

Georgia State University

## ScholarWorks @ Georgia State University

---

ECON Publications

Department of Economics

---

1993

### The Tax and Intergovernmental Sharing System

Roy W. Bahl

*Georgia State University*, [rbahl@gsu.edu](mailto:rbahl@gsu.edu)

Follow this and additional works at: [https://scholarworks.gsu.edu/econ\\_facpub](https://scholarworks.gsu.edu/econ_facpub)



Part of the [Economics Commons](#)

---

#### Recommended Citation

Bahl, Roy W. "The Tax and Intergovernmental Sharing System" in Fiscal Decentralization: Intergovernmental Fiscal Relations in Russia, 77-101. Edited by Christine Wallich. Washington, D.C.: The World Bank, Studies of Economies in Transition, 1993.

This Report is brought to you for free and open access by the Department of Economics at ScholarWorks @ Georgia State University. It has been accepted for inclusion in ECON Publications by an authorized administrator of ScholarWorks @ Georgia State University. For more information, please contact [scholarworks@gsu.edu](mailto:scholarworks@gsu.edu).

STUDIES OF ECONOMIES IN TRANSFORMATION  
PAPER NUMBER 6

# **Fiscal Decentralization**

## **Intergovernmental Relations in Russia**

Christine I. Wallich

The World Bank  
Washington, D.C.

Copyright © 1992  
The International Bank for Reconstruction  
and Development/THE WORLD BANK  
1818 H Street, N.W.  
Washington, D.C. 20433, U.S.A.

All rights reserved  
Manufactured in the United States of America  
First printing December 1992

Papers in the "Studies of Economies in Transformation" series present the results of policy analysis and research on the states of the former USSR. The papers have been prepared by World Bank staff and consultants and issued by the World Bank's Europe and Central Asia Country Department III. Funding for the effort has been provided in part by the Technical Cooperation Program of the World Bank for states of the former USSR. In light of the worldwide interest in the problems and prospects of these countries, dissemination of these findings is encouraged for discussion and comment.

The findings, interpretations, and conclusions expressed in this paper are entirely those of the author(s) and should not be attributed in any manner to the World Bank, to its affiliated organizations, or to members of its Board of Executive Directors or the countries they represent. The World Bank does not guarantee the accuracy of the data included in this publication and accepts no responsibility whatsoever for any consequence of their use. Any maps that accompany the text have been prepared solely for the convenience of readers; the designations and presentation of material in them do not imply the expression of any opinion whatsoever on the part of the World Bank, its affiliates, or its Board or member countries concerning the legal status of any country, territory, city, or area or of the authorities thereof or concerning the delimitation of its boundaries or its national affiliation.

The material in this publication is copyrighted. Requests for permission to reproduce portions of it should be sent to the Office of the Publisher at the address shown in the copyright notice above. The World Bank encourages dissemination of its work and will normally give permission promptly and, when the reproduction is for noncommercial purposes, without asking a fee. Permission to copy portions for classroom use is granted through the Copyright Clearance Center, 27 Congress Street, Salem, Massachusetts 01970, U.S.A.

The complete backlist of publications from the World Bank is shown in the annual *Index of Publications*, which contains an alphabetical title list (with full ordering information) and indexes of subjects, authors, and countries and regions. The latest edition is available free of charge from the Distribution Unit, Office of the Publisher, The World Bank, 1818 H Street, N.W., Washington, D.C. 20433, U.S.A., or from Publications, The World Bank, 66, avenue d'Iéna, 75116 Paris, France.

ISSN: 1014-997X

Christine I. Wallich is principal economist in the Public Economics Division, Country Economics Department, of the World Bank.

#### Library of Congress Cataloging-in-Publication Data

Wallich, Christine, 1952—

Fiscal decentralization : intergovernmental relations in Russia /  
Christine I. Wallich.

p. cm. — (Studies of economies in transformation, ISSN  
1014-997X ; paper no. 6)

Includes bibliographical references.

ISBN 0-8213-2359-8

1. Intergovernmental fiscal relations—Russia (Federation)
2. Intergovernmental tax relations—Russia (Federation)
3. Decentralization in government—Russia (Federation)
4. Privatization—Russia (Federation) I. Title. II. Series.

HJ1208.52.W35 1992

336.47—dc20

92-42199

CIP

0# 1-761-417

# 4

## *The tax and intergovernmental sharing system*

The structure of subnational government financing is in transition—moving from a system of negotiated tax sharing to one in which revenue sources are to be “assigned” to each level of government. The “Basic Principles of Taxation” law, was passed in December 1991, gives the VAT to the federal government and assigns the corporate and personal income taxes (CIT and PIT) as regulating revenues to subnational governments. Several minor taxes go to the oblast and rayon governments, without rate-setting autonomy. The federal government is responsible for assessing and collecting all taxes.

The new system has not yet been implemented fully. In the first quarter of 1992, it was superseded by a transitional budget, which continued the traditional negotiated tax sharing and subventions; transitional arrangements are also in place for the remainder of 1992. In the second and third quarters, the VAT was shared at a uniform 20 percent, about 60 percent of the CIT (19 of 32 percentage points) was retained at the subnational level, and the PIT was allocated fully to subnational governments. Excises from vodka are shared 50/50, excises from motor vehicles go to the federal level, and other excises go fully to the subnational level. Transfers and subventions, not specified in the law, are negotiated between MOF and the oblasts; both the aggregate volume of the transfers and their amount for individual oblasts are determined on a quarterly basis for deficit oblasts. The ad hoc mechanism for filling revenue shortfalls has apparently shifted from variable tax-sharing rates to the distribution of

subventions.<sup>1</sup> For the final quarter of 1992, the plan is to share the VAT at rates of 25 percent, 30 percent, and 35 percent (depending on the economic situation of the oblast), and to reduce the level of transfers by a corresponding amount.

### **The Impact of the Current and Proposed Intergovernmental Regime**

The recent reforms of the intergovernmental system and the proposals contained in the Basic Principles have many strengths. They move toward making intergovernmental finances more transparent and less subject to negotiation, and attempt to define a sphere of revenue influence for each level of government. Giving subnational governments some prescribed revenue sources of their own also creates incentives for increasing tax effort at the subnational level. Reforms have also addressed the fiscal gap at the subnational level.

But some problems with the assignment system proposed in the Basic Principles as well as with the transitional system currently implemented require adjustment and probably call for a new law. While these reforms have sought to improve the transparency of the intergovernmental system by defining all sharing rates and removing the opportunity for bargaining, the tax regime has not been successful at reducing the ad hoc approach to assignments and sharing. The sharing rates have been adjusted each quarter, and transparency is clouded by negotiated subventions. The “unified” approach to tax

administration has not been successful at forcing compliance, and subnational governments still influence the central collectors. Much uncertainty surrounds the new tax regime, and oblast governments often overrule the tax laws and the revenue-sharing rules.

