	Fixed share of national PIT proceeds, discretionary rate of VAT (lump sum)	Predetermined share of federal government revenues	SNG contributions, annual state budget appropriations
Involvement of Intermediate Governmental Tier	County governments determine the actual equalization of municipal budgets	Regional governments fully determine the equalization of budgets of municipal units	Equalization of budgets of oblasts, rayons and cities of oblast significance is done separately by the MoF; on the sub-county and sub-city level—by rayon and city authorities
Allocation Mode	C: Formula, with respect to expenditure needs (decreasingly, eliminated completely in 2002) and fiscal capacity M: Nontransparent	R: Formula, with respect to expenditure needs and fiscal capacity M: Nontransparent	R, C, M (cities of oblast significance): formula with respect to expenditure needs and fiscal capacity M (cities of rayon significance, settlements, villages): Nontransparent

Legend: R—region; C—county; M—municipality

6. AGENDA FOR REFORMING EQUALIZATION POLICY: USING LESSONS FROM THE EXPERIENCE OF OTHER COUNTRIES

Proposals to shape equalization policy in the three countries can be effective only within the broader context of intergovernmental fiscal relations: functions and expenditure assignment, revenue assignment, and correcting for horizontal fiscal deficiencies. Thus, if no improvement is possible in the current state of the two first layers of intergovernmental arrangements, then there is no sense in proposing changes to the equalization branch.

The above comparisons reveal some common problems that are still present, not only in the countries that are analyzed in the following chapters, but also in other transition countries whose instruments of intergovernmental finance are undergoing rapid change.

Need for a Complex Approach

The countries in question lack a comprehensive approach to fiscal equalization. Not all issues concerning the institutionalization of SNGs have been solved. In Russia and Ukraine most territorial units in rural areas do not have the status of municipal units, nor do they have their own budgets; so they are excluded from direct participation in intergovernmental relations despite the fact that legislation grants them the right to revenues for implementing their own functions. If all local authorities are to receive their full rights, reassessment of the current administrative structure is recommended for Ukraine and Russia. This recommendation is based on the fact that fiscal equalization volume depends on the administrative structure of the respective countries. The smaller the units of the basic governmental level, the greater the need for equalization tends to be. Creating fiscally self-reliant governmental units at this level will blunt the issue of equalization in both political and financial dimensions. This has been proved by the experience of several transition countries in the fSU rim.

The other issue that could reduce the volume of equalization is reconsideration of the tax-sharing system. In all three countries tax-sharing is done according to the origin principle, i.e., the taxes are shared with the government(s) in whose territory the head office of the firm is located. Such an approach per se creates significant horizontal fiscal disparities. Although disparity could be lessened through a policy of flexible regionally differentiated sharing rates as practiced in some transition countries, the preferable policy would be to fix long-term sharing rates with a redistribution of tax proceeds on a per capita basis.

Taking into account all the stages of the equalization process, it should be recognized that only the final stage of fiscal equalization is more or less worked out; the other important basic issues (rational function and expenditure assignment, as well as own revenue development) could be seen as the hidden part of an iceberg; so the citizens of the three countries are still waiting for a well-weighted approach.

Functions Reassessment

The root of the ongoing difficulties in the area of fiscal equalization can be found in the very vague assignment of functions within the public sector. It appears there is no significant political will on the national level to sort things out, to clarify who within the state administration is responsible for doing what.

In Ukraine and Russia, current legislation has no provisions concerning the criteria of function assignment. The delineation of expenditures does not exclude multi-sourced funding of service delivery with the simultaneous involvement of governments of several tiers. Service delivery is administered according to the historical traditions of the socialist period without applying any objective criteria. There is some confusion too with actual service delivery because in many cases local governments, being very weak both in a fiscal and administrative sense, delegate their basic functions to upper level governments—to the territorial state administrations of the regional and county levels.

The other problem here is the very limited scope of real subnational functions over which SNGs actually have discretion. In Ukraine, the own expenditure competence of local governments extends to only 10 percent of total expenditures; in Romania and Russia the situation is better but not to a great extent.

The recommended policy is a strict legal separation of functions and responsibilities within the vertical structure of the public administration sector with special account given to the size of local units: authorities of the big city and the small village cannot have the same range of functions. This is very important because if we know "who should do what," we can calculate a more accurate revenue amount needed for function implementation, without a loss in efficiency due to mutual bargaining and informal commitments between administrators of upper and lower governmental levels.

One of the remedies for the weak system of intergovernmental finance is fostering horizontal cooperation on the basic level of self-government. This cooperation, supported through state conditional grants and voluntary horizontal grants, will diminish the need to shift some LG responsibilities to upper governmental levels. Good candidates for such an approach are health care and educational (primary and secondary) services, where the service beneficiaries are located within the boundaries of the local government of the basic level. Another positive direction in efficient local service delivery would be the creation of special local governments having their own authority and revenue sources. In use for many decades in federal countries (e.g., United States and Canada), this approach is an innovation for unitary transition countries. There have been some positive achievements with this innovation in Poland, where health care has been separated from the scope of functions of general local governments.

Revenue Base Broadening

A growing vertical imbalance is one of the most critical issues prompting a framework for equalization policy from the central government.

Less successful have been the attempts at developing own revenues for subnational governments in the countries. The trend is the concentration of fiscal power on the central level. In Romania, draft legislation will confine the rates for property tax—the largest source of own revenue—within a range, with caps above and below imposed from the center; thus the degree of discretion exercised by SNGs in this field will be significantly reduced. In Russia, due to the latest governmental projections, SNG discretion over revenues will be reduced. In Ukraine, there are no positive changes foreseen in revenue base (the recently adopted Budget Code did not address this issue).

This all means that a large vertical imbalance will become reality, and will continue to grow. Deficiency in fiscal autonomy will combine in the long run with a large inflow of external resources to local budgets. Such an arrangement can be judged as more or less satisfactory, as it approximates the practices of some developed countries (e.g., Great Britain, Netherlands) where local discretion over fiscal issues is quite low. The greater value to be had is stability. And this is the most frequently challenged value in many cases.

Making Things More Transparent

One problem found in all of the reviewed countries is a lack of transparency in equalization policy. Without exception, in all three countries the intermediate level is involved in the equalization issue. Due to the discretion that the central government vested on regional and county governments, these intermediaries undertake equalization activities in the absence of any strict regulation (although legislative frameworks exist) and in a very subjective manner according to their own ideas of how the process should be carried out. The result is unsatisfactory equalization on the basic level (there is no equalization observed or its degree is very modest).

The following are possible policy recommendations: separate equalization for intermediate and basic levels of government. Dividing up the equalization funds between the two levels will result in more transparent and stable funding. Of course, such an approach will consume some administrative resources at the central level, but the final outcomes in terms of direct and implicit benefits will more than compensate. Informal bargaining will be superseded by a clear procedure.

Incorporating Stimuli

From the authors' analyses we can conclude, at the risk of being overly optimistic, that the stimulating effect of current equalization schemes is very modest. With respect to revenue collection and sound fiscal management, the current equalization techniques seem rather to counteract subnational fiscal efforts. For example, the methodology for calculating expenditure need in Russia gives SNGs incentives to spend the sum of money received from upper level governments without working to improve the quality and quantity of services delivered; in short, the methodology is a disincentive to the pursuit of a rational economy of expenditures. Efficiency is punished with diminishing grant money for the next fiscal year. The same is also true to some extent for Romania and Ukraine.

An appropriate policy response is a comprehensive strategy of encouraging SNGs to collect more money for their own budgets. But, frankly speaking, this is feasible only when internal revenues begin to compose a significant portion of total subnational revenues. Introduction of the real estate tax in Ukraine, and increasing SNG discretion in tax administration in all countries could be recommended as steps in this direction.

Securing Goal Compliance

The mere goal of equalization instruments is to achieve a degree of equalization. The instrument that is best suited to equalization is a *general grant*. This means that an equalization fund should not deliberately intervene with other goals of grant policy, e.g., price subsidizing or stimulation of special types of subnational expenditures. From this point of view, in Russia steps should be taken to release equalization funds from inappropriate goals as mentioned above.

There is some confusion with goal compliance of the equalization process in Russia. Empirical studies have observed that the per capita revenue differences between subjects of the federation are growing instead of diminishing. This gives reason to suggest the following: first, that the real equalization goals might be distant from the declared ones (e.g., political instead of economic); second, that the real procedure of equalization deviates from the legislated one; and third, that the elaborated mechanisms of equalization are not able to address the problem of interregional equalization.

One of the acute problems in Ukraine that undermines the effectiveness of equalization efforts, is the financing of delegated functions (these must be fully funded from the state budget—according to legislation) assigned to SNGs by the central government with the own revenues of SNGs. In an environment of insufficient resources, the fulfillment of delegated state obligations requires LGs to substitute their own resources, which reduces the funding available for important functions of local concern. Until this hidden deficit of fiscal resources is eliminated, equalization procedure will not help.

There is a tradeoff between the economic and political reasoning of equalization. The former promotes equalization as an efficient and fair way of public fund disbursement between governmental levels, while the later sees it as a means of securing a status quo in the balance of power and extracting higher political rent.

Stabilizing Intergovernmental Fiscal Flows

According to theory, the critical issue in fiscal equalization is the stability of the mechanism. The temptation to change the rules in order to solve short-run budgetary problems is especially high in transition countries, due to the vulnerable nature of their economy and, correspondingly, their public finance system. Recently adopted legislation will probably be revised in Romania; in Russia, almost annually the federal government makes changes in the equalization formulas; in Ukraine, the provisions of the recently adopted Budget Code have been permanently modified through annual budget laws and governmental regulations. So, basic budgetary arrangements are undergoing "creeping" changes.

All these modifications make for unpredictable intergovernmental finance, damaging the ability of SNGs to plan financially even in the short run. Therefore, a good step in the right direction would be a moratorium for basic equalization procedures (formulaic components) and a fixing of tax-sharing arrangements (in Romania and Russia especially) for some period of time. After analyzing all the problematic issues during the period of moratorium, the comprehensive reform of equalization could be launched.

Stability of equalization techniques is one of the prerequisites for less distortion in the fiscal behavior of SNGs; stability relates to all components of the equalization process.

First of all, the size of the equalization fund should be more or less constant. The current procedures—

where the size of the fund is determined through annual budgetary appropriations (Romania and Russia) or through SNG contributions (Ukraine)—seem prone to instability and fluctuation in the amount of central funding committed toward the equalization of fiscal disparities. Better alternatives involve fixing the sum to economic indices that reflect general trends in the economy. A pool of several national taxes (or a fixed portion of) that are most important for public revenue formation could serve here best.

Second, the allocation of equalization funds should be done on a stable basis and, if possible, without the deviations of annual budget laws and other governmental regulations. The discrete procedure of grant allocation that may be best for the central government has nothing in common with other goals of public sector policy, such as preserving and fostering local democratization and growing public involvement in decision-making on the lowest governmental tier. If we take local autonomy as a social value, then we have to realize that it develops best in a stable environment.

Reconsidering Equalization Formulas

According to well-known theoretical studies in the field of fiscal federalism and grant theory (Ahmad 1997; Musgrave 1961; Shah 1994), the most effective approach to fiscal equalization is the simultaneous equalization of both fiscal needs and fiscal capacity.

The practice of the surveyed countries shows that current approaches could be more compliant with the recommendations of theory. However, the problems preventing such compliance are obvious: the lack of reliable statistical data on the fiscal performance of local authorities; insignificance of local own revenues for SNGs; insufficient fiscal discretion in expenditure policy; and failure to find appropriate measures, especially for expenditure needs.

Reconsideration of formulas may lead to decreased inequity if a strict implementation procedure is employed in order to minimize the deviation between legal and actual mechanisms of equalization.

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ENDNOTES

1 See detailed data presented by Slukhai 2002b.

2 According to Brennan-Buchanan collusion hypothesis, the state tiers form something like a cartel in order to avoid competition in service delivery resulting from decentralization process; Wallis-Oates hypothesis says that fiscal decentralization is followed by a growing subnational government share and a decreasing national government share.

These hypotheses are presented in detail by Shadbegian (1999).

3 For more detailed information on this issue see: Engelschalk 1999; Slukhai 2002a.

4 According to Budget Code of Russian Federation (1998), the PIT proceeds should accrue to combined regional budgets. But according to current budgetary practice, they are still shared between federal government and regions, with a dominating SNG' share (99 percent in 2001).

5 We make a distinction between direct and indirect grants. Indirect grants are intergovernmental fiscal transfers in the form of shared national taxes; direct grants are funds disbursed from the governmental budget.

Sorin Ioniță

Halfway There: Assessing Intergovernmental Fiscal Equalization in Romania

Halfway There: Assessing Intergovernmental Fiscal Equalization in Romania*

Sorin Ioniță

Immediately after the fall of the Communist regime, Romania made some timid steps towards decentralization. The process accelerated in 1997–98 with the passing of a new Law on Local Public Finance, but there are still many flaws in the functioning of intergovernmental finance. This paper focuses on a particular category of transfers—equalization grants—and highlights the achievements and the shortcomings identifiable so far. The analysis is based on budget execution data from all local governments of Romania: 41 counties and 2,950 localities (except for the capital, Bucharest, which has a special status and does not receive equalization funds). While many conclusions and recommendations are country-specific, some are more general and may apply to other transition countries too.

First, states with weak administration and poor financial discipline should not attempt to implement complex redistribution rules or rely on data that are unreliable or difficult to develop. In many cases second best solutions should be adopted if they minimize the implementation costs and increase transparency and predictability, preventing narrow interest groups from taking advantage of intricacies and abusing the system. Simplicity and daylight are the best disinfectants for public funds.

Second, the battle lines in the process of decentralization are not always clear-cut, with the good guys on one side (local governments) and the bad guys on the other (central government, presumably opposing decentralization). Instead, local decision-makers may cherish those aspects of decentralization that bring them more resources, but not those that require painful decisions, and hence incur political costs. They may prefer a situation when funds keep coming from the center, instead of having to raise own resources from the community and pay a political price for it. This is important because many times analysts assume that local politicians do want more local autonomy—which may not be the case.

Third, local governments are not a monolithic group: different tiers or types of localities may have diverging interests when it comes to financial decentralization, and the central government ends up as a mediator rather than a player in the process. For example, in Romania's case, too much discretion for county councils in the allocation of funds affects the financial autonomy of localities. A careful balance should be found between the legitimate interests of all tiers of government, so that resources match responsibilities and moral hazard or rent-seeking situations are avoided.

Finally, the new democracies should learn that good governance means not only passing legislation, but also implementing it, collecting feedback on a steady basis and adjusting the policies whenever necessary. Had Romanian decision-makers done so in the case of intergovernmental equalization, they would have noted that the main goal of the whole exercise—i.e. equalization—is often not met. Because of its loopholes, the system works erratically and even, in some instances, transfers resources from poor communities to rich ones. This paper concludes with a set of recommendations aimed at making the Romanian

* All the data presented in this paper are based on the primary aggregation of financial reports available from the Romanian Ministry of Finance. I am particularly indebted to Mr. Marin Cojoc, director in the MoF, for kindly providing access to the financial data from local governments. Many points and arguments presented in this paper were developed during various discussions with Romanian civil servants, and foreign and Romanian independent consultants and academics working in the field of local government. I am grateful to all of them, but since their number is large I can only mention here two of them, whose comments were particularly helpful: Francis Conway from the Urban Institute, and Tom Spofford from the Research Triangle Institute.

equalization system simpler, more transparent, and as a result, fairer.

1. INTRODUCTION

Like all other post-communist countries, in the early nineties Romania started the transition towards democracy and the market economy in a global intellectual environment where decentralization and public sector reform were the words of the day. There are many motives for why most of the developed and developing nations have engaged in decentralization in the last decades: to stimulate economic growth, reduce urban-rural disparities, deepen democracy, and encourage civil society at the local level. These objectives were only partially fulfilled through the previous top-down policies pursued by the centralized states (Manor 1999). In other cases, central governments wanted simply to get rid of part of the development burden at a time when the public sector was facing tighter budgetary constraints, by placing it on the shoulder of locally elected politicians. In one way or another, decentralization was seen as the right solution to many types of problems.

However, it was soon discovered that, as in real life, any policy has its own downside. More local autonomy and less central intervention in resource allocations lead to increasing disparities among communities. The tolerance towards inequality is not very high in the region, given the expectations built into the public in the decades of Communism, and the previous centralist tradition of the pre-communist states. Inefficiency and corruption can also be decentralized, so that there is no guarantee that by simply transferring more attributions and resources to local governments the state will function better. On the contrary, overall public spending may increase, creating additional problems for the national macroequilibria. Moreover, when designing and promoting decentralization the central government, officials, and experts assume that local decision-makers prefer more autonomy and self-reliance. However, this is not always the case: often local officials avoid making use of their full decision-making power, especially when it comes to raising local taxes—if they have the more convenient alternative of getting funds from the center without any political costs attached.

These considerations converge into a more general vision that underpins all the proposals outlined in the final part of this paper: in spite of the apparent complexity of the equalization system, its design and monitorization cannot be left entirely to technical experts. The role of technical expertise in the process of policymaking must be better understood. Too often, we who live in Central and Eastern Europe have the impression that each public problem has one right solution, and all we have to do is find the best experts in the field—and occasionally, appoint them to positions of power—to sort things out. This is naïve and unworkable. Experts, whether in public institutions or independent, can help by framing the discussion properly, identifying and analyzing alternative courses of action, pointing out inconsistencies in existing policies, and clarifying options. But ultimately, like in other public policy areas, the basic design of intergovernmental fiscal relations embodies fundamental choices that must be made deliberately by the broader community in an informed and rational manner, as much as this is possible. In our case, for example, there are tradeoffs where a decision is needed, such as: how much money should be eventually transferred (i.e., how much equality do we want to achieve); or what is the right balance between economic efficiency, which may require larger local governments, and a higher degree of autonomy in smaller, traditional local units that may be sub-optimal from an economic point of view. Another tradeoff exists between the flexibility of fiscal arrangements, between allowing adjustments or bailouts of local communities in need by higher-level governments on the one hand, and the safeguards against discretionary political interference or rent-seeking behavior on the other.

All these considerations must be taken into account when designing intergovernmental financial relations. The equalization grant systems must strike the right balance between local autonomy and national solidarity, administrative tradition and the new public sector reform requirements, self-interest and external control. Unfortunately, it is a rare case when such decisions are taken in a coherent and deliberate way. Most often, the system of relations between the tiers of government in a country evolve at least in part by default, its structuring being the byproduct of economic and fiscal decisions that do not follow a deliberate decentralization strategy or the result of institutional struggles among local interest groups. Romania is no exception, though some rationality has been instilled into the system with the 1998–99 reforms.

This paper analyzes the functioning of the equalization grants in Romania, a few budgetary cycles after they were introduced. The basic questions are: so far, have they actually fulfilled their goal—i.e., provide extra resources to the poorest communities? And can something be done to improve their effectiveness? The next two sections present and discuss the structure and legal framework of local governments in Romania, focusing on those elements that influence the equalization transfers. Section four analyzes the functions and revenues of local governments and the influence of their assignment on local disparities. Section five evaluates the grants system with its two conceptual components—vertical and horizontal equalization—and outlines its current shortcomings. The final section concludes with a blueprint for reforms aimed at improving the equalization system, phased over two stages: short-term and medium-term.

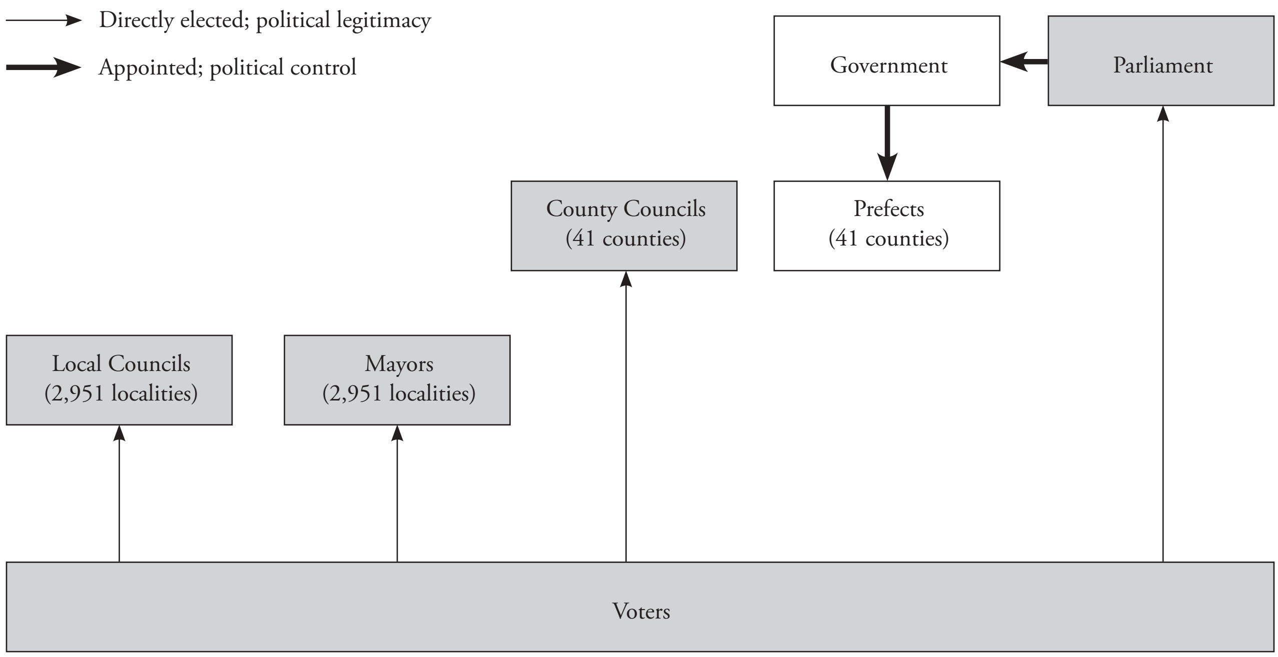
List of Abbreviations

ASBL	Annual State Budget Law
CEE	Central and Eastern Europe
LG	local government
LLPF	Law of Local Public Finance
LLT	Law of Local Taxes
MoF	Ministry of Finance
PIT	personal income tax
VAT	value-added tax

2. THE STRUCTURE OF LOCAL GOVERNMENTS IN ROMANIA

The local administration in Romania is organized on two tiers: localities and counties (Figure 2.1). There is no hierarchical administrative subordination between localities, counties and the central government, each constituting a component of the public sector with full political legitimacy. The ruling bodies of the localities and counties are the councils, elected directly every four years. Since both convene only periodically—usually not more than two or three times per month—they need executive structures to oversee the

Figure 2.1
Central and Local Governments (2 Tiers) in Romania



daily operations of local government. In practice the counties are led on a daily basis by a Standing Delegation, which is elected by the councilors from their own ranks and headed by the county president (also elected by the councilors). The county presidents exert much power, formally and informally, since they control the budgets, the appropriations process, and the human resource policies of the executive bodies of the county government, plus, under the current system, a good part of the equalization funds distributed to the localities in the respective county.

The councils of cities, towns, and communes elect council chairpersons too, but they have far less power than the county presidents—actually, they are not part of the executive of the local governments proper. Instead, the head of the executive is the mayor, elected directly through uninominal vote[1] for a term of four years in the same local elections, and hence possessing her own political legitimacy.

The only exception from the uniform pattern outlined above is Bucharest, with a special—and, in some respects, unclear—status. The capital city does not belong to Ilfov county—which for the purpose of this paper makes little difference since Bucharest does not receive equalization funds anyway—and so indirectly enjoys county status. On the other hand, it is divided into six "sectors," each with their own elected councils and mayors. Each sector has approximately the population of an average county, and most of the attributions that are common for large cities.

In brief, counties have monolithic government, while localities have dual government with the power split between the legislative and executive. In theory each of them is independent from the higher-order authorities and accountable only to the citizens. In practice the real distribution of powers between tiers of government or between executives and legislatures varies greatly, being influenced by the party affiliation of mayors and council majorities, their relationship with the prefect, and, last but not least, by the personality of mayors and county presidents. Sometimes, especially in the case of cities, mayors can be powerful characters who manage to act almost independently from their councils, very much in the way a strong British prime minister controls its Parliament. On the other hand, the real independence of action in local government can be constrained by the lack of administrative capability, opaque budgetary allocations, or interference from the part of the central government. This is usually the case in poor rural communes, where mayors and local councils try to build good informal relationships with the president of the county council, the prefect or the deconcentrated offices of the ministries, especially the Ministry of Finance, in order to make their ends meet.

Paralleling this structure, there is also a number of offices that are not local government proper, but nevertheless influence local policies in general, and the equalization process in particular. The prefects are the representatives of the central government in territory, acting as coordinators of the ministry branches at the county level and heads of the territorial emergency services. They also perform "legality supervision" of the decisions taken by local governments, both at county and locality level, which means they can challenge LGs in administrative courts whenever they consider an act or action undertaken by councils or mayors in their jurisdiction to have exceeded the limits of the Constitution or national laws. In such cases the local decision or action is suspended until the court issues a final ruling. Since they are not elected but appointed, prefects are not part of the system of local government proper, being an impartial instrument of the central government's check over locally elected officials. However, since the local elections are held every four years just a few months before the general ones, and so the ruling party is likely to have majorities in many county councils too, the prefects tend to have close party links with the county councils and presidents. As a result, prefects are perceived as officials with a pro-county bias. They are more likely to take tougher action against local councils or mayors, especially against those affiliated with an opposition party.

Some ministries such as Finance, Transportation and Public Works, Agriculture, Environment or Home Affairs have offices in territory, typically in county capital cities. While all of them have legal attributions in aggregating sectoral policies, some are important for the activity of all local governments. Romanian public institutions must keep all their funds in the State Treasury,[2] which is a unit of the Ministry of Finance. The Treasury offices collect and disburse all the funds in/from LG accounts. Moreover, the County Directorates of MoF assist LGs in the process of preparing their own budgets, aggregating financial data for reporting purposes, and collecting and allocating the shared national taxes (PIT and VAT). The frequent interactions of these MoF branches with LGs make them important instruments in the hands of the central government for exerting informal control over local affairs.

3. SUBNATIONAL GOVERNMENT FRAMEWORK

By tradition, the modern Romanian state born in the second half of the nineteenth century copied the centralized, uniform structure of the French republic. For the majority of time since its inception local government has been organized on two tiers (though there were several attempts to create a third tier). But if the details of the administrative structure changed several times in the last century and a half, the institutional culture in local government has remained more or less the same: central government intervention in local affairs is tacitly accepted, or at least tolerated, especially when it comes from the office of the prefect. Local autonomy has never been as strong as in Central Europe, which was more exposed to the German influence. Moreover, since nation- and state-building were top priorities in the nineteenth century, all other political goals were subordinated to the urge to create a modern and functional national body politic and bureaucracy. Local needs and agendas were seen as secondary and accepted only as long as they did not threaten the interests of the broader national community.

Therefore, a uniform pattern of local units was created which, though not totally independent of regional traditions, was meant to serve first of all the functional imperatives of the young state. Grassroots democracy has been traditionally weak and all attributions of local governments, irrespective of the formal constitutional setting, were perceived as mandates or liberties delegated or created by the nation-state.

The Communist regime that took over in 1948 effected many changes in the local government framework, but found the old arrangements fundamentally convenient for its own purposes. Since local communities were generally accustomed to being patronized—and sometimes abused—by the central government, they did not represent a real obstacle for the new authorities. As a result, when decentralization was embarked upon immediately after 1989, being regarded as a mandatory stage on the "road towards Europe," the historical experience of local self-government was neither rich, nor very useful in the new context. Creating a functional network of local governments turned out to be both a challenge, because of the difficulties, and an opportunity, since a new system could be built up from scratch in a coherent manner.

As in real life, a complex system such as this could not be organized entirely rationally. Many decisions that affected the process of decentralization were taken by default rather than deliberately, and the final result is sub-optimal. Many characteristics that support this conclusion will be discussed further in this chapter—and a good deal of them have to do with the allocation of transfers and equalization grants. But eventually a system did emerge. As far as intergovernmental fiscal relations are concerned, it relies on four main streams of legislation:

- The Law on Local Public Administration (LLPA) was adopted in 1991 and amended many times afterwards, until it was replaced by a new LLPA in 2001. This piece of legislation defines the structure and attributions of local governments in Romania, at both the local and county level. It actually formalizes the return to the Romanian subnational administrative structure from the interwar years.[3] The language is rather general as far as the functions are concerned, enumerating a long list of attributions and making very few distinctions between the two levels of local government.
- The Law on Local Taxes (LLT) was adopted in 1993, and modified in 2002. This act established in law the notion of own taxes, controlled and levied by the local governments (though the control has never been total). Thus, the property tax became the main source of own revenues for subnational government in Romania.
- The Law on Local Public Finance (LLPF) was adopted in 1998. This act governs the system of transfers, shared taxes, equalization grants, and municipal borrowing issues. In its current form it represents an attempt to codify and make the revenue-sharing system in Romania more transpar-

ent and rule-based. The annex of the law contains the chart of accounts that must be used by local governments in managing their own revenues and expenditures.

- The Annual State Budget Laws (ASBL) governs one budgetary cycle (January–December) and must be passed by Parliament before the end of the previous year. ASBLs specify the total amount of funds transferred from the central budget to local governments in the form of equalization money or conditional grants. It also sets the criteria to be used by the Ministry of Finance and counties in the process of equalization.

While in the early '90s the ASBL was the focus of local government policy, reflecting a high degree of centralization in decision-making and high uncertainty at the local level, the situation has gradually changed over time. LLPA and LLT substantially extended local administrative autonomy and created own sources of revenue for local governments. However, many fiscal issues had not been sorted out and the predictability of the allocation process remained low.

Changes in the Local Taxes norms passed in 1997–98 increased LG control over their own revenues and authorized local councils to administer their own taxes. First, monitorization and collection of local taxes were entirely transferred to LGs. Second, an automatic formula of sharing the personal income tax (PIT) among the three tiers of government was introduced, which improved the predictability of intergovernmental finance. A system of equalization grants was also introduced, thus reducing the central government's discretion in earmarking sums for LGs.

Shortcomings remain, however, some of which became apparent only subsequently in practice. The rate of shared taxes has been altered each year through ASBLs, though lately it has stabilized around the values specified in the LLPF. Special funds dedicated to investments continue to exist, and are allocated to LGs in a way that is neither transparent nor very accountable. Some matching grants for investments are included in the state budget with a known destination. But some of them are simply given to the relevant line ministries, who are responsible for administering them (most often Public Works or Industries, since the typical investments are in roads, social housing, water systems, and gas pipes).

Another problem is the substantial interaction taking place between county and locality officials—through both formal and informal channels—in the process of drafting the budgets and allocating the transfer funds. As counties have to wait for the passing of the ASBL in order to see how much money they will eventually get, so the localities have to wait in turn for the county councils to finalize the equalization process. This process creates many points of entry for political lobbying and rent-seeking behavior.

4. INTERGOVERNMENTAL FISCAL RELATIONS

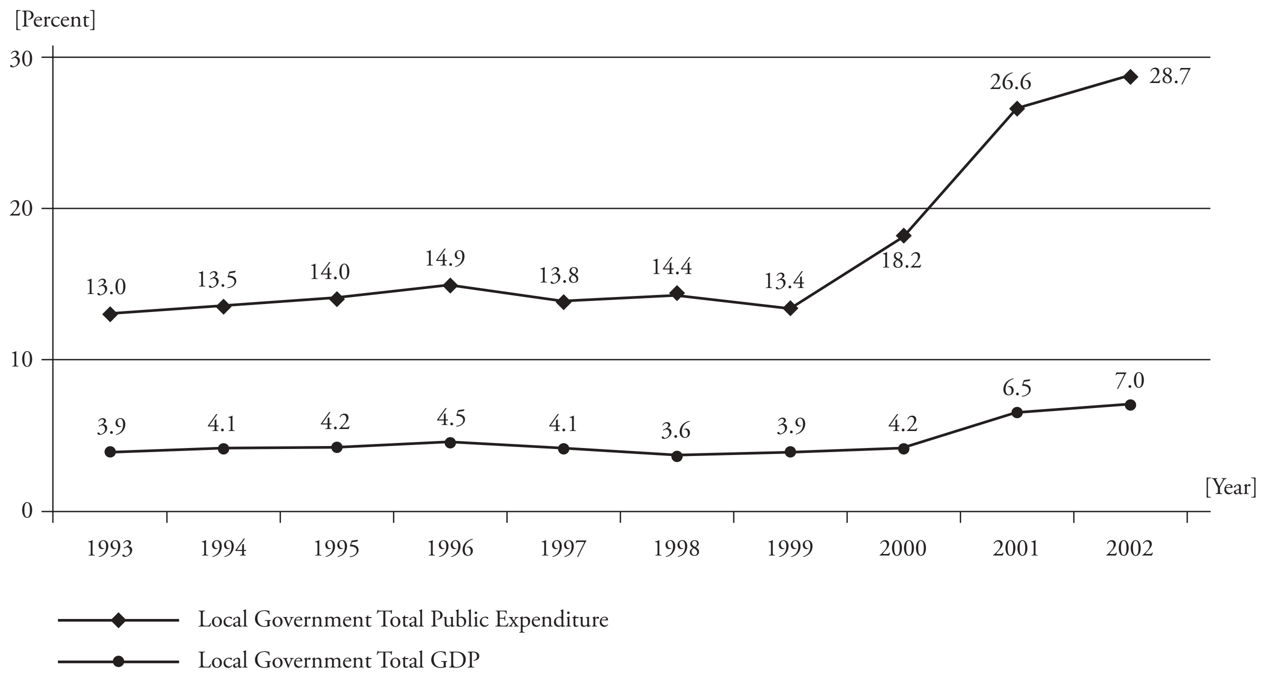
In the last decade we have witnessed a steady process of reassignment of both functions and revenues to subnational levels of government in Romania. The language of the LLPA drafted in 1991 was loose enough so as to accommodate the subsequent reassignments without problems. As a result, until 1997–98 a slow "creeping" decentralization took place. Two kinds of motivations at the central level may explain this process:

- Successive governments faced mounting external pressure to implement reform packages, whether from international financial institutions or the bilateral aid agencies of the European Union. Decentralization was a crucial component in all these packages.
- The central government wanted to get rid of some spending and administrative burdens, and hence transferred responsibilities to the lower levels.

On the other hand, there were constraints that sometimes made the decentralization process look half-hearted, such as:

- The genuine concerns in central government regarding LGs' poor managerial capabilities, possibilities of fraud or municipal bankruptcy, overall public debt, rising inequality, etc.
- The well-entrenched paternalistic attitude towards LGs, who are not regarded as equals by top central government officials and the public, no matter what the law says.

Figure 2.2
Size of Local Government Expenditure



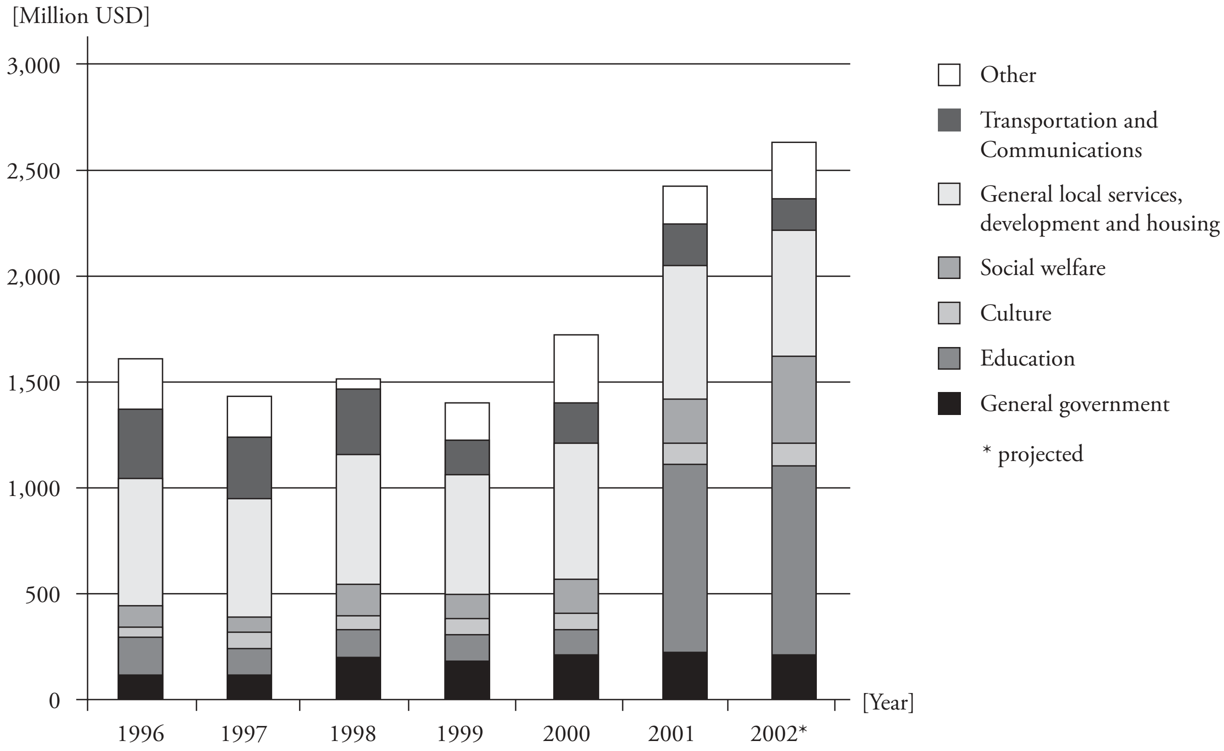
Nevertheless, decentralization continued and actually gained speed on both dimensions—attributions and revenues—after the big push initiated in 1998 and continued in 2001. Figure 2.2 displays the evolution in time of the size of local government expenditures. While the trend may be judged as positive, we should also bear in mind the warning of Vito Tanzi (2001): in modern and democratic societies, decentralization in spending correlates with a larger public sector. *In other words, some European countries may be more decentralized just because they have more state and less private sector in their societies.* Many times when assets or services are privatized, these are more likely to come from the portfolio of local governments. Which is to say that privatization may be an even better alternative than decentralization.

4.1 Functions of Local Governments

Central authorities have a tendency of maintaining control over the level of LG expenditures for macroeconomic reasons on the one hand, and because they are partially funded from the state budget on the other hand. Local autonomy is highly restricted when central authorities micromanage expenditures at the local level. In fact, in this situation, local authorities are only used as agents in executing national policies (such as education) or play the part of revenue distributors (up to an amount set at the central level) to public services that, by their nature, need to be provided at the local level (utilities). At the other extreme is strong local autonomy, where the central authority only exerts control at the consolidated level of local governments, leaving LGs unrestricted decision-making power on the amount of expenditures and their allocation.

The post-communist countries, Romania included, are somewhere in-between these two extreme cases. Their place on the continuum is defined by the combination of own and mandated functions, imposed on them by the central government. The analysis below distinguishes between mandatory and optional tasks of LGs, taking into account the way a particular service is financed, provided and regulated, as well as the degree of limitation on local decision-making power each of them implies. Figure 2.3 gives an idea of the functional structure of expenditures at

Figure 2.3
Local Government Expenditure (Average Yearly Exchange Rate) [USD]



the local level in 2002, which is the most extensive the Romanian LGs have seen so far.

Several observations can be made about the attributions of LGs in Romania in connection with their degree of autonomy. First, the scope and extent of services has increased steadily over time, as the central government transferred additional functions to lower levels. Currently, the most important mandates, both in terms of visibility and share in local budgets, are those that were transferred (or redefined) more recently: *education* and *welfare support*. Second, some mandates were terminated, such as the obligation to subsidize local public transportation. And third, many substantial attributions are currently in the process of being decentralized, such as police, emergency services, or the specialized health sector. All these generate important effects for the equalization system. The new functions and mandates will probably reinforce the current trend of increasing the share of LG expenditure in total public expenditure through earmarked sums allocated by the central government, both by functional destination and geographical area. In practical terms, this will reduce both the share of own revenues in LG budgets and their autonomy to make spending decisions.

On the other hand, the government argues that the decentralization agenda will not be expanded forever, and that this will be the last wave of substantial reassignments of functions. When these are completed, in one or two years, the situation will stabilize and we shall have a clearer picture of the costs of each service—and of the true vertical and horizontal imbalance in Romanian intergovernmental fiscal relations. With stabilization the central government has committed itself to relaxing some of the mandates now imposed on local governments and transforming some of the dedicated transfers associated with them into own revenues, or at least into general purpose tax shares. Until then, the pure quantitative analysis of trends in both expenditures and revenues is somewhat misleading if not supplemented with an institutional assessment, as well as a description of the general direction of evolution.

Nevertheless, the overall impression one gains from the unfolding of the decentralization of functions in Romania is that a uniform template was used so that the attributions do not differ by region or type of local unit. The central government was in charge and the whole process is very much centrally driven. The principle of correspondence was followed most of the time in decentralizing the functions. However, there are marginal variations from this principle which could be attributed to "subsidiarity by default": for example, when service provision is maintained at sub-optimal levels, either because of sheer institutional inertia or local opposition to the transfer of the service to the next upper level. A good case in point is education in small rural communities, provided in schools that continue to function with very few pupils.

4.2 Revenues of Local Governments

According to the OECD classification (OECD 1999), fiscal discretion in local government should be evaluated using two criteria: freedom to determine the *taxable base* and the *tax rate*. Starting from a situation of complete local autonomy, when LGs can determine both the rate and the base of a tax, the freedom of movement is reduced in subnational units as the central government can intervene and set the base or the rate of a local tax—or both. In addition, the various tax-sharing arrangements range from those controlled by LGs to those completely controlled by the central government. Evaluated on these terms, the situation of Romanian LG own revenues is the following:

i) *Own revenues proper*, the most important of which are the local taxes and fees regulated by the LLT:
   - Since 1997–98 until January 2003: LGs had some discretion in setting the tax rate, within a range specified by law for local *property taxes* (land, buildings, vehicles) and other *user fees* (licenses, permits, etc.); all qualify for b, but just.
   - After January 2003, when the new LLT will be enacted: all of the above are governed by the new Local Taxes Law, which narrows the range of local options for the property tax rate—so everything moves to e.
   - The special purpose taxes that can be introduced by LGs at their own will and other own revenues that are not affected by the new LLT remain in category a.

ii) *Personal income tax shares* (considered to be own revenues for the purpose of municipal borrowing, for example) qualify for category d4: both the base and the rate are set by the central government, but the revenue is split automatically on a monthly basis according to a formula specified in the LLPF that can be modified by the Annual State Budget (Table 2.1). The PIT shares serve for both horizontal and vertical equalization, as shown in the next section.

iii) *VAT share grants*, allocated yearly through the Annual State Budget. They were introduced for the first time in 2001, the amount of transfers is set discretionary by the central government and the money is earmarked.

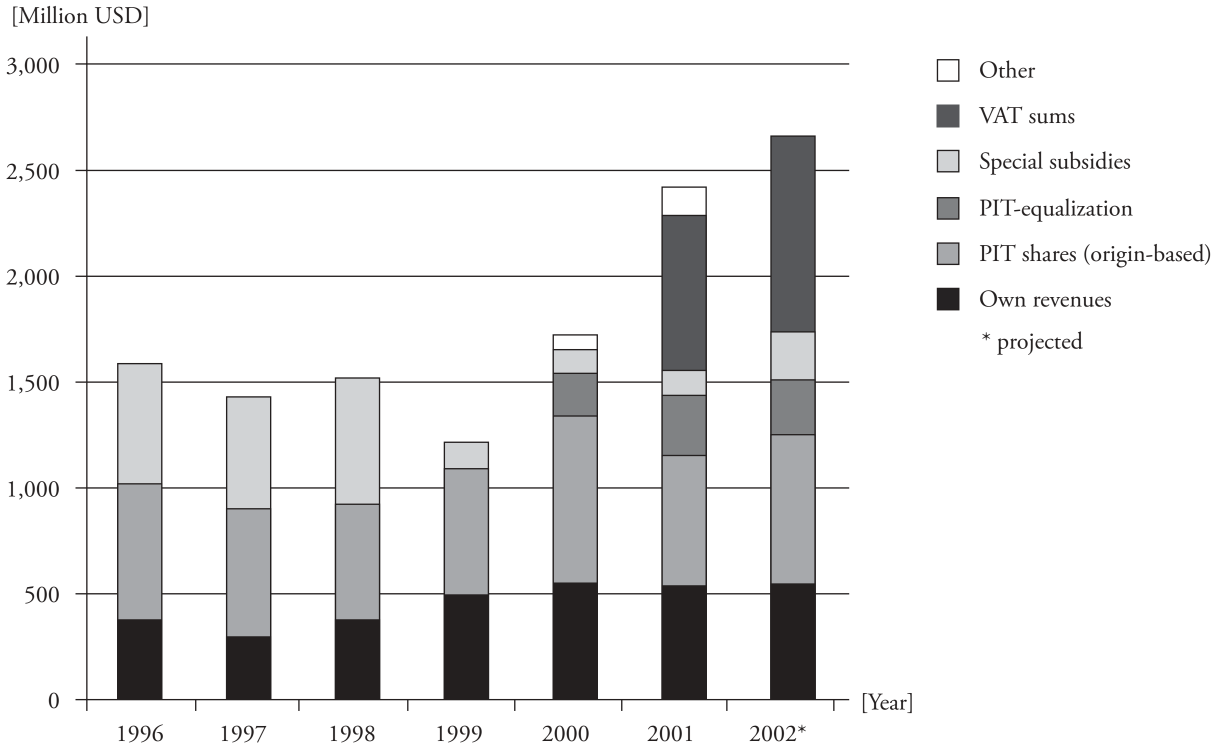
iv) Other transfers and subsidies from special funds, also defined in the ASBL.