In summary, the intergovernmental financing system is still in transition, and more changes are necessary. Subnational governments do not have confidence in the system—some have openly defied the rules—and the central government has not found the right way to balance the expenditure needs of subnational governments with the assignment of revenue. Searching for a solution will require addressing several, additional challenges.

#### *The Absence of "Correspondence" between Assigned Revenues and Expenditure Needs*

Correspondence between the taxes assigned to the subnational level of government and their expenditure responsibilities seems to be absent. The revenues available to subnational governments under the Basic Principles are a function of the corporate tax (CIT) and personal income tax (PIT) collected in their jurisdiction. The bases of these two taxes (profits and workers' wages) may be unrelated to expenditure needs—probably for the subnational sector as a whole and certainly for the individual oblasts. If revenue is overassigned to the subnational governments under the Basic Principles, no provision has been made for an extraction back to the center; if revenue is underassigned, no provision has been made to grant subventions to compensate for the difference.

A full analysis of correspondence would require a detailed assessment of expenditure needs for each oblast, which is beyond the scope of this report. However, an idea of the magnitude of the potential mismatch implied by the Basic Principles emerges from a comparison of the distribution of the revenue of each oblast under the present transitional system and a simulation of its (hypothetical) revenue under the Basic Principles (see Table 4.1). Based on first-quarter 1992 revenue data, for example, simulations show that the median oblast in Russia would lose 29 rubles per capita under the Basic Principles, an amount equal to about 4 percent of its present revenue. Of the 69 oblasts analyzed, 41 (60 percent) would suffer revenue loss under the Basic

Principles. Their median per-capita loss would be R 118 (under these simulations)—about 20 percent of revenues. Some oblasts would lose as much as one third of their revenues. Revenue for 28 oblasts would increase under the Basic Principles, with a median per-capita increase of R 139, about 18 percent of revenue. Some oblasts would gain more than 30 percent of current revenue. Regression analysis shows that the "winning" oblasts under the Basic Principles would be those with a lower per-capita GVIO, higher average wages, a smaller population, and lower rates of urbanization.<sup>2</sup>

The underlying problem is that the decisions about revenue assignment have preceded decisions about expenditure assignment, and have been made in the absence of a detailed assessment of expenditure needs. Essential to determining the division of revenue is understanding the fiscal implications of expenditure assignment. "How much will it cost subnational governments to carry out the expenditure responsibilities they have been given?" The recent transfer of expenditure responsibilities for consumer protection to the subnational level without quantifying or effecting a corresponding shift in revenue shares is a dramatic example of what happens when revenue and expenditure assignment are not considered jointly. This mismatch will continue, since there is no reason to expect that the taxes and expenditures assigned to the subnational level will grow at the same rate. Achieving correspondence requires concrete empirical work to define the present magnitudes (and the elasticities) of taxes and expenditures assigned to the subnational level. This complex and technical task should be the next step in planning Russia's future intergovernmental system.

#### *Equalization*

In attempting to define tax assignments concretely, the Basic Principles do not give the necessary prominence to the "equalization" issue. Assigning income taxes to the subnational level on a derivation basis necessarily means that higher-income territories regions will derive more revenue. Only by pure happenstance would revenue assignments match expenditure needs, either for the entire subnational sector or for any particular subnational government. For this reason, intergovernmental transfers are used to supplement revenue so that subnational gov-

**Table 4.1 Simulated Impact of Proposed "Basic Principles" on Oblast Revenue***for selected oblasts, 1992:Q1*

	Actual per capita Oblast Revenue (R)	Simulated per capita Revenue under Basic Principles (R)	Difference per Capita (R)	Difference (Percent)	Revenue Shares (percent)		
Oblast	(1)	(2)	(3)	(4)	Present system (5)	Basic Principles (6)	Difference (7)
Baskirskaya AR	627	592	-35	-5.65	2.46	2.19	-0.27
Buriatskaya AR	890	525	-365	-41.02	0.92	0.51	-0.41
Dagestanskaya AR	448	197	-251	-56.08	0.80	0.33	-0.47
Kabaldino-Balkarskaya	652	415	-237	-36.35	0.49	0.30	-0.20
Kalmytskaya AR	883	268	-614	-69.59	0.28	0.08	-0.20
Karel AR	835	837	2	0.19	0.66	0.62	-0.04
Komi AR	830	1079	250	30.07	1.04	1.28	0.24
Mariysaya AR	713	484	-230	-32.22	0.53	0.34	-0.19
Mirdovskaya AR	699	550	-149	-21.30	0.67	0.50	-0.17
Severo-Osetinskaya AR	747	503	-244	-32.66	0.47	0.30	-0.17
Tatarskaya AR	567	721	154	27.18	2.05	2.46	0.41
Udmurdsкая AR	686	550	-136	-19.81	1.09	0.83	-0.27
Checheno-Inkuskaya AR	574	256	-318	-55.40	0.73	0.31	-0.42
Median value of loss (R)			(29)	(4.29)			-
Number of losers			41	41			62
Median negative value (R)			(118)	(20)			(0.15)
Number of gainers			28	28			27
Median positive value of gain (R)			139	18			0.29

ernments can meet their expenditure responsibilities. Transfers also help equalize the often substantial differential capacity of localities to raise revenues, in the light of the wide inter-regional variations in resource endowments. The Basic Principles and the quarterly budgets that have superseded it are silent in this area. Of course, equalization may have been overlooked intentionally: not all countries give priority to evening out inequalities fully. But some form of subvention for equalization will almost certainly be necessary for protecting the budgetary position of territories whose economic base is not strong enough to support an adequate level of public services.

One possibility is that the Basic Principles will introduce the system of subventions similar to what is currently used to address revenue shortfalls. The current system is oriented toward "gap-filling" transfers (that is, providing the additional resources necessary to meet subnational deficits when they occur) than toward transfers whose objective is to ensure equalization (or to

provide incentives to mobilize revenue). In the first quarter, equalization was targeted by the oblast-by-oblast negotiated VAT sharing rates, an approach that does not address equalization explicitly, since expenditure needs are not considered explicitly. Russia lacks a tradition of using an objective formula for revenue sharing.<sup>3</sup>

There is no strong evidence that the transitional system of revenue sharing is equalizing. The VAT distributions in the first quarter were ad hoc, as was the distribution of subventions in the second and third quarters. According to empirical regression results, a larger percentage of taxes are retained by (arguably better off) oblasts in which the average wage is higher and the population smaller and less urbanized. However, no evidence exists that the revenue allocated to oblasts corresponds to expenditure needs, or recognizes low fiscal capacity in a special way. A significant negative relationship exists between the share of retained revenues and per capita output (GVIO). Taken alone, this relationship would suggest that the federal government did

redistribute resources toward poorer oblasts. However, regressions also show that tax yields are also higher in oblasts in which average monthly wages are higher (primarily because income taxes are retained on a derivation basis). (See Appendix Tables) This finding is important because the Basic Principles assigns income taxes to the subnational level—and will have the most beneficial impacts on oblasts in which average wages are higher.