The evolution of the proportion of each type of revenue is shown in Figure 2.4. LGs are allowed to introduce *new local taxes* (and then the revenue is usually earmarked for a specific purpose) for which they will determine freely the taxable base and the rate. Many have done so, but their total contribution to the budgets is hard to evaluate since they are not usu-

Table 2.1
The PIT Shares Assigned to LGs by LLPF and the Annual Budget Laws [Percent]

	LLPF	1999	2000	2001	2002	2003
Municipalities	40	35	35	36.5	36.5	36
Counties, own	10	15		10	10	10
Counties, for equalization			15	15	16	17

Figure 2.4
Local Government Revenues (Annual Average Exchange Rate) [USD]



ally shown separately in the aggregated reports. The percentage is likely to be small, though it may make a difference for the provision of that particular service.

Though in theory the government encourages LGs to become more self-reliant, this does not always happen in practice. There have been instances when county prefects sued local councils in administrative courts when they tried to introduce new local taxes (it happened in Bucharest in 2000). Some ministers have repeatedly reprimanded local councils that levy "unreasonable taxes on the already-impoverished population" (on pets, garbage collection, vehicles pulled by animals, park entrance fees, etc.). The media, more often than not, is also ready to pour scorn on any such local initiative.

On the other hand, as mentioned above, the same government recently rescinded from the new Local Taxes Law the authority of LGs to go the other way and lower taxes—a minister argued that, for "populist reasons," irresponsible mayors were threatening the local own revenues base. Several large cities were given as examples, but no hard data were produced to back the allegations. Moreover, there seems indeed to be a "race to the bottom" in small towns or rural municipalities: the mayors underestimate their own revenues in the draft budgets in order to secure more equalization funds. This is a typical case of the substitution effect induced by the equalization system which has been confirmed by local CFOs and becomes apparent when one analyzes the differences between the projected budgets and the execution one year later: the projected own revenues have systematically been lower than what was actually collected.

The mayors and CFOs do not seem much affected by the newly introduced limitations (the shift from b to e tax categories). They estimate that the new law, because of the zoning policy and other provisions, will increase their revenues by at least 20–25 percent.

5. THE EQUALIZATION SYSTEM

The equalization system is an important component of intergovernmental fiscal relations, in both federal and unitary states. Even loose confederations like the European Union have set up systems to transfer funds between their components units—nation-states—in order to compensate for disparities in the level of development (structural funds) or cross-unit externalities (environmental or agricultural subsidies). In theory, LGs may provide public goods that not only benefit their own residents, but residents of other localities as well. Because of these externalities, the central government is assumed to set up programs of intergovernmental transfers that function as Pigovian corrective subsidies (Wildasin 1997). If we consider, by stretching a bit the meaning of the concept, that a certain amount of equality among regions and localities is also a public good, then the moral ground for fiscal equalization is established: by redistributing a portion of local income, the government maximizes the general welfare of society.

However, the basic premise of the theory is that public sector decision-making proceeds sequentially, in two steps. First, the central government's program of corrective intervention sets normative budgetary limitations for localities. Then, in turn, LGs choose their level of local taxes and expenditures according to the local autonomy principles. But the circle does not close here. After observing the local fiscal decisions, higher-level authorities can intervene in a third step with extra subsidies or bailouts, transparent or hidden under various disguises, in those places where resources do not match "needs." Knowing this, the LGs can anticipate the moves of the central government and act in such a way that they become net receivers of financial help—either by overspending or by not exploiting fully local revenue generating power. This is a typical *moral hazard* situation, and all those who design equalization systems try to build safeguards against it.

Nevertheless, no matter how carefully these safeguards are projected, the basic fact remains that equalization grants are subsidies for poor LGs—and as with any other good, the more you pay for poverty, the more of it you get. In time the agents in cause will adjust their behavior creatively to the rules of the subsidy system, and the claims against the equalization system will multiply. In order to minimize these perverse effects, the analysis and recommendations below concerning the equalization system in Romania start from a few simple principles:

- The simpler, the better. Transparency discourages rent-seeking and makes rule-bending more difficult.
- Enforcing hard budget constraints (Kornai 1986) is a prerequisite for sustainable intergovernmental fiscal arrangements. The local budgets should be "hard" in the sense that the third step of intergovernmental policy mentioned above does not occur—or is exceptional enough so that it does not represent an easy exit for local officials. Moral hazard should thus be prevented, whether it is related to municipal borrowing proper, or overspending and accumulation of arrears.
- Whenever a change in rules needs to be made, it should lead to as few fiscal shocks as possible in the short run. In other words, new rules may be introduced as long as they assume a gradual departure from the status quo. Otherwise, it is unlikely that the proposed fiscal reforms will be accepted by the majority of the stakeholders (Molle 1997).

5.1 Sources of Funds

There are two main sources of funds used for horizontal and vertical equalization in Romania: the Personal Income Tax (PIT) and the Value-Added Tax (VAT). Until 1999 the first was actually a simple salary tax and the central government used to allocate discretionary amounts to local governments through the Annual Budget Law from the total yield of the tax. It was only the LLPF that introduced in 1998 the notion of sharing the *PIT revenues* according to predefined quotas among the three tiers of government. The sums are collected by stoppage at origin (the location of the workplace) and transferred to localities, counties, and the state budget on a monthly basis. Therefore the system works more or less automatically and is fairly predictable—because of which people sometimes argue that the PIT shares can be assimilated to LG own revenues. However, local governments cannot control the base, the rate or the collection system, and hence this is actually a typical shared tax. The sums allocated as shared PIT has increased in time from 50 percent of the total yield indicated in the text of the LLPF to 62.5 percent in 2002 (see Table 2.1),[4] which reflects a higher degree of financial autonomy at the local level.

Figure 2.5

The Sharing of the Personal Income Tax (PIT, Shared Tax) Revenues among Tiers of Government, 2002

Equalization system: sums (3+4) and share (8).

Counties decide the allocation of horizontal equalization funds (boxes 4 and 8); in theory they should use the same formula as the government in allocating PIT by county. Shaded boxes are those where counties can intervene in vertical and horizontal allocation.

The rest of 11.5% of the PIT collected and not allocated to local governments goes to the central government's budget.

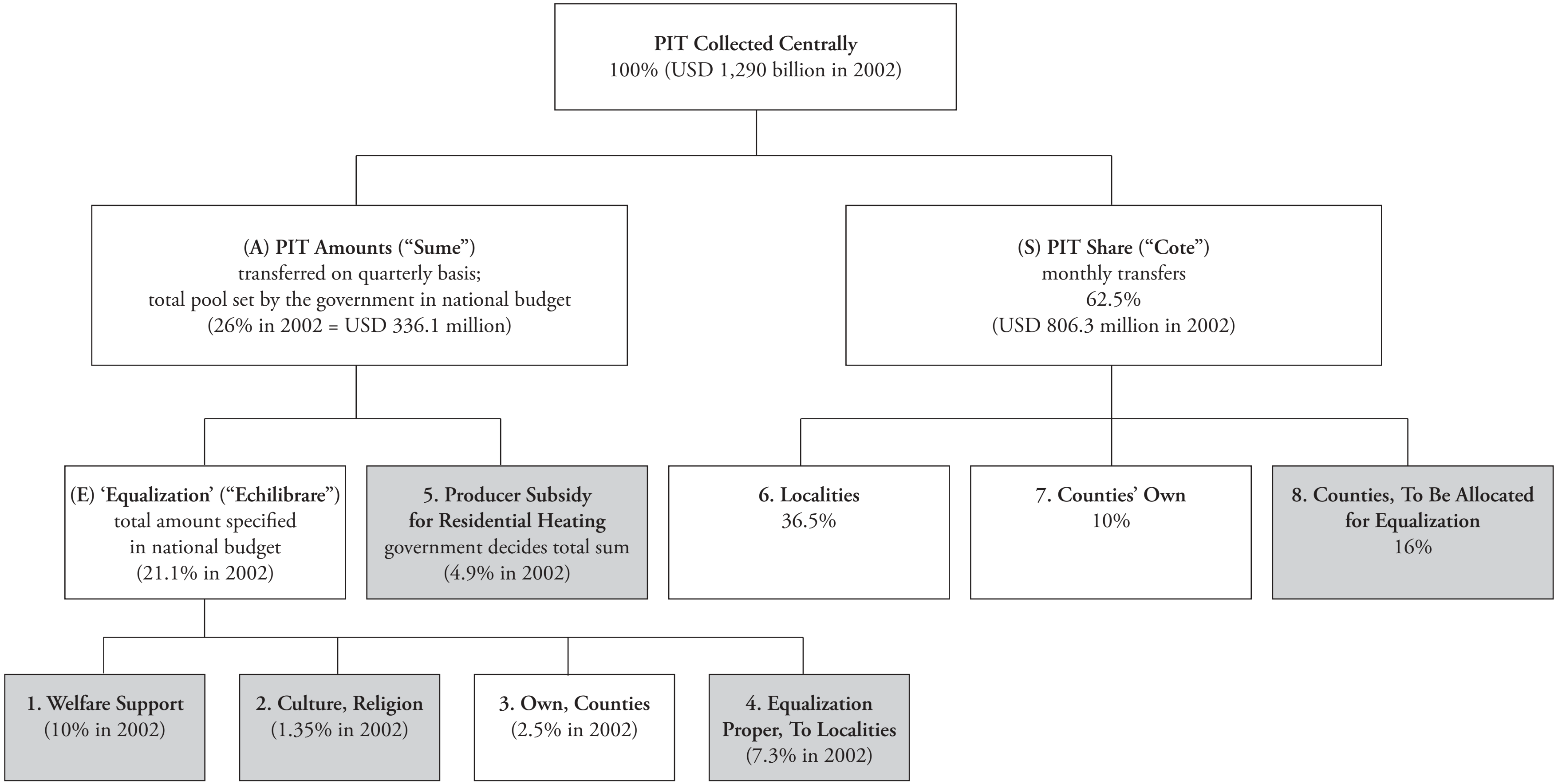
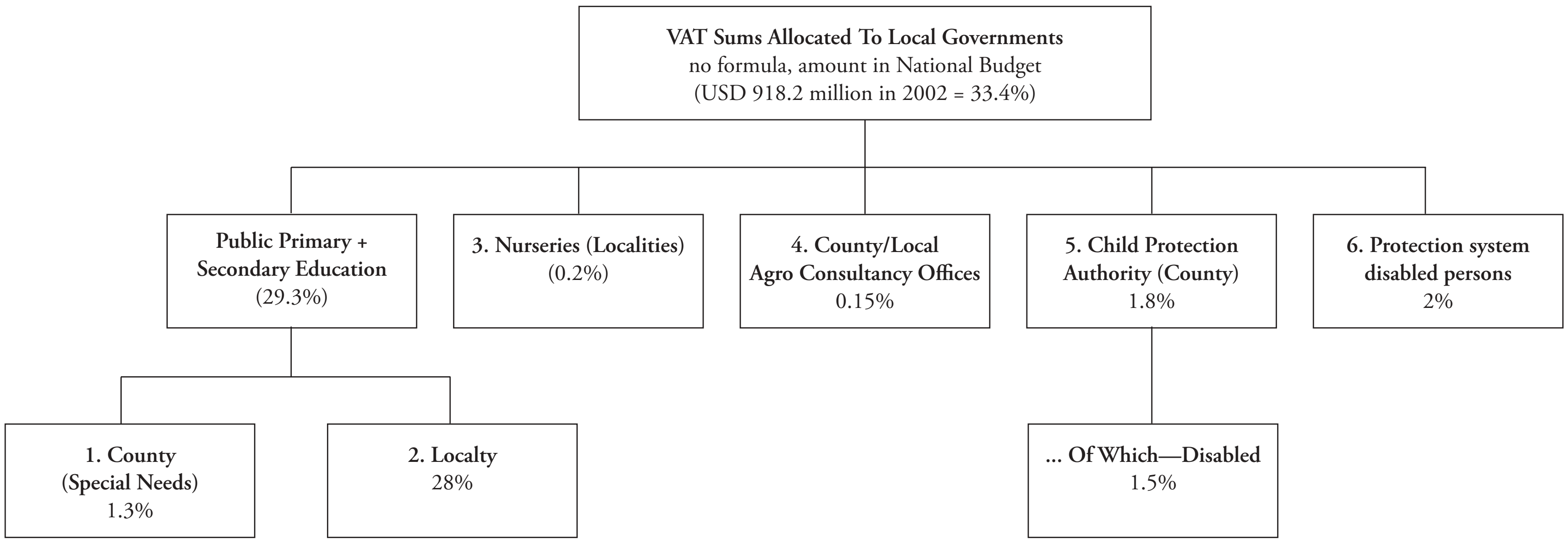


Figure 2.6
The Sharing of the VAT (National Tax) in the 2002 Budget

All sums are earmarked
Total VAT Revenues (100%) = USD 2,746.5 million



Of the PIT shares they receive, the counties must allocate some funds for the purpose of horizontal equalization. This amount was not defined as a specific share at the beginning, and hence the counties have tended to abuse the system by confiscating most of the funds. Starting with 2000 the State Budget Laws have split the county shares into two parts: own, and earmarked for equalization (Table 2.1).

The rest of the PIT revenues (37.5 percent in 2002) goes to the state budget—but part of it returns to LGs as conditional grants attached to some mandates (hence serving the purpose of vertical equalization) or block grants for horizontal equalization. Eventually, the state budget is left with little more than 10 percent of the total PIT revenues. The actual split of PIT revenues by destination in the 2002 budget is detailed in Figure 2.5.

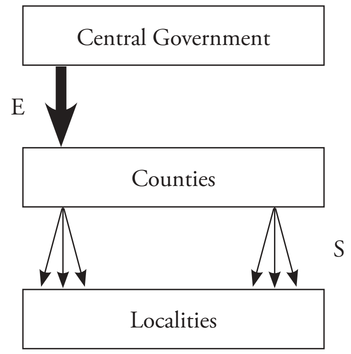
As mentioned before, the PIT sharing system combines horizontal and vertical equalization. Moreover, the conditionality and destination of sums should be analyzed in connection with the assignment of functions discussed in the previous section. Certain aspects that influence the process of fiscal equalization should be outlined here. First, the PIT revenues transferred to LGs are split into two main categories:

- PIT shares (*cote*), defined according to the percentages specified in LLPF and Annual State Budget Laws (box S in Figure 2.5). Even though the ASBL can alter these percentages, they tend to remain stable in time with a slight upward tendency that benefits LGs (Table 2.1). Part of the shares that go to counties is earmarked for horizontal equalization (box 8). The percentages that define PIT sharing are fixed for one budgetary cycle (and fairly stable since their introduction) and apply to all local government units. No county or locality is allowed to change the rates or apply surcharges.
- PIT "amounts" (*sume*), defined as discretionary by the central government in the Annual State Budget Law (box A in Figure 2.5). There is no legal requirement as to the size of this pool of funds taken from the central government's share of PIT. However, it has always revolved around 25 percent of the total collection.

Figure 2.7 represents in simplified form the flow of funds for equalization, with their two main components, E and S, and the two-step transfer for the component E.

Figure 2.7
The Basic Design of the Equalization System in Romania

(E = boxes 3 and 4; S = box 8 in Figure 2.5)



The PIT "amounts" (box A) serve both for vertical and horizontal equalization:

- Welfare support, introduced for the first time in the 2002 budget (box 1): general welfare support distributed by LGs and based on means testing; residential heating supplementary subsidy (heating vouchers), also based on means testing.
- General price subsidy paid to utilities through local budgets (box 5).
- Horizontal equalization grant allocated to counties; they can withhold up to 25 percent of it for their own use (box 3), and distribute the rest to localities from their jurisdiction (box 4).

The grants depicted in boxes 1, 2, 4, 5 and 8 (Figure 2.5) are those where county councils can intervene in their allocation to localities, because the money is transferred first to them and they then distribute it further. The language of the law is not clear—typically it refers to "consultations" among county councils, mayors, and the relevant deconcentrated ministry offices. The issue is important especially for the process of horizontal equalization (boxes 3, 4 and 8) and creates problems in the allocation of funds. We will come back to this in the next section.

The counties receive the sums from the state budget, following the list annexed to the State Budget Law. In turn, the counties transfer the funds further to localities—where applicable (boxes 2, 3, 4, and 6)—according to the local needs that were originally incorporated into the draft local budgets. There is still not much experience with this process, and no firm criteria to be followed. As a result, the process is not yet very transparent. In practice, the county councils decide how much to give and to whom following the need estimates contained in the local draft budgets sent to the MoF in the first stage of the budgetary cycle. If the MoF allocates less money than the LGs requested at the aggregate level, then the shares of each locality are reduced proportionately. The whole process is based on consultations among county council presidents and mayors, with expert advice from the part of the county offices of the relevant ministries (finance, education, welfare, etc.).

5.2 Vertical Equalization

Vertical disparities in Romania have fluctuated widely in the last decade. In the early '90s, when LGs were still not consolidated and lacked a reliable base of own revenues, most of the spending was controlled and financed from the center. As a consequence the disparities were high and many functions were matched by conditional transfers. By the mid-nineties, after the adoption of the Law of Local Taxes, the LGs were able to secure their own basis of revenues—the most important of which has been the property tax—and their fiscal independence increased. In 1996–98 the proportion of own revenues in total expenditure increased slowly to 25–30 percent.[5]

The situation improved even more in 1999 and 2000 with the introduction of the PIT sharing system: if we include the automatic shares of the PIT allocated to LGs, the rate of coverage surpassed 50 percent. In these two years the total transfers from the state budget aimed at financing mandated functions were roughly one-third of LG expenditure (the rest included various subsidies and funds earmarked for non-mandated functions).

But the substantial reassignment of functions that begun in 2001 reversed the trend. Section 4.1 in this chapter explains why this happened: many new functions that were transferred to LGs in fact created mandates for the subnational government (Table 2.2). The typical cases are salaries in education and the national welfare policy, in which the central government maintains many points of intervention. In parallel with the assignment of these mandates, earmarked grants were created—supplementary PIT "amounts" and VAT shares—to finance their provision. As a result, the total LG expenditure increased by almost 40 percent in absolute volume, the share of own revenues declined proportionately and the portion of transfers aimed at making up for vertical imbalances surged.

This long-term trend is reflected in the evolution of the Hunter coefficient—the ratio of own revenues to total revenues in LGs—over the last years (Figure 2.8). Since 1998, when the sharing of PIT was inaugurated and the shares proper have become quasi–own revenues (boxes 6 and 7 in Figure 2.5), the Hunter coefficient can be calculated in two ways:

- conservatively, by taking into account the own revenues only (the black line);
- more broadly, by including among own revenues the PIT shares (the grey line).

Table 2.2

Categories of Expenditure in LG Budgets [Percent]

		Before 2000	2001–2002
Not mandated	General local services	40	25
	Public transportation	20	8–9
Mandated	Education	10–12	35
	Welfare policy	5–6	15

Figure 2.8
Vertical Imbalance the Hunter Coefficient (Own Revenues of Local Governments/Total)

In both cases, the value is slightly higher if we separate the two tiers of local government and refer to the first one only (localities). In other words, localities have a little more control over their own revenues than do counties. However, the numbers may underestimate the important role the counties play in allocating the equalization amounts (box 8 in Figure 2.5), especially since they can decide how much of these funds to withhold.

For both counties and localities, the trend is clear: the proportion of sums spent covering the cost of mandates has risen at the expense of the non-mandated functions. The situation is unlikely to change much in the near future. The government has set an ambitious agenda for the next one or two years—more attributions will be reassigned to LGs. The list includes police, disaster relief, emergency services, and local power plants. The exact impact on local budgets is hard to estimate, but the direction of change will be the same: more mandatory spending, and probably more dedicated transfers paid from VAT revenues collected at the national level.

In the long run, the government will probably be able to transform some of the earmarked sums and subsidies into own sources of revenue (or at least general purpose transfers with stable allocation formulas, such as shared taxes) and the local budgetary process will become more stable. Until then, attempts to fine-tune revenue allocation are probably useless, and attention should focus on the few big issues that can make a difference irrespective of how the final assignment of functions looks.

The process of transfer is complex and unpredictable and sometimes even the central government cannot control it fully. For example, some services that will be transferred to LGs must first be demilitarized (police, firefighters). This is a sensitive and visible issue. Most probably, the stakeholders will fiercely oppose the reforms, not wanting to be made into local civil servants and have their special military status abolished. This creates uncertainty and political risks until the reassignment is completed. Moreover, it is difficult to make an estimate of the real costs of these services as long as they are part of central ministries because many auxiliary operations and overheads are shared with other departments. The only realistic option in this respect is learning by doing—and hence the central government has one more reason to continue for some time to use earmarked sums and preserve some room for maneuvering.

5. 3 Horizontal Equalization

The capacity of LGs to raise their own revenues varies substantially from one unit to another. For example, the county revenues per inhabitant in the 2001 budgetary cycle range more than 1:3 from the poorest to the most well-off county (Table 2.3). This range of variation is larger than that of the PIB per capita or any other measure of development because it reflects not only the absolute level of poverty in a particular area, but also the incapacity of the government, central or local, to develop a tax base and collect revenues in that constituency. The value of property varies more than the average salary from region to region; moreover, the informal economic sector is much larger in some areas than in others—for example, in predominantly rural regions with strip farming and household consumption of production. Without valuable property to tax and official jobs that generate PIT within the constituency, local governments cannot realize own revenues. If anything, the disparities are even more pronounced within than among counties. The power to generate own revenues in the lower tier of local government, the localities, varies from 1 to 600 (Table 2.3).

The formula of PIT sharing introduced in 1999 is simple and straightforward (Table 2.1), but it has a downside: it functions as a generator of horizontal imbalances especially at the lowest level of LGs. Since the tax is collected at the point of origin and then split among national, county and locality budgets, it benefits those municipalities (usually large cities or towns) which have many official jobs on their territory. When residents of rural settlements commute to work in the nearby town, the latter collects all the corresponding share of the PIT. Thus, the differences in revenue raising capacity are magnified, both at the local and county levels. Richer counties also benefit, because at the same level of personal income you are more likely to have a formal job here than in a poor county, where a larger part of the real income tends to remain hidden.

Therefore, the need arises to mitigate the effects of these discrepancies. There are many reasons to do this: it would be politically unacceptable to decrease the provision level under a certain threshold even in the poorest communities. Even if, strictly speaking, not all local government functions are national mandates, certain general government and local services have to be offered to every citizen. Moreover, in post-communist states almost all local communities have inherited a network of local services, more or less extended, and a strong expectation that they will continue to function. Terminating this tacit social contract is difficult even in the direst financial situations. Many local governments are now confronted with the issue of overextended services and shrinking finances—especially small towns, where urban services cannot benefit from economies of scale.

Before the adoption of the Law of Local Public Finance in 1998, it was hard to distinguish in Romania between vertical and horizontal equalization. Both

Table 2.3

Variations in Resources Per Capita in LGs: Own Revenues Plus PIT shares, 2001

USD/Cap	Counties	Localities
Average	8.6	33
Max	25.6	705
Min	2.9	1.2
Standard deviation x average	0.48	0.9

kinds of imbalances were addressed through the distribution of conditional transfers. The criteria for the distributions were numerous and kept changing from one year to the next, while vertical negotiations at all levels were playing an important role. The basic idea was to develop a comprehensive set of normative criteria that could approximate as closely as possible "the real need of the community." Many things were factored in at one moment or another—such as the area, number of inhabitants, length of roads, size of the running water and sewerage systems, number of children in school, hospital beds, persons assisted in special institutions, but they were not specified in a text of law. The problem with this system was that the rules were cumbersome, negotiable and thus unpredictable. They created perverse incentives: LGs had strong motives to oppose any kind of reform or rationalization in the social services, since the transfers were not linked with performance but with the physical extension of the service.

Horizontal equalization was not so much a goal as such, but rather a byproduct of distribution based on normatives. Moreover, the pattern of allocation ran against it: the richer and better endowed with local services a local community was, the more money it was likely to receive. Corrections were applied to this distribution, but in a non-systematic manner.

The decentralization reform package initiated in 1998 separated the objectives and instruments for vertical and horizontal equalization. It also introduced the notion of fiscal capacity as a benchmark to be used in the process of equalization across LGs. At the beginning, fiscal capacity was weighted only 30 percent in the process of equalization. The remaining 70 percent depended on a combination of normatives used as a proxy for the community "need." Gradually all the other criteria were removed one by one, so that in 2002 fiscal capacity represents the only element used for horizontal equalization.

The gradual removal of needs as a factor in horizontal equalization, shown in Table 2.4, is the result of a long debate that could not be settled in 1998. The "fast reformers" (Ministry of Local Administration, foreign advisers) tended to favor a simpler solution based predominantly on the fiscal capacity principle. They also argued for the inclusion of the precise notion of "equalization formula" in the text. On the other hand, the "conservatives" (Ministry of Finance) wanted to preserve some room for maneuvering by continuing with the looser concept of "equalization criteria." Even though the latter prevailed at first, the formula-based equalization gained ground and eventually won. Currently a formula is included in the ASBL that uses the collection of PIT in each local government area—a variable beyond the control of LGs—as a proxy for local fiscal capacity.

The Fiscal Capacity Formula:

$$E_L = \frac{(OR_C/P_C)/(OR_L/P_L) \times P_L/P_C}{\sum_{L=1}[(OR_C/P_C)/(OR_L/P_L) \times P_L/P_C]} \times E_C$$

E_L = equalization grant per locality

E_C = equalization grant per county

OR_L = own revenues (including PIT shares) per capita—locality

OR_C = own revenues (including PIT shares) per capita—county

P_L = population of locality

P_C = population of county

Table 2.4

Criteria for Horizontal Equalization, in time

	Need		**Fiscal capacity**
1999	Population, length of streets, number of houses, water and sewerage network, children in school, children in orphanages, disabled persons	70%	30%
2000	Population, length of streets, number of houses, water and sewerage network, children in school, children in orphanages	70%	30%
2001	Area of LG, children in school, children in orphanages, disabled persons	30%	70%
2002			100%

The system of horizontal equalization works in two steps:

- First the MoF allocates by county the total pool of funds defined as PIT “amounts” (box A in Figure 2.5, corresponding to the 2002 budget). The fiscal capacity formula is then applied and the resulting distribution of funds is published as an annex to the State Budget Law.
- In the second step, the counties withhold their share of the equalization funds (up to 25 percent of the sum received) and distribute the rest to localities. This stage of equalization is much more problematic, since not all the counties use the fiscal equalization formula. Actually, few of them do so—and only as a base for starting negotiations with the mayors of localities. Most counties interpret the provisions in the ASBL as mere “guidelines” and argue that strictly following the formula’s results is not workable in practice. MoF has been unable so far to enforce a uniform and transparent equalization mechanism at the sub-county level.

By design, the fiscal capacity formula aims at compensating the counties and localities for both the relative poverty of a region and the adverse effect of the PIT shares stopped at origin. The departures from this policy goal at the county level are only marginal, and are due to the differences occurring between the budget projection and execution.

The problem is that the inclusion of own revenues as a fiscal capacity indicator creates disincentives to maximize them at the LG level—the typical substitution effect of own revenues with equalization money. The phenomenon was not apparent in the first years of application of the new mechanism, but as people become more accustomed to it, especially in rural communes, the practice is spreading fast. Since the data introduced in the fiscal capacity formula are the projected own revenues for the following year, the LGs can underestimate them in order to get more equalization funds at the expense of their neighbors. In time, this triggers a “race to the bottom” among the localities in the same county that only skews the pattern of distribution, while the total pool of funds stays the same. A quick solution is needed here in order to remove the vicious incentives from the system.

Apart from the above, counties get additional equalization funds on a monthly basis, as a direct share of the PIT yield (box 8 in Figure 2.5, defined as 15 percent of the PIT in 2001 and 16 percent in 2002). They distribute this money to “communes, towns, cities, and their own budget, after getting expert advice from the territorial MoF offices.” This second pool of money is more reliable and predictable than the first, since it depends on the level of PIT collection, not on the central government’s wishes. However, the legislation ignored a small detail: to impose a cap on the share that can be withheld by the counties. As a result, predictability only applies to counties; the localities are completely at the mercy of the county councils and presidents, who in some cases have decided to give nothing to the localities. Figure 2.9 below reproduces the basic logic of the equalization system in Romania displayed in Figure 2.7 and shows the most important sources of problems in the process of fiscal equalization—in the form of loopholes or “points of entry” for discretionary decisions.

Figure 2.9
Main Sources of Problems in the Romanian Equalization System

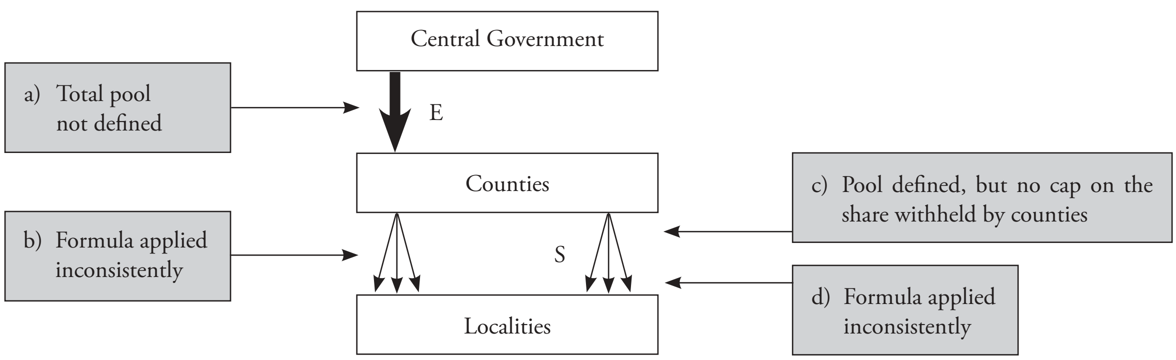


Figure 2.10 illustrates the wide range of variation in allocating the second PIT share (S) by localities—i.e., the effects of the loopholes described in boxes (c) and (d) in Figure 2.9. The discretion exerted by counties is total: in some cases the localities are given next to nothing (e.g. Vrancea county); in others, large cities get a disproportionate share. Rural communes, who are generally most in need, are the most likely to suffer from this erratic distribution. What is more, there is no obvious correlation between the general poverty of counties and a specific pattern of allocation. Which suggests that it is entirely up to the county councils to decide how to distribute the equalization funds.

The current practices governing the relations between counties and localities generate problems for both tiers of local government. Lacking appropriate instruments to pursue their legitimate goals—investments with interlocality spillover or economies of scale effects, regional development, etc.—the counties resort to informal pressures, conditioning of investment allocations, or distorting the equalization mechanisms. The sums are sometimes used to reward political associates, and sometimes as a lever to force localities into thinking more broadly and cooperate with each other. The first goal is illegitimate, the second is legitimate—but in both cases the instrument should not be the equalization grants system.

Rural communes are the most affected by these interventions since in most cases their financial autonomy is weaker. But all the localities suffer, more or less. Professional multiannual budgeting becomes impossible when they cannot estimate in advance the size of the equalization grants. Ideally the grants should only depend on the overall size of the equalization pool in one year. The allocation formula is only meant to provide a ranking of localities according to their fiscal capacity. If the evaluation is correct, there will be relatively little change in this ranking from one year to next, and so local officials will know in advance with a high degree of probability where they stand and what will be the level of resources they can rely on. Their incentives will thus be to focus not on permanent lobbying for larger sums, but on prioritizing the spending items.

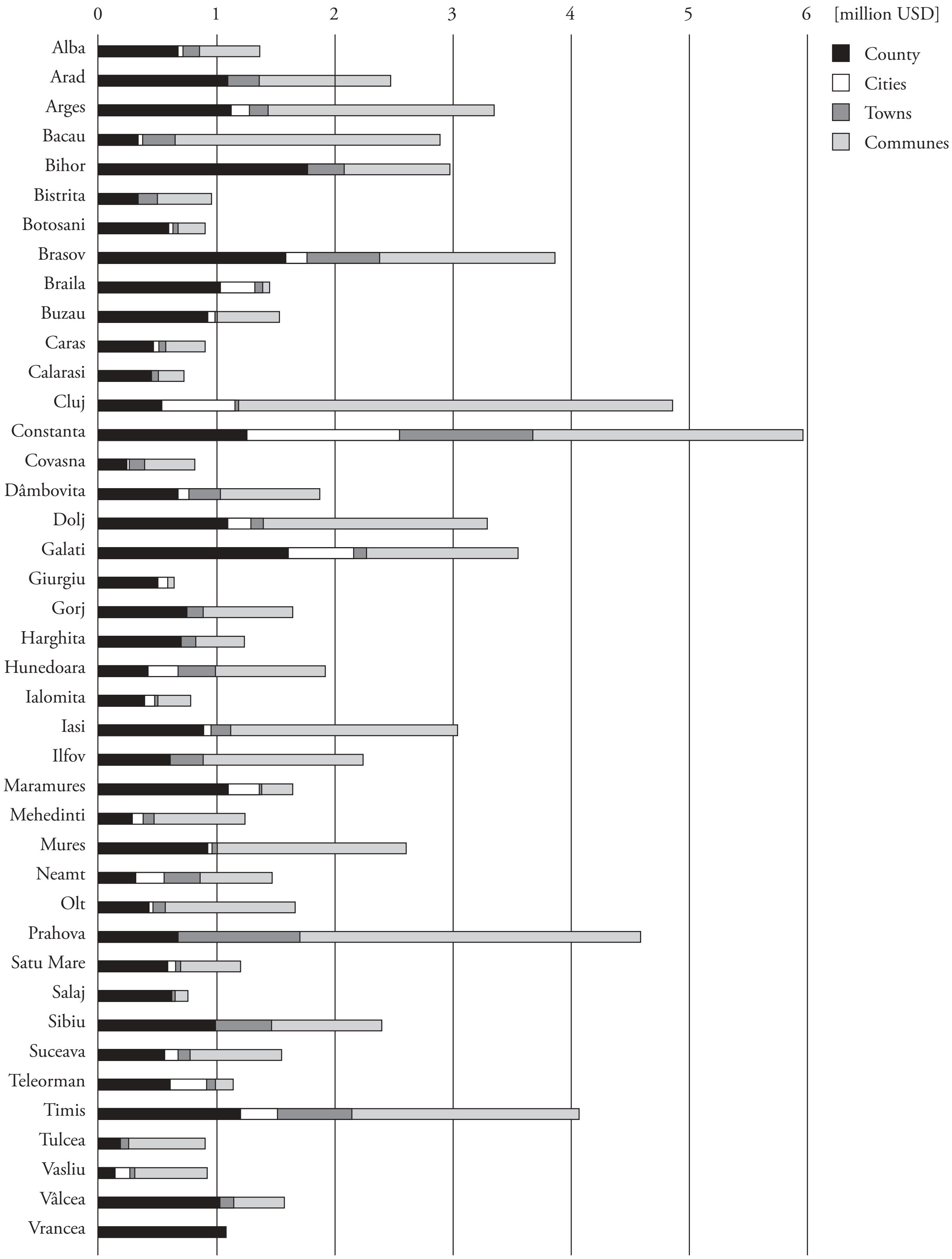
More specifically, several systemic flaws can be identified as far as the rules of equalization grants are concerned.

Unfairness. The equalization funds are distributed more or less randomly, both at the locality and county level as Figures 2.11a–c show. Though in theory these sums should compensate LGs with low capacity to generate own revenues, and hence there should be a clear inverse correlation between fiscal power and grants funds, legal loopholes allow counties to intervene and bend the rules. First, since there is no limit on the portion of the 16 percent PIT share that the counties can withhold for their own budget (box 8 in Figure 2.5), a wide variation appears in the pattern of distributing these funds (Figure 2.10). Some counties take much more than others, at the expense of the localities in their geographical area—and thus shift funds from the horizontal to the vertical equalization component. The process is not controlled or coordinated, and hence the resulting distribution has nothing to do with equalization: in Figures 2.11a–c there is no relationship between the fiscal power of counties and the per capita sums received (or withheld) as equalization funds. This creates a serious problem for rural communes left at the mercy of cash hungry counties.

Second, the counties do not follow the fiscal capacity formula when distributing equalization funds at the sub-county level. Though the reason usually put forward by county officials is that the formula is too rigid and does not provide enough resources to the poorest localities, Figure 2.11 shows that the current "flexible" practices do not actually improve fairness. The 2,951 Romanian localities are plotted on the charts according to the level of own revenues (proper + PIT share) and the equalization funds per capita they receive. There is very little correlation between the "need" of localities and what they actually get from the equalization system. County discretion in defining the total pool of equalization funds going to localities, and the rules of allocation to localities, create the combined effect displayed in Figure 2.11a and b: cities and towns receive funds almost randomly; several dozen rural communities receive disproportionately large funds; while many poor LGs have no money either from own sources or transfers.

These findings are not surprising, nor are they specific to the case of Romania. It has been noted before that there is a systematic asymmetry in the way hard budget constraints are enforced in inter-

Figure 2.10
The Way Counties Have Distributed the PIT Share for Equalization, 2000—15% (box 8 in Figure 2.5)
(The absolute sums also show the relative wealth of counties)



governmental fiscal relations: larger LGs tend to face "softer" constraints (Wildasin 1997). This tendency is manifest both at the level of localities and regions. Cities (especially county capitals) often get more than their fair share of the equalization funds (Figure 2.10), sometimes as a result of overspending in previous years. Counties definitely face softer budgetary constraints, as was explained above, since they can interfere in the equalization process and adjust at will the portion withheld for their own budget. A good system should counteract this trend that puts smaller and poorer LGs at disadvantage.

Lack of clarity of purpose. This refers to many things: policy objectives of the equalization system; procedures for aggregating financial data; and the allocation of investment funds. In theory, LLPF and ASBL define, indirectly, two streams of funds that are meant to (1) alleviate disparities among the three tiers of government (central, county, local), and (2) perform some redistribution among local government units within the same tier of administration. In the terminology used above, the first objective is vertical equalization; the second is horizontal equalization. In practice, the discretionary power of each county in defining how much of the PIT equalization share (box 8 in Figure 2.5) actually goes toward horizontal equalization, and how much is kept in the county budget, muddles the process on both components. The total pools for vertical and horizontal equalization thus become uncontrolled and unpredictable. Together with the inconsistent use of equalization formulas mentioned before, this generates an uncertain environment for localities, especially small rural ones, which makes long-term budgetary planning difficult.

The current reporting procedures of financial data is also a problem. The procedures are not designed to allow modern public management on the part of LGs and policy analysis at the macrolevel. Much relevant information is lost in the process of aggregating data, as data are passed up from LGs to the Ministry of Finance. The accounting system is still cashbased, so that many assets, liabilities, and debts are not recorded. There is additional pressure on them not to report these, since the law does not allow LGs to close the budgetary cycle with deficits. More generally, there is no tradition in the Romanian public sector of analyzing and reporting financial data to external users (banks, firms, independent analysts, or ultimately, the citizens) in the appropriate format and with due diligence. This lack of transparency in the use of funds, even when there is no need to cover something up, eventually turns against the institutions: for example, it would be easier for localities to demonstrate that they are abused by counties if they were to analyze and present the distribution of equalization funds like in Figure 2.11.

The way in which LGs and MoF classify revenues can also hide useful information and skew the redistribution rules: the "Other" category is too large and unspecified, and it may be that both localities and counties divert funds towards it from the "Own revenues" line in order to get more equalization funds. The special transfers—price subsidies for heating, special funds for roads, housing, etc.—also contain money that are unevenly and opaquely distributed, functioning in fact as a counter-equalizer (Polishchuk 2001).

6. CONCLUSIONS AND RECOMMENDATIONS

In spite of the shortcomings mentioned in the previous section, the current equalization grants system introduced in 1998–99 represents an improvement when compared with the situation that existed before. The notions of vertical and horizontal equalization have been operationalized separately and it is now possible to estimate how much financial effort goes into each of them, and to follow trends in time. A simple and clear allocation formula was eventually reached which is applied consistently in the first step of the equalization process: the distribution of funds from the central government to the counties. Even if the formula is not consistently applied in the second step—from counties to localities—it remains a benchmark against which the process of horizontal equalization can be assessed.

In this context, it is now possible to outline an agenda for improvement. The agenda must fix the flaws in the system that have become apparent so far —but on the other hand take into account the need for flexibility and uncertainties that will continue for a while. The reassignment of functions to LGs is not yet complete and substantial transfers are on the

Figure 2.11a
County Revenues, 2001 [USD/cap]

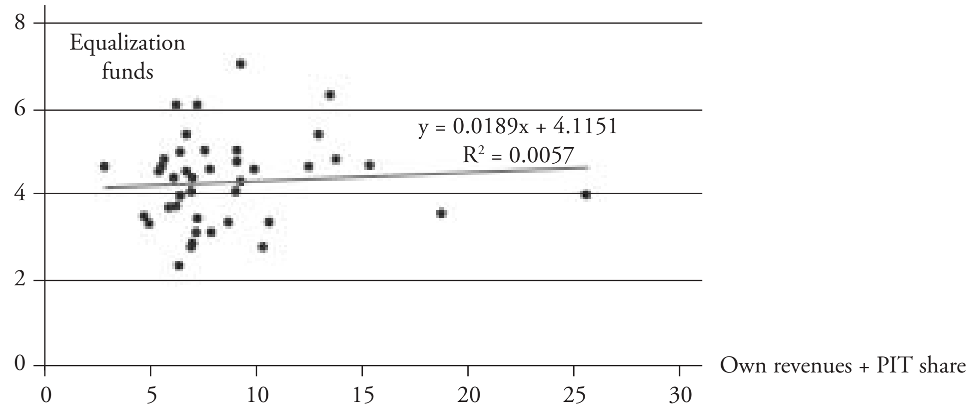


Figure 2.11b
Localities' Revenues: Urban, 2001 [USD/cap]

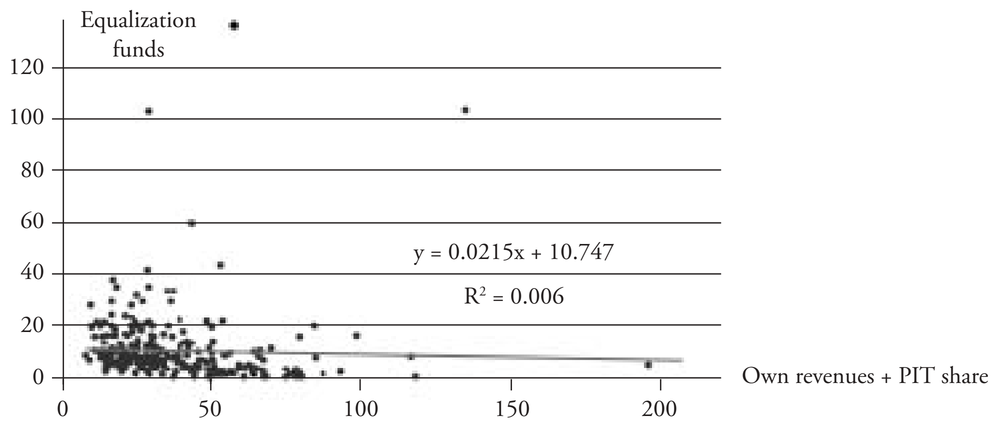
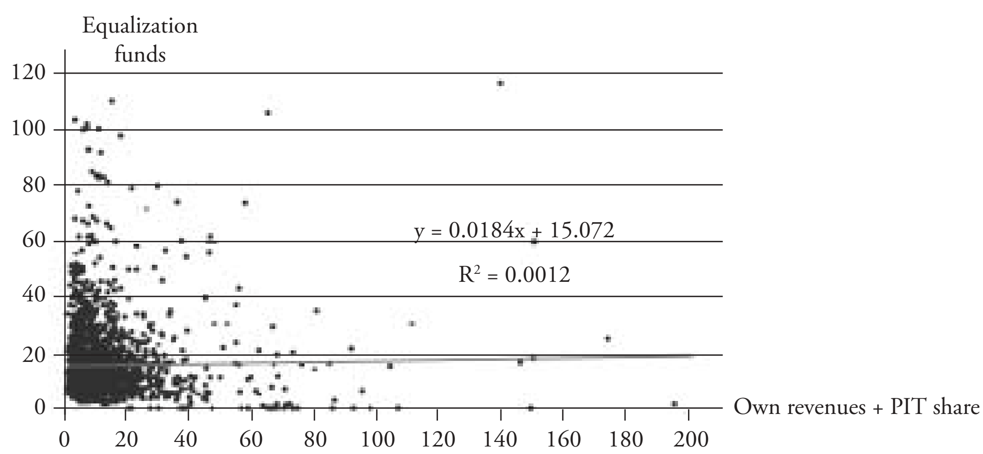


Figure 2.11c
Localities' Revenues: Rural, 2001 [USD/cap]



agenda for the next one or two years. The calendar—or indeed costs—of these new transfers of functions are difficult to foresee. Therefore, any attempt to fine-tune and write in stone the intergovernmental fiscal rules is premature. It is likely that any new major reallocation of attributions by the central government will be matched with a slice of funds taken from the national general budget—most likely, from the state's residual share of the PIT or the VAT revenues. Only with the passing of several budgetary cycles with the new arrangements, can the policy be stabilized and more automatic transfers set up that will minimize the vertical imbalances and stabilize the horizontal equalization mechanisms in the long run.