Because per-capita subventions are significantly higher in oblasts whose per-capita GVIO is lower they appear to be equalizing according to this measure of fiscal capacity. However, subventions are significantly higher in oblasts in which the average wage is higher, suggesting a counter-equalizing pattern. Finally, per-capita subventions tend to be significantly higher in oblasts whose populations are smaller and which are more urbanized. In sum, no strong evidence exists that either the old the first-quarter system of variable VAT retention rates or the new second-quarter system in which retention rates are uniform and subventions are also provided, is equalizing. Certainly, there is no evidence that either is strongly equalizing.

#### *"Tax Assignment" vs "Tax Sharing"*

Is tax assignment appropriate for Russia? For the following reasons, the proposed changes specified in the Basic Principles may not be desirable.

- Tax assignment may provide incentives for the State Tax Service (STS) to collect national taxes more efficiently than subnational taxes (in which the federal level does not retain a share).

- While tax assignment channels all revenue from the assigned taxes to the subnational level, it does not give subnational governments any discretion over the tax base or rate setting, and the leaves subnational revenue base vulnerable to federal tax policy and other economic policy changes. The CIT base is sensitive to changes in federal industrial policy. For example, new central decisions about wage rates, commodity and input prices, foreign exchange and interest rates, and so forth, could have a direct impact on the revenue of subnational governments, and the impacts could vary substantially across oblasts. Changes in the PIT base or VAT rate (such as those that were made in the third quarter of 1992 in the name of social policy) will have important and unintended effects on the revenue of subna-

tional governments. Thus, tax assignment may be too inflexible, and assignment per se leaves subnational governments vulnerable. The term tax assignment is in fact a misnomer, since subnational governments have not been assigned any major taxes, but only their revenue. The absence of any rate or base-setting authority (characteristic of true tax assignment) is a major omission.

- All revenue bases are highly volatile. Recent estimates for the first half of 1992 show that, at the aggregate level, the PIT and CIT overshot budget estimates by a factor of 50 percent, while the VAT substantially underperformed. For some oblasts, the overshooting or undershooting was on the order of 300 percent. The assignment of *any* one or two tax sources to any level of government will certainly generate erratic and unpredictable revenue; sharing all taxes would mitigate this volatility, giving all levels of government greater revenue stability.

- Revenue assignment means that subnational governments lack fiscal discretion and remain without the ability to raise taxes in line with local preferences, creating disincentives for strengthening tax effort by subnational governments. Indeed, the analysis of tax effort in the Russian Federation (see the following discussion) suggests that the scope for encouraging revenue mobilization at the subnational level is limited unless subnational governments receive additional discretion. (See box 4.1 for principles of revenue sharing and box 4.2 for international experience.)

#### *Revenue Adequacy*

Deficits at the subnational level indicate that the present system is not revenue adequate. Final budget results for the first quarter of 1992 showed that 57 of 91 oblasts had a revenue shortfall totaling R 99 billion, while 34 had a revenue surplus totaling R 48 billion.<sup>4</sup> This finding of revenue inadequacy was verified in field investigations of individual subnational governments. The deficits were covered through some combination of ad hoc subventions from the federal government, deferred expenditures, or late payments to creditors (increasing arrears).

#### *Revenue Mobilization Incentives*

The current system does not offer strong incentives to subnational governments to increase their rate of revenue mobilization. Our (admit-

tedly crude) estimates are that tax effort among the oblasts range from two times the national average to less than half of the national average. Thus the extent to which subnational governments urge tougher enforcement on the local STS authorities and better compliance on their enterprises varies widely.

### **Options for Reform: A Framework for Tax Sharing**

#### *Objectives of An Alternative Tax and Transfer System*

The problems inherent in tax assignment are severe enough that the government should

reconsider the Basic Principles and the ad hoc nature of the implemented budgets. Indeed, enthusiasm for implementing the Basic Principles does not appear to be pervasive, and current plans are to continue modifying the current system. If the door is in fact open to rethinking the intergovernmental system, the first step is to weigh the objectives of the government. No one can determine for Russia what its priorities should be—this decision is political. It is possible, however, to enumerate the various objectives that most countries would consider:

- Enhancing ability of the central government to use fiscal policy for macroeconomic stabilization

#### **Box 4.1 Principles for Sharing and Dividing Revenue**

Subnational governments are financed in a variety of ways. Sources often include shares of national taxes. In addition, subnational governments, in many market economies, have their own tax sources, such as property tax, excises and taxes on industry and the professions. To finance the expenditures not covered by these taxes and charges, subnational governments rely on additional revenue from transfers, which are often formula-based.

Several models for providing subnational governments with shares in national tax revenues are available. Four ways to assign or share taxes are described below. (Box 4.2 describes some international experience with tax assignment and sharing.)

*Tax Separation/Tax Assignment.* A rigid separation of revenue sources is sometimes used for its simplicity. Under this system, taxes are "assigned" to one or another level of government, which then has sole rights to collect and use the tax, and often full authority to set its rate and base. Typically, the central government will be assigned the individual and the corporation income taxes, while subnational governments may be assigned taxes whose yield potential is lower, often including the property tax, business taxes, and a variety of licenses. When subnational governments do not have authority to determine the tax base or rate, they will be vulnerable to changes in central tax policy, and will not be able to pursue discretionary tax policy on their own. An advantage of this system to the center is that it keeps local governments on a "short leash," making them responsible for meeting their expenditures from the assigned tax sources. However, because these taxes are unlikely to be sufficient for financing subnational expenditures, assignment systems are almost always accompanied by transfers from the central government.

*Tax sharing.* When the central government levies and collects most taxes, a proportion of these revenues can formally be assigned to subnational governments. These funds may be shared by each subnational government on the basis of collections, or they may go into a central pool to be redistributed on the basis of population, urbanization, per-capita income, or other criteria. The advantage of this system is its simplicity, and its strength is that certain share of revenues is guaranteed.

*Tax-base sharing/surcharges.* Another alternative is to allow localities to levy surcharges on national taxes or on national tax bases, usually subject to some ceiling. This system of "piggy-backing" on the national tax base is simple, and can work well when all levels of government use a consistent definition of the tax base, and if the surcharges do not differ too much among localities. Subnational governments can usually rely on the superior administrative machinery of the central government to collect these surtaxes.

*Concurrent tax powers.* Both levels of government may tax an activity or tax base, and the precise definition of the base may differ. Switzerland is an example: federal and cantonal governments tax the same bases, but the precise definition of the base (personal income and corporate profits) varies between the national level and the cantons. The same is true for many U.S. states.



#### Box 4.2 Federalism, Tax Sharing, and Tax Assignment in Practice

Intergovernmental systems vary considerably, with actual practice explained by historical and political factors and by the administrative capacities of each level of government. As a general principle, trade taxes and taxes with stabilization and income redistribution properties (the CIT and the PIT) should be central taxes; broad-based, stable-yield sales taxes (other than the VAT) and excises are well suited to the subnational level, and property taxes and other business taxes and fees are appropriate for the local level. Practice does not always parallel these principles, and, depending on a country's particular situation and goals, the principles may not apply.

In some federal systems, subnational governments enjoy substantial fiscal sovereignty. State and/or provincial governments in some Western federations levy one or more of the following taxes: individual income tax (levied by the state/province of residence), corporate (enterprise) income tax (levied by the state/province of the source of income), retail sales tax (levied where consumption occurs), the VAT (Brazil only), and excise taxes (levied by the state of consumption). Resource-rich states and provinces have used revenues from taxes on natural resources to replace such taxes, to avoid having to levy them, or to support lower rates than would otherwise be the case.

In the *United States*, each of the three levels of government is responsible for collecting its own taxes. Taxes are not shared by the federal and state governments. The federal government has been authorized to collect income taxes for the states, but no state has availed itself of this service. However, the federal and state administrations cooperate closely, and over half of the states have adopted the federal income tax base as their tax base.

The U.S. Constitution does not assign tax instruments to different levels of government. Both federal and state governments can use any tax not prohibited by the Constitution or, for the states, by federal law. Moreover, few limitations are placed on the taxing power of the states (which thus enjoy considerable fiscal sovereignty) and local governments. The only explicit limitations contained in the Constitution prohibit states from using import and export duties. In sum, the U.S. states have substantial fiscal responsibility. While grants comprise about 17 percent of their revenue sources, U.S. states cannot rely on federal grants to compensate for revenue shortfalls.

In *Australia* the federal government is empowered to impose all forms of taxation but cannot discriminate among the states. States are prohibited from using any form of sales or indirect tax, given a judicial interpretation of the constitutional prohibition against states' using customs and excise taxes. A law dating from World War II excludes states from the taxation of individual and company income. Because these restrictions leave the states dependent on relatively unimportant sources of own-tax revenues, and on grants from the federal government, the states were given exclusive right to payroll taxation during the 1970s. As late as 1981-82, the central government collected 80 percent of total taxes.

*Switzerland* has "concurrent tax powers": local jurisdictions (the cantons and states) are allowed to levy corporate income taxes, as well as personal income taxes and natural resource taxes. In *Canada*, provinces can levy a surtax on the central income tax, which is transferred directly to them.

In *Hungary*, a combination of tax sharing and tax assignment is used. Local governments have access to general taxes and also receive a share (based on "derivation") of the central government's personal income tax.

In *Brazil* a combination of tax assignment and overlapping tax authorities is used. State governments have substantial and elastic revenue sources, including a VAT. Since a federally levied VAT also exists, the central government fixes maximum rates and has limited the tax base by exempting certain goods or services from taxation for social equity purposes, and in order to avoid possible conflicts and competition among provinces.

In *India*, a system that combines tax sharing and tax assignment methods is used; the center shares a fixed proportion of the proceeds of certain taxes with the provinces. Thus, 85 percent of the income tax and 40 percent of the excise tax are shared with state governments. These taxes are shared and allocated among the states on the basis of an index of need, population, and provincial collections. The provinces have complete operating flexibility over those taxes that are "assigned" exclusively to them (sales, excise, and certain minor taxes).

In *Germany*, 35 percent of the VAT currently belongs to mid-level governments (Länder), and is distributed among them according to an equalization formula.

In *Nigeria*, where the tax assignment method is also used and the states have been assigned income taxes, steps have been taken by the current government to make the tax rates and the base uniform across provinces. Until recently, export duties were local taxes.

- Achieving correspondence between the expenditures necessary for providing a minimum level of services across localities and the revenues assigned to the subnational governments

- Ensuring equalization to offset differences in fiscal capacity or to reflect differences in expenditure needs

- Providing incentives to subnational governments to increase their revenue mobilization

- Involving the local population in budgetary decisions and increasing the accountability of subnational government officials to their local constituencies.

- Ensuring the flow of resources to regions whose marginal productivity of additional investment is greater

- Minimizing administrative costs

- Gaining public acceptance and confidence—by individuals, enterprises, and subnational governments—thus increasing compliance.

#### *An Alternative Approach to Tax Sharing*

Any restructuring of the Russian system of inter-governmental financing should currently focus heavily on stabilization issues but any new system should also include elements of equalization and at least some provision for enhancing the fiscal discretion of subnational governments. The importance of these objectives, and how they may be achieved, will change as the Russian economy changes. For this reason, and given the economic and structural changes in the transitional period, fixed and unchangeable solutions—such as those delineated in a constitution—should be avoided at this time.

To assist the Government in thinking about the options available for reforming its intergovernmental financing system, this report suggests a flexible design framework with four “legs”<sup>5</sup>:

- A “common pool” of revenues divided first between the federal and the subnational governments based on expenditure assignments

- The allocation of a portion of the subnational pool on a derivation basis

- The distribution of the remainder of the subnational pool according to a formula

- Subnational taxes and surcharges

This four-part proposal retains many of the good features of the Basic Principles but attempts to remove some of its weaker features and ambiguities. As noted, the first step would

be to quantify the expenditure responsibilities of the central and subnational governments in order to establish the relative magnitudes of the resource requirements of each level (see figure 4.1).

#### *The “Common Pool”*

All revenue from four major federal taxes (the CIT, PIT, VAT, and excises) would go into a common pool. The central and subnational shares in this pool would be determined on the basis of expenditure assignment. For illustration, MOF’s July budget estimates for 1992 would imply that 57 percent of the resources in this pool would have been allocated to the federal government, and 43 percent to subnational governments.<sup>6</sup> Figure 4.1 thus assumes that the subnational share is the smaller of the two, but this assumption is a function of any modifications of expenditure assignments that might be made. Such clarity and transparency in establishing the size of the subnational pool is preferable to ad hoc arrangements or annual decisions by MOF because it permits subnational governments to budget and plan.