The agenda for reform has thus to be organized in several stages and put into the broader policy context.

In the short run, several quick improvements are possible that will address some of the problems identified in the previous section.

a) The total amount of funds distributed as equalization grants should be stabilized, by tying it more clearly to the total PIT yield. As of now only one component is defined in this way: the 16 percent PIT share (box 8 in Figure 2.5); the other component (PIT "sums"—boxes 3 and 4 in Figure 2.5) is not, though in practice it has been remarkably stable over the last few years, at about 10 percent of the PIT revenues. Since counties can be removed from the process of allocation altogether (c. below), the two parts should be merged into *one single equalization fund, defined as 26 percent of the PIT*. In this way, no additional financial burden on the state budget will be created, but one fundamental condition will be met for increasing the predictability of the intergovernmental fiscal relations.

b) Vertical and horizontal equalization have to be recognized as legitimate and distinct policy objectives, and hence two separate pools of funds must be created out of the 26 percent of the PIT defined above. (This would be equivalent, under the current system, to a cap imposed on the percentage withheld by counties for their own budget from the second source of equalization funds—box 8 in Figure 2.5). The total equalization funds should be split from the beginning of the budgetary cycle into two components: *funds for counties, and funds for localities*. No transfer of money would be allowed between them. This way vertical equalization will be implemented much more coherently and no tier of government would siphon off funds for its own vertical compensation at the expense of the horizontal equalization in other tiers. Currently the counties keep about ¼ of the PIT "sums" (boxes 3 and 4) and $^2/_5$ of the 16 percent share (box 8). In order to preserve the stability of expectations and the current degree of vertical balance, the total fund should be split into two according to the average ratio of $^1/_3$: of the 26 percent of the PIT earmarked for equalization, *8–9 percent would go to counties and 17–18 percent to localities*.

c) *Counties can be excluded from the process of allocating equalization funds to localities*. Their role can be very well taken over by an automatic mechanism under the supervision of the central government. Right now, the counties only make the system unpredictable and permeable to political lobby. They have their own specific functions such as coordinating regional development or supplying services with economies of scale larger than a local community. But none of these must interfere with the equalization system, which should not become an instrument for forcing localities into compliance with countywide objectives.

d) After the two pools of funds are separated (a. above), the allocation of the two by county and locality should *strictly follow the fiscal capacity formula*, so that all LGs can estimate in advance how much money they will receive and plan accordingly. Two adjustments need to be done to the fiscal capacity formula currently in use (see section 5.3 above):

   - *Own revenues should be excluded from the calculation of fiscal power*, in order to prevent LGs from limiting their efforts to raise revenue and get more equalization money in return. Moral hazard will thus be eliminated. As a result, the only proxy for fiscal capacity of LGs remains the automatic share of PIT collected locally (box 6 for localities and 7 for counties), per capita. The exclusion of own revenues would not influence much the ranking of LGs by fiscal capacity, since PIT share per capita and own revenues per capita are two closely correlated variables. But it would remove the possibility of substitution: LGs do not collect the PIT themselves, and thus cannot adjust their behavior so as to maximize the equalization grants received.

- *A cap may be imposed on the per capita equalization sum*, so that the outlayers do not receive disproportionately high amounts. The calculations below are done for a cap of 45 USD/capita, which is about 3 times the average per capita equalization grant in rural LGs.

The logic of this impoved system of equalization is summarized in Figure 2.12, which should be compared with Figures 2.7 and 2.9 above. Its distributional effects are presented in Table 2.5.

Contrary to the often-expressed opinion that a more automatic formula-based allocation cannot take care of particular local needs, the analysis shows that the equalization system proposed here (I in Table 2.5) is both simpler and fairer, at the county and locality levels. Simplicity is crucial because it reduces the administrative costs of implementation, which is especially important when such costs are not immediately apparent but spread across many central and local public institutions. It also increases stakeholders' confidence in the system, since everybody can understand how the system works and has little incentive to engage in rent-seeking. On the contrary, if rules are complicated and depend on data that are either unavailable—which is often the case in CEE—or easy to manipulate, the system will be perceived as unfair and unreliable.

Table 2.5 compares the results of the proposed system with those of the current practices, and with those of an alternative system (II). The latter is based on allocating the equalization pool (defined as the same PIT share) not on fiscal capacity but on "need," as measured by the size of population.[6] The proposal I put forward here substantially reduces the variations in allocation, especially across rural LGs, where the problem is the most serious.

More important, the proposed system produces results that are fairer than the current ones, by better targeting the equalizations funds towards LGs that really need them. This is true in the case of counties, towns and municipalities, and rural communes: in the annex we present the allocative effects of the current system (Figures 2.13–15a) alongside those of the proposed system (Figures 2.13–15b). It also increases exponentially the sum per capita transferred as the total revenues per capita before equalization decrease, especially in rural LGs, thus reflecting the economies of scale in providing most local services—general government included.

In the medium- and long-term, depending on the pace of policy reform in attributions reassignment, there are some elements the government would be well advised to take into consideration.

- It is important that the government resist the temptation to complicate the horizontal equalization system by factoring in various "normatives" meant to function as a proxy for local needs. Once they start to go down this road, the proliferation of "needs" will be unstoppable and the system will become unmanageable (Hungary is sometimes cited as a bad example in this respect). It was

Figure 2.12
Proposed System (I): Separating Vertical and Horizontal Equalization

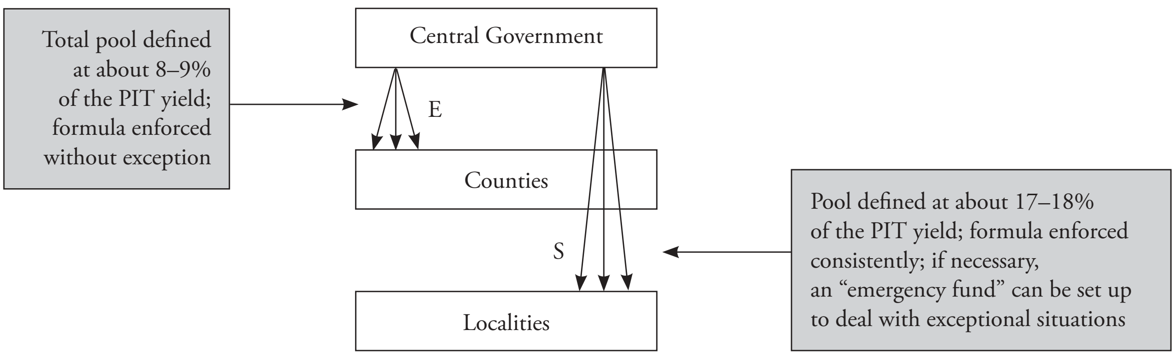


Table 2.5
Results of Applying Different Equalization Systems: Total Revenues of Local Governments [USD/cap], 2001

County Level		Current	Proposed (I)	Alternative (II)
	Average	17.7	17.7	17.7
	Max	32.5	29.8	32.8
	Min	11.6	13.1	11.6
	Standard deviation/average	0.3	0.22	0.28
Locality Level		**Current**	**Proposed (I)**	**Alternative (II)**
Total	*Average*	81.3	81.3	81.3
	Max	782.9	741.7	785
	Min	11.8	24.7	14.6
	Standard deviation/average	0.44	0.37	0.42
Urban	*Average*	109.3	107	
	Standard deviation/average	0.43	0.42	
Rural	*Average*	53.2	55.5	
	Standard deviation/average	0.61	0.47	

noted above that there is a tradeoff here between simplicity and transparency on the one hand, and technical refinement on the other. From the experience available so far with the current Romanian system, which is fairly simple and easy to understand, *the biggest problem turns out not to be design, but consistent implementation.* As long as rules are not enforced at the lower levels so that they create stable expectations and the right incentives, the design is practically irrelevant.

- The central government should plan carefully so as to allow some degree of flexibility, without compromising the stability and predictability of the equalization system. The intergovernmental fiscal relations in Romania concern about 3,000 local units; it is not possible to build it according to a predefined plan down to the last detail. Feedback during implementation should be collected and analyzed in order to effect corrections when the need arises. The best way to do this is by creating a joint *grants commission* with the participation of central government officials and Parliament staff, to conduct periodic reviews of the equalization policy. When changes are proposed all the stakeholders should be consulted—primarily LG associations—and sufficient time should be allowed for the local governments to understand them and adjust their behavior. As a rule of thumb, all changes should be decided at least one budgetary cycle before they become effective. The setting up of a grants commission can be useful in the long-term as more services will be reassigned to LGs. The commission would periodically evaluate the best way to locally finance services like education and health care, sectors where reforms are not likely to be finalized soon; study the cases of inter-constituency spillovers from locally provided public services; develop benchmarks; and advise decision-making bodies on what intergovernmental instruments—capitation, matching or general purpose grants—are most appropriate for a particular type of service.
- As reporting procedures and databases improve, a *more accurate indicator of true fiscal capacity of LGs* can be developed to replace the current PIT/capita collected. However, this should remain simple and based on elements that are outside the control of local government officials. All the indicators should be easily measurable and the data put in the public domain.

- In the long run, when all the reassignments are complete, the situation stabilized, and LGs have accumulated enough experience in managing their new functions, local autonomy can be formally increased by transforming most of the additional conditional grants (such as PIT shares for welfare support, price subsidies, etc.) into *general purpose transfers*, preferably in the form of predefined tax shares. The Hunter coefficient would thus increase (Figure 2.8) and the need for vertical equalization will be reduced accordingly. Their allocation to LGs should not be based on complex normatives, but on simple and available data: for example, funds can be distributed on a per capita basis.
- In a few cases transfers that are currently earmarked would be best kept tied to a specific service. They could be stabilized in the form of a *capitation grants system*, where the money is made conditional on a specific level of performance to be achieved by local providers. Taking into account the administrative tradition in the region, education (and health care, if it is reassigned to LGs) is a sector where earmarking of funds is likely to continue.
- Competitive grant-giving funds should replace the current discretionary financing of investments (roads, housing, etc.) and here counties may play a role in administering some of them with the purpose of promoting countywide policies. More specifically, a matching grant system can be established to encourage investments in those particular projects that generate positive spillovers across jurisdictions. Again, the grants would act as Pigovian subsidies and contribute to the increasing of efficiency in production (Bird 2000).
- Professional financial reporting and data analysis should be introduced, starting with the relevant MoF units that interact with local governments. Under the current procedures, there is a lot of uncertainty regarding the true financial position of LGs, and as a result the equalization rules can be exploited by those who engage in "creative bookkeeping." Elements of accrual accounting should be introduced and more refined reporting standards imposed, so that budgetary categories like "Other revenues" are reduced in size.

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ENDNOTES

1 As a result, there are three ballots in Romanian local elections: party lists for county councils, party lists for locality councils, and uninominal ballots for the office of mayor.

2 Romania has adopted the National Treasury system of unified cash management.

3 With slightly larger counties: now 41 instead of 60 before World War II within the current borders of Romania (or 74 including the ceded territories).

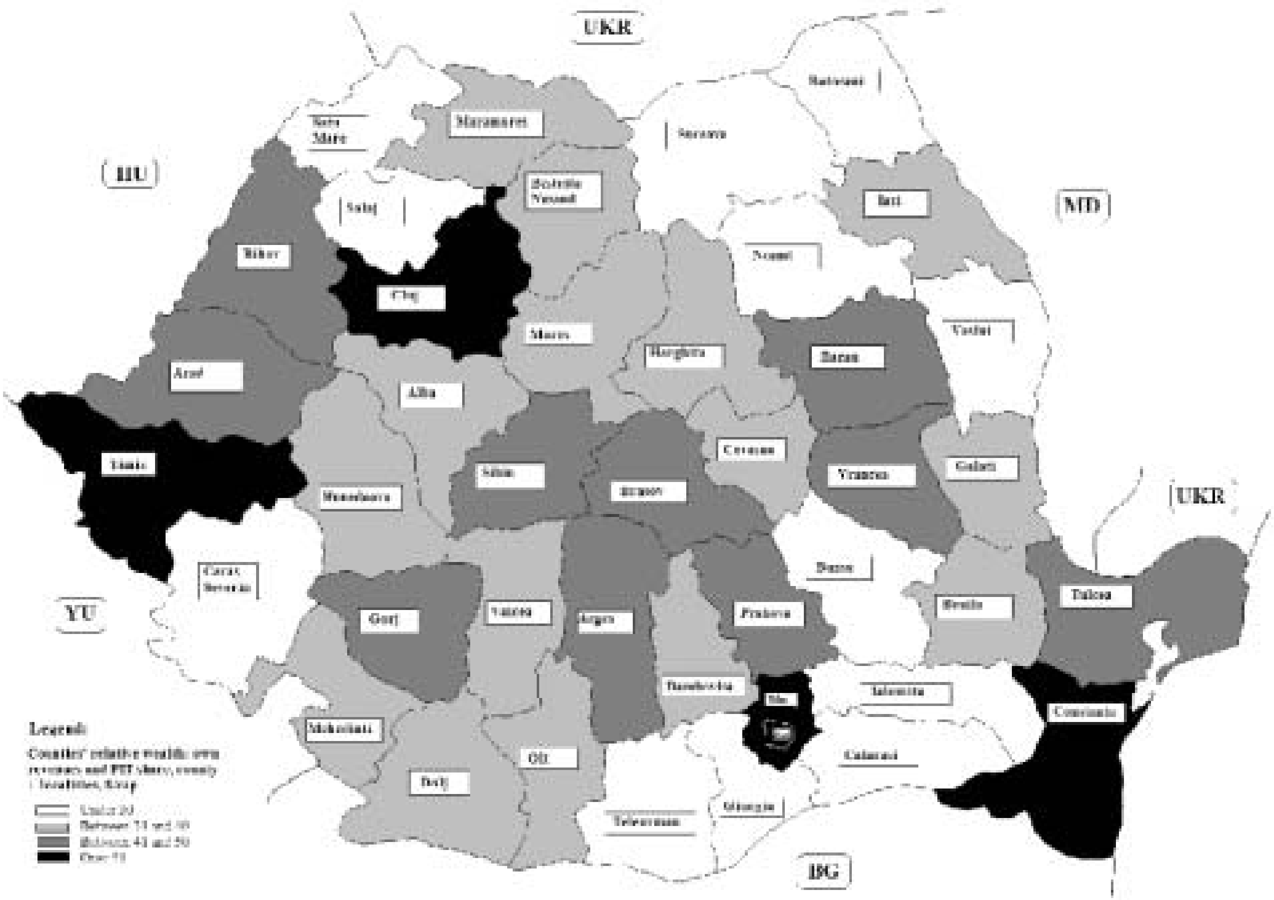
4 The LLPF was passed in 1998 and the article that specifies the shares was meant to serve only as guidance—an ideal target to be met in time—since the actual shares can be modified by Annual Budget Law. In the first year when the new system was implemented, 1999, the actual percentages were indeed lower than those provided by in LLPF (Table 2.1).

5 However, the real ($) values for 1999 are the least reliable due to a surge in the inflation rate that occurred in the spring of that year and which reduces the significance of the yearly average exchange rate.

6 One of the options currently considered in the discussions for amending the Law of Local Public Finances. Its main attraction is simplicity.

ANNEX

Figure 2A.1
Map of Romania



DILEMMAS AND COMPROMISES

Ildar Zulkarnay

Fiscal Equalization Policy in the Russian Federation

FISCAL EQUALIZATION IN TRANSITION COUNTRIES

Fiscal Equalization Policy in the Russian Federation

Ildar Zoulkarnay

This chapter presents and discusses the problems of vertical and horizontal fiscal equalization in the Russian Federation. Federal equalization policy and sub-regional equalization and its problems are analyzed. The chapter also outlines the Russian federal system and discusses vertical imbalance; horizontal interregional disparities and their equalization; horizontal and vertical equalization on the sub-regional level; the program of intergovernmental finance reform for 2000–2005 and its implementation in 2000 and 2001. The study uses statistical data for the years 1992–2001, and in some cases for the first six months of 2002. Finally, the chapter provides recommendations for the improvement of the Russian fiscal equalization system on the federal and subnational levels.

During the investigation special interest has been paid to the force of budget incentives, their direction ("good" or perverse), and the clarity of formulas used in the current methodology of resource allocation. The most significant recommendations concern measures to strengthen "good" budget incentives in the framework of the current federal mechanism for allocation of financial resources, and ways of introducing formula-based resource allocation on the sub-federal level.

1. INTRODUCTION

The Russian Federation is known to be one of the grand federations of the world. However, Russia has no experience as a real federative state, and therefore the country is in the midst of a transition from a unitary to federal state. Actually, the long history of centralized development (e.g., the former Russian Empire and the former USSR), which gave shape to corresponding informal institutions of society, creates an inertia which works against the development of Russian society. Thus, considerable political forces inside the country actually represent the interests of the unitary state, with similar moods common among the population. These factors ensure that Russia's transition to federalism will continue to be complicated by the legacy of the previous unitary state.[1]

The limited development of civil society is apparent not only with respect to the federal center and the subjects of the Russian Federation, but also at the level of local self-government. The population does not want to participate in self-government, nor does it have the prerequisite skills for self-governance. Moreover, the staff of central and subnational governments have outdated management skills and tend to hamper any innovations.

This chapter analyzes the development of intergovernmental fiscal relations in the Russian Federation over the last decade while concentrating on the current situation and the initial results of the budget, tax, and intergovernmental reforms that were initiated at the end of the 1990s.

The first section below provides information about the assignment of revenue and expenditure responsibilities among different levels of government in the Russian Federation. Then in section two both federal and regional policy on vertical and horizontal equalization is presented and analyzed. This is the core of the paper. The final section is devoted to a brief explanation of the results of the analysis and policy recommendations on corrections to the continuing reform of intergovernmental fiscal relations begun in 2000.

The methodology of this investigation is based on a critical analysis of the algorithms employed in the equalization mechanism carried out in Russia, with simulation of present schemes and possible innovations as proposed by this author.

The state of equalization in the Republic of Bashkortostan—one of eighty-nine subjects in the Russian Federation—is analyzed and conclusions are drawn about the current state of equalization among subjects of the federation; possible means for improvement are suggested. Bashkortostan is a very interesting region for the application of formula-based schemes of resource allocation for the following reasons. First, Bashkortostan is one of the five regions that have the largest volume of industrial and agricultural production. It is also a multiethnic republic with a population of four million and a territory which approximates that of Greece; 65 percent of the population lives in cities, 35 percent in rural areas. And finally, Bashkortostan is one of the ten regions which accounted for 63 percent of federal revenues in 2002.

List of Abbreviations

AO	autonomous okrug (type of subjects of the federation)
BC	Budget Code of the Russian Federation
EPT	enterprise profit tax
FG	federal government
FFSR	Fund for Financial Support of Regions
FFC	Federal Fund of Compensations
FL	federal law
GRP	gross regional product
HC	Hunter's coefficient
IBE	index of budget expenditures
ITP	index of taxable potential
LG	local government
MoF	Ministry of Finance
PIT	personal income tax
RB	Republic of Bashkortostan
RF	Russian Federation
RG	regional government (government of the subject of the federation)
RP	normalized per capita revenue
TTR	total taxable resources
VAT	value-added tax

2. TRENDS IN INTERGOVERNMENTAL FISCAL RELATIONS

In the Russian Federation there are three main governmental levels: federal, subnational (regions of the federation), and local governmental level. Within the latter there are up to three distinct local levels (depending on the subject of the federation), which provides the ground for five models of sub-regional government:

- Forty-eight subjects of the federation use the model that consists of one level of government of the subject of the federation and one level of self-government (Kurlyandskaya, Nikolaenko, and Shishkin 2002). Local governments are formed in cities and rayons, and create their own bodies in city districts and villages.
- Approximately a dozen regions have two levels of government of the subject of the federation and one level of self-government. The second level of regional government is formed from its local bodies in cities and rayons. Self-government is constituted in city districts and villages.
- Another dozen regions use a model which, like the previous one, includes two levels of government of the subject of the federation and one level of local self-government. However, the second level of regional government has representative and executive bodies. Legislation of Bashkortostan calls this level "state local government."
- About two dozen regions use the model with one level of regional government and two levels of local government. These latter two levels are referred to as "municipality of the first level" and "municipality of the second level."
- Moscow and Saint Petersburg have a special status in the RF. Both cities are subjects of the federation and are also localities. In Moscow there are no local governments at all.

This sophisticated system is further complicated by the fact that there are about forty closed administrative territorial formations—cities, which are under direct subordination to the federal government and have intergovernmental fiscal relations only with the federal center (Kurlyandskaya, Nikolaenko, and Golovanova 2001). This last issue is revealing of subnational government in Russia.

According to data from 1 September 2000, the total number of municipalities in Russia was 11,729. Of these, 1,488 of them were administrative rayons, 592—cities, 126—districts, 519—urban-type settlements, 8,790—rural administrations, and 210—village administrations (Zavarina 2001).

2.1 Assignment of Expenditure Responsibilities

According to federal legislation there are significant restrictions on the amount of discretion exercised by regional and local governments in expenditure policy. It is possible to classify these responsibilities into three groups:

- Federal laws on assignment of expenditure responsibilities;
- Obligatory expenditure norms introduced by the federal government;
- Federal mandates.

Federal legislation on assignment of expenditure responsibilities. The main idea of fiscal federalism is a clear-cut division of powers between the federal center and subnational units, so that both the levels have independent financial sources (Ferejohn 1998). In connection with this principle there are many problems in Russia. Neither the Federal Treaty nor the Constitution has clearly defined expenditure responsibilities in the Russian Federation. As Martinez-Vazquez and Boex consider (2001, 11), the *de facto* assignment of expenditure responsibilities that prevailed in Russia as of 1997 primarily complied with the general principle that each level of government should be responsible for expenditures within its geographical boundaries. However, there was, and at present is, some ambiguity in the assignment of responsibilities. The 2001 Program of Budget Federalism Development in the Russian Federation proposes development of expenditure assignment by 2005 (Table 3A.1 in Annex). From the table, it is obvious that many expenditure responsibilities were entrusted to two or three levels of government.

The general problem of delimiting expenditures in Russia is a mix of two notions: expenditure responsibilities and functions. Federal legislation says nothing about the functions of sub-federal governments, or their tasks in delivery of public services. For example, as a result of the vagueness and contradictions in federal legislation, local governments frequently refuse to fund teacher salaries and cite Article 87 of the Budget Code. This article states that the organization, maintenance, and development of educational infrastructure is a local responsibility. Local authorities then argue that "maintenance of educational infrastructure" refers exclusively to school buildings and school inventory, not to payment of teacher salaries.

The Federal Law on Financial Base of Local Self-Government (1997) supposes that every subject of the federation should adopt its own law to concretize the basic financial regulations of the federal law. However, the elaboration of such regional laws is very problematic in view of the fact that the main taxes that the regional government cedes to local government are federal. Every year the federal government controls and changes the sharing of not only the federal taxes but also of some regional and local taxes (Tables 3A.2–4 in Annex), and makes it impossible to fix a particular arrangement of intergovernmental fiscal relations within regions.

Obligatory federal expenditure norms. Obligatory expenditure norms introduced by FG leave little room for discretion on the part of subnational governments. For example, federal officials determine key points of educational policies such as the elaboration of curricula and selection of textbooks. The federal center also determines the set of expenditure norms and capacity specification to be used in regional and local service provision, such as the size of the child allowance. In reality, the degree of true discretion in expenditures at the regional and local levels is rather low. At present there is one set of expenditure norms which is uniformly applied across the RF—the so-called general tariff system of salaries in public organizations, issued and timely revised by the FG. This system regulates employee salaries in all the organizations that are funded by federal, regional or local government, except for employees of governmental administration bodies. Thus, the wages of school teachers, staff in public health institutions, university teaching staff, and workers of municipal enterprises—all are subjected to this system of norms. In other fields of budget expenditures, federal legislation formally allows using regional and local expenditure norms but introduces "minimal expenditure norms" which are obligatory for regional and local governments. Formally, sub-federal governments can introduce expenditure norms higher than the federal ones. However, in reality, they do not have revenues enough to execute assigned expenditures at the level required by minimal norms and therefore use federal minimal expenditure norms as grounds for receiving additional financial support from upper level governments. On account of this, the FG has discussed delegating to the regions the right of determining the salary tariff system.

Unfunded expenditure mandates. One of the main problems of the Russian intergovernmental system is unfunded mandates. This issue arose at the start of the transition period in 1992 when the federal center shifted expenditure responsibilities for many social welfare programs to subnational governments. The federal center did not plan budget reforms and gave up expenditure responsibilities to subnational levels not with the aim to decentralize, but rather to solve its own budget problems. Therefore, while shifting expenditure responsibilities, the FG did not want to provide subnational governments with corresponding revenue sources.

The following mandates were in existence by 2001 (Kovalevski 2001):

- Mandates concerned with passing some responsibilities to subordinate governments (mostly in the social security field)
- Classical mandates to keep new federal standards in accomplishing regional and local responsibilities (ecological and construction standards)
- "Voluntary" mandates when LGs have to keep federal legislation on social security even if they do not have corresponding authorities
- Additional funding of federal institutions such as tax offices to improve their work
- Indirect losses of LGs caused by the tax policy of the FG

The main issues of unfunded mandates were intensified by two factors: the drop of revenues in budgets on all levels and the adoption by the Federal Parliament of some additional laws whose implementation was imposed on subnational governments.

Thus, from 1992 to 1999 the State Duma (parliament) of the RF adopted twenty laws on social protection for different categories of the population. The primary federal mandates in 1998 are listed in Table 3A.5 in the Annex; the actual funding for all federal mandates was as high as 31 percent of total expenditure needs. The general number of laws granting subsidies and discounts for certain categories of citizens ran up to 120. Forty-five of the 120 laws had been adopted before 1992, but remained in force until 2000 (Kurlyandskaya 2000a). To illustrate the nature and complexity of these laws: 21 different categories of individuals were granted the right to receive medicine at preferential prices and 38 different categories of individuals could ride free on public transport.

After six years of transition, the Parliament began to comprehend the extent of damage arising from unfunded mandates and undertook measures to reduce their number. Thus, the 1997 Federal Law on Financ-ial Foundations of Local Self-Government prohibited RGs from issuing unfunded mandates to LGs. The Budgetary Code (BC) adopted in 1998, and which came into effect in 2000, prohibited unfunded mandates at every level of government. The Budget Reform Program for 2000–2005 included some mea-sures to eliminate unfunded mandates as shown in Table A3.6 in the Annex. One can see that the primary remedy against unfunded mandates is funding from the federal budget; full abolition of the mandate with the inclusion of the discount profit into the salary; refusal of discount and benefit ensured by mandates.

Before 2000, in addition to the target of equalization, the Federal Fund for Support of Regions (FFSR) had included subsidies for some federal mandates to regional and local governments. There were mandates for the implementation of the Federal Law on Veterans and the Federal Law on Welfare Payment for Citizens Having Children. The FFSR also contained subsidies earmarked for other special purposes:

- Financial support for the buying and shipping of oil, mineral oil, and fuel to the northern regions and to some other regions with a restricted period for delivering products/goods;
- Compensation for the tariffs on electricity in the regions of the Far East and Arkhangelsk oblast.

Since 2001, another fund, the Federal Fund of Compensations (FFC), has been established alongside the FFSR. The subsidies enacted through the Law on Welfare Payment for Citizens Having Children was passed from the FFSR to the FFC. So, the FFC has started to subsidize the regional obligations based on this federal law and another, Law on Social Security of the Disabled in the Russian Federation, which was previously an unfunded federal mandate. Since 2002 the FFC has subsidized a few regional and local obligations (Table 3A.7 in Annex).

Development of expenditure responsibilities assignment. After 1992, three processes could be observed in government expenditures:

- The steady decline of national production: the drop in GDP from 1992 to 1997 was over 40 percent and since the end of 1998 the economy has grown slowly.
- The share of expenditures of the consolidated federal budget—excluding extra-budgetary funds—dropped from 69 percent of GDP in 1992, to 33 percent in 1997, and finally to 24 percent in 2001 (see Table 3A.8 in Annex);
- The federal share of the consolidated budget declined, while the regional and local shares increased in the late 1990s (Figure 3.1).

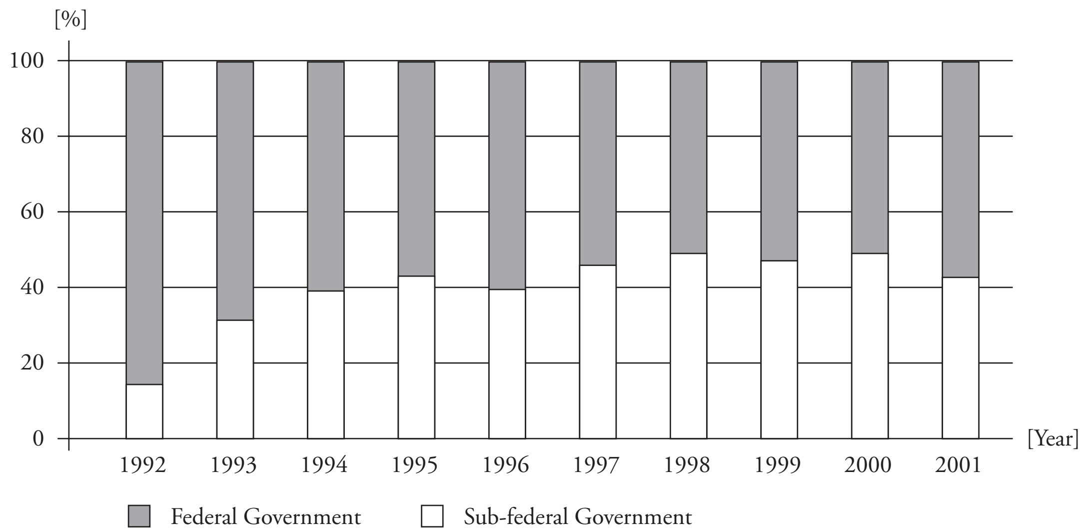
From Figure 3.1 we can see that roughly half of the consolidated federal budget was allocated to subnational governments from 1998 to 2000. The consolidated regional budget was spent by regional and local governments in equal parts (Figure 3.2). It seems therefore that decentralization of expenditure responsibilities occurred, but this is an ambiguous conclusion because in many expenditure areas substantive decisions were made by higher-level authorities—an issue that was briefly explained above.

During the transition period there were significant changes in the structure of expenditures. The most considerable shift took place in the category of national economy: in 1992 the FG share was originally 80.8 percent of consolidated federal budget expenditures, whereas by 1997 the FG share was reduced to 21.6 percent—in the middle of the transition period (Martinez-Vazquez and Boex 2001, 15). Regional expenditures in this category were mostly subsidies to industry and transportation, while local governments provided subsidies for housing services. For instance, Bashkortostan continued to finance the construction of a huge chemical plant, Polief, the funding of which had been stopped by the center after the disintegration of the USSR. Industrial policy still had a rather modest share in the federal expenditures in 2001 (3 percent, Figure 3.3). At the same time, support to industry accounts for the largest share of the total expenditures of the Bashkortostan consolidated budget (52 percent, Figure 3.4).

There were also significant shifts in the fields of education, culture and mass media, where the FG share decreased by nearly 30 percent. In some re-

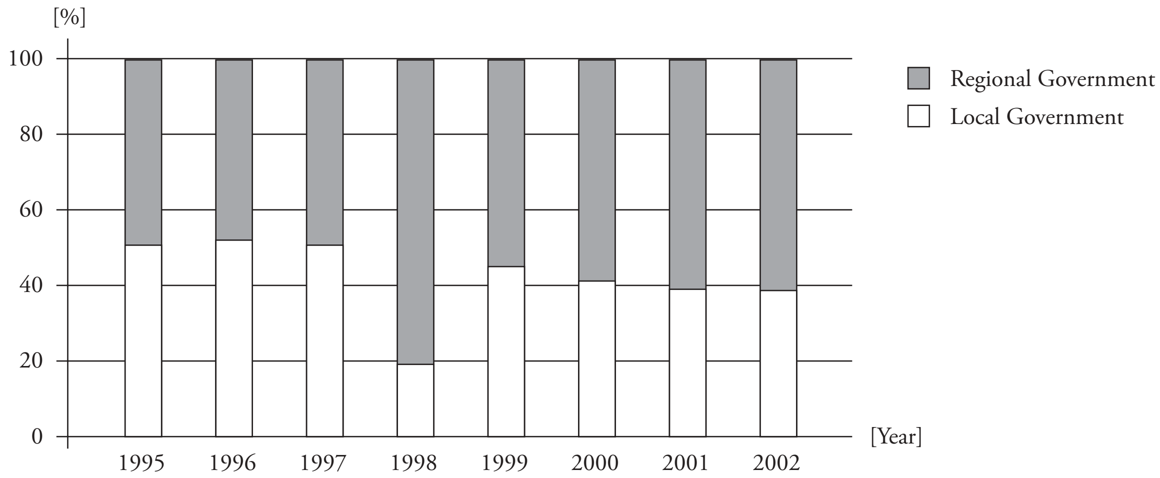
Figure 3.1

Sharing Expenditures between Federal and Sub-federal Governments



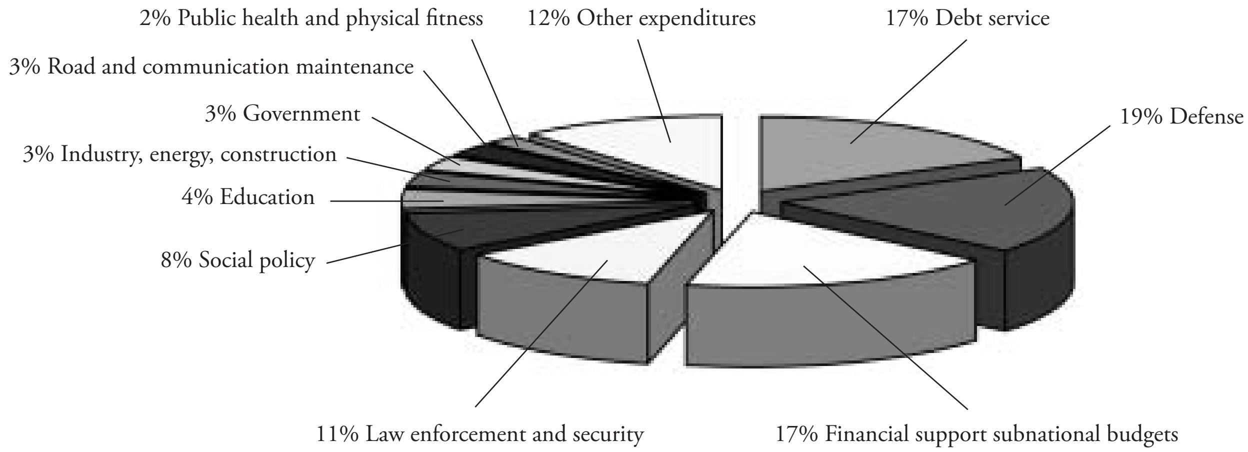
Source: Author's calculations on data of RF MoF, and OECD (Institute of Economic Analysis 1998; Posdnyakov, Lavrovskii, and Masakov 2000; OECD 2002).

Figure 3.2
Sharing Expenditures between Regional and Local Governments



Source: Author's calculations on data of RF MoF, and OECD (Institute of Economic Analysis 1998; Posdnyakov, Lavrovskii, and Masakov 2000; OECD 2002).

Figure 3.3
Structure of Federal Government Expenditures in 2001

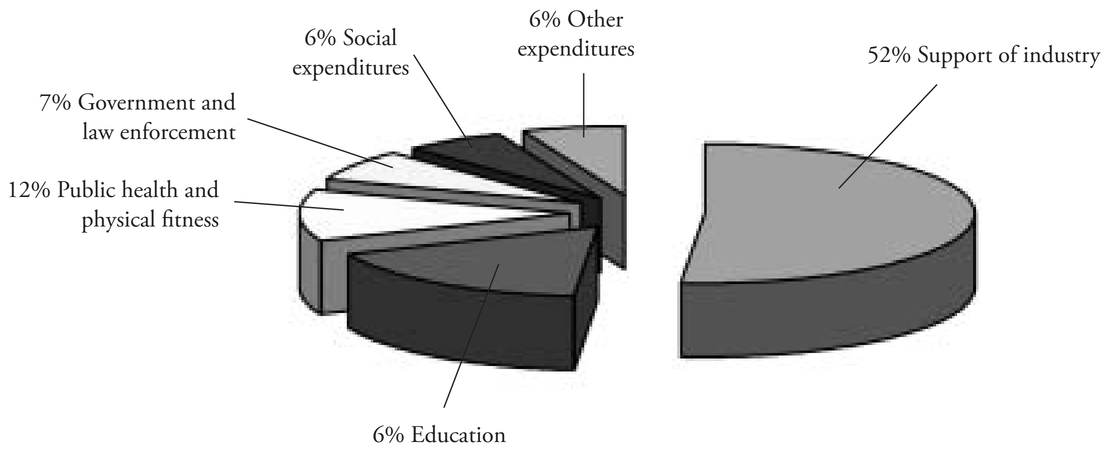


Source: RF MoF (2002).

gions, for example in the Republic of Bashkortostan, FG did not pay for culture and education (including higher education) according to the bilateral treaty (before 2000). In 2001, FG spent 4 percent of the federal budget on educational services; for the same year, Bashkortostan's expenses on education were 17 percent of its consolidated budget. This disparity reflects expenditure assignment, according to which the maintenance of primary and secondary schools is an LG obligation, and the maintenance of universities is the responsibility of FG (Table 3A.1 in Annex).

The federal share of expenditures on social protection—excluding pensions, benefits for disability, or the federal unemployment fund—dropped from

Figure 3.4
Expenditures of the Republic of Bashkortostan's Consolidated Budget in 2001



Source: Author's calculations using data from RB Statistical Department (2002).

71.8 percent in 1992 to 18.5 percent in 1995, but increased up to 41.3 percent in 1997. FG social policy expenditures remain the most important item of the federal budget, being 8 percent in 2001. Bashkortostan's social expenses were 6 percent of the consolidated budget for the same period.

2.2 Revenue Assignment

Revenue assignment on the federal level. The evolution of revenue assignment from 1992 to 2002 is summarized in Table 3A.2 in the Annex. Three developmental periods of revenue assignment can be identified in transitional Russia:

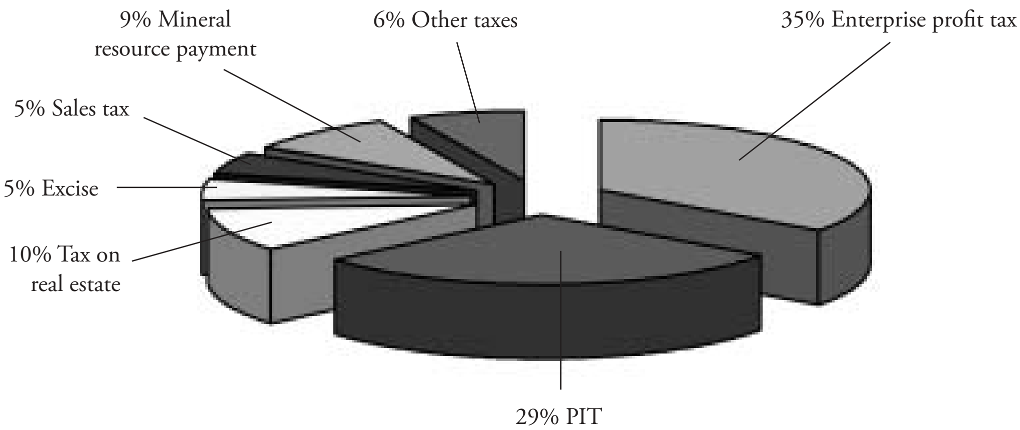
- 1992–1993: characterized by the disintegration of the old Soviet fiscal system, when the federal government had no program of reforms and regions had to build new relations with the center. For example, three ethnic republics Tatarstan, Bashkortostan, and Sakha (Yakutia) held to the single-channel inter-budget policy according to which they retained all tax collections and negotiated a single payment with the federal authorities. Additional revenues were partially retained by 24 of 89 regions. The Chechen Republic never paid any taxes.
- 1994–1997: a period during which the federal government attempted to put in good order its fiscal relations with the regions. For example, the first version of a formula-based allocation mechanism of federal financial support was introduced during this period.
- 1998–2000: a period of reforms.

The main innovations of the last period arise from the Tax Code, which was adopted in 1998 and came into effect in 2000 (Table 3A.9 in Annex). The Tax Code called for the following changes:

- VAT, PIT, EPT, and excises remained federal taxes but were to be shared with subnational governments.
- Regional and local governments lost their right to collect many old taxes of the mid-1990s, but obtained a few new taxes in return.
- RGs again gained a degree of revenue autonomy, but to a lesser extent than in the 1994–1996 period. They had had the power to introduce a final sales tax of up to 5 percent for goods not taxed by excise, and up to 10 percent on excised goods.

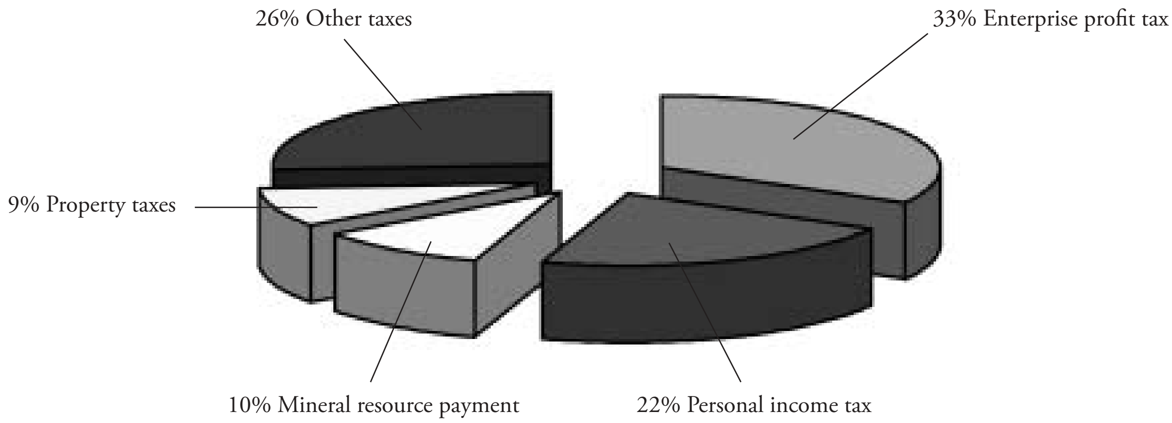
VAT, EPT, custom duties, PIT, excises, and the mineral resource payment comprise the main rev-

Figure 3.5
Revenues of the Regional Budgets in 2001



Source: Kovalevskaya 2002.

Figure 3.6
Tax Revenues of the Republic of Bashkortostan's Consolidated Budget in 2001

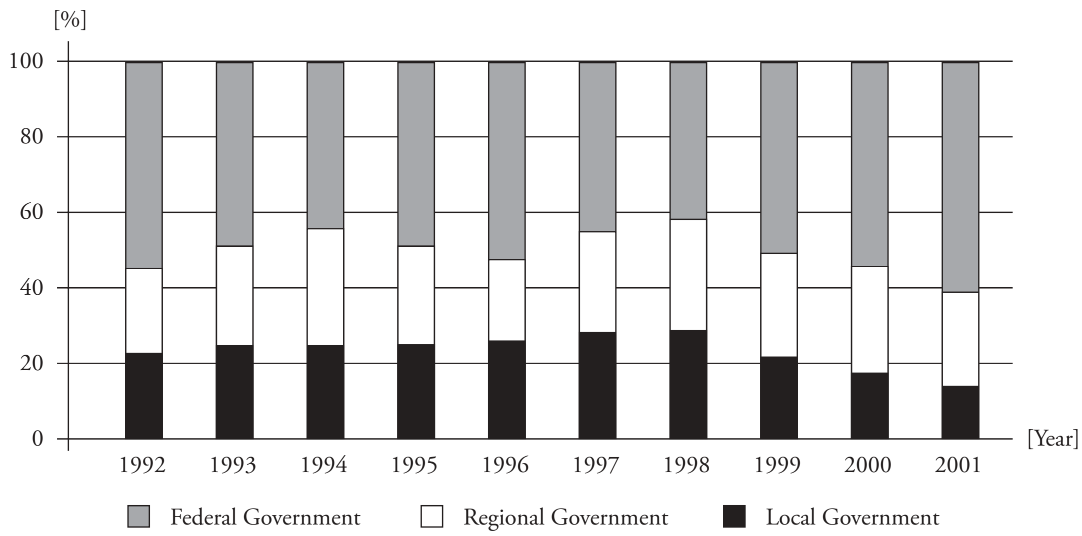


Source: Author's calculations using data from RB Statistical Department (2002).

enues of the Russian budget system. VAT and EPT accounted for practically half of all revenues of budgets on all levels. The greater part of VAT which provides more than a quarter of all Russian revenues was assigned to FG, but as of 2001, 100 percent of VAT has been assigned to FG and this tax has become the main tax source of the federal budget: 46 percent in 2001, and 45 percent for the first six months of 2002. Other taxes accounted for the following shares of regional budgets in 2001: EPT, 35 percent; PIT, 29 percent; the tax on real estate, 10 percent; the mineral resource payment, 9 percent; excises, 5 percent; and the sales tax, 5 percent (Figure 3.5).