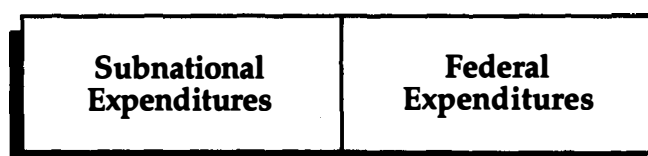
The share for subnational governments would then be distributed across oblasts partly on a “derivation” basis (meaning that taxes would accrue to the territorial budgets where they are collected) and partly on a formula basis. (The present system of subventions would be abolished in favor of the distribution formula.) The shares to be distributed by formula and derivation would depend on the priorities of the government according to the objectives delineated earlier. A “Grants Commission” could be established to design the grant formula and sharing system (as in Australia and other countries). To enhance the transparency and the revenue certainty of the system further, as well as to insulate it from ongoing political pressures, the Commission would fix both the size of these two pools of funds (the overall volume of funds shared and the volume to be shared on a derivation basis) and the distribution formulas for a three- to five-year period.

#### *Sharing on a “Derivation” Basis*

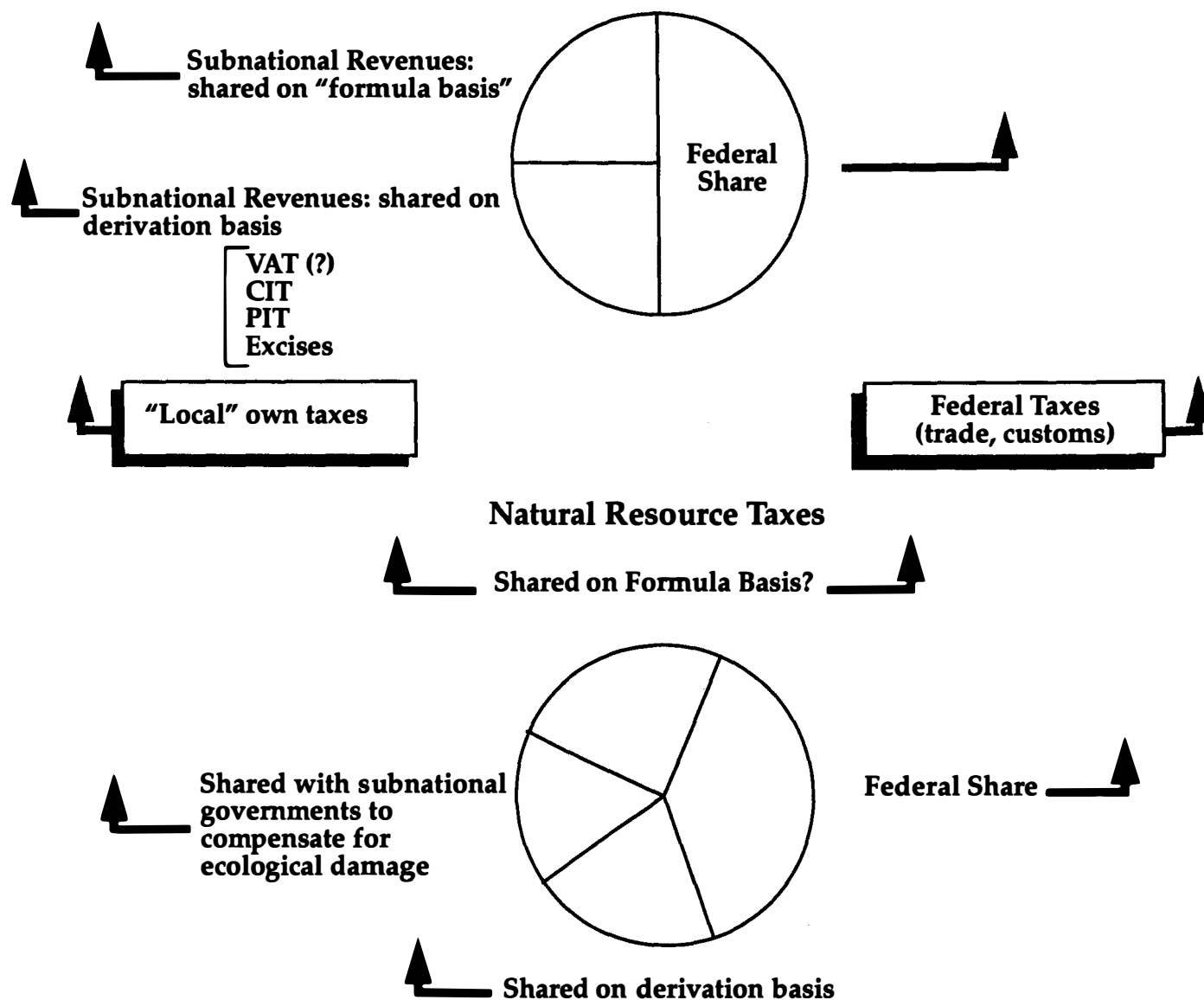
One portion of the subnational pool of major taxes would be shared on a derivation, or “origin,” basis—that is, the locality where the taxes are collected—and a uniform rate of sharing across

## Figure 4.1 A Framework for Revenue Sharing in the Russian Federation

Reforming the Revenue Sharing System



### Revenues: The Sharing Pool



all oblasts would be established. The derivation sharing rule could be simple. For example, suppose that a decision was made to allocate on a derivation basis an amount equivalent to 50 percent of the divisible subnational government pool. Some share of the collections from each tax in the derivation pool would be retained by the oblasts, calculated to exhaust the 50 percent. The tax shares should be fixed for three to five years, and would be uniform across all oblasts. The greater the proportion of the subnational government pool that is shared on the basis of derivation, the more resources the system will channel into regions whose taxable base is larger.

The advantage of this derivation proposal is that it can easily be understood, and is similar in concept to the existing system. Moreover, administering and monitoring the system would not be expensive, and, as long as the retained shares do not vary too widely, it would not give the STS an incentive to collect one tax more efficiently than another. This sharing strategy would reward oblasts that can attract and promote industry, and the uniform sharing rates would remove the negotiation and bargaining that characterize today's sharing system. It would also give subnational governments a more certain flow of revenue and would promote efficient budget planning.

*Some Complications.* One concern is that revenue sharing on a derivation basis is not equalizing. Since this method assigns taxes to the jurisdiction where they are collected, higher-income territories will receive greater revenue. This mechanism would be counter-equalizing, requiring that the distribution formula incorporate an equalizing component.

Another major issue is that the VAT may not lend itself easily to derivation sharing as the Russian economy changes in the next few years. Industrial provinces whose value added is high may have a decided advantage, and oblasts whose enterprises sell to foreign markets may suffer a decided disadvantage from zero-rated exports, "port" cities and oblasts would gain, if and when imports are taxable under VAT. In the model proposed here, this problem could be accommodated if the VAT were eliminated from the part of the common pool that is shared on a derivation basis. However, doing so would involve an important trade-off because eliminating the VAT would make the derivation sharing pool

more vulnerable to the business cycle, and it would probably necessitate setting the PIT and CIT sharing rates at high levels, possibly increasing the STS incentive problem. Balancing these concerns would probably necessitate eliminating the VAT from the derivation-shared pool.

A derivation-shared (or subnationally assigned) CIT must eventually be allocated among jurisdictions for enterprises with branch operations. This necessity is not yet a major problem because few enterprises in Russia have locations in more than one oblast, and because the present system allows the CIT to be prorated on an employment basis. But the government must begin planning for the time when it must allocate the profits of national firms among oblasts, because the solution will inevitably imply a more complex tax system—one whose administration is already overburdened. Moreover, the current assignment of total PIT revenues to the rayon of employment, and not to the rayon of residence must be adjusted.

#### *Sharing Through Formula Distribution*

A second part of the common pool would be earmarked for subnational governments according to a formula that explicitly considers expenditure needs and tax capacity. The distribution formula would provide sufficient funds to enable subnational governments whose tax capacity is weak and expenditure needs are great to provide a "minimum" level of service. Formula-based sharing makes receipts for subnational governments more certain, thus enhancing their ability to plan efficiently. Depending on what the formula includes, distributions from this pool can direct resources toward oblasts whose fiscal capacity is relatively weak and/or whose level of need is relatively great. The more of the pool that is allocated to the formula component (and thus the less that is allocated to the derivation component), the more equalizing the overall system might be.

What indicators should be included in the formula? In most countries that use this strategy, the formula consists of (1) some estimate of expenditure needs, (2) an assessment of revenues to finance these needs, and (3) a rule about how far the equalization should reach. The most difficult task is to define the expenditure needs of each jurisdiction. The configuration of the formula is as follows: Grants = Expenditure needs -

Revenue capacity. With expenditure needs and revenue capacity estimated, the formula-based distribution would be allocated across oblasts to fill either the estimated deficiency or a proportion of the estimated shortfall. Some strategies used by other countries are described in Box 4.3.

In Russia for the time being, *simplicity* should be an overriding concern. Some countries use as simple an indicator as population, and establish equal per-capita needs. (Ultimately, the objective should be to move toward broad indicators of need and fiscal capacity.) Russia is probably not ready to move to a system based on income as an indicator of fiscal capacity, due in part to the difficulties associated with existing measures of income. But it should be possible to identify some broad indicators of need. For example, the size of the population, the concentration of high-cost citizens (for example, pensioners), and the degree of urbanization are examples of indicators sometimes used in industrialized countries. Basing the formulas on certain key indicators of public service needs (for example, miles of sub-standard roads, or deficiencies in school and hospital space), is a strategy used by other countries. Still other countries (notably Denmark) quantify expenditures, item by item. This concept of this strategy is similar to the system of expenditure norms once used to determine expenditure needs in Russia. However, the drawback of this strategy is that keeping it up-to-date is complicated and expensive.

The initial construction of the formula is an arbitrary process. Many countries have chosen to resolve this problem by establishing a Grants Commission to develop a formula on a consensus basis.

#### *Derivation Sharing and Formulas: Some Issues.*

How large should the derivation pool be relative to the formula distribution pool? In most countries, some equalizing is appropriate, thus arguing for a sizeable formula-based pool, especially if the national consensus is that levels of service provision should not differ "excessively" across oblasts. And if the federal government does not provide cost-reimbursement for nationally mandated safety net programs, some equalization might also be necessary, given that responsibility for the social safety net has been passed to sub-national governments.

But important tradeoffs exist. Equalization will penalize better-off regions that have the greatest potential for industrialization and growth; excessive equalization can push a region to rely on transfers, and can reduce incentives for local resource mobilization efforts. At this point in Russia's history, the intergovernmental fiscal system should probably place priority on the initiatives and fiscal energies of the better-off areas, in the interests of more rapid economic growth. It could do so by allocating a relatively larger proportion of revenues on a derivation basis, but also by giving oblasts and larger cities some powers to set tax rates, possibly through a surcharge mechanism (described later).

#### *Enhanced Subnational Taxes*

The fourth leg of this framework is independent subnational taxing power. Until oblast governments are allowed to make not only tax but also expenditure decisions, they will never be fully accountable for the efficiency with which they

#### **Box 4.3 Revenue Sharing Formulas: Some Strategies**

Two strategies are available for estimating expenditure needs, a crucial element in any formula-based system. One begins with concrete expenditure norms, and then seeks to "cost them out." Russia could do so by using existing (or modified) expenditure norms—for example, per-pupil costs of education, given the standard cost of a teacher, classroom operation, and so forth, to derive a cost figure in rubles. Performing this calculation for each expenditure function can build up each jurisdiction's expenditure need. While the precision of this strategy has much appeal (it is being applied successfully, for instance, in Denmark), its drawback is its complexity and the cost of keeping the indicators current.

A different and far simpler way to define expenditure needs is based on umbrella variables such as population, per-capita income, city size, poverty rates, density, the centrality of a city, and so forth. This strategy is used in Germany and for some grant programs in the United States. The population figure is weighted higher for larger German cities to reflect their "central place" functions. The total weighted population is used to distribute the available equalization funds.

### Box 4.3 continued

The formulas in many countries also incorporate an estimate of the revenue capacity of localities. The revenue-raising capacity of localities is important, because, if actual revenues and not tax capacities are used, an oblast could reduce its tax effort and collections and receive correspondingly higher transfers. An appropriate measure for estimating local revenue capacity might include any local tax bases—in Russia, tax bases such as property values and business turnover; in other countries, taxes over which the local government has discretion. Estimating the revenue potential of an oblast would entail multiplying the estimated tax base by the average tax rate for each base.

In *Brazil*, taxes on income and industrial products are placed in a common pool from which a pre-specified share of federal taxes is transferred to the States' Participation Fund (FPE). The Council of States then determines state shares based on area, population, and per-capita income. Other taxes, such as payroll tax and a tax on hydroelectricity and on minerals, are not distributed via the formula, but based on derivation.

The merits of the FPE are transparency, predictability, autonomy, and redistribution. The distribution also reflects fiscal need (by basing it on population), reflects fiscal capacity (basing it on per-capita income), and a guaranteed basic minimum grant. The FPE also has flaws: income is an imperfect measure of fiscal capacity; the formula lacks any explicit standard of equalization; states with similar fiscal capacity receive widely different entitlements; and the States Council finds the formula results unacceptable.