EPT ranks fourth (12 percent) among the federal tax sources and first (35 percent) among the regions (Figure 3.5); this tax also ranked first (33 percent) among the revenues of the Bashkortostan consolidated budget in 2001 (Figure 3.6). PIT, a federal tax, was shared with sub-federal budgets in the proportion 1:99, and since 2002, it accrues entirely to sub-federal budgets. This tax provides a significant part of RG revenues—29 percent in 2001. In Bashkortostan, PIT pro-

Figure 3.7
Revenue Distribution among Federal, Regional and Local Governments



Source: Author's calculations on data of the RF MoF and OECD (Institute of Economic Analysis 1998; Posdnyakov, Lavrovskii, and Masakov 2000; OECD 2002).

vided 22 percent of revenues in 2001 (Figure 3.6) and increased to 36 percent in the first six months of 2002.

As the tax system evolved, changes were made annually in the distribution of revenues among the federal, regional, and local governments (Figure 3.7). The share of FG in the consolidated budget was on the decline until 1998, by which time the decentralization of revenues in the RF had reached levels common in most federal countries. Then, in accordance with a policy of centralization of revenues, the federal share increased to 60 percent. In comparing the shift in federal/regional/local total revenue sharing proportions—50:25:25 in 1998 to 60:25:15 in 2001—it is easy to conclude that the centralization of revenues took place primarily at the expense of LGs. Some authors argue that revenue sharing is even more centralized; for instance, Vladimir Lisenko (2002), deputy chairman of the Duma's Committee on Federalism and Regional Policy, suggests that the federal/regional/local total revenue sharing proportion is rather 63:27:10.

Sub-federal revenues. According to the Budget Classification (1996), revenue sources of subnational budgets consist of the following: regional and local taxes and duties; regional and local non-tax revenues; ceded federal taxes and non-tax revenues; shared federal taxes; conditional and unconditional grants. These are summarized in Tables 3A.4 and 3A.9 in the Annex.

The Russian tax system is very sophisticated with so-called ceded taxes and the sharing of not only the federal and regional taxes, but also of local taxes, among three or more levels of the budget system. Nine percent of the total tax revenues of the federal budget derives from local taxes, whereas 3 percent comes from regional taxes; on the other hand, revenues from federal taxes are allocated not only to the federal budget, but also to regional and local budgets in the proportion 68:20:12 (Kovalevskaya 2002, 21).

2.3 Some Problematic Issues in Intergovernmental Finance

Relations between the federal and regional governments. Federal budget and tax legislation formally regulates intergovernmental fiscal relations between the three governmental levels. However, in reality many complications arise in this field, which are discussed in the literature (Bird, Ebel, and Wallich 1999; Wallich 2000; Martinez-Vazquez and Boex 2000, 2001).

The ambiguity of the expenditure assignments as prescribed by the Constitution of the Russian Federation was partly lessened through bilateral agreements between the center and the regions. For example, on 3 August 1994 the Republic of Bashkortostan signed with the federal center the Treaty of the Russian Federation and the Republic of Bashkortostan on Distribution of Objects of Jurisdiction and Mutual Delegation of Authorities. Besides, every year, beginning in 1993, Bashkortostan established agreements with the federal center, which required that the Republic take up some federal expenditure responsibilities, for example, university expenditures and the construction and maintenance of federal roads (initially federal responsibilities). Bilateral treaties between federal and regional governments resulted in nonuniform expenditure assignments across regions. Besides, great differences existed among regions in the division of responsibilities between the governmental tiers. For example, Bashkortostan implements republican programs on paving rural village roads, bringing natural gas to villages and industrial settlements, and telecommunications. These problems are the responsibility of local administrations in most other regions in the RF.

According to federal legislation intergovernmental fiscal relations between the federal and subnational governments are constituted as symmetric relations despite their different names: republic, oblast, autonomous oblast, kray, autonomous okrug; and also despite the fact that some subnational units are parts of other similar units. The practice is quite different.

Federal equalization policy affects 88 of 89 subnational units of the federation, with the exception of the Chechen Republic where federal financial support is calculated by count-up (RF MoF 2001).

There is a peculiarity in the sharing of federal taxes amongst subjects of the federation that overlap or are parts of one another. Thus, in 2002, the tax on the use of mineral resources is shared in such regions in the following proportion: the federal budget receives 74.5 percent; oblast or kray receives 5.5 percent, and the autonomous okrug—which is part of the oblast or kray—receives 20 percent. In other regions this tax is shared in the proportion 80:20, where the federal budget receives 80 percent and the regional budget receives 20 percent. Moreover, the Republic of Tatarstan and the Republic of Bashkortostan had special sharing rates until 2000. There is evidence of a so-called asymmetrical federation.

Finally, FG has direct fiscal relations with 40 closed administrative territorial formations. They are excluded from the basic equalization policy of the federal center, and their budgets are not included in consolidated budgets of the region to which they belong.

Relations between regional and local governments. There are many LGs in the Russian Federation that have no fiscal discretion. Their budgets are only an estimate of expenditures approved by upper level government (regional or local). This pattern is at the center of discussions between federal and regional legislators. The Federal Law on the General Principles of Self-Government (1995) permits the existence of a municipality on the territory of another municipality. At the same time, the law prohibits the subordination of municipalities to one another. Many legislators understand this law to be a prohibition of administrative subordination, which, however, is not applied to budgeting. Thus, the Federal Law on Foundations of Budget Rights (1993), which lost validity only in 2000, had permitted the existence of a few-tier local budget system. The Federal Law on Foundations of Tax System (1991) declares that local tax revenues might be either revenues of LGs in cities and rayons, or revenues of district, town, and village municipalities dependent on the decision of city or rayon governments. Here the discretion of lower level LG is limited by decisions of upper level LG. For example, budgets of the LGs of city districts can be approved and monthly funded by the city government.

As a result of these legislative collisions, the four main models of governmental structure in the RF result in vertical budget systems that vary from three to five tiers: including the federal level and two to four tiers on the sub-federal level. Therefore, municipalities are very different from the perspective of budget opportunities. In 2000, the total number of local administrations in Russia was approximately 29,500. Of these, 12,261 had federal registration as municipalities; 11,691 had elected councils; 11,209 LGs possessed municipal property; and only 4,705 administrations were real municipalities having some budget discretion and the right to introduce their own taxes according to federal legislation (Kurlyandskaya and Nikolaenko 2001b).

3. EQUALIZATION SYSTEM

Vertical and horizontal imbalances and effective fiscal equalization are very significant economic issues for Russia due to the Soviet legacy and the prolonged absence of an intelligible federal equalization policy for the greater part of the transition period. The state policy pattern in this field depends on the degree to which society is democratized. If a country was initially centralized, as in the case of Russia, this policy then depends on the readiness of the center to offer real autonomy and discretion in decision-making processes to subnational governments. Russia has made some steps in this direction only since the end of the 1990s.

3.1 Vertical Imbalance and Its Equalization

Using the measures developed by Hunter (1977), the so-called Hunter's coefficient (HC), it can be concluded that Russia has a high degree of vertical balance with an HC #1 value located between that of Germany and the Netherlands, and an HC #2 which approximates Germany's (Table 3.1). Further, the distribution of revenues and expenditures among the federal, regional, and local levels were rather close to each other during the period from 1992 to 2001. However, this would be an erroneous conclusion because these coefficients do not take into account the degree of discretion that subnational governments have over their own revenue sources.

In actuality, in view of mandates and the federal determination of the norms of expenditure needs discussed in the previous section, the federal center controlled about 90 percent of the consolidated federal budget in 1999. Roughly speaking, both regional and local governments had discretion in only about 10 percent of combined expenditures (Lavrov 2000).

Figure 3.8 and Table 3.2 show that the distribution of revenues and the control of expenditures before the 2000–2005 reform (RF Government 2000) was characterized by:

- Decentralization of revenue sources
- High centralization of expenditure control at the federal level
- High imbalance between revenue sources and the amount of real discretion subnational governments could exercise in the determination of ex-

Table 3.1

Measures of Vertical Fiscal Imbalance for the Subnational Sector: International Comparison

Country	Coefficient #1	Coefficient #2
Russia[a]	0.270	0.841
Belgium	0.156	0.512
Denmark	0.172	0.611
Estonia[c]	0.088	0.686
Finland[d]	0.191	0.654
Germany[b]	0.244	0.794
Latvia[c]	0.069	0.491
Lithuania[c]	0.111	0.869
Netherlands	0.288	0.345

Note: [a] Based on 1997 data.
[b] Subnational sector includes Laender as well as local governments.
[c] Based on 1994 fiscal data.
[d] Coefficients calculated using 1990 local expenditure data.

Source: Martinez-Vazquez and Boex 2001.

penditures and regulation of quality and quantity of public services

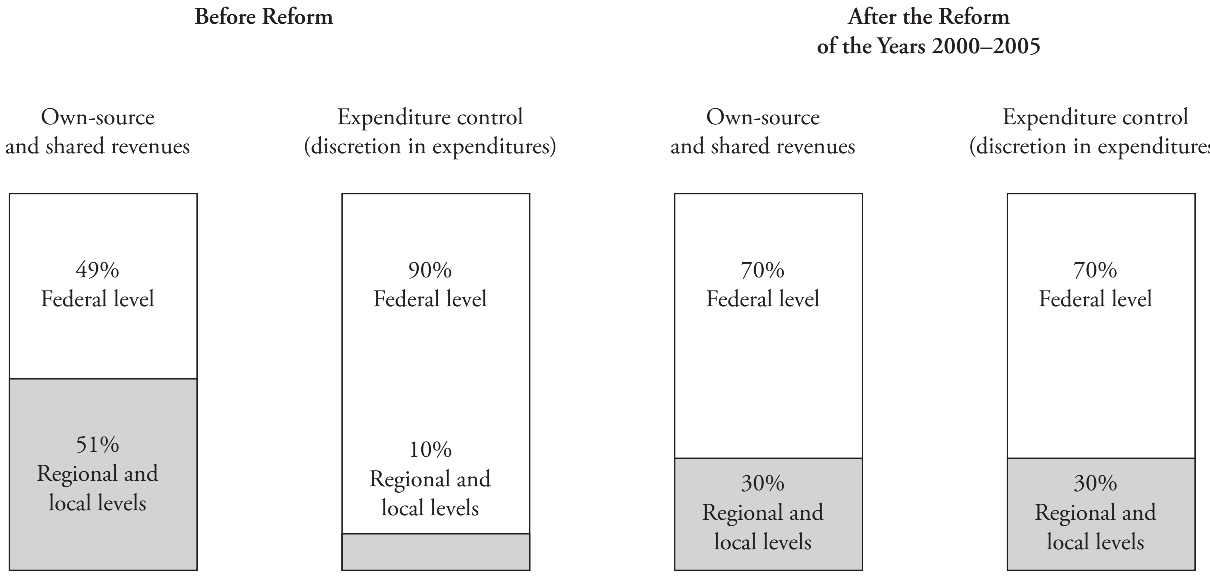
Moreover, the relatively high degree of vertical balance between the federal and regional levels is not replicated between regional and local levels. In 1999, before starting the last budget reform, LG own taxes covered only 13 percent of their expenditures (Kurlyandskaya and Nikolaenko 2001b).

Within the 2000–2005 reform, the intention is to increase the federal share of total revenues from 49 percent to approximately 70 percent. On the other hand, there is a corollary plan to increase the discretion of subnational governments in expenditures. Thus, in 2001 HC #1 and HC #2 became equal, respectively, 0.324 and 0.833. The value of HC #2 in 2001 is practically the same as it was in 1997. This means that there still remains a need to equalize transfers to counter vertical imbalance. While computing HC #1, shared taxes were taken into account, although they cannot be considered as own taxes because they are often changed. Almost all federal shared taxes were taken into account in the calculation of HC #1: EPT, PIT, joint tax for small business, tax on imputed earnings, tax on resources. Their sharing rates have been changed rather frequently by FG and only the sharing rate for excises remains unchanged since 1994; this is why they can be seen as "quasi" own taxes. The value of HC #1, computed in this way for 2001, is higher than that for 1997. It means that the contribution of shared taxes in countering the problem of vertical imbalance decreased over that period. The vertical fiscal gap was bridged by a combined use of shared taxes and direct federal transfers.

Tax-sharing. Federal and regional taxes are used as instruments of both vertical and horizontal equalization:

- VAT—a federal tax, 15 to 25 percent of which was assigned to regional governments for equalization before 2000. As of 2001, 100 percent of VAT accrues to the federal budget.
- PIT—a federal tax, 84 to 100 percent of which has been assigned to RGs.
- EPT—a federal tax, two-thirds (66 percent) of which has been assigned to RGs and LGs.
- Excise duties—the federal taxes, different kinds of these have been assigned to the federal and local governments at sharing rates of either 50 or 100 percent.

Figure 3.8
The Degree of Federal Expenditure Control and Sub-federal Expenditure Discretion Before and After the Reform of the Years 2000–2005



Source: Presented according to Lavrov (2000).

- Regional taxes—the sales tax; the tax on property of organizations (a 50 percent share is assigned to FG, another 50 percent to the local level, according to federal legislation).

The Federal Law on the Financial Base of Local Self-Government (1997) introduces some conditions on the use of these taxes for equalization purposes. RGs have to apply at least 50 percent of PIT and 5 percent of EPT to equalization policy within their territory of jurisdiction. This same FL also demands that RGs introduce some minimal rates of federal shared taxes that could be assigned to LGs on a constant basis. There are additional restrictions that create a need for federal control, but only complicate equalization policy within the subjects of the federation.

Conditional and unconditional grants. Conditional grants are used for funding federal mandates and for executing federal law. Regional budgets are used as transit accounts for transmitting the funds to LGs. For example, conditional grants are allocated from the FFC, which amounted to 1.3 billion USD in 2002, and is used for the provision of seven social benefits (Table 7 in annex). Unconditional grants are used mostly for horizontal equalization. On the federal level they are disbursed from the FFSR—which totaled 4.75 billion USD in 2002. There is also an account named "funds reimbursed on mutual settlements of accounts, including compensations from regional budgets of the additional expenditures, occurring as a result of decisions of the government of a subject of the Russian Federation." This account appears during execution of the local budget, but not at the moment of its adoption. Additional financial support is transferred through this account. For example, in Bashkortostan the financial flow through this account varied from 20 to 50 percent of LG total revenues. Conditional and unconditional transfers and funds disbursed through the latter account comprised respectively 1.3, 6.6, and 17.3 percent of the total expenditures of the budget of Bashkortostan in 2000.

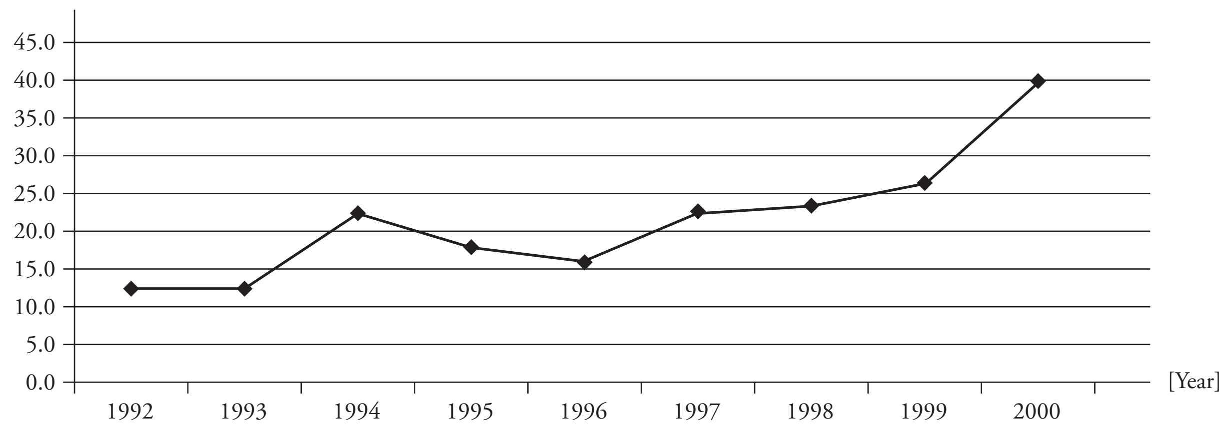
3.2 Horizontal Interregional Disparities and Their Equalization

The absence of a comprehensive equalization policy and/or reform program on the federal level in the first years of transition has resulted in fiscal disparities among regions, which increase from year to year. For example, the difference between regions with minimum and maximum values of per capita consolidated regional expenditures jumped from 12 times in 1992 to 40 times in 2000 (Figure 3.9).

Huge disparities in economic development amongst the subjects of the federation cause an acute

Figure 3.9

Horizontal Fiscal Imbalance: Ratio of Maximum per Capita Consolidated Regional Expenditures to the Minimum, 1992–2000



Source: Data for 1992–1997: Martinez-Vazquez and Boex 2001. Data for 1998–2000: author's calculation based on data from RF MoF.

Table 3.2
The FFSR Share in Federal Expenditures.

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002
Percentage	6.1	8.3	9.0	10.0	7.8	5.9	6.7	8.4	7.5

Source: Lavrov 2001, 106; and author's computation based on RF MoF data (2001a, 2002a).

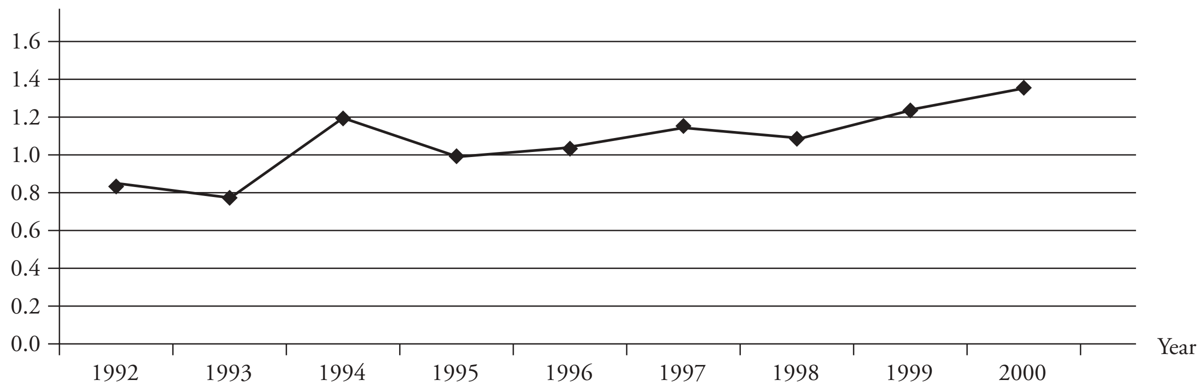
problem in identifying donors and recipients, which is not only of economic concern but also has political resonance in the Russian Federation. Answers to the questions, who is a donor and who is a recipient and to what degree, depend on the set of factors that one takes into account. For example, Lavrov's (2001) computation by formula, which compares FG support to the regions with FG tax and non-tax revenues on the territory of the regions, identifies 49 donors out of 89 regions from 1995 to 1999.[2] On the other hand, if we take into account FG direct expenditures in regions, the number of donors is reduced to 33 in 1998, and 44 in 1999. The whole picture is again altered to a significant extent if we take into account redistribution through extra-budgetary funds; the main ones of which are the Pension Fund, the Fund of Social Insurance, the Fund of Employment, and the Fund of Obligatory Health Insurance. Revenues and expenditures of extra-budgetary funds are equal to half the revenues and expenditures of the RF consolidated budget and are commensurable with revenues of regional budgets. For example, in 1999 revenues of regional departments of the extra-budgetary funds gained 96.4 percent of regional own revenues (Lavrov 2001,150).

The development of horizontal fiscal equalization took place in several stages: (1) before 1993, equalization of expenditure needs; (2) 1994–1999, equalization of revenues; (3) in 2000 first attempt to equalize fiscal capacity; and (4) since 2001 equalization of fiscal capacity. The main source of equalization funds is the FFSR established in 1994. The dynamics of the FFSR share in federal expenditures is shown in Table 3.2.

Coefficient of variation for per capita consolidated regional expenditures also increased for 1992–2000 (Figure 3.10).

In present-day Russia equalization policy on the subnational level is region-specific and mostly depends on the legislation of the subnational units. Federal legislation provides only a framework within which the RF regions carry out their own equaliza-

Figure 3.10
Horizontal Fiscal Imbalance: Coefficient of Variation of per Capita Consolidated Regional Expenditures, 1992–2000



Source: Data for 1992–1997: Martinez-Vazquez and Boex 2001. Data for 1998–2000: author's calculation based on data from RF Ministry of Finance.

tion schemes. However, the main problem in this field is the instability of tax assignment that is determined by the federal authorities. Irregularity of tax-sharing between the federal and regional governments has caused annual fluctuations in regional and local budget revenues. In view of these fluctuations, subnational governments have been unable to practice their own formula-based equalization policy.

3.2.1 Equalization of Revenues (1994–1999)

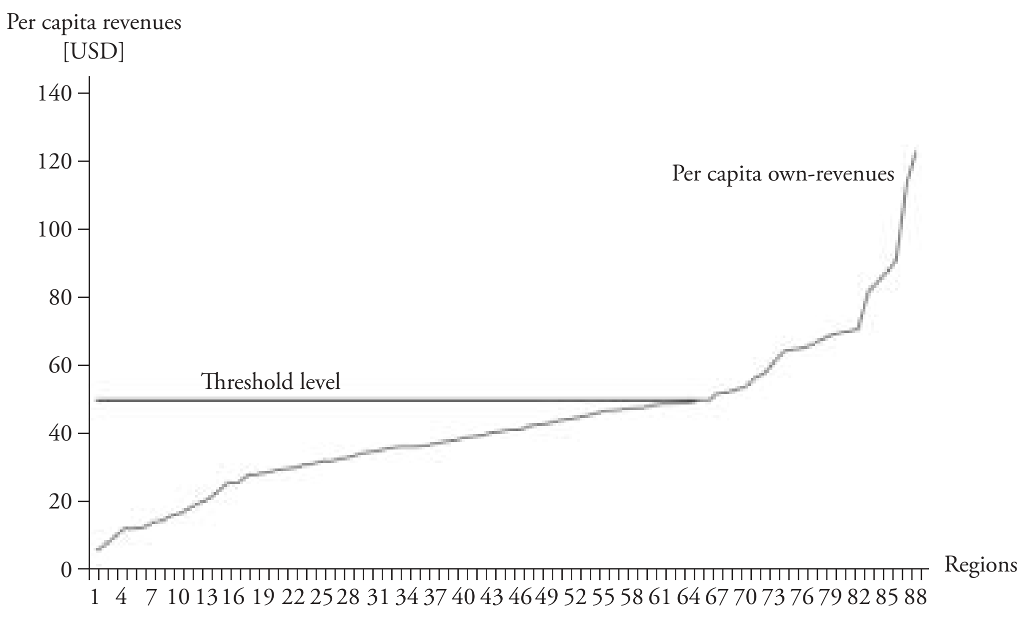
The first attempt to introduce transparency, stability, and objectivity into the equalization system occurred in 1994 when the system of negotiated federal subventions to subnational units was replaced by the formula-driven mechanism of equalization transfers. That year the FFSR was established with two main goals: (a) to fix the sum of transfers to be allocated to subnational units; and (b) to base the calculation of transfers upon a set of formulas.

The first formula-based mechanism for the allocation of transfers amongst RGs was based on the calculation of actual revenues and expenditures and did not incorporate fiscal capacity and expenditure needs. The result of this approach to equalization in 1999 is shown in Figure 3.11. This figure represents the distribution of per capita own revenues of regions corrected by the index of expenditures.

We can see that transfers from the FFSR were allocated so as to ensure a minimal degree of per capita revenues in regions where own revenues were insufficient. But the first version of the mechanism of fiscal equalization remained complicated, unstable, and nontransparent; formula-based transfer allocation was not fixed and remained dependent on negotiations. In addition to this, the mechanism did not appear to accomplish its main goal: to equalize per capita revenues among regions. And as one can see from Figure 3.11, regions with a low level of own revenues were not given incentives to develop their economies and work to increase their tax base.

As the FFSR accumulates funds for horizontal equalization, it determines to a great extent the equalizing capacity of the whole system of transfers. For example, since 1994 the share of two funds, the FFSR and the Federal Fund for Compensations (FFC), in total federal financial support had increased by 2002 from 10.5 percent to 75.5 percent (Table 3A.10 in Annex). But still the two funds equalizing capacity

Figure 3.11
Fiscal Equalization in 1999 According to the Principle "Assured Revenue Minimum"



Source: Lavrov 1999, 2001.

has not been very sizeable. In 1995 and 1996, the portion of FFSR grants was respectively 8.4 and 6.9 percent of subnational revenues. Since 1996 the size of the FFSR has been determined annually as a percentage of total tax collections of the federal budget, excluding some exterritorial revenues (Table 3A.11 in Annex).

This means of defining the FFSR is imperfect because of the uncertainty it generates in future transfer levels for subnational units, and as a consequence, for the future transfers and subventions for LGs. It might have led, and very likely did lead, to inefficient decisions on the part of regional and local governments regarding allocations. Moreover, it presumably reduced the overall stability of the intergovernmental fiscal relations system and hampered development of the economy. From the point of view of FG, an advantage of this mechanism was the budgetary flexibility it offered in times of budgetary crises.

One evident suggestion for improving the system is to fix the FFSR funding rate for a period of a few years, for example, for three years as suggested by Martinez-Vazquez and Boex (2001). The fixed rates could then only be altered in case of a stipulated emergency. This would mean that any alterations could be made only in the direction of diminishing of rates. In practice, the rate has hardly changed over the last three years. However, legislation is necessary to ensure a predictable size of the FFSR. Further, begun in 2001, the process of separating funds like the FFC from the FFSR, it seems, is not complete—the 2002 FFSR consists not only of equalization transfers, but also of different specific subsidies like subventions to support the delivery of certain goods to the northern regions.

Instability and unpredictability have inhered in practically all types of federal financial support, as well as in total financial support. So, as one may see from Table 3A.10 in the Annex, the share of total federal support in total federal expenditures was 6.87 percent in 1992. This share then rose up to 14.87 percent by 1994, fell to 10.97 percent in 1995, increased again to 16.35 percent by 1997, then fell again to 9.37 percent, and finally rose to 13.74 percent by 2001.

The set of formulas applied to the FFSR in the first years were unable to achieve the declared goals of transparency, objectivity, and stability.

3.2.2 Allocation of Transfers from the FFSR in 1999

A new approach to equalization funds disbursement was introduced in 1999. The main principles of the new transfer allocation techniques were as follows:

- Introduction of a solid formula-based system of fund allocation from the FFSR, in place of the earlier negotiated mechanism.
- Assistance to regions on the basis of the level of per capita own revenues which are adjusted for variations in the historical level of budget expenditures.

As one can see from Figure 3.11, in 1999 the value of the threshold of normalized per capita revenue was 49 USD. This approach and the formulas used in the 1999 methodology had a few disadvantages:

- Providing a threshold level of revenues for regions with a low level of own revenues did not give them any incentive to develop their economies and increase own revenues (Figure 3.11). Thus, 68 of 88 regions received transfers with resulting per capita revenues equal to the threshold level of 49 USD.
- The methodology used the actual revenues as a base for further computation of transfers. Using current revenues for the transfer calculation gave regions an incentive to raise less revenue, not more.

In their analysis of the 1999 equalization system, Martinez-Vazquez and Boex (2000) identified a further three disadvantages:

- The possibility of a misallocation of resources arose from theoretically calculated norms that can be insufficient for the delivery of some public services. This is a case when norms do not reflect real expenditures for the provision of certain public goods in the region. For example, real per capita cost of primary education in Bashkortostan is greater than in Sverdlovsk oblast because the latter has a smaller share of rural population. The other danger that accompanies the use of budgetary norms is an increased likelihood of budget extension with less attention given to budget performance and the level and quality of public goods.

Figure 3.12
Algorithm of Allocation of Transfers from FFSR in 1999

Formation of the FFSR—the Fund for Financial Support of Regions as 14 percent of the Federal government's tax revenues excluding customs and revenues of earmarked budget funds

Computation of IBE_i—the index of budget expenditures of region i as the ratio of the total expenditure needs for region i and the region with the lowest overall expenditure needs:

$$IBE_i = \frac{\sum_{j=1}^{S} H_{ij}}{\min_i \sum_{j=1}^{S} H_{ij}}$$

H_{ij}: is the per capita budget norm for region i and expenditure category j

S: is the number of expenditure categories H_{ij}

Computation of normalized per capita revenue

$$normR_i^{PC} = \frac{R_i}{N_i \text{ x } IBE_i}$$

R_i: is the amount of own-revenues of the consolidated budget in region i

N_i: is the number of inhabitants in region i

Transfers for regions were calculated according to the formula:

$$t_i = \left(\overline{normR}^{PC} - normR_i^{PC} \right) \text{ x } IBE_i \text{ x } N_i$$

$\overline{normR}^{PC}$: is the threshold of normalized per capita revenue. Its value was chosen so that the sum of the transfers should be equal to the size of the FFSR:

$$\sum_{i=1}^{T} t_i = FFSR$$

Source: Presented according to Martinez-Vazquez, Boex (200).

Figure 3.13

Algorithm for Allocation of Transfers from FFSR in 2000

1. Formation of the FFSR—the Fund for Financial Support of Regions as 14 percent of the Federal government's tax revenues excluding customs and revenues of earmarked budget funds

↓

2. Computation of IBE_i—the index of budget expenditures of region i as the ratio of the total expenditures of region i:

$$IBE_i = \frac{\sum_{j=1}^{S} EN_{ij} \Big/ N_i}{\sum_{i=1}^{T} \sum_{j=1}^{S} EN_{ij} \Big/ N_{RF}}$$

N_i: is the number of inhabitants in region i

N_{RF}: is the number of inhabitants in the Russian Federation

T: is the number of regions

S: is the number of expenditure needs

EN_{ij}: estimation of expenditure need j in region i computed by the formula: $EN_{ij} = P_i \times \lambda_j \times q_{ij} \times N_{ij}$

where P_i: is the cost of living index in region i

λ_j: is the per capita norm of funding public service j

N_{ij}: is the population, which needs public service j in region i

q_{ij}: is the correction factor for N_{ij} for the structure of population

↓

3. Computation of total taxable resource for 1997 data

$$TTR_i^{97} = \sum_{(j)} a_j \times GRP_i^j$$

GRP_i^j: are Gross Regional Product (value added) produced in region i in sectors j: industry, construction, agriculture, services

a_j: are the shares of bite of taxes from four sectors for consolidated regional budgets

↓

4. Adjustment of the value of each region's total taxable resource for conditions of 2000

$$TTR_i^{2000} = 1.194 \times TTR_i^{97}$$

↓

5. Adjustment of the value of each region's total taxable resource within 20 percent limitation of the TTR deviation from actual revenues

As a result of this action carried out by complicated formula, TTR was within limits $1.2 \times R_i > TTR_i > 0.8 \times R_i$,

where R_i: the total actual revenues of region i in 1998, corrected to the tax conditions of 2000

↓

6. Computation of normalized per capita TTR:

$$TTR_i^{PC} = \frac{TTR_i}{N_i \times IBE_i}$$

↓

Continued to 7

Continued from 6

7. The FFSR was divided into three parts:

$$FFSR = FFSR1 + FFSR2 + FFSR3$$

where parts of FFSR1 and FFSR2 were defined as:

$$FFSR1 = 0.8 \times (FFSR - FFSR3)$$

$$FFSR2 = 0.2 \times (FFSR - FFSR3)$$

In accordance with the division of the FFSR into three parts the value of total transfer to each region also included three parts: $T_i = T(1)_i + T(2)_i + T(3)_i$

8. Computation of amount of facilities that region i needs to lift its Normalized Per Capita Total Taxable Resource up to the average level:

$$\Delta TTR_i = (normTTR^{PC}_{a\ ver\ age} - norm\ TTR^{PC}_i) \times IBE_i \times N_i$$

9. Computation of Transfer 1 proportionally the gap ΔTTR_i and according to the size of FFSR1

$$T(1)_i = FFSR1 \frac{\Delta TTR_i}{\sum_{i=1}^{T} \Delta TTR_i}$$

10. Computation of Transfer 2 which insures a certain minimal Normalized Per Capita Total Taxable Resource within the limits of FFSR2

$$T(2)_i = \left(normTTR^{PC}_{min} - normTTR^{PC}_i\ (T(1)_i)\right) \times IBE_i \times N_i$$

$normTTR^{PC}_i\ (T(1)_i)$: is Normalized Per Capita Total Taxable Resource after receiving transfer $T(1)_i$

11. Computation of Transfer 3 from FFSR3 for regions which received less federal financial assistance in 1999 than in 2000

$$T(3)_i = 1.18 \times F^{1999}_i - T(1)_i - T(2)_i$$

F^{1999}_i: is the federal financial assistance for region i in 1999 corrected by inflation factor (= 1.18) for 2000

12. After computation of Transfers 1, 2, 3 they were reduced by 2 percent and the resulting amount was allocated to the Republic of Dagestan as additional financial assistance.

Source: Author's presentation based on data from RF MoF (1999).

- Flawed fiscal management incentives arose from using physical norms. For example, a region richer in resources would have more school buildings and thus would receive more generous transfers for education according to physical norms, while poorer regions would receive correspondingly fewer resources.
- The use of expenditure norms defined by federal government bodies in the absence of clear and transparent formulas may be too complex and administratively costly. Besides, overly complex and nontransparent procedures for the estimation of norms return the equalization system *de facto* to a system of politically negotiated transfers.

3.2.3 Allocation of Transfers from the FFSR in 2000

In 2000 considerable modifications were made to the methodology for the allocation of transfers from the FFSR. Three main notions are relevant to the core transfer calculation: (1) total taxable resource of a region (TTR) and its derivatives such as a per capita TTR; (2) tax revenue of a region (R); and (3) index of budget expenditures in a region (IBE). Some innovations were introduced with this methodology. The first consisted of two types of transfers that were introduced in this same year. The second concerned the use of the new notion of TTR, instead of actual revenues. The algorithm of the transfer allocation is presented in Figure 3.13.

It is first necessary to make the following remarks on the modified algorithm:

1. The computation of TTR for 2000 was initially based on data from 1997. This data was used because 1997 was the year prior to the 1998 financial crisis in Russia and the data better reflected the economic conditions of the regions. Therefore coefficients a_i in the formula (box 3) use GRP and tax collection information for 1997 (Table 3.3).

Thus, the formula of box 3 took the following form for 1997:

$$TTR_i^{97} = 0.265 \times GRP_i^{ind} + 0.163 \times GRP_i^{const} + 0.066 \times GRP_i^{agriar} + 0.113 \times GRP_i^{service}$$

2. The expenditure needs taken into account by the 2000 methodology are divided into three groups:

- Maintenance of public utilities
- Normative expenditure needs: primary and secondary education, infant day care, public health service, social security, culture and art, public conveyances and communication, law enforcement, and public administration
- Additional expenditure needs: child allowance; expenditure needs for implementation of the Law on Veterans; expenditure needs for implementation of the Law on Social Security of the Disabled; maintenance of habitation and cultural objects handed over to municipalities; maintenance of

Table 3.3
GRP and Shares of the Bite of Taxes for Economic Sectors in 1997

Sector	GRP [Billions Rubles]	Bite of Taxes [Billions Rubles]	Including		a_i
			Tax Proceeds	Increasing Tax Debt	
1	2	3	4	5	6=3/2
Industry	655 010	173 435	149 664	24 371	0,265
Construction	182 308	29 684	24 842	4 842	0,163
Agriculture	91 865	6 077	4 636	1 442	0,066
Services	816 682	92 656	83 751	3 945	0,113

Source: RF MoF (1999).

the new net and additional personnel of social security offices; maintenance of financial offices; and subsidies for electricity

3. Regions which had $T(3)_i > 0$ received the third type of transfer. There was only one problem. It was impossible to know the amount that was needed for assignment of T(3) in advance. Therefore, it was necessary to carry out an iterative procedure:

   Step1: Choose first approximation of FFSR3

   Step2: Based on FFSR3 to compute FFSR1 and FFSR2 with formulas in box 7

   Step3: Compute transfers T(1), T(2), and T(3) by formulas in boxes 9, 10, and 11

   Step4: In case the sum

$$\sum_{i=1}^{T} T(3)_i$$

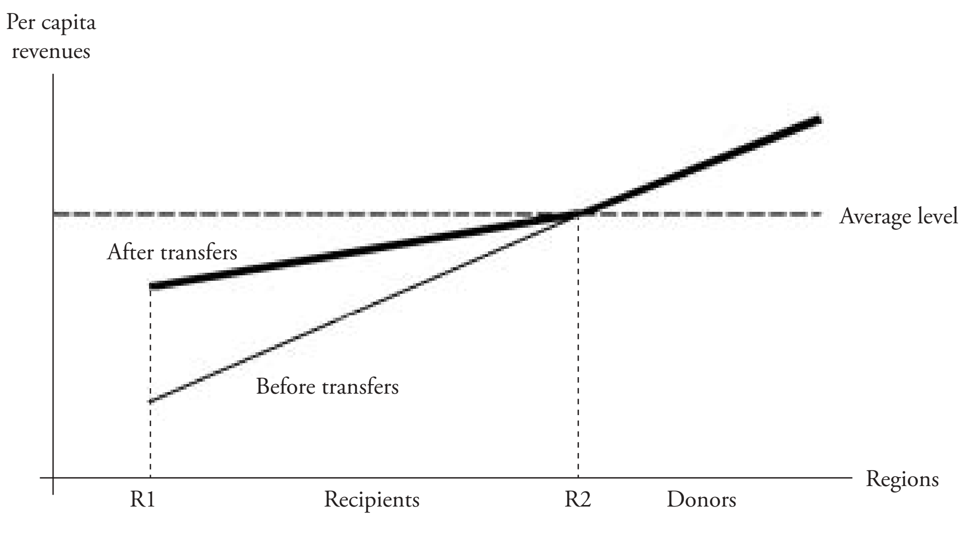
   exceeded or, on the contrary, did not obtain the full amount of FFSR3, it would be necessary to decrease or increase the latter and repeat steps 1–3 of this procedure.

4. Reallocation of 2 percent of transfers from all regions into the Republic of Dagestan in 2000 was caused by the need of additional financial assistance due to a force majeure.

5. The allocation of transfers from the FFSR in 2000 not only covered equalization functions but also subsidies for some federal mandates. Thus, three conditional transfers were included among the total number of transfers: child allowance; financial support for the purchase and delivery of oil, mineral oil, and fuel to the northern regions and to similar regions with limited periods of delivery; and compensation for the tariffs on electricity in the regions of the Far East and the Arkhangelsk oblast.

The key points of the 2000 methodology could be summarized as follows. TTR was intended to reflect the fiscal capacity of regions. In practice, as one can see from the algorithm in Figure 3.13, in the computation of TTR a kind of modified GRP (mGRP) was used that does not have the limitations for estimating fiscal capacity (Ma 1997; Martinez-Vazquez and Boex 2000). However, the 20 percent limitation on TTR deviation from actual revenues (box 5 in Figure 3.13) reduces this effect, and as a result TTR in the 2000 methodology reflects something like an average between real fiscal capacity and actual revenues. Nevertheless, the computation of expenditure needs (box 2) in the 2000 methodology was better than in

Figure 3.14
Proportional Equalization Principle



Source: Lavrov (2001).

the previous mechanism and satisfied the common approaches.

The primary idea behind the new allocation system was the creation of incentives for regions to boost their tax efforts and develop their regional economies. One means of implementing this idea is shown in Figure 3.14.

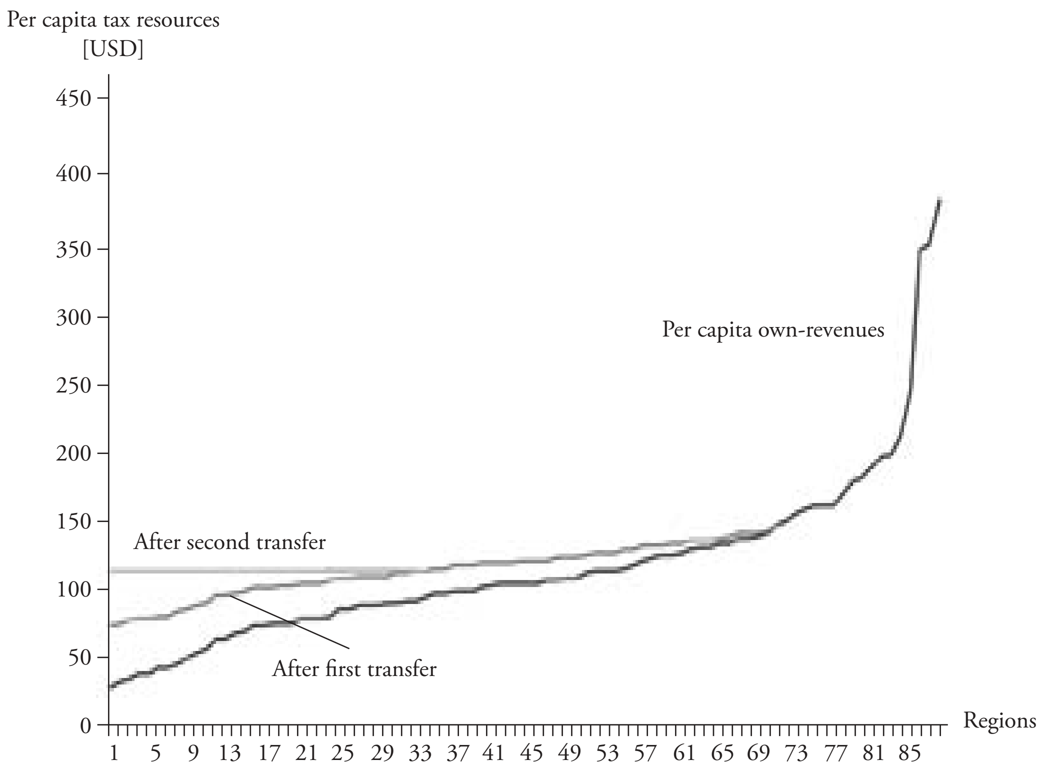
Here the region in position R1 has an incentive to increase internal revenues because in this case its total revenue increases and the region changes place and occupies point R2, where it receives more revenues after the allocation of transfers then when it occupied point R1. This may be possible if some change in regional own revenues is not entirely offset by changes in shared taxes and transfers like in Figure 3.11. But this system has one significant disadvantage: the region in position R1 after receiving transfers may still have insufficient fiscal resources for the provision of public services at some minimal level. In order to overcome this problem, the 2000 methodology combined the idea of Figure 3.14 with the approach of the 1999 methodology (Figure 3.11). Thus, the conception of transfer allocation from the FFSR in 2000 pursued the following goals:

- Generating incentives for subjects of the federation to increase their tax efforts and enlarge their own tax base (by allocation of Transfer 1, box 9);
- Insurance of some minimal level of total revenues for regions in order that all regions might obtain a certain minimal level of public services (by allocation of Transfer 2, box 10);

The results of the allocation of transfers in 2000 are shown in Figure 3.15.

Regions numbered 34–71 received FFSR transfers in proportion to the gap between some threshold and per capita own tax resources corrected by the index of expenditures, so that the total amount of revenue is raised according to the growth of their own revenue.

Figure 3.15
Fiscal Equalization in 2000



Source: Author’s presentation based on RF MoF data (see also Table 3A.12 in Annex).

The first 33 regions were equalized until a certain minimal level (USD 104 in 2000). So, incentive exists for regions 34–71 to increase their own revenues. And finally, the rate of total revenue growth in these regions is less than the rate of growth of their own revenues. The seventeen regions from 72–88 did not receive any transfers from the FFSR.

In summary, one can classify the regions into three groups:

- Recipients with a high level of own revenue insufficiency (regions 1–33)
- Recipients with a middle level of own revenue insufficiency (regions 34–71)
- Donors (regions 72–88)

According to the two rules (two goals) of the equalization system mentioned above, the FFSR transfer money has to be divided into two main parts (FFSR1 and FFSR2 in box 7). The first part comprises 80 percent of FFSR resources while the second part comprises 20 percent. This proportion between the two parts was not changed in 2001 and 2002.