In *India*, each major tax is assigned a formula that dictates how revenues will be distributed between the center and states, and among states. Although the weights placed on formula components differ by tax, the factors included in the formula are generally the same. For example, 85 percent of income tax goes into a state pool from which allocations are made according to each state's "contribution" to taxes, the "distance" of income per-capita relative to states with higher per-capita income multiplied by the population, population and "backwardness" (as measured by the population of tribal groups associated with underdevelopment and the number of agricultural laborers). The Finance Commission meets at least once every five years to make recommendations about the design of tax sharing and grant formula.

In *Nigeria*, most taxes are collected by the federal government, except for the personal income tax, which is collected and retained in full by the states. A share of federally collected funds (31.5 percent) is allocated into a States Joint Account (SJA). A formula is used to distribute 95 percent of the SJA, with the following components: population (40 percent); "minimum responsibilities of government" (40 percent—the proportion of recurrent expenditure to total federal revenue of the state with the smallest budget in a given period); a social development factor (15 percent) that currently includes indicators of school enrollment and may be expanded to include health indicators; and internal revenue effort (5 percent). The other 5 percent of the SJA is not placed in the equalizing pool, but is distributed to mineral-producing states on the basis of derivation.

In *Nigeria*, local governments also receive federal funding. Ten percent of all federally collected revenues are allocated to the local governments. Of this amount, 25 percent is distributed in equal shares to local governments; the rest is distributed by population. A problem with the local scheme is that it does not consider the capacities of local governments. A third special fund allocates 3.5 percent of federally collected funds for Federal Capital Territory and to states on the basis of their ecological problems. Formula-based distribution is important in *Nigeria* because, without it, distributions could be sensitive to political pressures.

In the *Philippines*, 20 percent of federally collected taxes are allocated to the subnational pool. This pool is distributed according to a formula which includes population (70 percent), land area (20 percent), and equal shares (10 percent). The tax on petroleum products is allocated on the basis of derivation.

In *Canada*, the goal of the equalization formula is to ensure that all provinces receive the equivalent of at least the national average tax rate applied to the national average revenue base. The following calculation is made for each provincial tax for each province. First, the national average tax rate is determined by dividing the total tax revenue for all provinces by the total tax base for all provinces. Second, this rate is applied to a province's revenue base, and a provincial per-capita yield is determined, which is applied to the total revenue base to determine a national per capita yield. The provincial entitlement is the difference in the above national and provincial per-capita yields, times the province's population.

deliver services to the local population. Accountability is one of the most important benefits of a decentralized system of intergovernmental fiscal relations. Moreover, the local population would be more amenable to tax increases if they are willing to pay to receive better services. At present, subnational governments can influence the rate of revenue mobilization but only through "back door" methods—exerting pressure on their enterprises to comply, and urging stricter enforcement by the STS.

#### *The "21 Local Taxes"*

The Basic Principles prescribe a list of 21 local taxes. With the exception of the land and property tax, the time may not be ripe to push ahead with these taxes, since they are not likely to be very revenue-productive and will strain the limited resources of the STS. In many countries, they would be considered "nuisance taxes" whose compliance costs slow down the workings of the economy. Finally, they are liable to divert the attention of policymakers away from more productive revenue alternatives, such as surcharges (see below) and the increase in user charges at the local level.

Some discretionary subnational tax sources are better and more revenue-productive: (1) a surcharge on the PIT, up to a limit prescribed by the federal government; (2) a tax on land values within urban areas; (3) a tax on the ownership and operation of motor vehicles. These taxes are advantageous because their burden falls on local citizens, thereby increasing the accountability of local officials; and they could engender greater compliance and be more revenue-productive than the minor taxes now proposed in the Basic Principles. All three would probably support the more progressive distribution of burdens. Their major disadvantage is that the property and vehicle taxes would require some investment in setting up an administration, and both would have to be collected by the STS, which would not share in the revenues.

#### *Surcharges*

Introducing surcharges would give subnational governments some limited power to set tax rates, giving oblast and rayon governments some influence over the amount of government spending, and making their spending decisions

more accountable to their constituents. One effective way to levy them is to allow subnational governments to place a surtax rate on the national PIT base. The surtax could be administered by the STS. The added administrative burden imposed by this system is surprisingly small. Each year, the oblast governments would establish the next year's surcharge rate. The local STS office would be informed of the rate and, together with the central rate, would apply it to the personal income tax base. The amounts thus collected would be remitted to the oblast accounts in the usual way. Box 4.4 shows how such a surtax might work.

The importance of increasing revenue from oblasts property, land, vehicle, and other taxes should not be underestimated. The present subnational tax base is weak. Many subnational governments continue to receive revenues from the profits of their enterprises, including some newly established joint ventures. They may also receive revenue from the sales of assets they own, in the course of the privatization process. But both are shrinking sources, since privatization will leave all earnings in private hands, and the locally owned stock of enterprises will eventually disappear.

#### *Conclusions*

This "four-legged" structure provides a flexible framework for intergovernmental finances. First, it supports a combination of strategies and permits these strategies to change over time. It is compatible with shifts in expenditure responsibilities between the federal and subnational level; if additional expenditures are shifted "downstairs," the subnational portion of the divisible pool can be increased. Second, it is compatible with changing the emphasis on growth rather than on equalization. If greater emphasis on equalization is desired at some later stage, the portion of the subnational pool distributed on a formula basis would be made larger. If a decision is made to allow the better-off areas to reap the benefits of their larger fiscal capacities, the derivation pool could be enlarged. Choosing the degree of equalization is essentially a political judgment, made differently in different countries, and changeable over time. Third, the four-legged structure is compatible with changing the share of "own revenues" and shared revenues:

#### Box 4.4 Tax Surcharges and Base-Sharing Model

Under tax-base sharing, subnational and central governments share in the base of major national taxes, such as those on personal or enterprise income. In principle, a surcharge on the PIT is preferred because the PIT falls on local residents, and a tax imposed on local residents is more suitable for local financing than one that falls on those outside the local area, such as a CIT or VAT. Moreover, subnational governments already share in the PIT in Russia. The PIT may also give subnational governments a more stable tax base (wage income) than would the CIT or VAT; and a PIT surcharge is administratively simpler than a surcharge on the VAT or CIT.

The VAT is especially unsuited for a surtax (or for derivation sharing). One problem is that oblasts that specialize in intermediate goods would almost certainly prefer to "export" taxes to other oblasts, rather than to zero-rate their own "exports." A true destination VAT would require an adjustment for taxes on "imported" goods, as will now be the case in European Community (EC) countries. However, it is doubtful that oblast governments would wish to give credit for "foreign" taxes on "imported" inputs purchased from suppliers in other oblasts. In Brazil, the provincial VAT, creates considerable administrative and collection problems, even though the federal government sets maximum rates. While the EC experience of VAT harmonization offers some parallels here, it appears unlikely that a regionally rate-differentiated VAT could operate satisfactorily in Russia.<sup>a</sup>

Under a surcharge model, the national (central) tax would be totally independent of the subnational tax; as long as subnational governments did not change the central base, they would be permitted to elect a surtax rate on the central tax (within a range). For example, a basic rate (say 12 percent) on the PIT could remain, and individual subnational governments could impose an additional rate of 1 percent (minimum) or 5 percent (maximum) at their discretion.