3.2.4 Allocation of Transfers from the FFSR for the Years 2001 and 2002

Some stabilization of the federal equalization mechanism has been observed since 2001. Essentially, the 2001 methodology and the 2002 methodology do not differ. The main steps of their algorithm are presented in Figure 3.16.

Like the 2000 methodology, the goal of the first part of the FFSR was to motivate regions to increase their own revenues, and the goal of the second part was to ensure the delivery of a certain minimal level of public services. In accordance with the division of the FFSR into two parts, the value of a total transfer to each region also included two parts: $T_i=T(1)_i+T(2)_i$

In comparison with the 2000 methodology, the algorithm in Figure 3.16 contains innovations in the computation of the Total Taxable Resource, which seems more complicated and incomprehensible. The methodology (RF MoF 2000, 2001a) does not provide formulas for a and V_i—clarifying this problem requires some mathematical transformations. First, it is necessary to formalize the definitions of a and V_i. From their wording given in boxes 2 and 3 the following formulas appear:

$$a = \frac{\sum_{i=1}^{T} R_i}{N_{RF}}, \qquad V_i = \frac{\dfrac{GRP_i}{N_i}}{\dfrac{GNP_{RF}}{N_{RF}}}$$

where

R_i: is tax revenue in region i, predictable for the next year

GRP_i and GNP_{RF}: GRP in region i and gross national product of the RF in sense of value-added.

Substituting these formulas for the formulas in boxes 2 and 3 of Figure 3.16 and making some transformations, it is possible to obtain the formula for TTR_i:

$$TTR_i = \beta \times \frac{mGRP_i}{N_i}$$

where

β measures the average effective level of regional taxation:

$$\beta = \frac{\sum_{i=1}^{N} R_i}{GNP_{RF}}$$

and $mGRP_i$ is modified GRP which reflects the industrial structure of region i:

$mGRP_i = GRP_i \times C_i$

Now it is easy to see that TTR does indeed measure per capita fiscal capacity as was originally proposed by Martinez-Vazquez and Boex for the 1999 methodology.

The formulas in boxes 4 and 6 (Figure 3.16) are more complicated than those of 2000 (boxes 8 and 10 in Figure 3.13). However, it is possible to show mathematically that they are essentially the same and, therefore, that it is reasonable to use the formulas here.

Figure 3.16

Algorithm of Allocation of Transfers from FFSR in 2000 and 2001

1. Forming FFSR and computation of IBE like in the 2000 Methodology

↓

2. Computation of Index of Tax Potential of region i:

$$ITP_i = V_i \times C_i$$

↓

3. Computation of Per Capita Total Tax Resource:

$$TTR_i^{PC} = A \times ITP_i$$

↓

4. Computation of the amount of facilities that region i needed to lift its Normalized Per Capita Total Taxable Resource up to the average level

$$\Delta TTR_i = A \times \left(1 - \frac{ITP_i}{IBE_i}\right) \times IBE_i \times N_i$$

↓

5. Computation of Transfer 1 proportionally the gap ΔTTR_i and according to the size of 0.8 x FFSR

$$T(1)_i = 0.8 \times FFSR \; \frac{\Delta TTR_i}{\sum_{i=1}^{T} \Delta TTR_i}$$

↓

6. Computation of Transfer 2 which insures a certain minimal Normalized Per Capita Total Taxable Resource within the limits of 0.2 x FFSR2

$$T(2)_i = \left(TTR_{min}^{PC} - \frac{(A \times ITP_i + t(1)_i)}{IBE_i}\right) \times IBE_i \times N_i$$

↓

7. Picking out some conditional transfers from the amount of transfers for financial support of buying and delivering products to the northern regions and similar regions with limited periods of delivery of products; compensation of the tariffs for electricity in the regions of the Far East and the Arkhangelsk oblast

V_i : is per capita value added in region i divided by per capita value added in the Russian Federation

C_i : is a factor of industrial structure of region i which is computed by the consecution of very sophisticated formulas that reflect the regional industry structure in detail

A : factor A is per capita average tax revenue throughout all regions of Russia. For example, A was equal 5,413 rubles for 2001

TTR_{min}^{PC} : is a possible value up to which total revenues can be lifted within (0.2 x FFSR)

$t(1)_i$: per capita transfer 1 for region i

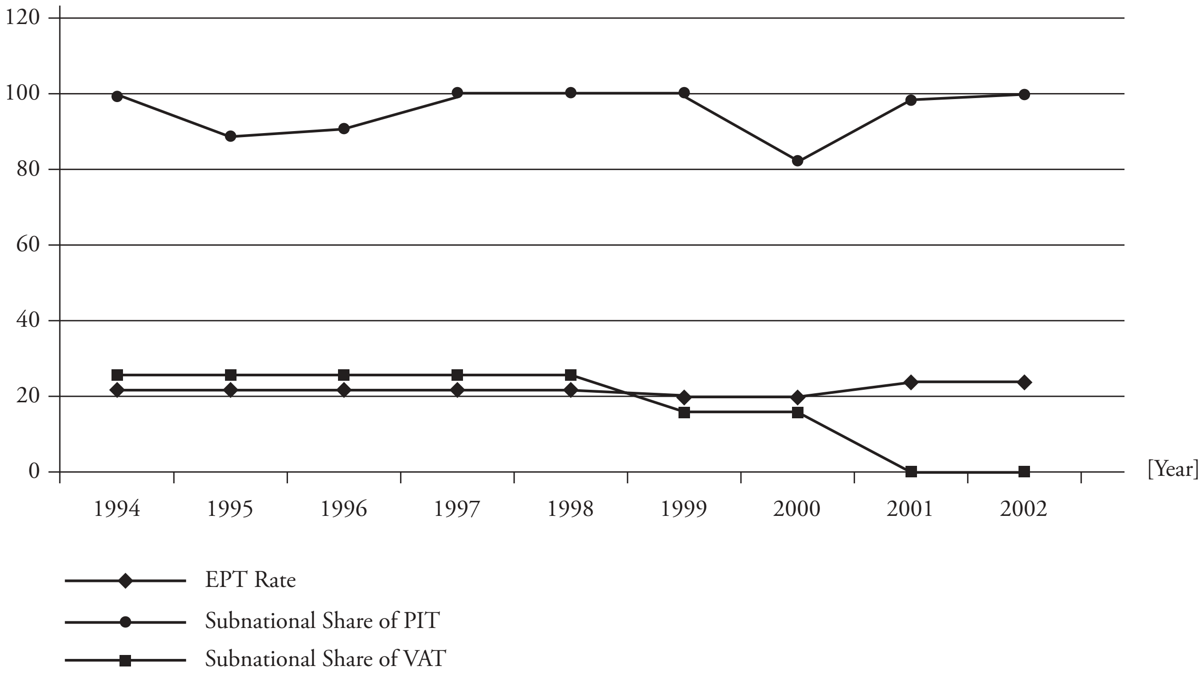
Source: Author's presentation based on data from RF MoF (2000, 2001).

3.3 Horizontal and Vertical Equalization on the Sub-regional Level: The Case of Bashkortostan

As discussed above, HC #1 and HC #2 computed for both 1997 and 2001 show a low degree of vertical imbalance between federal and sub-federal governments. However, the situation is different with regard to vertical fiscal imbalance on the sub-regional level. Thus, these same coefficients calculated for LGs in 2001 show significant vertical imbalance: HC #1 = 0.142 and HC #2 = 0.676 (based on the data of RF MoF 2002b). In the calculation for HC #1, not only the federal shared taxes (EPT, PIT, joint tax for small business, tax on imputed earnings, tax on resources) were taken into account, but also regional shared taxes (enterprise property tax, sales tax) and the local shared tax (land tax), because the sharing rate of all three is defined by FG. The low value of HC #1 testifies to the fact that federal and regional governments actively use their right to manipulate shared taxes. As a result, LGs have no opportunities to predict and plan their revenues for the future. One might expect RGs to "freeze" at least the proceeds from regional shared taxes. Indeed, FG recommends that RGs do just this—in addition to introducing formula-based horizontal equalization mechanisms.

However, the instability in federal equalization schemes during the last decade did not allow territories an opportunity to build formula-based equalization mechanisms on the subnational level, not within subjects of the RF, nor on the local level. The rates and shares of the main taxes—EPT, PIT, and VAT—assigned to subnational governments were changed rather frequently and to a considerable extent over the last ten years (Figure 3.17). Instability in tax-sharing between FG and RGs caused annual fluctuations in regional and local budget revenues. As a result, except for a dozen oblasts, at present the subjects of the federation do not employ formula-based equalization schemes. In fact, the regions show a high degree of reluctance toward new approaches in public finance administration. Still, the federal center encourages regional governments to develop formula-based mechanisms for the computation of transfers for LGs.

Figure 3.17
Changes of EPT Rate and Shares of VAT and PIT Assigned to Subnational Governments



Source: Author's presentation on the basis of the RF laws on the budget.

Thus, in 2000 the RF MoF issued the "Interim Methodological Recommendations on Regulating Intergovernmental Relations in the Regions of the Russian Federation" (RF MoF 2000a) and an "Explanatory Note" (RF MoF 2000b) with the above recommendations. The Russian government issued, in August 2001, a Decree on the Program of Budget Federalism Development in the Russian Federation for the Period until 2005 (RF Government 2001). Both these documents state that intergovernmental relations on the subnational level have the following imperfections:

- Unclear and irrational distribution of responsibilities between the local and regional levels
- Disparity between revenues and expenditures entrusted to localities
- Ineffective mechanism for allocation of fiscal support

Bashkortostan and the majority of the other subjects of the federation practice the following procedure of allocation. First, the republican and local governments, independently of each other, compute the size of the gap between the estimated tax and non-tax revenues of local governments and their expenditure needs for the next year. Then they come to an agreement through bargaining. Local governments tend to underestimate their revenues and overestimate expenditure needs. For the forecast of revenues and expenditures in the coming year, finance departments of the republican and local governments use the obsolete methodology of the Soviet period. Thus, the forecast of future revenues is based on an estimation of the actual execution of the previous year's budget. This estimation is adjusted by different coefficients which reflect changes in taxes and rates. The finance departments also take into account the forecast of the performance of enterprises on the territory of their jurisdiction. Trying to gain an objective estimation of expenditure needs, the republican government attempts to compute the minimal social norms for each expenditure need. Obviously, this computation activity and the regional and local negotiations take up an enormous amount of time and incur additional costs for the governments, which cannot be justified.

Table A3.13 in the Annex shows the structure of republican and local government expenditures in the Republic of Bashkortostan for 2000. LGs spent about 30 percent of expenditures on education needs and over 17 percent on public health service needs. Apparently, this is a accurate picture for other years too, and LGs did not have enough of their own revenues to maintain these services and needed the financial support of the republican government. Thus, in 2000 the republican government spent a quarter of its budget on financial support for LGs. As Table 3.4 illustrates, horizontal equalization policy allows for the mitigation of differences in budget revenues among rayons and cities of Bashkortostan. In 2000, before equalization, the ratio between the minimum and maximum value of the per capita own revenues (tied transfers inclusive) was 11 times, after allocation of equalization transfers the ratio decreased to 4 times, and then further deceased to 3 times after allocation of compensations for additional expenditure mandates. Figure 3.18 demonstrates the results of all types of financial support for LGs from the government of the Republic of Bashkortostan in 2000. In the graph, LGs are ordered according to the growth of their per

Table 3.4

Horizontal Equalization in the Republic of Bashkortostan, per capita terms, in 2000

	Revenues Before Allocation of Tied Transfers	**Revenues, Tied Transfers Included**	**Revenues, Tied and Equalizing Transfers Included**	**Total Revenues (with Compensations of Mandates)**
Min value [USD]	13.9	22.2	68.5	114.9
Max value [USD]	256.7	256.7	264.0	307.2
Mean value [USD]	68.3	74.5	109.0	163.7
Coefficient of variation	0.8	0.7	0.4	0.2

Source: Author's computations on the basis of RF MoF data.

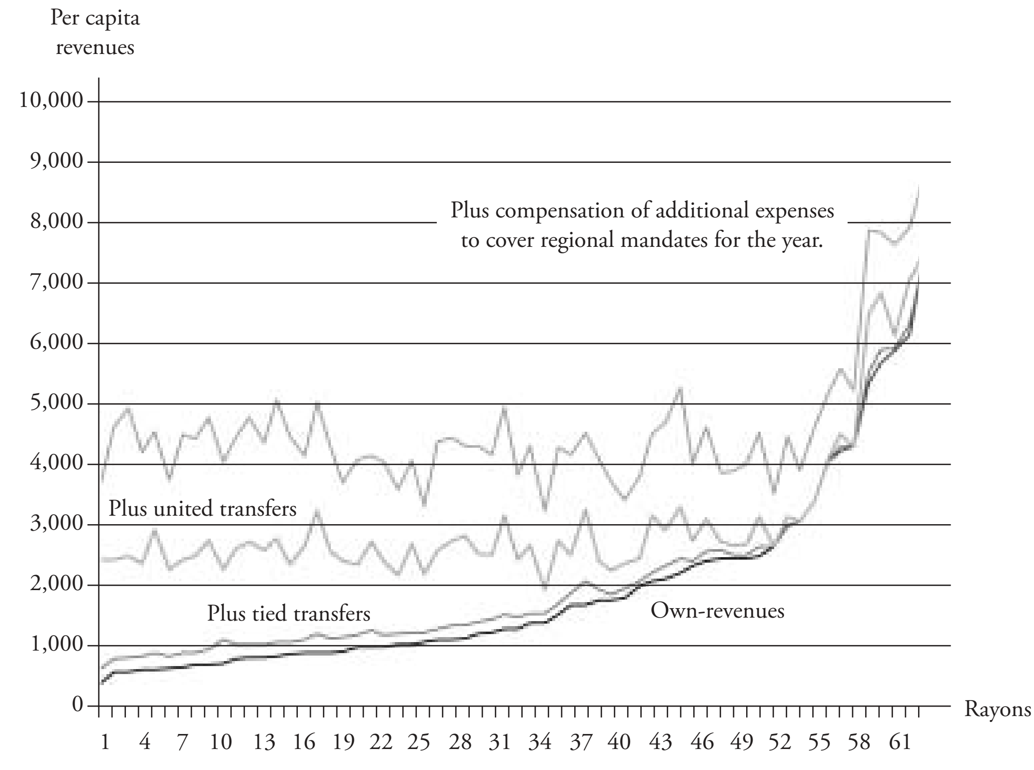
capita own revenues (in rubles). One can see that tied transfers—such as child allowance—increased local revenues slightly but did not change the picture of revenue disparity among localities. Untied transfers and compensations for additional expenditure mandates contributed significantly to the equalization of revenues and lifted per capita total revenues up to 3,500–5,000 rubles for the majority of localities.

However, the method for allocating financial support is not transparent. Only tied transfers such as the child allowance are allocated on the basis of the number of consumers; but these transfers amounted to only 5 percent of total republican support for localities in 2000. The allocation mechanism of untied transfers is based mostly on providing the current infrastructure with adequate funding to meet the level of actual expenditure needs, or, where they exist, the level of minimal norms of expenditure needs. Thus, in the computation of financial support, the Republic of Bashkortostan MoF takes into account the following data:

- The average number of days of maintenance required for one hospital bed throughout a single year and the number of beds planned for the year; e.g., for 2002, the number of planned beds was 49,442 and each was to be occupied for 320 days on average.
- The number of visits to a physician.
- The number of places in homes for the elderly and in boarding schools.
- Actual expenditures on libraries, museums, theatres, clubs and other cultural and sports facilities.

Tied and untied transfers are determined by the annual budget law of the Republic of Bashkortostan, but they do not constitute the entirety of financial support granted. Thus, tied and untied transfers were

Figure 3.18
Fiscal Equalization in the Republic of Bashkortostan in 2000



Source: Author's computations on the basis of Bashkortostan MoF data.

equal to 31 percent of the total financial support for localities in 2000. The other two-thirds of support was allocated through the special account for funding additional mandates. These funds are allocated throughout the year and the method of their allocation by MoF is not transparent.

As a result of this approach in Bashkortostan, despite the high level of equalization noted above, there were significant distortions in per capita total revenues after allocation of all types of financial support (Figure 3.18). Thus, in 2000, one rural rayon with per capita own revenues of 583 rubles ended up with 4,624 rubles after receiving all support, whereas another rayon with a beginning per capita revenue figure of 1,373 rubles had only 3,216 rubles after receiving all support. The same inconsistency can be observed in those subjects of the RF who have a large number of little municipalities, e.g., Tyumen oblast (Kurlyandskaya and Nikolaenko 2001b).

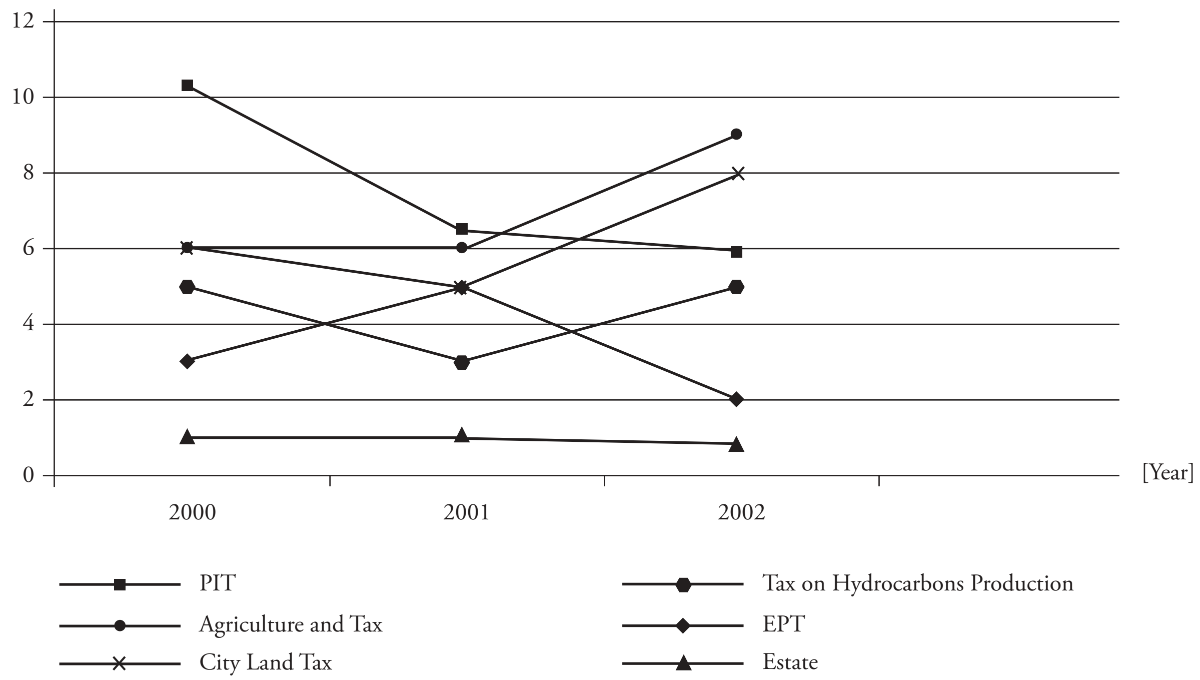
The other important problem concerns the stability of the tax rate. It has already been mentioned (Figure 3.17) that Russia's tax system was unstable over the last decade. Figure 3.19 demonstrates the situation with the taxes assigned by the government of Bashkortostan to Ufa—the capital of the republic—which provides approximately half of the republic's collected taxes. There have been permanent changes in the EPT and PIT sharing rates and in the rate of tax on real estate assigned to Ufa (LG shares of hydrocarbon excises, urban and agricultural land taxes have been reduced by a factor of ten so that they will be comparable with other tax rates in the figure).

In summary, the Bashkortostan case illustrates the imperfections of intergovernmental relations in Russia's regions, as highlighted by the RF MoF. To overcome these, the MoF recommends that RGs employ the following measures:

- Formalization of the equalization process amongst subnational units. The use of a formula with indicators for the unbiased measurement of revenue capacity and expenditure needs is recommended for transfer allocation.
- Avoidance of unfunded mandates. Localities should receive subventions for expenditures delegated from a higher level, e.g., the federal and regional levels.

Figure 3.19

Changes of Tax-Sharing Rates in Ufa



Source: Author's computations on the basis of the laws on the budget of the Republic of Bashkortostan for 2000, 2001, and 2002.

Figure 3.20

Algorithm of the Formula-Driven Mechanism of Equalization in a Subject of the Russian Federation

1. Computation of the amount of financial support for localities by the formula:
FS = (Total expenditures of the localities) – (Own revenues of the localities)

Total expenditures of the localities and their own revenues are summed up for all localities using the data of the previous year.

N^{EDU}, N^{HEALTH}, N^{SOCIAL}: the numbers of consumers of educational, health, and social services in the RB

Ni, N: the numbers of inhabitants in locality i and in the RB;

N_i^{EDU}, N_i^{HEALTH}, N_i^{SOCIAL}: the numbers of consumers of educational, health and social services in locality i

E^{EDU}, E^{HEALTH}, E^{SOCIAL}, E^{OTHER}, E: expenditures for educational, health and social services, and others in the RB

2. Computation of federal and regional government mandates and total amount of resources for mandates

3. Sharing of the amount of financial support among three funds:
a) fund for extraordinary situations
b) fund for conditional support and special investment programs
c) fund for unconditional support of localities

4. Computation of the index of budget expenditures

$$IBE_i = \frac{\dfrac{N_i^{EDU}}{N_i}}{\dfrac{N^{EDU}}{N}} \times \frac{E^{EDU}}{E} + \frac{\dfrac{N_i^{HEALTH}}{N_i}}{\dfrac{N^{HEALTH}}{N}} \times \frac{E^{HEALTH}}{E} + \frac{\dfrac{N_i^{SOCIAL}}{N_i}}{\dfrac{N^{SOCIAL}}{N}} \times \frac{E^{SOCIAL}}{E} + \frac{E^{OTHER}}{E}$$

5. Computation of the tax potential (fiscal capacity) in each locality:

$$FC_i = \sum_{j=1}^{K} BI_j \times t_j$$

FC_i : the tax potential in locality i
B_{ij} : tax base of tax j in locality i
R_{ij} : actual tax collection of tax j in locality i
K : number of taxes
L : number of localities
t_j : the average representative rate of tax j:

$$t_j = \frac{\sum_{i=1}^{L} R_{ij}}{\sum_{i=1}^{L} B_{ij}}$$

6. Computation of each locality's per capita fiscal capacity normalized by the index of budget expenditures

$$FC_i^{PC} = \frac{FC_i}{N_i \times IBE_i}$$

Choice of means of equalization by the subject of the federation

7.1 Full equalization: fulfilling the gap between fiscal capacity and expenditure need

7.2 Partial equalization: allocation of transfers in proportion to the gap between fiscal capacity and expenditure needs

7.3 Relative equalization: allocation of transfers in proportion to the gap between each locality's per capita fiscal capacity normalized by the index of budget expenditures and its average level throughout all localities

7.4 Combination of partial and relative equalization

8. Insurance or the absence of insurance of a certain minimal level of the sum of financial support and per capita fiscal capacity, normalized by the index of budget expenditures

Source: Author's presentation on the basis of RF MoF data (2000a).

- Revenue capacity of localities should not be estimated on the basis of actual taxes collected over prior years, but estimates should be based rather on the size of taxable resources.
- Expenditure needs should be calculated on the basis of the number of budget service customers (unemployed, elderly, disabled, and the like).

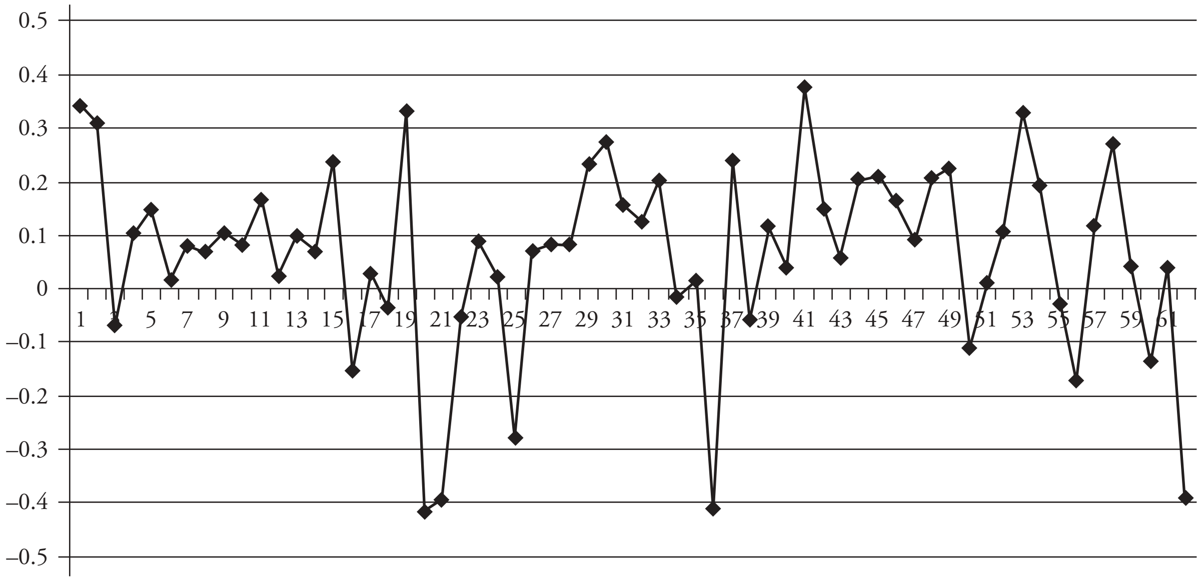
RF MoF also proposed the key points or framework of a formula-driven mechanism to be introduced by subjects of the RF (Figure 3.20).

These recommendations for subnational units are a replica of measures used by the federal center in their own horizontal fiscal equalization policy for regional units. However, methods appropriate for the federal level may prove unsuitable for the regional level. Thus, the indiscriminative and direct use of the RF MoF recommendations can result in underfunding of public services. For example, Article 6 of the Federal Law on the General Principles of Self-Government in the Russian Federation (1995) vests municipal units with responsibility for the maintenance of primary, secondary and vocational schools, and public health services. But these institutions were spread very unevenly across localities in the Soviet period. For example, a hospital in one rural rayon delivered health services not only to the inhabitants of the rayon in which it was located, but also to those of neighboring rayons. If expenditure needs are calculated on the basis of the number of budget service customers of the rayon, the hospital in question will not receive enough funding to deliver services at the intended level. Figure 3.21 demonstrates this problem with respect to Bashkortostan.

Here we can see a balance between normative expenditure needs computed according to the number of customers, and the actual expenditures of the LGs of Bashkortostan in 2000. Two-thirds of the 62 local governments are rayon governments; these have been labelled from 1 to 42. Cities and towns are represented by numbers 43 to 62. We can suppose that the actual expenditures of local infrastructure reflect the expenditure needs of current LG infrastructure because the government of Bashkortostan provides localities with funds up to the minimal expenditure needs of the current infrastructure. To enable comparison of the data, the balance is shown in Figure 3.21 as a relative value, i.e., as a ratio of the value of the balance of normative and actual expenditures to the value of actual LG expenditures.

Figure 3.21 allows us to draw a few interesting conclusions. First, the deviations of the balances are

Figure 3.21
Balance of the Normative and Actual Expenditures of 62 Local Governments of Baskortostan in 2000
Given as a Relative Value



Source: Author's presentation on the basis of RF MoF data.

very considerable. In some localities the actual expenditures exceed the normative ones by up to 40 percent; and there are a few localities where, on the contrary, the actual expenditures are less than the normative ones, again, by up to 40 percent. Thus, the standard deviation here is 0.14, whereas if infrastructure were arranged in proportion to the population, the standard deviation would be zero. This simulation confirms the above-mentioned opinion of the Bashkortostan MoF that full implementation of the approaches suggested by the RF MoF may result in underfunding of schools, hospitals, and other infrastructure in a majority of local jurisdictions in Bashkortostan. This explains the regional governments' reluctance to follow the federal recommendations.

Both approaches (the current one and that recommended by the RF MoF) have advantages and disadvantages. Nonetheless, the second approach is more favorable. The best path of development seems to be an evolutionary transition from the first approach to the second. It seems reasonable that a new model of intergovernmental relations in Bashkortostan satisfy the following requirements:

- Financial support has to be allocated among localities on the basis of a formula, which should immediately create good budget incentives. However, the allocation should not result in underfunding of organizations that deliver budget services.
- This formula should gradually transform into another formula described in the recommendations of the RF MoF.
- Under the new conditions local and republican authorities need recommendations on how to reorganize the work and financing of their infrastructures (schools, hospitals, etc.). For example, one recommendation might be that LGs reach an agreement among themselves on joint financing of schools and hospitals on their territories; with LGs able to provide services for their neighbors.

4. CONCLUSIONS AND RECOMMENDATIONS

The transition process in the public sector of the Russian Federation has developed over the last decade without adequate consideration of equalization policy. As a result,

- The majority of regional and local governments had perverse budget incentives because any changes in their own revenues were almost completely offset by changes in transfers and regulatory taxes. Only during the last three years has the federal government adhered to a formula-driven mechanism of allocation to subjects of the federation.
- The federal and regional governments issued unfunded mandates to lower level governments. In recent years the federal government has reduced the number of such mandates but the problem remains.
- Horizontal disparities among regions increased by a few multiples.
- Vertical imbalance between the federal and regional levels is not high in Russia, when compared to Germany and other developed countries. However, there is significant imbalance between own revenues and expenditure discretion of subnational governments. Local governments especially suffer.

4.1 Current State of Intergovernmental Fiscal Relations in the Russian Federation and Equalization Policy Recommendations

Only for the last 2–3 years has FG implemented reasonable steps toward the improvement of intergovernmental fiscal relations. The new Tax Code and the 2000–2005 Budget Reform Program are the bulwarks of fiscal reform. Based on the above analysis, we may draw the following conclusions concerning the current situation and make policy recommendations:

Vertical Equalization in the Federation

1) Federal legislation has failed to assign expenditure responsibilities between the regional and local governments in a way that could be optimal for all subjects of the federation, in view of their significant differences in degree of economic development, models of sub-regional government, and the preferences of their populations. In order

to solve this problem Russia needs to clarify the distribution of powers according to the subsidiary principle. Only then will an effective equalization procedure be possible. Further, federal legislation provides for the separation of expenditure responsibilities, but not for the separation of functions and tasks for the delivery of public services. For example, Article 87 of the 2000 Budget Code assigns to LGs the construction and maintenance of public health institutions but not the delivery of public health services. As a result, local governments do not have incentives to improve the delivery of public services and goods. The other consequence is the eruption of conflicts between local and upper level governments as to which government must bear the expenses for a certain expenditure need. Thus, federal legislation, in particular the Budget Code and Tax Code, could be developed in the direction of the distinct separation of federal, regional, and local functions in the provision of public services. It is also necessary to avoid contradictions and ambiguity in the assignment of expenditure responsibilities. This can be achieved on the basis of the conclusions of the RF Presidential Commission on the development of suggestions for delimitation of responsibilities among federal, regional, and local governments. However, some changes in responsibility assignments are obvious. Road construction and maintenance should be vested to the appropriate level of government depending on the location and primary purpose of the road in question: federal roads should be federal responsibility; regional roads should be regional responsibility; and local roads should be local responsibility. And, obviously, they should be formulated as functions. Fire protection should not be the subject of joint responsibilities and should remain exclusively a local responsibility. If sub-regional government has insufficient funds for road maintenance or for fire protection, this problem then needs to be solved within the framework of horizontal equalization policy.

2) Today, subjects of the federation do not have their own laws on the assignment of functions and responsibilities, which prevents local governments from forecasting their own revenues and from pursuing their own financial policy. For their part, regional legislators cannot elaborate such regional law in view of the fact that the main tax proceeds, which the regional government allocates to LGs, are federal taxes and FG regulates the sharing of not only federal taxes, but also some regional and local taxes. Irregularities in tax-sharing between the federal and regional governments cause annual fluctuations in regional and local budget revenues, in view of which regional governments cannot practice a formula-based regional equalization policy. Thus, for regional governments to elaborate and adopt regional legislation, which would serve to define the financial base of local governments, the following measures are advisable:
   - The Federal Constitution or a constitutional federal law should prescribe that amendments to the Tax Code and the Budget Code may be done only once within a three-year period.
   - Before its introduction, a new budget and tax arrangement should be discussed on all governmental levels within the Russian Federation. The new tax and budget arrangement should then come into force as a single legislative act, for a period of no less than three years.
   - To ensure that RGs have time to prepare amendments to regional legislation, approximately one year should elapse from the moment a new amendment is adopted to its enforcement on the federal level.

   To improve the federal tax system, it would reasonable to:
   - Eliminate the practice by which the federal government regulates regional taxes: the base, the rate, and the sharing of regional taxes must be defined only by the regional governments.
   - Simplify the so-called ceded taxes and the system of sharing federal, regional, and local taxes among three or more levels of the budget system. The federal budget obtained 9 percent of its total tax revenues from local taxes, and 3 percent from regional taxes. It is necessary to move in the direction of tax separation: one tax for one government (federal, regional, or local).

Horizontal Equalization Policy of the Federal Government

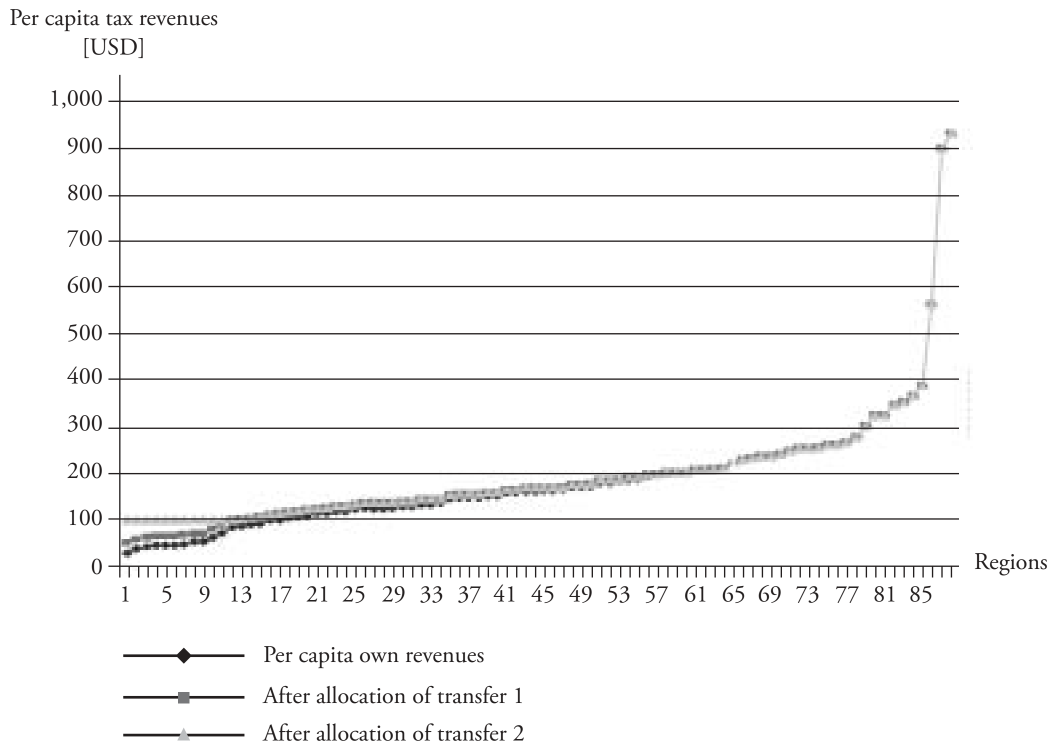
1) The tax-sharing system continues to cause interregional distortions: collection of EPT is based on the location of corporate headquarters, collection of VAT is based on the place of sales, collection of PIT is based on a taxpayer's place of employment and there is no system for the redistribution of these taxes according to the economic activity of regions. It is necessary to elaborate and to introduce a formula-based mechanism of redistribution for at least some part of VAT and EPT proceeds, among the subjects of the federation according to their economic contribution. Indicators such as the number of employed, productivity, and so on, could be used. Such redistribution would certainly provide incentives to the regions to develop their economies, but may lead to considerable interregional distortions in their own revenues. This negative consequence can be offset with equalization transfers from the FFSR.

   Such redistribution is especially significant in view of the fact that VAT proceeds have been assigned to the federal budget since 2001. The federal center promised to redistribute an additional 15 percent of VAT revenues through the FFSR. FG planned to collect 516 billion rubles in VAT in 2001, and 15 percent of this (77 billion rubles) was to be additional federal income that, according to the arrangement of 2000, would go to subnational governments. However, the FFSR was 57 billion rubles in 2000 and grew to only 100 billion rubles in 2001—instead of the planned 134 billion rubles. This is evidence that the "centralization of revenues for equalization" actually leads to increased federal expenditures for other goals and to an undermining of RG incentives. It would be reasonable to redistribute the additional federal VAT revenues (15 percent) among the regions in proportion with the GRP of each region. The FFSR must be formed from revenue sources that were used until 2000 as a percentage of the total tax collection. Figure 3.22 shows the results of a simulation. In the figure, a part of the funds has been extracted from the FFSR for 2001, amounting to revenue of as much as 77 billion rubles, and was redistributed as the additional VAT revenue among the regions in proportion to GRP. In this case, only the three wealthiest regions would not receive these funds. The other part, 23 billion rubles, was allocated according to the 2001 methodology. This methodology does not show a significant difference in results from those for 2000, but does have the advantage of intensifying incentives for RGs. Thus, in the simulation only 13 regions are equalized up to the minimal level in 2001, whereas the actual number of equalized regions was 38 in 2001 and 31 in 2000 (the minimal levels in Figure 3.16 and Figure 3.22 are approximately the same).

2) Over the last two years (2001–2002) the methodology for the computation of horizontal transfers has stabilized, due largely to the implementation of well-known recommendations in the field of equalization:
   - For estimation of fiscal capacity modified GRP is used, which takes into account the specifics of regional economies. These data are corrected by the index of budget expenditures that reflects the expenditure needs of the region. Computation of this index is based on indicators of needs such as the share of population that is unemployed, elderly, disabled, and the like. However, the formulas used in the 2001–2002 methodology are more sophisticated than that of the 2000 methodology, with the obvious disadvantage of being absolutely incomprehensible without deeper analysis. They can be represented in a simplified and more understandable form.
   - Among the indicators employed there are some glaring absences, such as indicators of needs for higher education and some other needs that are funded directly by the federal government. This arrangement then preserves interregional differences in the delivery and consumption of certain public goods.
   - The allocation of transfers serves to create incentives for regions with a low level of own revenues to develop their economies. Thus, 80 percent of the FFSR funding consists of transfers that are computed in proportion to the gap between normalized own revenues and the average level of revenues. And only 20

Figure 3.22

Simulation of Fiscal Equalization in 2001: With Additional VAT Revenues of the Federal Government Allocated in Proportion to GRP



Source: Author's simulation on RF MoF data.

percent of that funding can be recognized as transfers that raise up to some minimal level the total revenues of those regions with lowest own revenues. However, incentives in the transfer allocation system prove not to be very great—about 40 percent of all regions receive transfers from the second part of the FFSR, but gain only a minimal level of revenues. Thus, the remaining 60 percent of regions have incentives to develop their economies and tax collection systems. A better solution would be to choose the number of regions which must have incentives and then to disburse the FFSR into two parts. For example, if 80 percent of regions were to have incentives, then 14 percent of the FFSR should be allocated in 2001 to raise up to some minimal level the total revenues of those regions with the lowest own revenues.

- The size of the FFSR varies with every coming year which makes it an unpredictable funding source for regional governments. Improvement to the system could be had if the funding rate were to be fixed legislatively for a period of several years and further alterations could only be justified in the case of a stipulated emergency.
- Since its introduction in 1994 the FFSR has served different targets. The FFC, designed in 2001, released the FFSR from seven of these specially targeted needs. However, the 2002 FFSR continues to consist of subsidies for a few special needs, which together comprise about 10 percent of the fund. It is necessary to separate out tied grants from the FFSR, leaving it only one function—the allocation of equalization transfers.

4.2 Current State of Intergovernmental Fiscal Relations in Bashkortostan and Other Subjects of the Federation and Equalization Policy Recommendations

The main conclusion to be drawn is that local governments are not given incentives to increase their own revenues and optimize their expenditure policy. The limited autonomy of local governments in budgeting, slack budget decisions, and a subjective means of allocation—all result in reduced budget incentives for local governments. Local governments can grant unjustified tax credits to enterprises, use ineffective techniques in delivering services, maintain or obtain ineffective social infrastructure. They are also interested in concentrating revenues in off-budget funds, and to develop informal relations with potential taxpayers.

According to the analysis presented in this paper, the following specific problems relating to local governments have to be solved during the reforms:[1]

1) *The ambiguous status of local governments*. Federal legislation addresses only three levels of government—federal, regional and local—and fails to provide a comprehensive explanation of extant models of government in regions for which the strict three-tier model of intergovernmental fiscal relations is unfitting; for the resulting collisions between federal and regional governments account for many of the shortcomings of local government institutions. Bashkrtostan's experience shows that a system with two local levels of government is reasonable: LGs of cities and rayons with elected councils (referred to as "state local governments"), and LGs of villages and city districts. It would thus be rational to include this arrangement in federal legislation.
2) *Vertical imbalance*. The high level of centralization of revenues contrasts with the fact that a considerable part of the expenditure responsibilities of the regional consolidated budget is entrusted on the local level. Before the last reforms in 1999, own tax revenues covered 13 percent of local expenditures (Kurlyandskaya and Nikolaenko 2001b). It is therefore necessary to assign additional revenue sources to LGs. For example, it seems reasonable that all taxes on small business should be assigned to LGs because the development of small business depends on institutional conditions that are mostly formed locally. Thereupon, it is necessary to introduce amendments to federal legislation. For instance, present federal legislation institutes a tax rate on imputed earnings of up to 20 percent, 33 percent of which will be a federal share of tax collection for firms. If the taxes on small business had been assigned to local governments, the tax collection from small business would have been 1.7 percent of Bashkortostan's local own revenuers for 2001. Obviously, this tax collection cannot create considerable incentives for local governments to develop small business, and it is unreasonable to diminish these incentives. Therefore, it would be reasonable to introduce amendments to the Federal Tax Code, where 100 percent of the collected tax on gross receipt and on imputed earnings should be assigned to sub-federal governments. In its turn Bashkortostan should assign 100 percent of these collected taxes to local governments through regional legislation. Also, it is reasonable to assign 100 percent of land tax revenues to LGs through federal and regional legislation, which presently divides land tax proceeds among federal, regional, and local governments.
3) *Slack budget decisions*. There are at least two areas where budget decisions of regional governments are not fixed. The first area is allocation of financial support to local governments. Even if regional government uses formula-based techniques to allocate subsidies and equalization transfers, and allocation of transfers are fixed in the regional budget law, in practice, during the financial year, these decisions are not fully executed. The second and most significant area of shortcomings in the budgeting process is concerned with the local budget sheet account #03020303 named "funds received on mutual settlements of accounts, including the compensations from regional budgets of the additional expenditures, occurring as a result of decisions of the government of a subject of the Russian Federation." This account allows regional executive bodies to allocate additional funds without transparency and practically without control on the part of regional councils. For example, in

Bashkortostan the financial flows through this account varied from 20 to 50 percent of total revenues of local governments. As a result of this system of allocation, the size of financial support to local government often depends on the political power of local leaders. The other possible consequence is that the local government can pursue unsound budget policy. Moreover, the fiscal equalization systems in Bashkortostan and the majority of the other subnational units of the Russian Federation preserve outmoded principles: the annual changing of tax shares and use of physical norms. Obviously, to solve these problems it is necessary to introduce regional laws on the budget system, where tax rates and shares would be fixed for at least three years, and a formula-driven mechanism of allocation of financial support would be used.

4) *Problems with the introduction of a formula-based mechanism for resource allocation*. There are some federal government documents that recommend RGs to introduce a formula-based mechanism for the allocation of financial resources. As the simulation with the Bashkortostan data shows, the indiscriminate implementation of the RF MoF recommendations could result in underfunding of the current infrastructure and in social problems. Today LGs are unable to fulfill expenditure responsibilities, which according to federal legislation they are required to bear. There are different ways to solve to the problems which arise in the course of implementing the RF MoF recommendations:
   - The move from the physical measurement of fiscal capacity, e.g. based on the number of hospitals and schools, to a measurement which accounts for the number of consumers must be carried out slowly, in an evolutionary manner. The entire budget needs to be divided into two parts, so that the first part includes needs that are very disproportionately distributed among localities; while within the second part the needs of all localities are treated relatively equally. The regional government has to subsidize the first part of local needs directly and by formula-based mechanism, i.e., to allocate transfers for localities that do not have sufficient own revenues to cover expenditures from the second group. With regard to the other needs, the allocation of transfers according to the number of customers does not cause distortions on the scale of those in Figure 3.21. On 16 May 2002, Bashkortostan's Parliament submitted to the RF Parliament a bill on changing the Federal Law on the General Principles of Self-Government in the Russian Federation (1995). This bill proposed reducing the number of local mandatory functions from 30 to 20; among the 10 unwanted local functions were the maintenance of primary, secondary and vocational schools, and public health service institutions. If this bill is passed, it will be possible to introduce a formula-based allocation of support as well as to escape underfunding of schools, hospitals, and cultural objects because they will be funded directly by the Bashkortostan government. For this interim period, three to five years, the Bashkortostan government will be able to implement measures aimed at the reorganization of infrastructure in accordance with the normative expenditure needs of customers.
   - Another solution is to utilize opportunities to establish horizontal agreements between local governments, and form alliances of local governments that would collaborate to solve their common problems—as has been suggested by federal and Bashkortostan legislation. Thus, the disproportion between actual expenditure needs of the infrastructure and those of customers can be regulated by the contracts among neighboring LGs.
   - A third way is to carry out a reorganization of local infrastructure as a first step, and after a few years, introduce a formula-based allocation of resources and supplement it with horizontal cooperation.
   - Finally, a fourth solution is to introduce a transition formula. This formula would account for the upcoming transformation in the allocation of resources—from the present method to the method recommended by the RF MoF. Thus, if Bashkortostan were to decide on full equalization by the algorithm

Figure 3.23
Possible Transition from Present Method of Resource Allocation in Bashkortostan towards the Method Recommended by the Federal Government

1. Computation of

E_i(consumer)—Total normative expenditure need of locality i computed according to the number of consumers by the algorithm in Figure 3.20

E_i(infrastructure)—Total normative expenditures of locality i computed using expenditure norms and the physical needs of the infrastructure

2. Computation of the gap between the expenditure needs of the infrastructure and the expenditure needs computed according to the number of consumers

$Gap_i = E_i(\text{infrastructure}) – E_i(\text{consumers})$

3. Allocation of equalization transfers according to RF MoF recommendations (the algorithm in Figure 3.20). This algorithm takes into account the number of consumers and causes distortions as large as Gap_i.

The local governments have to adapt to the new formula-based system and transform their infrastructure within four years.

4. Allocation of the compensation transfer for each locality, which should mitigate the gap

$TR_i = (4 – Y) \times Gap_i / 4$

Y = 1, 2, 3, 4—the number of the years using the formula

Source: Author's presentation.

presented in Figure 3.20, the result will be a gap between the expenditure needs of the infrastructure and expenditure needs computed according to the number of consumers. The special transfer computed by the method presented in Figure 3.23 partly compensates for this gap over a period of a few years. In the first year this compensation covers three-fourths of the difference, half in the second year, and one-quarter in the third year. During this transition period LGs can adapt to the new formula-based system and transform their infrastructure.

The other problem concerning the implementation of the RF MoF recommendations has to do with the fact that some minimal norms of public services—such as education or public health and also the salary tariff system—are established by the federal center, without ensuring sufficient financial resources for their implementation. Two decisions seem reasonable here. One is to eliminate all minimal norms—the policy of deregulation. The second possible proposal is for the federal center to finance the provision of the minimal social standards that it introduces through federal legislation. Subnational units would then have to finance service delivery only for those institutions that were established in accordance with regional minimal social standards. In other words, minimal norms of public service delivery, e.g. the child allowance, have to comprise three parts: federal, regional, and local. In this case citizens can see how each government meets its own obligations.

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ENDNOTES

1 According to Douglas North's terminology "path dependence" (North 1996).

2 The computation was done for 1995, because this was the first year when allocation of transfers became the most significant form of federal financial support. 1999 was the last year for which the authors of the investigation (Lavrov 2001) had complete information.

ANNEX

Tables and Figures

Table 3A.1
Assignment of Expenditure Responsibilities in Russia by 2005 According to the Program of Budget Federalism Development in the Russian Federation for a Period Until 2005

<table>
<tr><th>Expenditure</th><th>Federal</th><th>Regional</th><th>Local</th></tr>
<tr><td>Defense</td><td>100 percent</td><td>None</td><td>None</td></tr>
<tr><td>Justice/Internal Security</td><td>100 percent</td><td>None</td><td>None</td></tr>
<tr><td>Foreign Economic Relations</td><td>National programs</td><td>Some regions maintain their own relations, especially on RF frontiers</td><td>None</td></tr>
<tr><td rowspan="2">Education</td><td>Research institutes</td><td>Technical and vocational schools</td><td rowspan="2">Wages, operation, construction, and maintenance of primary and secondary schools</td></tr>
<tr><td colspan="2">Universities</td></tr>
<tr><td>Culture and Parks</td><td>National museums and theaters</td><td>Regional museums</td><td>Local objects</td></tr>
<tr><td rowspan="2">Health Care</td><td rowspan="2">Highly particularized services</td><td>Tertiary, psychiatric and veteran hospitals, diagnostic centers, and special service hospitals (cardiology, etc.)</td><td>Medicines</td></tr>
<tr><td colspan="2">Secondary hospitals, primary health clinics</td></tr>
<tr><td>Sport</td><td colspan="2">National reserve sport</td><td>Facilities for amateur sport</td></tr>
<tr><td rowspan="3">Roads</td><td>Construction and maintenance of federal roads</td><td></td><td></td></tr>
<tr><td colspan="2">Construction and maintenance of regional roads</td><td></td></tr>
<tr><td></td><td colspan="2">Maintenance of rayon and city roads</td></tr>
<tr><td rowspan="2">Public Transportation</td><td>Air and sea transport</td><td>Long distance transport</td><td>Some transportation facilities</td></tr>
<tr><td colspan="3">Motor, river transport and subway systems</td></tr>
<tr><td>Fire Protection</td><td colspan="2">Most fire protection services</td><td>Voluntary, military, and enterprise services</td></tr>
<tr><td>Libraries</td><td>National libraries</td><td>Special library services</td><td>Most local library services</td></tr>
<tr><td>Police Services</td><td>National militia</td><td>Traffic police and national militia</td><td>Local security police</td></tr>
<tr><td>Sanitation (Garbage Collection)</td><td>None</td><td>None</td><td>Garbage collection</td></tr>
<tr><td>Sewage</td><td>None</td><td>Infrastructure capital investment</td><td>Most of the operational expenditures</td></tr>
<tr><td>Public Utilities (Gas, Electricity, and Water)</td><td>None</td><td>Subsidies to enterprises</td><td>Subsidies to enterprises</td></tr>
<tr><td>Housing</td><td>None</td><td>None</td><td>Housing construction, subsidies and maintenance</td></tr>
</table>

Table 3A.1 (continued)

Assignment of Expenditure Responsibilities in Russia by 2005 According to the Program of Budget Federalism Development in the Russian Federation for a Period Until 2005

<table>
<tr><th>Expenditure</th><th>Federal</th><th>Regional</th><th>Local</th></tr>
<tr><td>Price Subsidies</td><td>Part of food and medicine subsidies</td><td>None</td><td>Fuels; mass transport; food (bread, milk); medicines</td></tr>
<tr><td>Welfare Compensation</td><td>Partly FG responsibility</td><td>Partly RG responsibility</td><td>Managing programs funded by upper level governments</td></tr>
<tr><td>Environment</td><td>National environmental issues</td><td>Regional environmental problems, (the preservation of forests)</td><td>Regional environmental problems (for example, in agriculture)</td></tr>
<tr><td rowspan="3">Economic Policy</td><td>Modernization of industry, conversion of military and coal industry; Federal investment programs, subsidized credits, subsidies to particular sectors</td><td>Subsidies to particular sectors, investments, grants, tax benefits</td><td rowspan="2">Various explicit and implicit subsidies and benefits</td></tr>
<tr><td colspan="2">Support of agriculture</td></tr>
<tr><td colspan="3">Development of market infrastructure</td></tr>
</table>

Source: RF Government 2000.

Table 3A.2

Legislated Sharing Rates of Federal, Regional and Local Taxes, 1994–2002 [Percent]

Tax	Period	Federal Budget	Regional Budget	Local Budget
Federal Taxes				
Enterprise Profit Tax (EPT)	1994–1Q 1999	13	No more than 22; No more than 30 for banks and financial companies	
	2Q 1999–2000	11	19 and 27 accordingly	
	2001	11	19 and 27 accordingly	No more than 5
	2002	7.5	14.5	2
Value-Added Tax (VAT)	1994–1Q 1999	75	25	
	2Q 1999–2000	81	15	
	2001–2002	100	0	
Personal Income Tax (PIT)	1994	0	100	
	1995–1996	10	90	
	1997–1999	0	100	
	2000	16	84	
	2001	1	99	
	2002	0	100	
Excise on Spirit, Vodka and Alcohol Drinks	Since 1994	50	50	
Other Excise, Except Excise on Import Goods, Oil Gas, Petrol, Coil, Cars	Since 1994	0	100	
Tax on Buying Foreign Currency	1997	100	0	
	1998	60	40	
Tax on Gambling Business	Since 1998			
Joint Tax for Small Business	Since 1996	3.33 of total receipt	6.67 of total receipt	
Tax on Imputed Earnings	Since 1998	25 for company; 0 for entrepreneur	50 for company; 75 for entrepreneur	

Table 3A.2 (continued)

Legislated Sharing Rates of Federal, Regional and Local Taxes, 1994–2002 [Percent]

Tax	Period	Federal Budget	Regional Budget	Local Budget
Special Enterprise Tax for the Support of Industry (cancelled since 1997)	1994	80	20	
	1995–1996	67	33	
Fees for the Use of Resources:				
a) Hydrocarbon Resources	Since 1995	40	30	30
	2002	80	20	0
b) Water Resources	Since 1998	40	60	
c) Forest	Since 1997	40 or 0 depending on wood-cutting area	60 or 100 depending on wood-cutting area	
Regional Taxes				
Enterprise Property Tax	Since 1994	0	50	50
Sales Tax	Since 1998	0	40	60
Local Taxes				
Land Tax	1994–1995	20	20	60
	1996–2001	30	20	50

Source: Lavrov 2001.

Table 3A.3
Summary of Legislative Control over Regional Taxes, 2002

Tax	Legislative Level Introducing the Tax	Legislative Level Determining Tax Base	Legislative Level Determining Tax Rate	Legislative Level Determining the Sharing Rate	Budget(s) to which Tax Revenues Accrue
Enterprise Property Tax	Federal	Federal	Regional within the federal limitations	Regional within the federal limitations	Regional and local
Duty for Needs of Educational Organizations	Regional	Federal	Regional	Regional	Regional
Sales Tax	Regional	Federal	Regional within the federal limitations	Regional within the federal limitations	Regional and local
Tax on Imputed Earnings	Regional	Federal and regional	Federal	Federal, then regional	Federal, regional
Joint Tax for Small Business	Regional	Federal and regional	Regional within the federal limitations	Federal	Federal, regional
Forest Tax	Federal	Federal	Regional within the federal limitations	Federal and regional	Federal, regional and local

Source: Ministry of Finance and Center for Fiscal Policy.

Table 3A.4
Summary of Legislative Control over Local Taxes, 2002

Tax	Legislative Level Introducing the Tax	Legislative Level Determining Tax Base	Legislative Level Determining Tax Rate	Legislative Level Determining the Sharing Rate	Budget(s) to which Tax Revenues Accrue
Individual Property Tax	Federal	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Land Tax	Federal	Federal	Local within the federal limitations	Federal, then regional	Federal, regional and local
Registration Fee for Private Enterprise	Federal	Local within federal legislation	Local within the federal limitations	Regional within the federal limitations	Local
Tax on Industrial Construction in National Resort Areas[2]	Local	Federal	Local	Regional within the federal limitations	Local
Resort Duty	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Duty for the Right to Sell[1]	Local	Federal	Local	Regional within the federal limitations	Local
Duties Earmarked for Education, Militia Maintenance and Other Goals	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local

1 See also RF MoF 2000a, 2000b; RF Government 2001.
2 According to the Federal Law #150-ФЗ adopted on 31 June 1998, this tax is revoked if the regional government introduces the sales tax.

Table 3A.4 (continued)
Summary of Legislative Control over Local Taxes, 2002

Tax	Legislative Level Introducing the Tax	Legislative Level Determining Tax Base	Legislative Level Determining Tax Rate	Legislative Level Determining the Sharing Rate	Budget(s) to which Tax Revenues Accrue
Tax on Advertising	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Tax on Resale of Cars and Computers	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Dog Tax	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
License Fee for the Right to Sell Alcohol	Local	Federal	Federal	Regional within the federal limitations	Local
License Fee for the Right to Issue Lottery	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Fee for Issue of the Flat Voucher	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Fee for Car Parking	Local	Federal	Local	Regional within the federal limitations	Local
Duty for the Use of Local Symbols	Local	Federal	Local within the federal limitations	Regional within the federal limitations	Local
Racing Charges	Local	Local	Local	Regional within the federal limitations	Local
Duty on Race Winning	Local	Local	Local within the federal limitations	Regional within the federal limitations	Local
Duty for Bidding at the Race Track	Local	Local	Local within the federal limitations	Regional within the federal limitations	Local
Duty for Stock Exchange Deal	Local	Local	Local within the federal limitations	Regional within the federal limitations	Local
Duty for the Right to Produce Cinema and Tele-exposure Process	Local	Local	Local	Regional within the federal limitations	Local
Duty for Clearing the Territory	Local	Local	Local	Regional within the federal limitations	Local
Tax on Opening Gambling Business	Local	Local	Local	Regional within the federal limitations	Local

Source: Ministry of Finance and Center for Fiscal Policy.

Table 3A.5
The Main Federal Mandates in Russia, 1998

Federal Laws	**Year of Law Adoption**	**Total Expenditure Responsibility, Percent of GDP**	**Actual Funding, Percent of Needs**
The Law on Veterans	1995	1.64	29
The Law on Social Defense of Enables in the Russian Federation	1995	0.64	21
The Law on Welfare Payment for Citizens Having Children	1995	1.16	39
The Law on Social Provision of Citizens Who Were Exposed to Radioactivity of Tchernobilskaya Atomic-electro Power Station	1991	0.02	35
The Law on Status of Servicemen	1998	0.15	69
The Presidential Decree on Social Support of Many-Children Families	1992	0.16	25
The Law on Blood Donor System	1993	0.02	55
The Law on Education	1996	0.15	31
The Law on Undertaker Work	1996	0.01	57
The Law on Proving Victims of Political Repression in the Rights	1991	0.08	31
The Law on Compensation for Pupils' Food	1996	0.28	16
The Law on Militia	1991	0.07	36
The Government Resolution on Urgent Measures on Social Protection of Children-Orphans	1992	0.12	26
The Law on Additional Guarantees on Social Protection of Children-Orphans and Children Without Parental Support	1996	0.08	34
The Law on Fire Safety	1994	0.03	23
The Law on Social Services for Elderly Citizens and the Disabled	1995	0.58	8
The Supreme Council Resolution on Work in Domestic Affairs Services	1992	0.08	47
The Government Resolution on State Support for Development of Medical Industry	1994	0.3	18
The Government Resolution on Facilities for Qualified Workers in Rural Areas and Industrial Communities	1930	0.06	42
The Government Resolution on Urgent Measures for Improving the Status of Children in the Russian Federation	1992	0.1	11
The Law on State Guarantees and Compensations for Persons Working and Living in the Northern Regions and Regions with Similar Status	1993	0.99	19
The Law on the Social Development of Rural Areas	1990	0.23	96
The Presidential Decree on Militia of Security (Local Militia) in the Russian Federation	1993	0.23	96
The Government Resolution on Arrangement for Free Maintenance of One to Two-Year-Old Children by Milk Formula	1997	0.08	12
The Law on Medical Insurance of Citizens in the Russian Federation	1997	0.23	13
Total		7.74	31

Source: RF Ministry of Finance.

Table 3A.6

The Plan for Elimination of Federal Mandates for the 2000–2005 Period

Type of Mandates	Examples	First Actions	Result
Federal Offices and Institutions	Public utilities of universities, federal offices and property	Regulation of federal funding, limits	Funding from federal budget
Professional Facilities	Public utilities and free ride for military men	Partial abolition, including to ministry expenses	Full abolition, including salary
Territorial Facilities	Northern regions, rural population	Partial abolition, including to budget worker salary	Full abolition, including special grants
Social Allowances and Facilities	Child allowance, laws about veterans, disabled	Federal subventions to regions	Payments from the federal budget
Salary in the Budget Sphere	Regional factor for salary of Ural population (15 percent)	Partial funding by federal subventions	Reduced regulation: abolition of the flat rate system
Financial and Material Norms	Expenditure norms for state schools, hospitals	Abolition of obligatory character of norms	Introducing indicators of public service quality

Source: RF Government 2000.

Table 3A.7

Federal Mandates Funded Since 2002 from the Federal Fund of Compensations

	Federal Mandate
1	Federal Law on Welfare Payment for Citizens Having Children: the part attributed to consolidated budgets of the subnational units according to federal legislation
2	Federal Law on Social Security of the Disabled in the Russian Federation: the part attributed to consolidated budgets of the subnational units according to federal legislation
3	Federal Law on Proving Victims of Political Repression in the Rights
4	Federal Law on the Status of the Heroes of the Soviet Union, Heroes of the Russian Federation and the Awarded by the Glory Orders of All Levels
5	Federal Law on Delivering Social Services to the Heroes of Labor and the Awarded by the Labor Glory Orders of All Levels
6	Compensations for Discounts to Citizens who were Exposed to the Radioactivity of the Chernobil Nuclear Power Station and Nuclear Explosions on Semipalatinsk Testing Area on their Payment for Public Utilities, Telephone Services, Using Public City Conveyances and the Local Train
7	Compensations for Discounts to Military Men, Militiamen, Staff of Bodies of Internal Affairs, and Tax and Customs Police on Payment for Public Utilities and Communications

Source: RF MoF 2001b.

Table 3A.8

Distribution of Revenues and Expenditures between Governmental Levels, 1992–2002, as a Percentage of GDP

	1992	1993	1994	1995	1996*	1997*	1998	1999	2000	2001 H1**	2002***
Federal Budget											
Revenues	14.6	13.0	11.9	12.0	12.8–12.5	10.9–10.2	8.9	12.6	16.0	17.8	16.8
Expenditures	59.2	28.6	22.5	17.4	20.5–20.9	17.4–17.1	13.7	13.9	13.7	13.7	15.2
Transfers to Regions	1.7	2.5	3.6	1.8	2.5–2.4	2.0–1.9	1.6	1.3	1.4	3.1	—
Regional and Local Budgets											
Revenues	13.8	16.1	19.0	14.3	14.7–15.0	15.5–16.7	14.5	13.6	15.1	14.8	—
Including Transfers	1.7	2.5	3.6	1.8	2.5–2.4	2.0–1.9	1.6	1.3	1.4	3.1	—
Expenditures	11.9	16.3	18.0	14.8	15.7–16.0	16.7–18.0	14.9	13.6	14.6	13.7	—
Consolidated Budgets											
Revenues	26.7	26.6	27.3	24.5	25.0–25.1	24.5–25.0	21.8	24.9	29.7	29.5	—
Expenditures	69.4	42.4	36.9	30.4	33.7–34.5	32.2–33.2	27.0	26.2	26.9	24.3	—

* There are two figures for 1996 and 1997 because two sources provide different data, resulting from a difference in the methodology of computation: the first part of the table is computed with the International Monetary Fund methodology, the second part is computed with the OESD.

** Only first half of 2001.

*** Budget draft data.

Source: Institute of Economic Analysis 1998; Federal Intergovernmental Relations 2002.

Table 3A.9
Assignment of Taxes in 1998 Due to Tax Code (came into effect in 2000).

Federal Taxes	**Regional Taxes**	**Local Taxes**
Value-added tax	Tax on property of legal entities	Land tax
Excises on specific goods	Tax on real estate	Individual property tax
Excises on raw materials	Road tax	Tax on advertising
Enterprise profit tax	Transportation means tax	Inheritance or gift tax
Capital gains tax	Sales tax	Local license tax
Personal income tax	Tax on gambling	
Contributions to state off-budget funds	Regional license fees	
Customs duties		
State duties		
Tax on subsoil use		
Tax on rehabilitation of minerals		
Tax on additional income from hydrocarbons production		
Fee for the right of use of fauna and water biological resources		
Forest use tax		
Water use tax		
Ecological tax		
Federal license fees		

Table 3A.10

Federal Financial Support for Subjects of the Russian Federation from 1992–2002

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Donations		0.02	0.09	0.06	0.09	0.13	0.10	0.06	0.15	0.14	0.11
Subventions	0.79	0.69	0.42	0.12	0.12	0.09	0.02	0.20	0.03	0.11	0.04
Transfers from Fund for Financial Support of Regions	—	—	0.36	1.17	1.04	1.22	1.12	0.98	0.95	1.19	1.34
Transfers from the Fund of Compensations	—	—	—	—	—	—	—	—	—	0.54	0.37
Transfers from the Fund for Regional Development	—	—	—	—	—	—	—	—	—	0.04	0.16
Transfers from the Fund of Development of Regional Finances	—	—	—	—	—	—	-—	—	—	0.01	0.01
Transfers from the Fund of Co-financing Social Expenditures	—	—	—	—	—	—	—	—	—	—	0.17
Balance of Mutual Settlements	0.61	1.95	2.54	0.42	0.81	0.43	0.36	0.14	0.16		
Loans Minus Repayment to Other Governments	0.09	0.03	0.02	0.04	0.23	0.64	-0.03	-0.28	0.01		
Other Kinds of Financial Support										0.37	0.06
Total Transferred Funds	1.49	2.70	3.4	1.8	2.3	2.5	1.60	1.37	1.30	2.40	2.26
Share of Financial Support in Expenditures of the Federal Government	6.87	12.73	14.87	10.97	14.76	16.35	11.07	9.35	11.11	13.54	12.7
Share of FFSR and FC Transfers in the Federal Financial Support of Regions (loans excluded)	0.0	0.0	10.5	65.6	49.3	65.4	68.5	59.4	71.37	72.04	75.76
Share of Federal Financial Support in Revenues of Regional Budgets	6.4	18.1	21.0	14.3	16.7	18.3	11.9	8.9	9.0		
Share of Federal Financial Support in Expenditures of Regional Budgets	6.5	18.1	19.8	12.5	14.1	15.2	10.2	7.9	8.1		

Source: Data from 1992 to 2001: Sinelnikov et al. 2001. Data for 2002: Author's estimations on the basis of RF MoF data (2001a, 2001b, 2001d).

Table 3A.11

Development of the Methodology of Allocation of Transfers from the FFSR from 1994 to 2002

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**		**2002**
Source	22% of VAT incoming to the federal budget	27% of VAT incoming to the federal budget	15% of total tax revenues excluding customs		14% of total tax revenues excluding customs and revenues of earmarked budget funds	14% of total tax revenues excluding customs				
Sharing	none	56.04% for needy support; 43.96% for extremely needy units support	65.79% for needy support; 34.21% for support of extremely needy units	None			80% for all regions that are lower than the average level; 20% for extremely needy regions support			
Revenue Base	Actual revenues for 1993		Estimation of 1994 revenues under 1996 conditions	Estimation of 1995 revenues under 1997 conditions	Estimation of 1996 revenues under 1998 conditions	Estimation of 1997 revenues under 1999 conditions	Estimation of 1998 revenues under 2000 conditions with corrections for GRP	GRP		
Expenditure Base	Actual expenditures of 1993 under conditions of the current year		Actual expenditures of 1991 corrected for 1994 and 1996	Actual expenditures of 1991 corrected for 1995 and 1997	Actual expenditures of 1991 corrected for 1996 and 1998	Index of budget expenditures on basis of actual expenditures of 1997	Index of budget expenditures on basis of expenditure norms and inflation coefficients			

Source: Lavrov 2001.

Table 3A.12

Regional Per Capita Revenues Before and After Allocation of Transfers 1 and 2 [rubles]

Region	Before Equalization	After Allocation of Transfer T(1)	After Allocation of Transfer T(2)	Region	Before Equalization	After Allocation of Transfer T(1)	After Allocation of Transfer T(2)
Aginsk Buriat AO	356	1,637	2,813	Habarovsk K	2,548	3,006	3,006
Ingushetia R	474	1,710	2,813	Kaliningrad O	2,568	3,018	3,018
Tiva R	550	1,758	2,813	Chuvash R	2,613	3,046	3,046
Ust-Ordin Buryat AO	619	1,801	2,813	Karel R.	2,622	3,052	3,052
Dagestan R	638	1,813	2,813	Tula O	2,634	3,059	3,059
Komi-Permyak AO	740	1,876	2,813	Vladimir O	2,660	3,075	3,075
Evenk AO	745	1,879	2,813	Voronezh O	2,753	3,133	3,133
Koryak AO	873	1,960	2,813	Astrakhan R	2,800	3,163	3,163
Jewish AO	949	2,007	2,813	Krasnodar K	2,808	3,168	3,168
Kabardini-Balkaria R	1,045	2,067	2,813	Novosibirsk O	2,829	3,181	3,181
Chukotsk AO	1,149	2,132	2,813	Kirovskaya O	2,891	3,220	3,220
Altay R	1,379	2,276	2,813	Razan O	2,906	3,229	3,229
Karatchay-Cherkes R	1,385	2,279	2,813	Tomsk O	3,048	3,318	3,318
North Osetia R	1,463	2,328	2,813	Omsk O	3,079	3,337	3,337
Adigea R	1,565	2,392	2,813	Kursk O	3,124	3,365	3,365
Buryatia R	1,625	2,429	2,813	Hakasia R	3,150	3,381	3,381
Pskov O	1,650	2,445	2,813	Kemerovo O	3,182	3,401	3,401
Magadan O	1,673	2,459	2,813	Irkitsk O	3,253	3,446	3,446
Altay K	1,687	2,468	2,813	Murmansk O	3,292	3,470	3,470
Bransk O	1,702	2,477	2,813	Udmurd R	3,300	3,475	3,475
Chita O	1,786	2,530	2,813	Orenburg O	3,379	3,524	3,524
Kamtchatsk O	1,807	2,543	2,913	Saratov O	3,387	3,530	3,530
Ivanov O	1,811	2,545	2,813	Volgograd O	3,498	3,598	3,598

Table 3A.12 (continued)

Regional Per Capita Revenues Before and After Allocation of Transfers 1 and 2 [rubles]

Region	Before Equalization	After Allocation of Transfer T(1)	After Allocation of Transfer T(2)	Region	Before Equalization	After Allocation of Transfer T(1)	After Allocation of Transfer T(2)
Amursk O	1,882	2,589	2,813	Belgorod O	3,503	3,602	3,602
Morgovia R	2,001	2,664	2,813	Ulyanovsk O	3,538	3,624	3,624
Sahalin O	2,023	2,677	2,813	Leningrad O	3,598	3,661	3,661
Penza O	2,055	2,698	2,813	Moscow O	3,779	3,779	3,779
Taymir AO	2,062	2,702	2,813	Cheliabinsk O	3,879	3,879	3,879
Sasha-Yakutia R	2,066	2,705	2,813	Komi R.	4,052	4,052	4,052
Tambov O	2,096	2,723	2,813	Vologodsk O	4,062	4,062	4,062
Nenetz AO	2,148	2,756	2,813	Yaroslavl O	4,171	4,171	4,171
Primorski K	2,169	2,769	2,813	Krasniyarsk K	4,181	4,181	4,181
Mary El R	2,198	2,787	2,813	Bashkortostan R	4,203	4,203	4,203
Arkhangelsk O.	2,221	2,801	2,813	Nizhniy Novgorod O	4,477	4,477	4,477
Kurgan O	2,308	2,855	2,855	Lipetsk O	4709	4709	4,709
Kaluga O	2,309	2,856	2,856	Sverdlovsk O	4790	4790	4,790
Rostov O	2,372	2,896	2,896	Tumen O	5,013	5,013	5,013
Stavropol K	2,375	2,897	2,897	Tatarstan R	5,236	5,236	5,236
Kalmik R	2,404	2,915	2,915	Perm O	5,321	5,321	5,321
Orel O	2,455	2,947	2,947	St.Petrsburg city	5,656	5,656	5,656
Tver O	2,486	2,967	2,967	Samara O	6,646	6,646	6,646
Novgorod O	2,525	2,991	2,991	Yamal-Nenetsk AO	9,581	9,581	9,581
Smolensk O	2,531	2,995	2,995	Hanti-Mansi AO	9,771	9,771	9,771
Kostroma O	2,547	3,005	3,005	Moscow city	10,667	10,667	10,667

Source: RF MoF data.

Table 3A.13

Structure of Republican and Local Expenditures in the Republic of Bashkortostan in 2000 [Percent]

Function	Republican Budget	Local Budgets
Government	2.4	4.5
Agriculture Support	9.5	7.4
Education	4.0	29.6
Culture	2.1	3.3
Public Health	6.0	17.4
Public Security	1.2	2.6
Communications	3.5	1.3
Capital Development	7.2	21.7
Public Assistance	2.4	6.7
Road Building	16.6	—
Support of Local Governments	25.6	—
Other Expenditures	19.5	5.5
Total	100.0	100.0

Source: Author's computations on basis of Bashkortostan MoF data.

Figure 3A.1

Allocation of Transfers from FFSR Among the Subjects of the Russian Federation in 2002 [rubles per capita]

Source: Center for Fiscal Policy. From http://www.fpcenter.org/russian/map/map2_site.htm.

Yuriy Lukovenko

Ukraine: Steps towards Effective Fiscal Equalization

Ukraine: Steps towards Effective Fiscal Equalization

Yuriy Lukovenko

During the last decade of independence, the decentralization policy of the Ukrainian central government did not create strict budget constraints for local government bodies, nor did it make them "spend according to existing resources." Now, however, the Budget Code has introduced serious changes into the public fiscal system. It redefines the revenue and expenditure responsibilities of local governments. It also proposes implementation of a formula-based approach to equalization on the regional and sub-regional levels. Unfortunately, however, the changes in legislation barely address the issue of interregional fiscal inequity and vertical and horizontal disparities. The history of decision-making in this policy area shows that the good intentions of government very often fail because critical analysis of the driving forces behind the issue is lacking. It looks like the government now repeats the mistake, which could create difficulties for the implementation of these important decisions.

The aim of this study is to investigate reasons for interlocality fiscal inequity. The real origins of the inequity can be seen in the long period of nontransparent decision-making in intergovernmental fiscal relations, and the lack of community participation and consistent public policy. As a result, the budget process in Ukraine is still not under public control. The solutions require readjustment of equalization instruments on the basis of the involvement of territorial community and local government in policy formulation and the policymaking process. Such an approach clarifies local and central government responsibilities in public service delivery and creates stable "rules of the game" and conditions for permanent evaluation and improvement of the equalization mechanism.

1. INTRODUCTION

Disparities in public resource redistribution in Ukraine are very high, and there is a crucial need for equalization. One of the major problems impeding the effective provision of public services on the local level is the absence of clearly defined responsibilities of relations between central and local governments. The Constitution of Ukraine declares that all local governments are equal and that none of them can be subordinated to (or dominate over) another. But in practice the responsibilities for providing services by the different tiers of local government have not been clearly outlined. Relationships among the state, oblasts, the different types of localities, and consumers of public services are to a very great extent still stipulated by traditions, legal acts, and instructions of the Soviet era.

During the Soviet period communal services, social protection, health care, and education were state functions executed through the centralized system of social services: the entire population was obliged to work in state-owned enterprises through which almost all social goods and services were redistributed. After the collapse of the Soviet system, too many people were left without access to public services. Terms like "local government budget," "territorial (local) community," "responsibilities of local and central governments in delivering public services," as well as concepts of "fiscal decentralization" and "intergovernmental fiscal relations" are not familiar even today, and remain unclear for many citizens of Ukraine.

Up to now, the revenues of Ukrainian local governments consist mostly of central government transfers and most of the expenditure responsibilities of local governments have been delegated (and very often are unfunded mandates) by the central government. The disorder in expenditure responsibilities and revenue assignments, combined with the dependence on upper level governments, are the reasons for the continued reliance of local governments upon central or upper-level government donations. One of the results is a decline in financial discipline in the different tiers of power, which creates possibilities for shadow negotiations—some of which aim to cover gaps between LG expenditure needs and revenues which result in disparities between different local governments. Others are connected with the buying of power, privileges, and the use of public resources for private economic gain. Such shortfalls in financing result in arrears and inequality of access to public services, with the greatest (negative) impact on the low-income population.

This study aims to disclose some hidden causes of the reduction in quality and the increase in disparities in public resource distribution by local governments in Ukraine. For its analysis, the study relies on interviews with representatives of local and central governments and statistical data from 1998–2001.

List of Abbreviations

ACU	Association of Cities of Ukraine
APU	Administration of the President of Ukraine
AR	Autonomous Republic
ASD	average square deviation
BC	Budget Code
CIDA	Canadian International Development Agency
CG	central government
CM	Cabinet of Ministers of Ukraine
EPT	enterprise profit tax
GDP	gross domestic product
GRP	Gross regional product
FY	fiscal year
HC	Hunter's coefficient
ICPS	International Center for Policy Study, Ukrainian NGO
LG	local government
MATRA	Netherlands' Government Assistance Program for Developing States
MoEEI	Ukrainian Ministry of the Affairs of Economy and European Integration
MoES	Ukrainian Ministry of Education and Science
MoF	Ukrainian Ministry of Finance
NGO	nongovernmental organization
OR	Oblast Rada (Council)
OSA	oblast state administrations
PCA	Partnership and Cooperation Agreement between EU and third countries
PIT	personal income tax
RSA	Rayon State Administration
RR	Rayon Rada (Council)
SIDA	Swedish International Development Agency
SNG	subnational government
STA	Ukrainian State Tax Administration
VAT	value-added tax
WB	The World Bank
UAH	Ukrainian national currency (hryvnya), exchange rate: 5.2–5.5 for US $1.

2. FISCAL DECENTRALIZATION IN UKRAINE: MAIN ISSUES

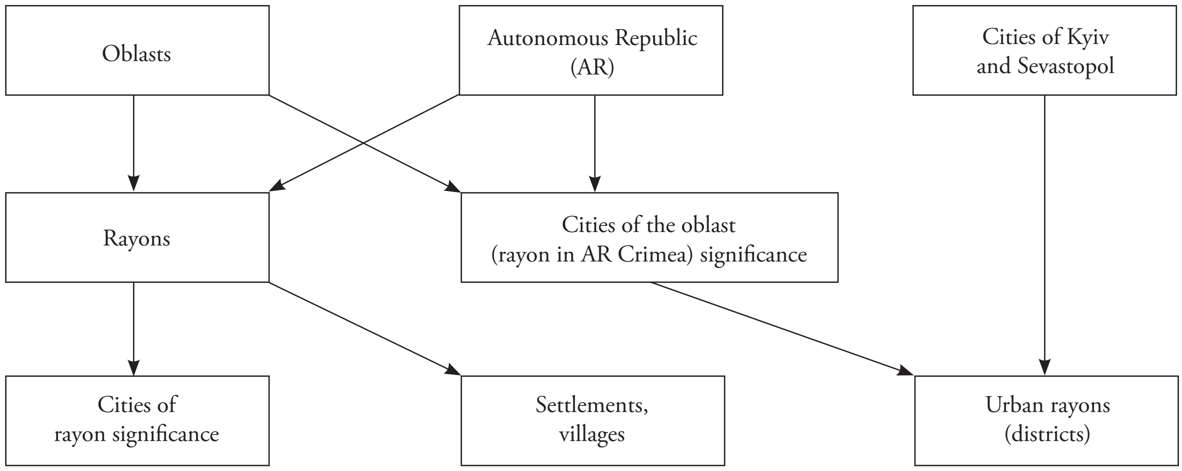
Ukraine has twenty-five administrative-territorial units of regional level: oblasts and the Autonomous Republic (AR) of Crimea, plus two cities—Kyiv and Sevastopol. To show relations between levels of power, the local administrative units of Ukraine can be depicted as in Figure 4.1.

Figure 4.1 shows that only a small portion of local governments in Ukraine—oblast centers, and Kyiv and Sevastopol (as cities with special status)—are not directly subordinate to the "upper level" of power. The relations between local governments in Ukraine are inherited from the Soviet past when all administrative-territorial units were vertically subordinated.

The authorities of oblast and rayon administrations are not clearly defined and overlap with the functions of the councils of these levels. As a result, rayon and oblast administrations are not accountable to the local community and are able to intervene in the authority of local governments of the "lower level." This vertical subordination determines the structure of fiscal relations in Ukraine.

According to data from the Association of Cities of Ukraine (ACU), Ukraine now has a total 451 local governments in cities and towns, and more than 29.5 thousand in urban and rural settlements (Kuibid 2000; ACU 2001).

Figure 4.1
Administrative Structure of Public Sector in Ukraine



One of the issues of Ukrainian fiscal decentralization is the limited capacity of newly established local governments to manage their public finances. The immediate relevance of this issue is demonstrated by the very rapid increase in the number of rural communities (which has almost tripled since 2000). Many of them cannot efficiently provide public services; they do not have their own budgets; and the incentives to improve their revenue base are very limited or almost absent.

Fiscal decentralization has not progressed in Ukraine since obtaining independence in 1991. Subnational government expenditures as a share of general government expenditures are shown in Table 4.1 below.

Table 4.1 shows that only shares of oblast and rayon government budgets increased, while budgets of cities and sub-regional governments now redistribute fewer public resources then during the first years of independence. Similar tendencies can be seen in the case of local government budgetary revenue. Instead of real fiscal decentralization, Table 4.2 shows a strong concentration of public resources at the oblast and rayon levels.

Taking into consideration the nature of the oblast and rayon governments, increases in the shares of budget revenue and expenditure on these levels have very little real impact on the improvement of public service delivery at the subnational level. A decrease

Table 4.1
Distribution of Expenditures Between Tiers of Budget System (without transfers and pension fund) [%]

Levels of Budget System	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
State Budget	68.57	62.18	60.49	64.66	52.70	56.36	60.10	51.86	54.58	64.70	59.7	60.0
Oblast	8.13	11.51	9.44	8.04	17.21	15.42	11.89	16.97	16.74	11.85	—	—
Cities of Oblast Significance	12.63	15.47	18.88	17.78	17.02	15.83	15.82	17.14	14.71	11.95		
Rayon	7.43	7.66	7.52	6.28	9.19	8.74	9.01	10.92	10.76	8.72	—	—
Sub-rayon Total	3.25	3.1	3.67	3.23	3.88	3.65	3.17	3.12	3.22	2.77	—	—

Source: Slukhai 2002.

in shares at the sub-oblast and sub-rayon level in the redistribution of public finance is evidence of permanent resistance by interest groups against the process of transparent fiscal decentralization in Ukraine.

The Soviet legacy has led to three kinds of difficulties in Ukrainian subnational policy and intergovernmental fiscal relations. The first is connected with the above-mentioned regional disparities caused by the disproportions and ideological biases of centralized Soviet economic planning. Some regional elites use their inherited privileged position to support disparities, defending their advantages by different means: through corruption, by buying power, or by influencing policymaking. Second, there is a high degree of government intervention of different types —explicit and implicit—in the economy and industrial development. Third, local governments have limited capacity to defend the rights of its citizens. Soviet power did not need local governments in the European sense; moreover, they were dangerous for the regime. Power was based on the extreme dependence of the population on government intervention in the personal life of citizens and community affairs within a centralized planned economy. Under the Communist regime, communal services were distributed to consumers through, as well as maintained by, industrial facilities. Taxes were collected automatically (though the socialist economy does not have a need for taxes). Nearly the entire population enjoyed access to communal services (of a very low level, but, nevertheless, almost free for consumers). After the collapse of the Soviet regime, local governments were needed to fill key positions in economic and social development, but they have so far failed to live up to this role. These three difficulties, inherited from the Soviet legacy, must be taken into account in any analysis of fiscal decentralization policy issues in Ukraine.

After 1991 funding from central to local government budgets was redirected through the oblast level. Oblast administrations today are not empowered self-government bodies representing real interests of local communities. They have no representatives directly elected by the population. The lack of political and financial capacity of local self-governments at the sub-oblast level makes the oblast a convenient place for the operation of "invisible power." The role of the oblast in redistribution of public finances has resulted in a decreased share of expenditures for other local governments, like cities and rural and urban settlements, and in an increase of the concentration of public finance at the oblast level.

Table 4.2

Share of Subnational Government Revenue in GDP (without pension fund and transfers) [%]

Budget Types	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Consolidated State Budget	25.15	24.40	33.47	35.62	30.27	28.24	30.40	28.19	25.20	28.40	25.71
State Budget	13.60	12.80	18.28	20.64	14.41	14.81	17.27	15.31	15.12	20.12	17.32
Total SNG	11.55	11.61	15.19	14.98	15.85	13.44	13.12	12.88	10.08	8.28	8.39
Oblast	2.47	3.50	5.44	4.57	7.50	6.42	6.61	6.38	4.87	3.45	—
Total Sub-oblast Levels	9.08	8.11	10.59	10.40	8.35	7.01	6.52	6.50	5.19	4.82	—
Cities of Oblast Significance	6.43	5.15	6.87	7.49	5.33	4.38	4.50	4.13	3.22	2.91	—
Rayon	1.58	2.12	2.94	2.13	2.28	1.94	1.34	1.74	1.45	1.38	—
Total Sub-rayon LGs	1.07	0.84	0.78	0.78	0,.74	0.70	0.68	0.63	0.53	0.53	—
Cities of Rayon Significance	0.30	0.22	0.20	0.22	0.22	0.25	0.22	0.21	0.19	0.19	—
Urban Settlements	0.29	0.22	0.20	0.21	0.19	0.17	0.17	0.16	0.14	0.13	—
Rural Settlements	0.47	0.40	0.38	0.35	0.34	0.28	0.28	0.26	0.20	0.22	—

Source: Slukhai 2002.

At the same time, the rayon level's share of expenditures did not change sufficiently—it was 2.42 percent of GDP in 1991 and remained nearly unchanged in 2000. To compare, the share of expenditures of the oblast level grew from 2.65 in 1991 to 4.47 in 1999, and then fell back to 3.30 in 2000 (Slukhai 2002). The share of revenues of cities and towns and other local authorities like urban and rural settlements decreased, in terms of GDP, more then 2.5 times on average during this period. While the share of revenue accumulated on the oblast level increased from 2.47 in 1991 to 3.45 percent in 2000 (Slukhai 2002).

This increased concentration of public resources at the oblast level took place together with a parallel concentration of power. But this was not real decentralization—rather a multiplication of central government bodies at the subnational level. The task of distributing the budget money among local authorities was transferred to oblast administrations. In an effort to secure their access to public resources, shadow interest groups supported this process by all possible means on all levels of decision- and policy-making.

Along with expansion of the administrative functions of oblast state administrations (OSA), the process of restricting the self-government role at this level of power also took place. Formally, OSA is representative of the central government on the territory in question, but in fact, OSA (not local councils) make decisions concerning the budget process. This is one of the reasons why until now fiscal decentralization in Ukraine has not been very successful. And at the same time, awareness of this fact was an argument in favor of the decision to displace the oblast level from intergovernmental budget relations. But this decision was unable to solve the problems of increasingly centralized decision-making and the strengthening of informal vertical administrative subordination on the subnational level, which create additional obstacles for the reform of intergovernmental fiscal relations.

Since 2001 oblast governments have been formally displaced from the direct redistribution of public resources. Instead, rayon governments started to play a decisive role in the redistribution of central budget resources on the local level. An interesting fact is that own revenues of local government budgets increased sufficiently over the last few years. The share of local taxes and duties has grown dramatically especially in small urban and rural communities—from 0.83 and 0.61 in 1991, to 16.41 and 6.48 in 1999 and 14.27 and 5.29 in 2000, respectively (see Table 4A.1 in the Annex for reference). Such an increase in local revenues is a "delicious piece," and attractive for the forces of the shadow economy who use the hierarchy of power in their illegal access to public resources. The existing vertical subordination of sub-rayon to rayon level governments paralyzes the decision- and policy-making of local governments of the sub-rayon level. Such subordination can make real positive change of intergovernmental fiscal relations doubtful. Ambiguous responsibilities and the uncertain legal framework of rayon power create a convenient environment for interest groups to exert their influence, exploiting the strong formal and informal dependence of sub-rayon governments on the upper levels of power. There is a risk that rayon governments will play intermediary roles in similar shadow schemes abusing the vertical subordination of power, which existed while oblasts redistributed a large share of public resources. This creates serious difficulties in the implementation of fiscal decentralization policy.

Lessons must be learned from the recent period of fiscal decentralization when oblasts redistributed a large share of the public finances of the sub-oblast governments. Decentralization is possible only if the capacity of local authorities is strengthened, and the responsibilities and functions of the different local governments of the subnational, sub-oblast, and sub-rayon budget levels are clearly defined.

When the responsibilities of government A are delegated to it by another government B, and if A is subordinated to B like to an "upper level government," then this type of fiscal relation is called *matryoshka* or "budget within budget." This hierarchical relationship inevitably leads to disparities in expenditure and revenue between governments as a result of nontransparent decision-making; it also leads to the concentration and abuse of power and the ineffective use of available resources. As recent history shows, *matryoshka* cannot be changed by mere decrees or policy documents, for in present-day Ukraine official government lacks sufficient executive power to implement constructive public policy and is under the control and strong influence of an "invisible power"—interest groups, who attain their goals through their privileged positions and their access to public resources (in short, through corruption).

Therefore, effective implementation of equalization instruments in intergovernmental fiscal relations is impossible without enhancing the capacity of local governments in exerting their right to decide about the provision of public goods and services, and their right to autonomy in policymaking. Absence of stable and equal "rules of the game" in the intergovernmental budget process creates a basis for informal relations between the main actors. Formulation of the existing relations and making them transparent is urgently needed; and would strengthen the public and legal accountability of the main actors of intergovernmental fiscal relations.

3. CHARACTERISTICS OF LOCAL FINANCE AND INTERGOVERNMENTAL FISCAL RELATIONS

3.1 Local Government Finance

From year to year there is much discussion in Ukraine about the expansion of the powers and financial resources of local government budgets. However, in reality local governments have not become more independent and powerful. Table 4.3 shows the general relative decrease of local government revenues.

Since independence the share of local budgets in the aggregated state budget in incomes (tax and non-tax incomes, without taking into account transfers and revenues of state-owned enterprises) has decreased to 33.9 percent as of 2001. At the same time, the share of transfers in incomes of local budgets doubled: the share grew by 30 and 31 percent in 2000 and 2001, respectively (in comparison with 1999 figures). Almost one-third of local expenditures in 2001 are special fund, whereas transfers approached about 70 percent (the share of transfers in the special fund of local budgets in 2000 was equal to zero). Local government planned revenues and expenditures are executed as concerned to special funds. At the same time, financing of the expenditure part of the general fund decreased. Such high densities of the targeted and tied expenditures of local governments (the latter are connected with implementation delegated by central government responsibilities) come into contradiction with social issues and hinder remedies to social problems which have accumulated in regions. A redistribution of budget revenues is going on in favor of the state budget in Ukraine without a corresponding transfer of functions to the state level, leaving local governments with a significant portion of functions.

Some of the increase in local government revenues, as shown in official statistical data, is virtual because the increase is the result of the so-called mutual settlements—calculations discharging the reciprocal debts of counteragents in an economic chain without an actual transfer of money. As a rule, the counteragents in the chain originate from one of the following institutions: oblast and rayon governments, enterprise-monopolist, and state-owned or communal entities located on the territory of local governments. The mutual settlements are done in favor of enterprises—monopolists and shadow interest groups—who exploit the difference between real (market) prices and the prices paid by energy carriers and other local providers of goods and services. The later prices are dictated by upper levels to local governments (and the budget entities located on their territory). The power of oblast and rayon administrations is a significant factor: for the settlements are grounded on alliances or "informal relations" between the apparatus of oblast and rayon powers and shadow business. Such power alliances continue to operate due to the conservation of the roles of these two levels of power

Table 4.3
Share of the Local Governments in Combined Budgets of Ukraine 1996–2001 [%]

	1996	**1997**	**1998**	**1999**	**2000**	**2001**
Revenues	36.2	43.2	45.7	40.0	29.1	25.1
Expenditures	34.4	39.9	48.1	45.4	35.3	33.9

Source: AHT 2001.

in the distribution of budget resources between local governments; and because of the low fiscal capacity of smaller local governments, weak community voice, and limited information and little skill or experience on the part of citizens in defending their interests.

The situation with local government revenues cannot be understood outside the context of trends in state revenues. In spite of economic growth (MoF reports a 9.1 percent increase of GDP in 2001), the main revenues of the state budget have not increased sufficiently. The growth of PIT in 2000–2001, to a certain degree, was caused by a reduction in the debt of enterprises for employee wages. But the most important factor in the growth of PIT proceeds is the infringement of the principle of tax relief for the poor, more specifically, for those living below the poverty level. This principle is considered an obligatory condition of social justice in the fiscal policy of many countries, but not in Ukraine.

The revenues of local governments in Ukraine can be divided into three groups: (a) own revenues, or revenues derived from local government territories and assigned to certain local governments; (b) national taxes, which are redistributed among central and local budgets; and (c) transfers from upper level government. The amounts from own revenues and national taxes are small. So, in fact, donations from the central budget make up the main source of subnational government revenues.

Changes in the central government budget process work against the generation of own revenues in local budgets. As a result, local government budgets become "artificially donated." In 2001 as many as eleven oblasts received 1.3–1.9 times more from the state budget than from their own revenues (Fomenko 2001).

Revenues from real estate tax, including land tax, could become a significant funding source for local governments. Several draft laws in this field have been submitted to Verkhovna Rada in previous years, but none of them were adopted. Moreover, the draft Tax Code, prepared in 2001, does not increase the financial independence of local governments. The local taxes provided for by the draft cannot become a reliable and sufficient revenue source for local budgets (Pyatachenko 2001).

3.2 Shortcomings of Ukrainian Intergovernmental Finance

Since gaining independence, Ukraine has tried to function with the system of public finance inherited from Soviet times. The inherited system's more notable features consist of its high degree of nontransparent and discretionary decision-making, its unstable expenditure and revenue assignments for local governments, and its disincentives for local governments to raise additional revenue and spend money more effectively. The following shortcomings of Ukrainian intergovernmental fiscal relations deserve closer inspection:

- *High degree of fiscal turbulence*. Almost every year since independence has been marked by a different pattern of tax-sharing and transfer payment arrangements. Moreover, local budgets consistently receive less than the whole sum of subsidies from the state budget as estimated in the budget law.

  Therefore, until 1997, VAT was shared in varying proportions between the central and local budgets. Variable tax-sharing also characterized the income taxes paid by individuals and businesses. For example, in 1997 and 1998 proceeds from the personal income and enterprise profits taxes (EPT) were assigned exclusively to local budgets. In 1999, however, these income tax sources were once again shared between the central and oblast budgets. For the year 2000, the PIT was assigned entirely to local budgets and the EPT became an exclusively central government revenue source.
- *No clear definitions of "who should do what."* On the expenditure side, responsibility for different tasks has suffered from the absence of clear definitions of "who should do what." Since independence the central government has steadily shifted most elements of social protection spending to regional and local governments. Such a policy has proved its effectiveness in most EU countries, where welfare support is a competency of local or regional governments. This approach is based on the assumption that the cost of life differs markedly across communities, so unique national standards would be unfair; if you want

to target assistance through means testing, this can only be implemented at the local level. But these arguments do not work in the conditions of contemporary Ukraine, where a large part of the population lives below the poverty level and cannot "vote by feet." Moreover, people suffer from arrears and disparities in public service provision, caused by the unfunded expenditure responsibilities.

Before FY 2001, oblast and rayon governments distributed public finances amongst the local governments. Very often it was done without any apparent rational purpose or criteria. As of 2001 this function remains only with rayon authorities.

- *Inequality in service delivery.* Because of unstable revenue patterns and unclear expenditure responsibilities, fiscal inequality between different local governments has grown. It is especially obvious when looking at variation in per capita service levels and expenditures on certain public services (Table 4.3; also Table A4.2 in the Annex). These variations result both from uneven distribution of revenue sources and informal redistribution of state donations.

The same factors have also led to a wide fluctuation of arrears in educational expenditures. Table 4.4 shows that arrear shares were 120 percent in rayons and cities of rayon significance in Lviv oblast and 189 percent in cities of oblast significance in Odessa oblast

Table 4.3

Coefficient of Variation in Expenditures on Medical Services on Different Governmental Levels, 2000

Levels of Government	Number of Places [%]	Number of Visits [%]
Oblast Centers	42	18
Cities of Oblast Significance	90	63
Rayons and Cities of Rayon Significance	67	66

Source: Calculated on ACU 2000.

Table 4.4

Variations in Educational Expenditure Debt at Sub-oblast Level, 2000

	Total Debt [%]	Salaries Debt [%]	Communal Services [%]
Rayons and Towns of Rayon Significance in Oblasts			
Lviv	120	217	124
Odessa	94	112	103
Luhansk	90	94	108
Kharkiv	83	83	110
AR Crimea	78	89	82
Cities of Oblast Significance in Oblasts			
Lviv	123	160	86
Odessa	189	135	117
Lugansk	106	77	126
Kharkiv	168	173	172
AR Crimea	89	105	99

Source: Calculated according to data from FAO 2000.

(an example of a sub-rayon level is depicted in Table A4.3 in the Annex). One explanation is that some local governments are more successful in personal contacts and use a permanent hidden budget deficit for leverage in nontransparent negotiations. Under such conditions equalization instruments are not effective, especially when the service level is decided by a central government which does not fulfill its own funding commitments. The survey of FAOs shows that, in FY 2000, in Lviv and Odessa oblasts the central government owed more than UAH 14 and 23 million, respectively, to local budgets for educational expenditures; in Luhansk oblast more than UAH 36 million; in Kharkiv and AR Crimea—more than 41 and 49 million respectively (FAO 2000).

3.3 Budget Code: New Approaches and Old Problems

The Budget Code (BC) proposed four important structural changes in intergovernmental finance. These changes comprise a rational set of expenditure and revenue assignments among different types of government, a targeted transfer program for certain kinds of social protection, and a formula-based transfer system connecting the state budget to all local governments, oblasts, cities, and rayons.

To meet their obligations, state and local budgets have distinct sources of revenue. The most important revenue sources prescribed by the BC for local governments are: local taxes and duties; PIT and land tax (shared between levels of subnational government); EPT of enterprises of communal property; incomes from selling communal property; own incomes of budgetary entities and organizations; industry tax; and taxes on owners of motor vehicles.

For financing expenditures calculated using budget norms, a basket of revenues has been defined to fund the budgets of territorial communities. This revenue basket comprises all of the proceeds raised in a local jurisdiction from the PIT, stamp duties arising from court actions, fees collected for issuing licenses and trade patents, for registering business entities, and fees generated from fines and penalties for legal infractions (except those collected by the state road patrol). The elements of this revenue basket are the logical components of a rationally designed local tax base because they all represent taxes and fees paid by local residents rather than by "outsiders" (though the current PIT does not fully meet this criterion and is to be eliminated by the future Tax Code). The composition of these taxes is in agreement with international practice and supports a linkage between the payment of local taxes and locally provided public services that will strengthen the accountability of local government officials to local taxpayers. A fraction of PIT, 25 percent, collected on the territory of an oblast or the AR Crimea will be allocated to fund, at least in part, the expenditures of regional budgets. In addition, the state establishes a special algorithm for the distribution of the PIT among towns, villages and settlements on the one hand, and rayons on the other—25:50 (the remaining 25 percent, as mentioned above, is paid to oblast budgets). For the cities of Kyiv and Sevastopol, their budgets will receive 100 per cent of the revenue basket. The full amount of other revenue sources in the defined "basket" is used to fund territorial communities. In this way, every subnational government will have access to a pool of locally generated revenue that, depending on the size of the tax base in an area, may or may not be adequate to finance transfer-related expenditure responsibilities. Transfers play a residual financial role in balancing local budgets in situations where the pool proves to be either inadequate or, in some cases, more than adequate.

To provide towns, villages, and settlements with some degree of revenue independence, rayons are required to leave no less than 25 percent of the PIT paid by citizens who work in the respective territorial unit. This distribution algorithm set for the most promising revenue source of local governments is designed to provide the communities with some fiscal autonomy.

Local governments receive 75 percent of the land tax (60 percent for towns, villages, and settlements) and some other minor sources for funding expenditure assignments that are not calculated on a norm basis and hence are actually own expenditures that are intrinsic for local self-government. It is important that the above-mentioned sources are not included in the "main" revenue basket and thereby are excluded from the base for transfer calculations. In other words, in contrast to the current practice, each "additional" UAH of local revenue does not "crowd out" transfer-related UAH from local revenues.

Some of the weaknesses of this revenue source pattern can lead to perverse incentives for the local governments of sub-rayon level. Relations of property are defined on the upper (rayon and/or oblast) governmental level, and very often decisions are not made in the interests of the local community. Even now there is no clear framework for municipal property, especially that of the basic local community level. Meanwhile oblast administrations are *de facto* owners of many state and communal enterprises and property. Another source of disincentives is the fact that local government revenues are determined by, and managed from, the rayon and oblast levels; thus many services—like land cadastre, city construction and planning, sanitary and ecological control, etc.—are concentrated in oblast centers and as a rule are subordinated to rayon or oblast administrations, or central agencies.

BC also sets a framework for the financial activity of local governments: oblast, rayon, city rayon and settlement budgets must be adopted without deficit in the operational budget (Article 72). To cover gaps in the execution of budgets, subnational governments are permitted—after the decision of related councils—to take short-term loans by upper-level subnational governments. Maximum time of crediting is three months and a loan must be repaid within one budget period. Other loans from one budget to another are prohibited. Such regulation limits the opportunities for local governments to attract additional resources, investments, or to raise their tax bases by working with real estate, land improvement, constructing new property and making contributions to infrastructure and human resources development. Instead, such limitation, preserved by BC, causes perverse incentives and hampers provision of public services and local economic development. It is especially harmful for poor and small local governments, which have very few possibilities to develop their revenue bases and increase the welfare of their citizens. Moreover, in conditions of arrears and unfulfilled obligations by the central government, such regulations—prohibition to adopt deficit budgets and restrictions on the use of financial market instruments—push local governments to nontransparent negotiations with the upper level of power and other shadow and unfair activities.

Adoption of a deficit budget would mean first of all formalization of needs, and could be a stimulus to look for resources to cover this deficit, in such forms as borrowing on the financial markets and horizontal cooperation. On the contrary, with such regulation, the BC legitimizes hidden deficits, at a time when local governments are interested in showing unreasonably exaggerated expenditure needs, in an attempt to establish a stronger position in shadow negotiations. In fact, the limitation preserved by the BC in this area pushes LGs away from financial management of municipal resources with the goal of increased own revenues, toward the old Soviet scheme of intergovernmental relations within centralized planning.

There are some changes in expenditure responsibilities of SNGs. Delegated expenditures are prescribed for the rayons and cities of oblast significance: on the state management (for cities of oblast and towns of rayon significance, for self-government bodies of rayon significance); education (preschool and secondary, residential schools, and other state education programs); health care; state programs of social provision and protection; implementation of the governmental policy towards children, youth, women, and family.

SNG spending is divided into three separate expenditure "pots": for oblasts; for cities and rayons; and (a smaller one) for towns, villages, and settlements. The content of each expenditure pot is different. Each pot is designed to have a comparative advantage over other "pots" in carrying out the functions that have been assigned to it. Choice concerning the content of each pot is guided by the principle of subsidiarity, or assignment of a particular task to the type of government capable of effectively carrying it out. The BC does not use the word "level of government" with respect to SNGs as the document is steeped in the ideology of subnational independence and autonomy.

Expenditures which potentially affect all residents of an oblast have been assigned by the new BC to oblast budgets (e.g., specialized secondary educational institutions for disadvantaged students; secondary boarding schools; vocational and higher education institutions; general hospitals of oblast significance; specialized medical services; specialized social protection facilities for orphans, disabled persons, and the elderly; hospices; and specialized sports programs). Expenditures whose scope of benefits does not ordinarily extend beyond the boundaries of the local area have been assigned to city and rayon budgets (e.g., general secondary education, general health care services including health education programs, and social protection programs that provide physical services to the socially disadvantaged residing in a local area such as residential home care for the elderly). Expenditure tasks of purely local significance have been assigned to the budgets of towns, villages, and settlements, all of whom will be responsible for preschool education, primary medical care offered through local clinics, first aid and obstetric centers, and cultural and entertainment programs. Larger towns with secondary schools and district hospitals will be responsible for the services provided by these facilities. Of course, cities will also undertake other responsibilities as described in the previous item.

Kyiv and Sevastopol take all of the expenditure responsibilities that are assigned to oblasts, cities and rayons, and towns, villages and settlements, taking into account other laws of Ukraine which define their special status.

For social protection programs that are of a cash nature and have a nationwide scale of benefits, cities and rayons provide the mandatory benefits to be compensated by targeted subventions from the state budget. Aid to families with young children, subsidies for communal services, and benefits to war and labor veterans are examples of the targeted transfer that will be provided to local budgets from the state budget.

All of the expenditure tasks that have been mentioned are transfer-related whose funding is calculated on the basis of financial norms of budget sufficiency. In other words, the state plays an important role in defining those resources that are designated to fund these functions, since the state is interested in providing these services at comparable levels in terms of volume and quality across administrative-territorial units. The state has the authority to regulate budgetary performance in these areas, as well as the responsibility to ensure that the areas are adequately funded through a combination of assigned tax revenues and either targeted or non-targeted transfers.

Those expenditure tasks that are left at the discretion of local governments and hence are not taken into account in defining the amounts of transfers, involve public services that are of a housekeeping nature such as water and sewerage supply, roads, refuse removal, and the general maintenance of local public sector infrastructure.

From the perspective of the budgetary process, at the stage of preparing their budgets local governments must strive to finance their total expenditures from their own source revenues, transfers, and the basket of revenues designated to fund transfer-related expenditure assignments. At the stage of budget execution, however, all moneys flow into a common revenue pool and can be used to finance any type of expenditure.

Within the limits of available resources, adjusted per capita expenditure norms (adjusted for geographic differences in the cost of providing social services as well as regional and local variations in socioeconomic conditions, climatic, environmental and other natural factors) are established for each type of delegated expenditure responsibility and guaranteed by the state.

One article of the BC proposes a mechanism for the reconciliation of relations between the budgets of rayons and cities (which serve at the same time as centers of rayons). In practice, residents of a rayon may use services provided by entities funded from the relevant municipal budget. In the past no payments from the rayon budget were made, and this led to conflicts. The BC has provided for both contract-based reconciliation of such cases and for transfer liabilities (if budget-funded entities of the rayon or city are not capable of providing funds in the needed amount). It should be noted that both the MoF and local financial departments were to consider this problem when preparing the 2001 budget, but there is always some room for improvement and this will be demonstrated by the 2002 budget.

Among unresolved issues, one in particular is worthy of note: the BC's forbidding execution of expenditures during one budget year from sources within more than one government budget. This prohibition reflects the unstable situation with property relations (transfer of property from one tier of government to another) and the changing responsibilities of different local governments for this or that kind of expenditures. The roots can be traced back to the Soviet legacy, when public services were very often tied to the facilities of enterprises, not to local governments. Now upper levels of power try to keep the "better pieces" and to "get rid" of the less attractive ones. But the interests of community are not a decisive factor in the midst of these turbulent changes. The decision to exclude the oblast level from provision of some services in these conditions has made the issue even more complex. Oblast administrations have not been distanced from property relations. Moreover, OSAs are in fact main communal property owners; they are also co-owners and corporate managers of main state enterprises, like electric power stations, heavy industry, and communications infrastructure. Therefore, the position of the oblast level in property and intergovernmental fiscal relations is very strong. Facilities and related expenditure responsibilities are distributed with the participation of OSAs. But at present the OSA is not engaged like local government but rather as an "invisible power," usually playing on the side of interests groups and using informal relations within the vertical of power (between the apparatus of oblast and rayon governments). Together with the above-mentioned reduction in financial autonomy of local governments, the unstable property relations lead to the deterioration of infrastructures because small and poor local governments cannot maintain facilities, that belonged before to oblast or rich enterprises. Improved quality and effectiveness in the delivery of services requires strong political will and increased local government capacity, as decisions concerning the adjustment of old facilities and the development of infrastructure require strategic skill and program management techniques. At present local governments are inclined toward populist decisions, or those that have been dictated by shadow interests.

Though it initiated many positive changes, the introduction of the BC raised many questions which have yet to be answered. The optimization of intergovernmental fiscal relations cannot be achieved solely by shifting the LG distributive function from oblast to rayon level. Just like some years before, when informal bargaining was topical on the relations between oblast and sub-oblast levels, such bargaining is now timely for the relations inside rayon levels because MoF does not define expenditures for governments of small communities. According to the BC, in regard to revenue base and the collection of revenue, rayons are disaggregated into rural and urban settlements and towns of rayon significance. At the same time, these sub-rayon governments are lumped into a single administrative-territorial unit when transfers are calculated. In respect to expenditures, the BC has rayon governments divide expenditures within their territories amongst other self-governments. Interviews with authorities of small local governments reveal that very often expenditures and revenue distribution is done in an arbitrary and nontransparent way. In fact, there is a continuation of the "budget within budget" approach or the *matryoshka* relations, on the rayon level.

4. FISCAL EQUALIZATION: TOWARDS NEW TECHNIQUES

4.1 Previous Policy in Local Government Expenditure Equalization

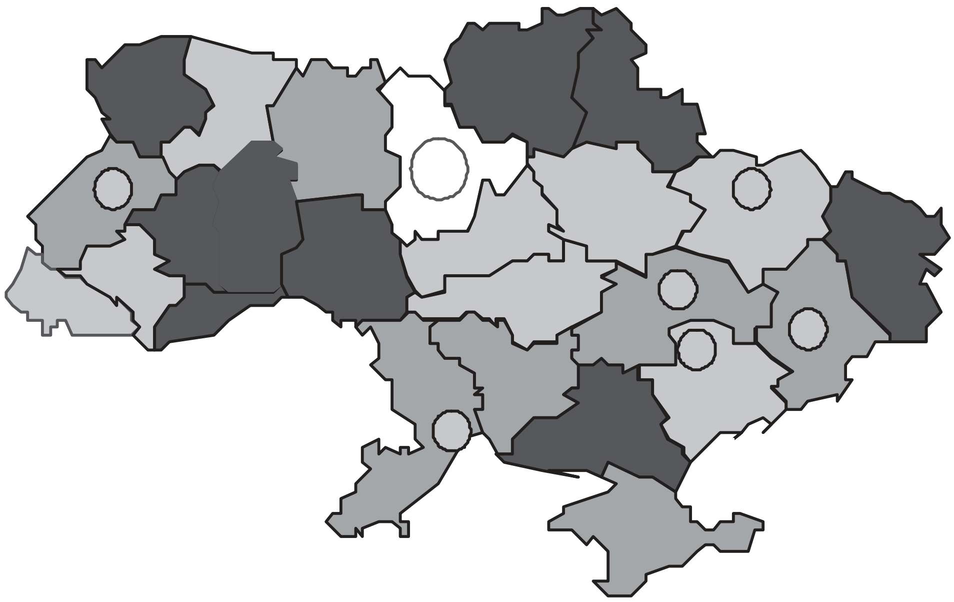
During the previous period, the equalization procedure—the so-called budget regulation—was performed by altering rates of shared taxes and transfers from the central budget. MoF also tried to control the expenditures of local government budgets by estimating minimum and maximum deviations from planned figures and using appropriate information to affect the expenditure distribution. However, the efforts of the government in equalizing expenditures were not effective. Planned expenditures of local governments on all levels were usually changed or "corrected" many times during the fiscal year. Quite typical were cases when local governments "adopted" or "confirmed" ex post expenditures, which "explained" and "justified" some extra spending of public resources.

The result was that execution of local government budgets never corresponded to MoF projections. In many cases interregional disparities in actual expenditures differed drastically from the planned ones. So, MoF insisted that 85 percent would be the minimum and 120–125 percent the maximum deviation from the national average per capita expenditures (See Table 4A.4 in the Annex*)*. For example, according to the calculated normative in 1998, expenditures of the local budget in Zhytomyr oblast should have increased up to 120.6 percent, relatively to the national average. While in fact the expenditures reached only 99.8 percent. Expenditures in Lugansk oblast were not only less then planned, but were much lower than the national average—only 77 percent, etc. At the same time, expenditures in Kyiv reached 181 percent of the national average, whereas the planned were 109.6 percent.

As Figure 4.2 below shows, there were large disparities in expenditures of local government budgets. Therefore, average expenditures of the local (consolidated oblast) budgets per capita in 1999 were UAH 317. In eight oblasts—Vinnitsa, Luhansk, Sumy, Ternopil, Kherson, Khmelnitsky, Chernigiv, Chernivtsy—the expenditures were lower than UAH 270. In other words, the expenditures in these eight oblasts were 15 percent lower than the country average (UAH 316.9). During the same period, in Zaporizhzha, Kyiv, Poltava, and Rivne oblasts the expenditures were 15 percent higher than the country average. The maximum level of average per capita expenditures of local budgets was in Kyiv—its estimates were 2.5 times higher then lowest one registered in Chernivtsy oblast (Lunina 2000).

These disparities can be explained by demographic differences, but the generally negative features of Ukrainian intergovernmental fiscal relations are the primary cause. The financing of certain services followed from the responsibilities of a particular tier of government for the provision of this or that educational, health care, social service, cultural, or industrial facility. In Soviet times, the central government permitted exceptional conditions for certain territories based on economic planning; even today the territories developed under these plans continue to assert their will upon the central government. Some local governments received additional resources for the development of facilities and communal infrastructures for social, medical, and cultural services, if in the past there were large factories or enterprises situated on their territories. Some local governments were motivated by the perverse incentives of the system to use economically inefficient infrastructure to prove a further increase in expenditure needs. This situation was reinforced by the List of Expenditures of the Republican Budget of the Crimea Autonomous Republic and the Local Budgets that was included in the Law on the Budgetary System of Ukraine (1995).

Figure 4.2
Local Government Per Capita Budget Expenditures, 1999



Legend:
Black—UAH 200–270 (Volyn, Khmelitsky, Luhansk, Sumy, Chernihiv, Kherson, Ternopil, Vinnitsa, Chernivtsi oblasts)
Dark grey—UAH 270–310 (AR Crimea, Zhytomir, Mykolaiv, Odessa, Lviv, Donetsk, Dnipropetrovsk, Kirovograd oblasts)
Grey—UAH 310–440 (Poltava, Rivne, Zaporizhzhia, Zakarpattia, Cherkasy, Kharkiv, Ivano-Frankivsk oblasts)
Bright—UAH 500–520 (Kyiv, Kyiv oblast)

In 2001, the BC abolished this law and introduced a new formula-based approach in financing the expenditures of local governments.

4.2 Vertical Imbalance

One might suppose that the vertical balance in Ukraine is quite high. The scale of vertical imbalance can be depicted by Hunter's coefficients (HC); where values closer to zero indicate a larger vertical imbalance because SNG total expenditures are covered mostly by revenue sharing and transfers. But these coefficients are indicative of a general vertical imbalance at the macroeconomic level. They are valid for stable countries with a transparent budget process and rule of law, and where democratic principles dictate intergovernmental fiscal relations. However, these data can offer us little insight into the conditions of a transition economy with a high level of normative turbulence, where written rules are often transgressed and shadow negotiations are common.

In Ukraine, in 1999, HC #1 was 0.275 and HC #2 was 0.814, which are very high even in comparison with well developed economies. In 2000, HC #1 rose significantly—up to 0.609, and HC #2 fell to 0.742 owing to a re-shifting of public revenues (the system of revenue sharing was superceded by the system of ceded taxes). According to preliminary calculations in 2001, HC #2 would be 0.874, higher than it was in 1999.

From these calculations one could conclude that Ukraine is successfully covering its vertical imbalance from year to year, with HC #1 doubling and HC #2 close to 1. But the truth is that these coefficients do not reflect the degree of discretion that subnational governments like oblast and rayon administrations have over different public resources. Very often redistribution of public finance within an oblast or rayon is done in a nontransparent manner. Small local councils, responsible for delivering public goods and services to their citizens, are not allowed to manage their own resources; they do not have their own budgets. Through such means upper levels of power try to control the revenues of small councils, with the unfortunate consequence that the functioning of small councils is impeded as they do not receive (or do not receive on time) the full amount of funding or resources to enable them to execute responsibilities connected with local government expenditures. Arbitrary decision-making in money allocation to small local councils results in arrears, disparities, and insufficient finances for the fulfillment of everyday responsibilities.

4.3 Horizontal Equalization in the Recent Past

One issue of Ukrainian fiscal equalization policy was the lack of stable "rules of the game" in the collection of taxes. Analysis of the available data shows that in many cases low tax receipts were related not to a region's level of economic development and, accordingly, not to a low base of taxation, but rather to differences in actual regional tax collection.

Table 4A.5 in the Annex shows that, for example, in Dnepropetrovsk and Zaporizhzhya oblasts— which are permanently counted in the top five oblasts for total added value per capita—the amount of taxes paid in 2000 was 17 kopecks per 1 UAH of added value; i.e., it was lower than the country average (19 kopecks), and is lower than, for example, in Volyn oblast which in total added value per capita was ranked 21st in 2000. In Luhansk oblast, which places 9th in per capita added value, the amount of taxes collected (without VAT) was only as much as 13 kopecks from each UAH of added value. This is less than in the Chernivtsy oblast, which occupies the last (27th) place in the total added value parameter. The Lviv oblast—which by the level of taxation can be included into the top five oblasts—occupies only the 18th place by the measure of regional total added value. In six oblasts of Ukraine, the level of taxation did not exceed 70 percent of the national average, i.e., was less than 13 kopecks from 1 UAH of the added value produced in the region, while the national average was 19 kopecks (Lunina 2000; AHT 2001).

The large disparities in the revenue share transferred from local to central budgets observed in Ukraine can also be explained by the annual writing-off of debts and other obligatory payments to the budget. Large sums of money were not paid to the central (as well as to local government budgets) because of the tax privileges granted to different communal, state-owned, and private enterprises. These negative tendencies were especially harmful as they destroy the incentives for enterprises to pay taxes, knowing that at some point in the future the accumulated tax debts will be written-off or restructured. The result is a loss of revenue for both central and local government budgets.

At the same time, together with strong centralized decision-making, intergovernmental fiscal relations reveal the weakness of the central government's policy management. An example is the PIT forecast calculation. During 1998–2000 some local governments covered arrears in the budget sphere, connected with arrears in salaries to education, health and social workers, and some other services that were not provided. Therefore, the central government provided additional funding for this purpose. SNGs which covered these debts received additional revenues from the PIT. In 2001 such a covering of debts was not planned in those oblasts which had no debts. At the same time, the central government planned a further increase of PIT collection, as if these oblasts had to continue to cover debts. The conclusion is that the central government was badly informed and simply did not take into account the fact that in some oblasts debts had been covered, while in others they had not (Fomenko 2001).

This example further shows that the central government, taking enormous responsibility in the redistribution of public finances, poorly managed the forecasting and regulation of the revenues and expenditures of local governments. It is clear that current disparities cannot be corrected by existing mechanisms.

4.4 New Equalization Procedure[1]

In order to correct the fiscal imbalance, the BC has introduced new fiscal equalization techniques aimed at establishing a workable decentralization process. A key element of the new Ukrainian equalization policy is that transfers are computed on the basis of a formula that takes into account the difference between a local government's estimated transfer-related expenditure needs and its estimated revenues.

The BC does not spell out the precise formula to be applied, but rather identifies the following set of principles with which the formula should conform:

- Equalization transfers are to be based on a percentage of the difference between a local government's estimated per capita expenditure needs and its estimated per capita revenue capacity multiplied by the size of the population served by the local government.
- In the event a city or rayon enjoys estimated revenue surplus to its estimated expenditure needs, a negative transfer or contribution, calculated according to the same formula, is to be made to the state budget.
- Estimates of revenue capacity reflect a local government's index of relative fiscal capacity, measured on a historical basis as the ratio of a SNG's per capita revenue basket relative to the national average.
- Once calculated, indices of relative fiscal capacity cannot be revised more frequently than once every three years. This is intended to encourage local government revenue efforts.
- A transfer is equal to the difference between a local government's estimated per capita expenditure needs and its estimated per capita revenue capacity multiplied by the number of residents. To encourage local government revenue efforts, the central government will not withdraw the so-called surplus which stems from the formula (in case the need in expenditures is lower than the anticipated revenue).

The algorithm for allocating transfers among different SNGs was first adopted by the Cabinet of Ministers of Ukraine in December 2000 (CM 2000). According to this document, the calculations of the equalization transfer should be done according to the following rules. In 2001, the *volume of the equalization transfer*—from the central budget to oblast, city of Sevastopol budgets; from budget of AR Crimea and oblast budgets to local government budgets of cities of republican (in AR Crimea) and oblast significance and to the rayon budgets; as well as transfer to the upper level budget (T_i)—was determined on the basis of general fund of budget as the difference between the calculated volume of expenditure of a given administrative-territorial unit (V_i), and the forecasted volume of revenues accumulated on its territories (D_i), according to the formula:

$$T_i = V_i - D_i;$$

In 2002, however, two equalization coefficients, "alpha" and "beta", were introduced (these coefficients are explained below); as a result the formula of the equalization transfer calculation received the following expression:

$$T_i = \alpha_i (V_i - \Delta D_i \beta_i).$$

4.4.1 Revenue Calculation

The forecasted volume of revenues for the general budgets of AR Crimea, oblast budgets, and the budgets of cities Kyiv and Sevastopol consists of (1) national ceded taxes and duties and own revenues, (2) EPT, accounted to the budgets of AR Crimea and Kyiv, and (3) excise duties on goods produced in Ukraine (with the exception of those on oil/petroleum products) that is accounted to the budget of AR Crimea, and is calculated according to the following formula:

$$D_i = D_{izak} + D_{ivl} + D_{ireg}$$

where

- D_{izak}: calculated volume of fixed revenues of the local government budget in the next year
- D_{ivl}: calculated volume of own revenues of next year's local government budget
- D_{ireg}: calculated volume of incomes from EPT, which is accounted to the budgets of AR Crimea and Kyiv, and excise duties from goods produced in Ukraine which are accounted to the budget of AR Crimea for the next budget year (with the exception of the duties on oil/petroleum products)

Calculation of *volume of ceded revenues of the general budget* of AR Crimea, oblast budget, and Kyiv and Sevastopol (D_{izak}) is defined according to the formula:

$$D_{izak} = D_{ikzak} + D_{isp} + D_{ipz}$$

where

- D_{ikzak}—calculated volume of the revenue basket fixed to the general budget of AR Crimea, oblast budgets, and budgets of Kyiv and Sevastopol which is calculated according to index of relative fiscal capacity, defined according to individual calculation (CM 2000)
- D_{isp}—calculated volume of fixed agricultural tax in part belonging to the particular budget which is defined according to individual calculation
- D_{ipz}—calculated volume of income from selling land plots of non-agricultural usage (with the exception of those plots owned by the state), defined according to the individual calculation

The calculation of the volume of the revenue basket of the general budget of AR Crimea, oblast budgets, and budgets of Kyiv and Sevastopol is defined with the help of the index of relative fiscal capacity which is calculated on the basis of factual incomes of taxes, and duties (revenue basket) assigned to these budgets during the last three budget periods (basic period).

The forecasted volume of the revenue basket of the general budgets of the AR Crimea, oblasts, and Kyiv and Sevastopol budgets which is defined by means of index of relative fiscal capacity, consists of the following national taxes and duties: (1) PIT; (2) land tax; (3) state duty; (4) payment for licenses for certain kinds of economic activity and certificates, which are provided by AR Crimea Council of Ministers and executive powers of local councils and local governments; (5) payment for the state registration of subjects of entrepreneurial activity; (6) payments for commercial patent for certain kinds of entrepreneurial activity (not including payments for the commercial patent for selling oil/petroleum products); (7) incomes from fines paid to the budget of the local government on whose territory the transgression was committed (except for those fines which are exempted by the empowered officials of the Anti-monopoly Committee and State Automobile Inspection of Ukraine); (8) financial sanctions, fines and penalties for violation of fiscal legislation; (9) unified tax for the subjects of small business, in part belonging to related local government budgets.

Volumes of the revenue basket fixed to the general budget of AR Crimea, budgets of oblasts and the cities of Kyiv and Sevastopol are calculated on the basis of the forecasted volume of revenues of the general budget of Ukraine, defined on the basis of the main macroeconomic indicators of national economic and social development in the planned financial year, as well as by way of the *index of related fiscal capacity* of administrative-territorial unit, calculated by the following formula:

$$D_{ikzak} = D_{u4} / (N_{u1}+N_{u2}+N_{u3}) \times \overline{K_i}\ (N_{i1}+N_{i2}+N_{i3})$$

where K_i =

$$(D_{i1} \pm X_{i1} \pm P_{i1}+L_{i1}+T_{i1}+R_{i1}) / \frac{D_{u1}+X_{u1}+P_{u1}+L_{u1}+T_{u1}+R_{u1}}{N_{u1}} +$$

$$(D_{i2} \pm X_{i2} \pm P_{i2}+L_{i2}+T_{i2}+R_{i2}) / \frac{D_{u2}+X_{u2}+P_{u2}+L_{u2}+T_{u2}+R_{u2}}{N_{u2}} +$$

$$D_{i3} / \frac{D_{u3}}{N_{u3}} / (N_{i1}+ N_{i2} + N_{i3})$$

K_I: *index of related fiscal capacity* of the administrative-territorial unit (is defined with four figures after coma)

D_{u1}, D_{u2}, D_{u3}, D_{i1}, D_{i2}, D_{i3}: the revenue basket assigned to LG and to the budget of the administrative-territorial unit according to the factual incomes over the last three budget periods (basic period)

X_{u1}, X_{u2}, X_{i1}, X_{i2}: increase (+/–) of nonpayments (noncollection) of taxes and duties, included in the revenue basket fixed to all local government budgets and to the budget of the administrative-territorial unit during the basic period

P_{u1}, P_{u2}, P_{i1}, P_{i2}: increase (+/–) of overpayments of taxes and duties, included in the revenue basket fixed to all local government budgets and to the budget of the administrative-territorial unit during the basic period

L_{u1}, L_{u2}, L_{i1}, L_{i2}: the sum of preferentials and privileges, given by the LGs from the taxes and duties included in the revenue basket fixed to all local government budgets and to the budget of the administrative-territorial unit during the basic period

T_{u1}, T_{u2}, T_{i1}, T_{i2}: the sum of written-off debt for unpaid taxes and duties as of January 1st, included in the revenue basket fixed to all local government budgets and to the budget of the administrative-territorial unit, accounted during the basic period

R_{u1}, R_{u2}, R_{i1}, R_{i2}: the sum of the restructured debt for unpaid taxes and duties as of January 1st, included in the revenue basket fixed to all local government budgets and to the budget of the administrative-territorial unit, accounted during the basic period

N_{u1}, N_{u2}, $N_{u3,}$ N_{i1}, N_{i2}, N_{i3}: the population of Ukraine and the population of the administrative-territorial unit as of January 1st during the basic period

D_{u4}: forecasted volume of the revenue basket fixed to all budgets in 2001

In 2002 the CG introduced some changes to the calculation of the index of relative fiscal capacity (CM 2001). The calculation is now defined according to the following formula:

$$K_i = [((D_{i1} + L_{i1}) / (D_{u1} + L_{u1})) \text{ x } N_{u1} + ((D_{i2} + L_{i2}) / (D_{u2}+ L_{u2})) \text{ x } N_{u2} + ((D_{i3} + L_{i3}) / (D_{u3} + L_{u3})) \text{ x } N_{u3}] / (N_{i1} + N_{i2} + N_{i3})$$

As one can see, some parameters were eliminated while new equalization coefficients and techniques were introduced. According to changes introduced in 2001, when a local government budget in 2002 (the planned budget period) has a forecasted increase in volume of revenues exceeding 1.65 (comparatively with the factual data of 2000), the forecasted volume of revenues in 2002 (ΔD_{izak}) is decreased by the value of (ΔD_{izak} x β_i), where ΔD_{izak} is the difference between the volume of revenues of the budget of the administrative-territorial unit in 2002 and is defined by implementation of the index of related fiscal capacity and factual level of revenues in the year 2000, increased by 1.65 times. It is calculated by formula $\Delta D_{izak} = D_{izak}2002 - D_{izak}2000 \text{ x } 0.65$; β_i is the coefficient of "slowing of relative tempo of development," which can have values from 0 to 1.0 and is dependent on the intensity of the volume increase of the fixed revenue basket of the (i) administrative-territorial unit during the period between 2000 and 2002.

This coefficient is calculated by the following formula:

$$\beta_i = \frac{\beta_{i1} - \beta_{i2}}{\beta_{i2}} = \frac{\beta_{i1}}{\beta_{i2}} - 1$$

where

$\beta_{i1} = D_{izak2002} / D_{izak2000}$

$\beta_{i2} = D_{izak2000} / D_{izak1999}$

Introduction of β also foresees that "when the forecasted increase of a local government's budget revenues in 2002 is less than 1.65, then $\Delta D_{izak} \times \beta_i$ would have a value of zero" (CM 2001).

The alpha coefficient is applied for transfers of local government budget resources to the central budget. This coefficient can have individual meaning and vary within the diapason between 0.8 and 1.0, and depends on the annual average tempo of increase of the revenue basket volume of the i'th administrative-territorial unit's budget. This coefficient is calculated according to the data of the basic period, using the following formula:

$$\alpha_i = 1 - ((((D_{i3} + L_{i3}) / (D_{i1} + L_{i1}))^{1/2} - 1) \times K_p)$$

where

K(p): equalizing coefficient of the year's average revenue basket increase of the i'th administrative-territorial unit's budget during the basic period. In 2002 K(p) equals 0.4; for the oblast budgets its value is 1.

The introduction of this equalization coefficient did not clarify the situation. The government document introducing this change contains a passage that reads "during the calculations of the intergovernmental budget transfers for the FY 2002, α_i is taken as equal to 1 in case of local government budgets which are considered to be recipient ones." Who and how such a status is ascribed to a local government budget is not clear. The document does not contain a definition, and therefore, it in fact creates perverse incentives for local governments.

4.4.2 Expenditure Calculation

The allocation principle reflected in the use of norms is that LGs with higher than average demand for public services should receive a higher than average amount of resources to meet those needs. Norms that satisfy these requirements and can be applied in practice meet several criteria. First, the needs assessed according to norms should be common to all local governments. Second, these needs should be amenable to objective measurement. Third, they should be clearly linked to observable differences in the level of local government expenditure. Finally, it should not be possible to influence them through expenditure decisions of local governments. The generalized formula introduced in 2001 can be presented in the following way (FAO 2002):

$$V_i/P_i = V/P_u[\varphi A + \varphi HK_i + \varphi E(S_i/P_i \div S_u/P_u) + \varphi CS + \varphi S(R_i/P_i \div R_u/P_u)] \quad (\textit{Equation 1})$$

where

- V: the volume of total LG spending in the state budget
- V_i: the volume of estimated expenditure needs in the i'th oblast; the subscript "i" refers to an entire oblast
- P_i: population of the i'th oblast
- P_u: population of Ukraine
- K_i: a coefficient measuring the extent to which health needs in the i'th oblast differ from the national average need, as approved by Cabinet Resolution no. 1170 of 5 September 1996
- S_i: the weighted number of students in the i'th oblast
- S_u: the weighted number of students in Ukraine
- R_i: the number of social protection recipients in the i'th oblast
- R_u: the number of social protection recipients in Ukraine
- φ: the share of total expenditure, V, allocated to the k'th expenditure function

In the case of weighted student numbers, for example, students are distinguished by type (kindergarten, general secondary, specialized, part-time, vocational and higher) by location (city or rayon), as well as by topography. Differential weights are applied to each type and location reflecting differences in the cost, as estimated by the Ministry of Finance, of educating different kinds of students in different settings.

Recipients of social protection benefits are also broken down by type of LG and by type of social protection program for the purposes of determining the appropriate size of the targeted transfer. For example, for cities and rayons separate expenditure calculations are made for recipients of communal service subsidies, recipients of benefits for war and labor veterans, and recipients of cash aid to families with children.

The provision of these services will affect the calculation of the expenditure needs of each local government and the size of the equalization transfers. The variable "R" above is therefore to be interpreted as the number of recipients of this limited subset of social protection benefits, rather than the number of recipients of all kinds of social protection.

The formula also foresees the distribution of spending among oblasts. The use of expenditure norms must affect the pattern of local government spending across different oblasts. Although under the BC the oblast will no longer be the focal point of the state budget, the issue of inter-oblast resource distribution remains relevant because, from a regional perspective, each oblast can be considered as the sum of its LG parts, the oblast level administration, and all the cities and rayons within the oblast.

Given the total amount of local government expenditure in the state budget (V), the MoF sets expenditure priorities for local governments by allocating that total among five broad expenditure functions: state administration (VA), health (VH), education (VE), culture and sports (VCS), and social protection (VS). Expenditure norms are then applied to allocate these functional amounts among oblasts according to the formula.

The equation (Equation 1 above) is complicated only because it pays close attention to the detailed expenditure composition of local budgets. It simply states that per capita oblast spending for transfer related expenditures will be equal to average per capita spending in all oblasts, V/P_u, modified by the degree to which a particular oblast's expenditure needs in different functional areas depart from the national average. In particular, if an oblast were average in every respect, that is, if its health coefficient were unity, and its weighted per capita student enrolments and number of social protection recipients per capita were equal to the national average, then its per capita expenditure needs would be equal to the national average per capita spending. This result follows because, by definition, the sum of all the expenditure shares, φk, must be equal to one.

If, however, an oblast has a health coefficient larger than unity and its per capita level of weighted students and social protection recipients exceed national average values for these same variables, its expenditure needs will be greater than average and its per capita expenditure needs will exceed the national average. Conversely, if an oblast has below average values in all of these expenditure norms, its average per capita expenditure will be less than the national average.

Another way of looking at this result is to summarize the information contained in the calculation of expenditure norms in the form of an oblast index of relative budget needs. That is, the sum of the terms in the large bracket above objectively measures the extent to which the expenditure needs of a particular oblast depart from the average need taking into account the economic, demographic, and environmental peculiarities of the oblast. If this index is denoted as IBN_i, the preceding expression can be further simplified so that it appears as:

$$V_i/P_i = V/P_u\ (IBN_i) \qquad (\textit{Equation 2})$$

4.4.3 Possible Obstacles to the Successful Implementation of the New Equalization Procedure

The limited effectiveness of the previous CG equalization policy is not likely to disappear with the implementation of the new formula-based equalization approach. As mentioned earlier, the CG tried to introduce expenditure norms, to monitor the budget process, and to control SNG activity before introduction of the formula. However, the interterritorial disparities and nontransparent use of money were not the result of bad norms or the absence of unified criteria of expenditure distribution. Nor could the reasons for the ineffectiveness of the previous equalization policy be found in poor mathematics or the methodology of calculation, but rather in the weakness of the government's policy implementation, in the continued existence of implicit and nontransparent "rules of the game." SNGs, empowered by law to function in the interests of local community, are not strong enough; and CG did not succeed in establishing effective communication with them. Instead, CG attempted to use mediators—vertically subordinated powers of oblast and rayon administrations.

The conditions of intergovernmental relations did not change much after the new formula was introduced. As could have been foreseen, transparency and other important principles of the BC were opposed by the existing system of powers. This can be illustrated by the new changes to revenue calculations introduced in 2001. The additional revenue equalization coefficients, alpha and beta, are not in line with the increased transparency of the intergovernmental budget process declared by the BC and implemented with the first formula (CM 2000). These coefficients do not improve upon and/or simplify the first formula of 2000 (which perhaps appears overly complex). The new equalization coefficients of 2001 create more space for arbitrary and nontransparent decision-making in intergovernmental budget relations. In introducing these changes, the central government secures the right to intervene in the calculation of transfers and change the "rules of the game" during the financial year. For example, paragraph 8 of the BC (CM 2001) may be read in such a way.

Almost all taxes are administrated by territorial offices of the State Tax Administration of Ukraine (STAU). The STAU work in close partnership with oblast and rayon state administrations. Those two levels of power (OSA and RSA) serve national strategic interests on the local level by monitoring the implementation of formulas; at the same time oblast and rayon councils in fact ceased to be representatives of their respective territorial communities, as stated in the Constitution of Ukraine. Moreover, whereas oblast and rayon councils have become less accountable to the local community, oblast (OSA) and rayon state administrations (RSA) have been granted the unlimited ability to intervene in the competencies of local authorities by the central government.

As mentioned above, the new BC treats rayons as disaggregated when it concerns revenue calculations and collection of revenue, and as integrated into a single territorial-administrative unit when it concerns transfer calculations and distribution. With respect to expenditures, according to the BC the rayon government divides expenditures within its territories among other self-governments. The limited capacity of small LGs (especially of the sub-rayon level), serves to justify the abuse of power. Under such conditions oblast and rayon governments are not MoF partners in the implementation of equalization instruments—for their decisions are determined very often not by the public, but by private or shadow group interests and do not follow the prescriptions of the CG.

Arbitrariness exists within the redistribution of public finances and can be witnessed with the implementation of the BC in FY 2002. Studies and direct interviews with members of the councils of sub-rayon LGs have confirmed as much. Rayon administrations can reduce the expenditures of one sub-rayon government and increase the expenditures of another during the fiscal year. Therefore, Thirsk (2002) notes that "the distribution of payments from the land tax appear to breach the provisions of the Budget Code. The Code stipulates that 60 percent of these proceeds should be retained by town, villages and settlements, and only 15 percent of these proceeds should accrue to the rayon district budget. In all five rayons [in which studies have been conducted—Y.L.], however, the entire proceeds from the land tax show up as one of the revenue sources of the rayon district budget. Further investigation is needed to determine why this is the case." The author also found out "that none of the revenues collected from the unified (small business) tax are used to finance the rayon district budget." This can be explained by the concentration of power on the oblast level, which discriminates against the local (sub-rayon) governments.

To put an end to arbitrary decision-making, abuse of power and disregard for governmental legal acts, a process must be introduced by which the fiscal and managerial capacity of LGs is increased. This process must be supported by the participation of communities and NGOs in the policy process (including policy analysis, budget hearings, and evaluation) on the central and local levels.

One feature of the budget process throughout the implementation of the new BC and its formulas was the nonfulfillment of responsibilities by the central government. The so-called delegated responsibilities of the central government became in fact unfunded mandates. The formula is powerless in this case when other forces play more decisive roles. The following part of this chapter uses the education sector as an example to reveal the reality of expenditure distribution in Ukraine.

5. SUBNATIONAL EXPENDITURES ON EDUCATION: TOWARDS AN EFFECTIVE USE OF PUBLIC RESOURCES?

5.1 The Present Situation in Secondary Education after Independence

School education is one of the largest LG expenditure responsibilities. In the years since independence, the funding of Ukraine's education has not been brought into line with market demands and the new budget process. Instead of rewarding savings and mobilization of additional resources, the old supply-driven approach in public service delivery pushes SNGs to overstate their expenditure needs and understate their revenue means. Such is the state of interactions between central and local governments in education throughout the last decade of independence. The results are public sector expenditure arrears and great disparities between regions, within rayon and city, and between households in the delivery and consumption of educational services.

Schools are permanently underfinanced from the state budget. Such a trend is a consequence of the contradictory Article 67 of the Law of Ukraine on Local Self-Government which stipulates: "The state shall ensure the full financing of all legislatively stated responsibilities of the central government from local government resources." Thus it is not clear who is responsible for school financing. Though the Constitution stipulates that secondary education is compulsory and "free" (Art. 53), the Law of Ukraine on Education does not provide a clear answer to this issue—nor do other documents like the national program, Education: Ukraine 21st Century, adopted by Verhovna Rada in 1993 with amendments in 1996, or the National Doctrine of Development of Education signed by the President of Ukraine in 2001. The ambitious commitment of the state in the education sector is not founded on comprehensive and consistent public policy.

Spontaneously, state and society tried to adapt to the situation by the two following means:

1) Teacher salaries in Ukraine are very low, about \$30–45 per month plus compensation, which equals two additional month's salary each year. But up until recently past arrears in payments were 5–6 months and compensation was not paid in some regions. Fixed teacher salaries and arrears can dampen the impact of deficient financing and ineffective use of funds for some time. Though this policy drives down teacher qualifications and the quality of education.
2) Financing of all other spending items has been reduced, and parents are made to pay for "free" education in both formal and informal ways. But parent contributions cannot compensate for many important items, and the most impacted expenditures include the renovation of school buildings and such critical elements of education as the development of content, purchasing of textbooks, and retraining of teachers. Lack of financing for education results in a deterioration of the infrastructure and is dangerous for the entire system in general.

Ukraine's absolute expenditure for education in the late 1990s was very low. According to UNESCO, average expenses in the formal basic education system in 1997 amounted to UAH 275 (nearly \$140) per student. However, using official statistical data, it is difficult to estimate the lack of resources and impossible to evaluate whether the available resources are used effectively; with effectiveness measured as the ratio of resources used to results achieved. Until now in Ukraine only such results as student academic achievement and participation in international competitions have been measured, without comparison to state and local government spending on education. The quality of education is assessed using only the sector's internal criteria; such relevant factors as success in the labor market, professional career of graduates, their wages, etc., are not taken into consideration by the central government educational authorities.

SNGs have very little opportunity and limited capacity to effect change in this state of affairs because of centralized policy. In fact, the MoES itself provides secondary education and finances subordinate entities. LG responsibilities in education are very great in terms of obligations, and very small in terms of rights. Article 11 of the Law of Ukraine on Education (1991) defends the monopoly of the state in decision- and policy-making, but at the same time vests a great part of the responsibilities in local governments. Municipalities have to fulfill responsibilities delegated by CG and maintain communal infrastructure of schools, while MoES determines the academic load, teaching materials, salaries, and hires and fires administrative staff. Almost all secondary schools are subordinated to the MoES. The non-governmental sector covers less than 0.3 percent of student enrolment and 0.9 percent of the teaching staff (UCEPS 2002).[2]

5.2 Spatial Disparities in Educational Expenditures

Disparities in expenditures on secondary education—and, therefore, in the access to education for different groups of the population—exist between regions, between urban and rural areas, and between different schools within one locality.

Certain local communities—especially those in urban areas with substantial revenues from the collection of local taxes and levies—try to support their schools financially. According to studies conducted in 2001, LGs have to spend additional resources from their budgets as a result of CG not fulfilling its responsibilities, or not fulfilling them in a timely manner. According to interviews conducted with local authorities in the city of Kherson, this "supplement," an unfunded mandate issued by CG, constitutes 60–70 percent of all educational expenditures. Besides other negative effects, this means that cities which are forced to fund CG responsibilities have to reduce the outlays on their (own) other responsibilities.

Not all local communities are able to compensate for the implicit deficit of public resources and ensure the effective financing of education. Increase in the cost of education (costs of energy alone have increased by at least 40 percent over the last decade) is felt especially in rural areas where parents and local communities have less resources for additional payments, and where businesses are in a less fortunate position to assist schools, as compared with their counterparts in some urban regions. For example, rural educational entities in Kherson oblast spent as little as 8 kopecks for meals per child in 2000, compared with 20 kopecks in 2001 (Ukrainian Regional Review 2001).

During the period before the introduction of the BC, CG was involved in informal schemes of financial redistribution by the local educational authorities, which led to further inequity in the delivery of educational services. So, the coefficient of variation of the arrears in salaries and communal payments for schools was 89 percent in sub-rayon LGs of Kharkiv oblast and 189 percent in cities of oblast significance in Odessa oblast. The amount of debt for education expenditures in these two oblasts (on 1 January 2000) was more than 41 and 23 million UAH respectively. Such an extremely high degree of variation in arrears can be explained as, at least partly, the result of informal bargaining.

Studies conducted in Lviv in 2000–2001 show that some schools received from the city 20–30 percent more than others (Levitas 2001). This occurred under conditions of permanent fiscal deficit due to the use of such methods as split classes, extra hours for teachers, etc. Favorable conditions for some "elite" schools do not improve the quality of education, but on the contrary, make disparities even deeper.

Analysis of budget arrears in the educational sector in different localities shows that such tendencies were typical not only for big cities, but for all kinds of localities and for all regions. Equalization efforts of CG can do very little in a state of hidden resource deficits. The situation at the sub-rayon level is especially bad. Introduction of the BC has not altered conditions for the better in small towns, villages, and settlements. On the contrary, disparities have increased. The range of expenditure tasks in education required of different sub-rayon governments are considerably different across rayons. This diversity is reflected in the much wider range of per capita expenditure differentials observed across rayons for any tier of rayon government, than in consolidated rayon per capita spending (Thirsk 2002).

This can be explained partly by the fact that Articles 88 and 89 of the BC do not define distinct roles in the education sector for different tiers of government within a rayon. Article 88 stipulates that intergovernmental transfers involving towns, villages, and settlements have to cover expenditures on local administration, preschool, and general secondary education (as well as spending on first aid and obstetric stations, district hospitals, outpatient care and places of culture, clubs, and libraries). Article 89, prescribing the expenditure responsibilities of rayons and cities of oblast significance, includes the same expenditure powers as those in Article 88, as well as others of a broader nature—although a strict interpretation of Article 89 seems to preclude the funding of preschools from rayon district budgets. As a result of these overlapping responsibilities, rayons are permitted considerable discretion in deciding who should do what and how the delivery of public services will be organized within a rayon. As a result, "who actually does what" in a given rayon appears to be governed largely by historical decisions which have determined whether an area in a rayon would have, for example, a local school or district academies for sports, music, or children's art. Some towns, villages, and settlements have district educational facilities; others have none. Some fund general education schools; others do not. Some rayons finance portions of their district educational facilities from the rayon district budget; other rayons fund most of their preschools from the rayon district budget; while still other rayons fund most of their schools from village and settlement budgets (Thirsk 2002).

The other explanation for such great disparity in factual educational expenditures is that under tight fiscal conditions many educational administrators of all levels try to use all possible means to attract or force teachers to stay at schools, in spite of the low salaries and lack of perspective in their professional careers. Thus, in 2001/02 academic year there are 3,000 vacancies for school teachers in Ukraine; Kherson and Mykolayiv oblasts as well as AR Crimea experience an especially large lack of teaching staff (UCEPS 2002).

All these negative tendencies result in unequal access to education for children from families with different incomes. For a great many households, education became much more expensive today than in the Soviet era, due to the dramatic decrease in individual incomes. The official data on how many families in Ukraine pay for education are rather vague, as the payments are made through both official and unofficial channels. Independent studies reveal that parents spend UAH 40–50 million on tutoring, and UAH 350–400 million for "aiding" schools and other related expenditures (World Bank 1999). As low-income families have fewer possibilities to make extra payments for the education of their children, the inequality in incomes turns into inequality of access to education. A growing number of children from low-income families are failing to attend schools on a regular basis due to the failure of their parents to pay extras for their education. As independent opinion polls show, children from low-income families cannot attend nursery schools. As a result, they are less adaptable to secondary school life and have less chance of getting a quality education in the future. Moreover, as public education services are not provided in full to children from low-income families, poverty becomes a phenomenon which is then inherited and leads to further social inequality in the future.

As the situation on the sub-rayon level seems to be the most critical in terms of the delivery of educational services improvements in intergovernmental fiscal relations on this level are urgent. They must be introduced in line with the principles of budgetary transparency and subsidiarity. To promote greater transparency and implement the subsidiarity precept, more responsibilities for the provision of preschool and secondary education must be given to towns, villages, and settlements; and rayon district governments must be responsible for the provision of all special educational services and the operation of district educational facilities. There also needs to be a facilitation of public involvement in the budget process in education expenditure. Community participation has to increase and compel accountability and openness in local and central government budgets. In this way, funding of education would be done in accordance with the existing order and norms and would be steered by local councils and/or educational boards serving the interests of the local population.

6. CONCLUSIONS AND POLICY RECOMMENDATIONS

6.1 Conclusions

One of the main issues of intergovernmental fiscal relations in Ukraine is the absence of a clear and comprehensive policy toward decentralization. The behavior of CG officials does not correlate with declared policy. The state's strategy of fiscal decentralization is unclear and different normative documents in this area fail to complement, and instead contradict one another. In the absence of consistent and comprehensive public policy towards fiscal decentralization, the system of intergovernmental fiscal relations in Ukraine suffers from lack of clear revenue and expenditure assignments as well as transparent "rules of the game," which together have resulted in a decreased tax base and limited managerial capacity of LGs. CG has failed to efficiently equalize interregional disparities.

There are some policy documents which formulate positive ideas about the development of local self-governance, regional policy, and decentralization. The President's "Concept of the State's Regional Policy," adopted in 2001, formally supports decentralization of public finance. But the way in which political decisions are made tends to make this and other government documents pure declaration. In the case of Ukraine, we are still faced with nontransparent decision-making. From this point of view, fiscal decentralization policy must incorporate the analysis of previous policy documents and relations between different policy agents involved in the process. Very often legislative documents are not prepared as normative acts; they are not built upon analysis of previous effects and errors; they disregard implementation and therefore tend to become mere ideological documents directed only to change public opinion. They fail to contain clear definitions of the responsibilities of government and mechanisms of policy evaluation. Together all these features result in nonworkable documents, far from serving the real interest of society.

The BC has introduced changes in the system of public finance. Once again revenue and expenditure responsibilities of SNGs are redefined. The BC has also implemented a formula-based approach to equalization and gives much more responsibilities to the rayon level of power. But the real reasons for disparities and inequity were not analyzed sufficiently, and implementation of new principles and prescriptions are very slow and even doubtful.

The formula-based equalization transfers system introduced by the BC has been designed according to advanced theory and the best international practices of fiscal equalization. But this does not ensure that real improvements in intergovernmental finance will be realized in Ukraine. Other steps are required, i.e., eliminating the shortcomings of the existing policy.

As the situation on the sub-rayon level seems to be the most critical, improvements in intergovernmental fiscal relations on this level are urgent. Clarity will be bolstered if the rules that are adopted are made as uniform and as simple as possible, and if there is a clear delineation of expenditure assignments between the rayon district and other tiers of governments. If these conditions are met, it might be possible to construct a workable system of formula based transfers within the rayon. The current formula-based transfer system that applies to oblasts, cities of oblast significance, and rayons could be replicated within the rayons. With its implementation, the SNGs of sub-rayon level will witness greater transparency in the budget process, greater budgetary stability, and a fairer distribution of revenues.

6.2 Policy Recommendations

6.2.1 Objectives

The study of current fiscal equalization policy in Ukraine shows that effective implementation of new equalization instruments is impossible without establishing transparent "rules of the game" at the subnational level.

To reach this goal the following measures are proposed:

- *Relationships between the central government and different tiers of SNGs to be regulated by social agreements and contracts.* One such social agreement must concern the execution of delegated and own responsibilities by local governments. The issue is that people are not informed about the details of intergovernmental arrangements.

Sharing of responsibilities between tiers of government and the order of execution of budgets are not obvious to most people, especially to the more elderly. Central, oblast, rayon, and local governments often argue about their relations, and have different interpretations of normative acts and related debates and documents. All these things create conditions under which both central and local governments are prone to neglect the fulfillment of their responsibilities. Within this state of affairs, agreement amongst the local community, local council, and central government will make possible the implementation of such principles of intergovernmental fiscal relations as efficiency, subsidiarity, transparency, and accountability. The agreement also must include rules for calling offenders (of the agreement) to account. Such an agreement may serve as a basis for other kinds of contractual relations between the public sector, NGOs, and the private sector. The different tiers of government must be fully responsible for the execution of budgets and, in case they do not fulfill their obligations, must be penalized in some manner. Another type of contractual relationship is an agreement between several local councils in order to perform effective public service delivery.

- *Increasing transparency of the budgetary process while introducing a formula-based equalization approach on the sub-rayon level*. With clearly defined, constant and uniform expenditure assignments, the rayon budgetary process might conceivably unfold in the following manner. Knowing the amount of the transfer it will receive from, or make to, the state budget and based on forecasts of the rayon revenue basket, the rayon council could establishe an overall spending ceiling for the rayon. Within that ceiling the council would decide how much was to be spent on education, health care, and culture. From the education envelope, the council would deduct an amount needed to provide its own specialized educational services. The remainder would be allocated by formula among towns, villages, and settlements according to their share of the rayon's preschool and general education students. The share of each local self-government in that total would be determined on the basis of its population share in the rayon. The same type of procedure would be used to unravel and allocate the rayon's health care spending and culture envelope. With some provision made for local self-government administration, these calculations, when summed, would generate an estimate of the per capita expenditure need of each local self-government in the rayon. The difference between this estimate and a forecast of the per capita revenue in each government's revenue basket would yield a formula-based calculation of the transfer each would be either entitled to receive or required to make.
- *Institutional capacity of the local governments in Ukraine must be enhanced*. The goal should be to obtain international standards in the delivery of public services. Enhanced capacity will make possible implementation of the principles of transparency, subsidiarity, sharing of responsibilities, and economy of scale, in addition to clearly defining "who does what," etc.
- Public involvement in the budget process on the local level must be increased and institutionalized. Together with the formula-based approach to equalization this would increase institutional capacity, create conditions for greater accountability of LGs, and make possible the transfer of more responsibilities from the center downwards.

6.2.2 Approaches

Improvements to the expenditure calculation. Intergovernmental fiscal relations in Ukraine involve the calculation of the expenditure needs of 680 local budgets for oblast level administrations, cities, and rayons. The formula with the changes for 2001—presented in the government's 2000 document—is only the first step. For budgetary purposes attempts are now being made to disaggregate this formula into the constituent transfer-related expenditure needs of the different tiers of SNGs which comprise any oblast. The disaggregating process requires some modifications of the preceding formula (FAO 2002). Such modifications are prepared within MoF, which take the form of partitioning the functional expenditure categories among the different tiers of SNGs according to their respective expenditure assignments in each spending category. When this is done, the calculation of per capita expenditure needs for the j'th city or rayon within an oblast will be guided by the following formula:

$$V_j/P_j = V/P_u[\varphi_A \phi_j^A + \varphi_H K_i \phi_j^H + \varphi E(S_j/P_j \div S_u/P_u) + \varphi CS \varphi_j^{CS} + \varphi S(R_j/P_j \div R_u/P_u)]$$

where

φ_j: the share of total oblast expenditure undertaken by either all cities or all rayons within the oblast for each of the functional expenditure categories labelled as A, H, and CS.

The new variables appearing in the proposed formula, in the form of ϕ, are allocation variables designed to consistently allocate functional spending needs among different tiers of local government. For example, in the cases of health care, public administration, and culture and sports, the values for the ϕ variable have been established by the MoF from historical data. With regard to health care, this variable has a value of 0.34 for oblast administrations, 0.36 for cities, and 0.3 for rayons. In the case of physical fitness and sports, oblasts have been assigned a value of 0.4 while cities and rayons have a value of 0.6. For administration, the MoF sets different values for cities and for rayons. Obviously these values take into account the proportion of the population residing in cities and rayons. If, however, the formula were to apply the parameter of general expenditures on a per capita basis, this variable would have a value of 0.1 for oblast levels and 0.9 for both cities and rayons. The level of per capita expenditure established for an oblast is simply a variant of the formula for a city or rayon.

Improvement of revenue estimation. In introducing the new changes, CG must limit opportunities for intervention in the calculation and for changing the "rules of the game" during the financial year. CG regulations must preclude arbitrary decision-making. As discussed earlier, the revenue equalization coefficients introduced in 2001, *alpha* and *beta*, do not add to the transparency of the intergovernmental budget process; the new equalization coefficients create more space for arbitrary and nontransparent decision-making in intergovernmental budget relations.

A definition of the status of the recipient local government budget must be developed and published. The introduction to the new equalization coefficients (CM 2001) contains a passage that states, "during the calculations of the intergovernmental budget transfers for the FY 2002, *alpha* (i) is taken as equal to 1 in the case of local government budgets which are considered as recipients." Such definitions and the corresponding equalization policy must give LGs incentives to increase their revenue base.

To improve revenue distribution and the equalization process, the Tax Code must be adopted and the tax administration system changed.

Changes must be introduced which will reduce or prevent upper level governments from discriminating against the interests of LGs. For example, until now, payments from the land tax have not been distributed in line with the provisions of the BC. The Code stipulates that 60 percent of these proceeds should be retained by town, villages and settlements, and only 15 percent of these proceeds should accrue to the rayon district budget. In real life, however, the entire proceeds from the land tax is a revenue source within the rayon district budget. This practice can be explained by the concentration of power on the oblast level, which discriminates against the local (sub-rayon) governments.

Horizontal cooperation as a way towards improved fiscal equalization. Horizontal equalization grants between communities could be introduced which would be calculated on the basis of the actual budget execution. The aim of these grants is to use own LG revenues more effectively and redistribute them in the common interest, first of all, in meeting the needs and interests of the revenue-poorer self-governments. The second important issue, which could be resolved by this approach, is to provide the LGs with the opportunity to choose their partners for the execution of some functions. This recommendation is in line with BC articles, which declare that transfers may also occur between self-government budgets in exchange for contractually provided, and mutually agreed upon, public services. For example, towns, villages, and settlements may choose among themselves or contract another LG to provide assigned services. This may be necessitated by economic, historical, and geographic factors (economies of scale, more efficient provision of particular services by another LG, more convenient location of facilities, etc.). Such responsibilities are presently fulfilled by the oblast and rayon authorities, which are perceived by the local community as "upper levels of power."

The proposed approach provides a base for collaboration amongst LGs belonging to different administrative-territorial units. Horizontally cooperating LGs can belong to different oblasts, or to different rayons within a single oblast. They can create new governing bodies, or choose to delegate responsibility to an LG from among themselves to manage funds which are now usually transferred to and/or redistributed by rayon or oblast. Local governments can also combine their resources, attracting domestic and foreign investors in order to develop infrastructure and raise their tax base in the future.[3] Such mutually beneficial projects are important and will create a favorable social, economic, and political environment.

Under such arrangements, LGs would be accountable to the population of involved communities for the provision of certain public services. In this case, criteria are needed for evaluating the effectiveness of public resource allocation; special committees with representatives of local communities and self-governments must be established to monitor and evaluate effect-iveness of service provision.

Such an approach would contribute to the end of administrative-territorial reform. No one can forecast the final composition of the country, but such horizontal cooperation would facilitate some obvious trends. The oblast and rayon authorities of related territories would be obliged to clarify their role and function. Rayons are more likely to become local self-governments with all the prerequisites and responsibilities needed to be able to serve as effective partners in different forms of horizontal cooperation. Whereas the oblast level is becoming more of a CG representative, with competencies more geared towards control, supervision, and consultation of LGs.

Political resistance to this approach can be expected from some oblast and rayon powers, who are committed to conserving their role of "invisible power" in the redistribution of public finance. In response, CG may take a definite and consistent position; LGs may develop a shared strategic vision; and the respective community may voice support for the declared policy. Finally, a series of pilot initiatives in this field are soon to be launched.

Local spending programs. One of the problems of local spending programs is that while local communities with a sufficient revenue base, in theory, may launch their own expenditure programs to support education, others cannot. On the other hand, even the additional resources to be had cannot be used effectively under the existing conditions. Other issues concern the shortcomings of the methodology by which educational norms are calculated, which ties educational finance to the administrative unit and not to the service consumer.

To resolve the two problems—of disparity of revenue capacity among different LGs and ineffective norms in school provision—educational districts might be established. This is especially topical for rural areas, where in many cases the location of, and distances between schools, and villages result in inefficient educational norms of school provision.

Educational districts would give relatively wealthy LGs the opportunity to devote a larger portion of their revenues to education. For these purposes additional taxes or duties could be introduced by local governments (the BC and other state documents foresee this). Other poorer local communities, which before had only central government transfers to rely on, under the new approach would have the opportunity to receive additional resources distributed within the educational district.

The new territorial education (school) districts would not be obligatory and must cover the borders of the administrative unit. Which means that along with state governance of education on the territories (oblast- and rayon-level educational administrations), a new educational authority would need to be empowered by the local communities of small towns, settlements, and villages. Governmental bodies would then be more flexible in meeting the needs of the community. The activities of these community-based educational authorities, of the newly established educational districts, would assist in distributing central budget money more transparently and efficiently. Also, there is a good chance that additional funds (part of the own revenues of local government budgets, specific educational taxes and duties, and other possible incomes) could be attracted to provide additional resources for schools and educational services.

The second means of resolving these issues is to establish self-government committees at the school level, which would include parents, businesses, and local NGOs. Representatives of these committees would be responsible for strategic planning and determining the use of school resources.

School self-government committees and community-based councils of educational districts can be agents to cooperative agreements on the use of the additional funding attracted through the new structure. Both units—educational councils and school committees—could also contract out the provision of public services to other agents. Such contracting out may include repairing and reconstruction of school facilities to reduce heating and other communal expenses; micro-planning in developing school infrastructure with the help of local community experts; provision of computers and equipment to schools and publishing of textbooks; retraining of teachers and managerial staff of schools; etc. All these activities would help to reduce the inefficient distribution of resources and increase the quality of the educational process.

Such innovation would help promote greater transparency and implementation of the subsidiarity principle, which is now a primary concern in determining the needed changes to the delivery of educational services. Possible consequences of new educational districts are the following:

- Communities and local authorities of towns, villages, and settlements would become exclusively responsible for the provision of preschool and general educational services and would be given more fiscal responsibility than they currently exercise.
- School districts would be responsible for the provision of all specialized educational services such as art schools and sports academies, profile schools, lyceums, gymnasia, etc., in the interest of creating an integrated educational network.

6.2.3 Implementation

Implementation of the above-mentioned approaches can be carried out through local pilot projects. These projects must be organized within the following frameworks:

1) *Intergovernmental Contract (Social Agreement)*

   Contracting agencies: local government, territorial community (coalition of NGOs, regional departments of trade unions, parties), and central government (MoF, oblast or rayon state administration).

   Subject of contract: fulfillment of their obligations in the provision of specified public services.

   Responsibilities of contracting agents ("rules of the game"):

   a) Execution of expenditures of LG budgets
   b) Equalization of LG expenditure needs through central budget
   c) Equalization of the LG expenditures through horizontal cooperation
   d) Activities of the stakeholders and representatives of contracting agencies when other parties to the contract fail to meet their obligations e.g., in cases where: funding is not disbursed by CG either in full or on time, and in other similar cases.

2) *Municipal Loans*

   Covering deficits of local budgets by borrowing on the financial markets is prohibited in Ukraine. But in some cases (arrears caused by external factors) it can be justified. A portion of the interest could then be covered at the expense of other governments who are responsible for the SNG's budget deficit. For this purpose too, the "intergovernmental contract approach" can be helpful. But in general, LG borrowing on financial markets is not very successful in Ukraine (East-West Institute 2000).

   Some resources, aimed at covering certain LG expenditure needs and/or increased fiscal capacity of local government budgets, may be suggested by the financial institute acting in cooperation with LGs. These financial resources must be allocated to the improvement of infrastructures or to projects aimed at bettering public service delivery and increasing the own and shared tax base of the local government over the mid- to long-term. The CG budget could support such borrowing in two ways: by providing guarantees to financial institutions participating in such transactions and, through oblast-level budgets, by intergovernmental (within oblast) transfers which would cover risk of nonpayment of interest or arrears in repayment of the loan.

3) *Supporting Projects Effecting Systemic Change*

The new equalization instruments could be implemented through a number of pilot projects on the local level. These projects must be conducted by nongovernmental as well as governmental organizations in close cooperation with business and the public at large. They must be supported by the improvement of fiscal decentralization policy on the central level in the following areas.

Policy analysis, research and formulation

- Adjustment of Ukrainian legislation in the area of intergovernmental relations to the requirements of the European Community. Policymaking and document development projects must be launched, including analytical policy paper development and changes to legislation in connection with intergovernmental fiscal relations (Local Self-Government Law, Tax Code, Budget Code, Municipal Service Law, Municipal Property Law, Law on Not-For-Profit Organizations, etc.). This process must be based on a changing approach to policymaking on all governmental levels.
- Consultations with community, independent experts, involvement of foreign experts in the policymaking process. This project area must include different forms of public consultations, debates, and discussions of the draft policy papers and analytical documents prepared in the above project area.

Human resource development and training

- Introduction of education and training programs at schools, universities, and post-diploma educational institutions in order to facilitate community participation in the policy process aimed at the improvement of intergovernmental relations.
- Development of human resources for the above projects areas through the in-service training of municipal, CG and NGO representatives, who work within intergovernmental fiscal relations and with related issues in their everyday practice. This project area must be organized like a virtual college (or distance learning network) involving municipal managers of post-Soviet countries. They would create self-organized international teams collaborating with each other on projects in their respective country's local governments, within cross-regional programs. Professional growth in the related fields of public/municipal service and political, research, or academic careers would provide the incentive to participate.

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ENDNOTES

1 This chapter is based on analytical materials posted on the website of the Fiscal Analysis Group (www.fao.kyiv.ua) and on governmental documents on equalization issued in 2000 and 2001.

2 For a detailed analysis of education management in Ukraine, see Lukovenko et al. 2002.

3 There are some pilot projects pursuing community interests, which are represented by the association of LGs. Take for example, the territory of "Big Sudak," where some "poor" rural LGs combine resources with wealthier urban LGs. All of them have good potential for economic development because of the favorable location and opportunities for the development of small businesses and tourism. Each LG's potential can be better used with the coordination of activities and combining of resources. Moreover, such collaboration helps to attract investments in infrastructure and historical heritage reconstruction, which benefits all.

ANNEX

Statistical Data on Subnational Finance and Public Service Delivery in Ukraine

Table 4A.1
Share of Local Taxes and Duties in Local Government Revenues (without transfers from other budgets) [%]

Year	Consolidated Budget	Oblast Budgets	Cities of Oblast Significance	Rayon Budgets	Cities of Rayon Significance	Urban Settlements	Rural Settlements
1992	0.03	0.00	0.05	0.01	1.54	0.83	0.61
1993	0.13	0.00	0.27	0.03	0.34	0.10	0.63
1994	0.51	0.02	0.83	0.12	2.54	1.56	0.49
1995	1.46	0.35	2.96	0.35	8.86	6.94	1.90
1996	2.63	0.67	5.28	0.63	13.14	12.90	4.33
1997	2.94	0.78	5.42	1.24	15.38	14.38	5.21
1998	2.97	0.41	2.40	5.80	15.66	16.43	5.93
1999	3.36	0.29	3.16	6.66	14.59	16.41	6.88
2000	3.65	0.28	5.92	3.35	12.23	14.27	5.29

Source: S. Slukhai 2002.

Table 4A.2
Medical Service Levels in 1999, by City

City	Number of Places in Hospitals per 1,000 Population	Number of Daily Attendencies of Ambulatory-Polyclinical Entities per 1000 Population
Cities of State Significance		
Kyiv	11.7	31.2
Oblast Centers		
Kharkiv	11.1	23.2
Zaporizhzhia	8.4	11.6
Lviv	15.39	23.6
Mykolaiv	14	17.3
Lugansk	15.1	23.1
Kherson	6	23.4
Poltava	12.1	23.3
Cherkasy	6.5	22
Zhytomir	4.1	18.8
Sumy	13.9	

Table 4A.2 (continued)
Medical Service Levels in 1999, by City

City	Number of Places in Hospitals per 1,000 Population	Number of Daily Attendencies of Ambulatory-Polyclinical Entities per 1000 Population
Kirovohrad	5.7	12.5
Chernivtsy	19.1	23.2
Khmelnitsky	15.1	26.3
Ivano-Frankivsk	17.9	23
Rivne	11.3	23.5
Uzhgorod	22.1	27.7
Cities of Oblast Significance		
Makiivka	7.9	26.8
Dniprodzerzhinsk	7.4	18.7
Kremenchuk	8.8	21.4
Bila Tserkva	8.5	22.1
Kerch	8	18.7
Lisichansk	10	23.9
Severodonetsk	7.9	25.6
Berdiansk	7	...
Alchevsk	11.5	16.4
Kamianets-Podilsky	7.3	19.2
YenaKyivo	7.5	16.3
Drogobitch	10.3	25.1
Konotop	10.9	20.1
Uman	8.6	27.7
Shostka	8.3	80.2
Berdichiv	5	19.7
Krasnormiysk	7.8	11.3
Nizhin	8.3	14.3
Druzhkivka	7.1	27.4
Lozova	5.5	19
Kovel	14	—
Kupiansk	11.9	25.4
Striy	12.7	17.8
Kolomiya	7.7	10
Korosten	7.8	22.4
Svitlovodsk	7.1	15.9

Table 4A.2 (continued)
Medical Service Levels in 1999, by City

City	Number of Places in Hospitals per 1,000 Population	Number of Daily Attendencies of Ambulatory-Polyclinical Entities per 1000 Population
Dmytriv	7.6	37.7
Energodar	7.5	25.5
Novograd-Volynske	…	21.1
Debalzeve	6.6	25.9
Borispil	5.9	40.3
Marganets	72	15.9
Komsomolsk	5.6	23.7
Fastiv	12	18
Shepetivka	11.5	93.2
Voznesensk	12	22
Kahovka	10.5	14.3
Yuzhnoukrainsk	6.4	21.1
Vasylkiv	6.1	15.2
Pervomaiski	5.2	12
Cheguiv	5.6	11.5
Gluhiv	5.1	24.2
Mogiliv-Podolsky	6.1	19.6
Netishin	6.1	26.6
Znamianka	15.3	23.8
Lebedyn	5.3	18.6
Zolotonosha	11.7	20.4
Krasnoperekopsk	4.1	14.2
Pereyaslav-Khmelnitskiy	5.6	16.8
Pershotravensk	7.7	52.3
Slavutych	8.3	29.2
Truskavets	10	16.3
Cities of Rayon Significance		
Kostopil	3.1	19.4
Sarny	11.7	25.3
Polonne	11.9	57.5
Novy Bug	7.2	96.3
Pogrebysche	27.2	22.7
ASD for oblast centers	5.04	4.40

Table 4A.2 (continued)
Medical Service Levels in 1999, by City

City	Number of Places in Hospitals per 1,000 Population	Number of Daily Attendencies of Ambulatory-Polyclinical Entities per 1000 Population
Average	12.36	21.5
CV, percent	42	18
ASD for cities of oblast significance	9.09	14.52
Average	9.50	24.09
CV, percent	90	63
ASD for cities of rayon significance	8.16	29.41
Average	12	44
CV, percent	67	66

ASD—Average Square Deviation; CV—Coefficient of Variation.

Source: ACU 2000.

Table 4A.3
Debts in Educational Sector in Lviv Oblast (as of 1 January 2000), UAH [thousand]

Rayons and Cities of Rayon and Oblast Significance	Total	Salaries	Utilities
Brody	139.6	10.8	25.6
Brody	33.3	10.8	12.6
Busk	190.1		106.9
Busk	57.6		49.5
Gorodok	712.3	2.7	493.0
Gorodok	257.1		147.4
Komarno	6.8		4.0
Drogobych	106.2		80.6
Zhydachiv	516.4	157.1	210.5
Zhydachiv	33.8		25.9
Khodorov	21.1		14.3
Zhovkiv	321.6	0.5	235.3
Zhovkva	5.8		5.8
Dubliany	33.0		33.0
Rava-Rusa	26.4		26.4
Zolochiv	275.1	18.4	122.4
Zolochiv	14.4		14.4
Glyniany	2.2		0.0

Table 4A.3 (continued)

Debts in Educational Sector in Lviv Oblast (as of 1 January 2000), UAH [thousand]

Rayons and Cities of Rayon and Oblast Significance	Total	Salaries	Utilities
Kamianka Buzka	545.0	8.4	348.6
Kamianka Buzka	32.4	6.5	0.7
Mykolaiv	724.7	1.8	347.0
Mykolaiv	134.3		111.3
Novy Rozdil	231.5		94.1
Mostyska	141.4	7.3	76.2
Mostyska	42.6	4.4	36.2
Sudova Vishnia	10.7		6.3
Peremyshliany	322.6		250.9
Peremyshliany	79.3		73.6
Bibraka	107.1		107.1
Pustomyty	236.4		103.6
Pustomyty	86.4		76.5
Radehiv	494.9	2.9	148.0
Radehiv	25.1		24.1
Sambir	70.8	0.1	26.9
Rudki	0.0		0.0
Skol	24.8		14.4
Skol	1.9		1.9
Sokal	756.6	2.2	479.6
Sokal	256.8		220.1
Belz	51.7		28.6
Velyki Mosty	23.2		18.2
Ugniv	0.1		0.0
Starosambir	383.5		294.6
Stary Sambir	106.2		102.1
Dobromil	20.9		19.8
Horiv	14.6		13.2
Striy	682.5	225.0	13.0
Morshin	36.6		7.7
Turka	205.7		135.2
Turka	0.0		0.0
Yavoriv	567.3	0.7	419.1

Table 4A.3 (continued)

Debts in Educational Sector in Lviv Oblast (as of 1 January 2000), UAH [thousand]

Rayons and Cities of Rayon and Oblast Significance	**Total**	**Salaries**	**Utilities**
Yavoriv	7.7		0.1
Novoyavorivske	313.4		308.5
ASD	216.2	62.7	129.3
Average	179.1	28.7	104.1
CV	120.67	217.24	124.04
Cities of Oblast Significance			
Lviv	3,469.6	1229.6	1051.0
Borislav	176.2	0.7	129.7
Drogobych	497.7	180.7	179.6
Sambir	212.6	1.9	161.1
Striy	662.1	131.6	319.8
Truskavets	515.7	0.0	472.8
Chervonograd	554.7	236.6	157.5
ASD	1,074.3	407.9	306.5
Average	869.8	254.4	353.1
CV	123.45	160.63	86.97
Rayons Total	7,417.5	437.9	3,931.4
Cities of Rayon Significance	2,074.0	21.7	1,583.4
Total for Cities of Oblast Significance	6,088.6	1781.1	2471.5

Source: FAO 2000.

Table 4A.4
Expected and Actual Local Budget Expenditures, as Percentage of National Average

Regions	1993 Expected	1993 Actual	1997 Expected	1997 Actual	1998 Expected	1998 Actual	1999 Expected	1999 Actual
AR Crimea	116.3	142.8	96.0	98.8	93.8	89.5	96.5	97.9
Vinnitsa	90.9	85.2	92.9	82.7	90.9	73.9	89.6	70.6
Volyn	99.6	89.1	115.5	84.1	100.4	80.9	110.6	85.2
Dnipropetrovsk	123.3	96.8	103.1	139.6	107.6	99.7	102.0	87.0
Donetsk	99.9	93.3	95.8	104.3	99.7	108.4	93.5	88.7
Zhytomyr	98.4	116.6	124.9	105.7	120.6	99.8	116.4	99.2
Zakarpattia	84.5	68.0	99.9	79.3	91.7	77.4	112.6	107.4
Zaporizhzhia	108.5	139.5	99.3	92.8	110.7	108.1	100.0	118.7
Ivano-Frankivsk	80.3	68.5	96.6	81.5	93.2	82.1	103.5	102.4
Kyiv oblast	92.5	118.9	97.0	88.1	118.2	112.9	126.7	159.4
Kirovohrad	106.6	99.7	104.0	84.3	99.3	77.9	104.3	86.0
Luhansk	96.6	80.6	94.0	86.5	95.6	77.1	91.0	84.7
Lviv	84.8	81.6	96.7	78.5	96.6	77.7	96.7	92.1
Mykolaiv	98.0	109.8	100.0	104.3	96.6	110.5	94.3	97.0
Odesa	94.2	84.8	85.6	83.8	88.6	85.5	85.8	92.7
Poltava	88.3	85.3	99.8	113.3	101.7	157.4	104.1	138.9
Rivne	91.7	97.6	97.1	81.6	90.1	89.6	101.5	124.7
Sumy	94.1	93.6	98.1	88.6	99.4	87.3	94.6	80.6
Ternopil	98.7	78.2	96.8	81.1	90.2	74.9	108.7	76.8
Kharkiv	93.6	83.0	700.0	123.6	100.7	129.8	92.3	105.6
Kherson	111.3	116.6	100.3	92.3	96.2	80.2	100.0	77.4
Khmelnytsk	83.8	87.6	99.8	86.1	95.4	86.8	95.7	84.9
Cherkasy	111.8	90.5	107.7	101.8	108.8	100.9	109.1	105.8
Chernivtsi	91.6	97.7	94.2	80.6	86.0	74.6	93.3	63.8
Chernihiv	90.0	75.0	104.1	90.2	100.4	73.9	103.0	78.7
Kyiv city	125.9	182.1	118.2	152.0	109.6	181.2	19.9	163.0
Total for Ukraine	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Min	80.3	68.0	85.6	78.5	86.0	73.9	85.8	63.8
Min	125.9	182.1	124.9	152.0	120.6	181.2	126.7	163.0

Source: Lunina 2000.

Table 4A.5
Taxes under STA Control, calculated at UAH 1 of added value (kopeck/UAH rate) [Percent]

Region	1995	1996	1997	1998	2000	Deviation
The Crimea	38	35	34	32	23	121,9
Vinnitsa	21	22	22	19	14	71,9
Volyn	21	20	21	21	18	96,3
Dnipropetrovsk	30	25	29	22	17	87,5
Donetsk	25	28	27	23	18	92,6
Zhytomyr	24	23	23	21	12	64,7
Zakarpattia	23	25	24	24	14	72,5
Zaporizhzhia	32	26	23	22	17	87,5
Ivano-Frankivsk	34	36	34	28	15	81,3
Kyiv oblast	22	22	23	21	12	61,9
Kirovohrad	21	24	25	23	16	85,1
Luhansk	21	25	26	21	13	68,2
Lviv	44	36	36	33	21	112,0
Mykolaiv	24	25	25	28	19	102,3
Odesa	29	29	28	26	21	112,3
Poltava	33	36	43	42	26	136,8
Rivne	22	22	22	21	10	52,8
Sumy	31	36	34	24	24	128,1
Ternopil	21	21	24	22	11	59,4
Kharkiv	37	43	39	36	19	100,5
Kherson	24	22	22	21	13	66,8
Khmelnytsk	21	21	21	20	11	58,6
Cherkasy	26	26	29	28	17	89,1
Chernivtsi	24	22	25	27	14	74,2
Chernihiv	31	28	30	26	20	105,1
Kyiv city	50	66	47	51	32	166,1
Total for Ukraine	30	31	30	28	19	100,0
Max	50	66	47	51	32	166,1
Min	21	20	21	19	10	52,8

Sources: Lunina 2000; AHT 2001.

List of Contributors

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July 2003

Local Government and Public Service Reform Initiative

The Local Government and Public Service Reform Initiative (LGI), a network program of the Open Society Institute (OSI), is an international development and grant-giving organization dedicated to the support of good governance in the countries of Central Eastern Europe (CEE), South Eastern Europe (SEE) and the Newly Independent States (NIS). LGI seeks to fulfill its mission through the initiation of research and support of development and operational activities in the fields of decentralization, public policy formation and the reform of public administration.

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- Publication of books, studies and discussion papers dealing with issues of decentralization, public administration, good governance, public policy and lessons learned from the process of transition in these areas
- Development of curricula and organization of training programs dealing with specific local government issues
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