The simple numerical example below describes one version of how a PIT surcharge could work, and how an employee would be treated under this system. We have assumed a national tax rate of 12 percent and a surcharge of 1 percent, with the result that the STS collects R 2500 from this employee for the individual local government and R 31250 for the federal government.

Under this surcharge, all employees would have to inform their employer each year of their locality of residence, as of a certain date, just as they now disclose their family status. The withholding agent would withhold the tax appropriate to each individual, based on the tax tables. The amounts would be remitted to the STS, and, via the banking system, to the central and subnational government accounts.

In another version of the surcharge, local governments would receive a percentage of the tax: an additional (say, 5) percent of the tax would be collected for remittance to the local government. This differs from the base-sharing version, in that the local government would be affected by central decisions about tax rates, as well as tax-base structure. China uses this strategy for the local sharing of sales taxes, and some by the local governments in the United States use this method to share income taxes.

Gross Income	300,000
Less Exemptions	50,000
equals Net Taxable Income(tax base)	250,000
National PIT at 12 percent	31250
Oblast Surtax at 1 percent	2500

a. See Tait (1988).

as experience with surtaxes and other local taxes is gained, they can be modified.

The importance of developing a framework such as this, built on consensus and in the context of an institutional process to which all oblasts and the center adhere, cannot be overstated. An intergovernmental system that is perceived to be fair and equitable can defuse other

difficult resource allocation issues in the federation, such as natural-resources revenue sharing and the demands for autonomy by oblasts that contain ethnic populations. A transparent and fair system—where all agree on the rules—means that oblasts need not hold on to their few bargaining chips—natural resources and their revenue share. In sum, at a time when nation



building is paramount, a well- designed inter-governmental fiscal system can make an important contribution.

### Other Issues in the Tax Sharing Framework

#### *Scope of the Intergovernmental System*

Should the fiscal structure define tax (and expenditure) assignments only to the oblast level, and allow the oblast soviet to decide the distribution within its boundaries? Or should the intergovernmental system be structured to prescribe the exact allocation of fiscal resources to oblasts, as well as to cities and rayons? Extending the system to the sub-oblast level would give the federal government maximum control over the regional distribution of resources, since tax collection and assessment and much of the expenditure delivery and budgeting actually takes place below the oblast level. However, local affairs may be handled more efficiently by the oblast than by Moscow, especially in a country as large as Russia. A later section of this chapter discusses this issue in greater depth.

#### *Tax Administration Responsibilities*

The assignment of taxing powers specified in the Basic Principles conflicts with the present assignment of tax administration responsibility—the STS. The Basic Principles requires that the STS collect taxes which accrue to subnational governments, as well as several minor local taxes (from which the center derives no revenue), as efficiently as it collects taxes that would accrue to the center. A reasonable fear is that, since local STS offices suffer from scarce resources, they may devote their resources more heavily to collecting central taxes.

Given scarce administrative resources, the current central tax administration can and should be retained to collect taxes shared with subnational governments. The superior administrative capacity of the center, and the economies of scale associated with collecting and auditing multiple taxes, argue for a single tax administration. However, a central tax administration may not be a viable collection agency for purely local government taxes.

Switching to separate subnational and central tax administrations would be ill-advised at present. Subnational governments, especially at

the local level, have no existing capability to administer taxes, and a change would disrupt the functioning of government further at a time when stability is necessary. In the longer run, subnational governments may play a role in some aspects of property tax administration, but at present this is not advisable, given the dearth of administrative personnel.<sup>7</sup>

However, the government should seek to eliminate the de facto "dual leadership" faced by the STS, relating to its reliance on local governments for housing and fringe benefits. As in many other countries, rotating lead officials could address this dual leadership problem. The problem could also be resolved if the federal government assumed responsibility for providing all fringe benefits to STS officials, and for providing office arrangements, and so forth. Eliminating this dual loyalty is essential, since the STS is assuming a larger role in collecting and remitting taxes to the center. In Tyumen, for example, the STS has assumed the role previously handled by the State bank, in remitting locally collected taxes to the center: this role—and dual loyalty—make it both possible and tempting to remit less than the full amount—in effect going the "single channel" route.

#### *Fiscal Discretion for Large Cities*

Should special treatment be given to large cities? In Russia, as in most countries, the taxable capacity of the largest cities is greater, and they also have more complex and expensive expenditure needs. Special treatment could be thought of as additional taxing powers (for example, a larger surcharge on central taxes); alternatively, larger cities could also receive special support in implementing the property tax, or special rights to set prices (user charges) for municipally provided services over and above those allowed by the supervising ministries at the federal or oblast level. Special investments could also be made in better tax administration, and, in the future, borrowing powers could be enhanced. In Russia, these actions could include all oblast seats, or other large industrial centers whose expenditures needs are high and that are willing to tax their own citizens in order to provide better services than those financed through the standard regime.

### *The Need for a Transitional Mechanism*

Would the immediate enactment of a program such as the one proposed in this report be too much of a "shock" to the system? In all likelihood, it would. Some transition rules would be required to protect oblasts from unreasonable one-time effects.

### *The Conditionality of Tax Shares and Transfers*

The Basic Principles assigns taxes to subnational governments, and other legislation gives them autonomy in spending these funds. Thus, subnational governments could emphasize spending on projects that generate benefit primarily to localities, while underfunding projects whose benefits accrue to the national interests—those whose externalities are sizable. This tradeoff is an issue that faces designers of intergovernmental fiscal systems in all countries, and they usually resolve it by imposing some conditionality on the subnational governments. Somehow, issues associated with financing services that have major externalities must be addressed—either some expenditure mandates must be imposed or certain functions must be assumed directly by the federal government.

Subnational governments should be able to spend their own revenue sources as they want.<sup>8</sup> If local taxpayers are unhappy with the actions of their locally elected authorities, they can dismiss them. Conversely, local autonomy can make local governments more accountable to the central government (that is, to taxpayers in general) depending on how central government transfers are designed. In many countries, subnational governments are made accountable to national service provision standards—that is, educational achievement, health care provision, infrastructure maintenance, and so forth.

### *Targeted Intergovernmental Transfers*

In many countries, transfers may be used to influence spending patterns at lower levels of government. In Russia, the most important application of such transfers was to provide social protection and support capital investment, financed entirely or partly with nonmatching targeted grants to oblast-level governments until mid-1992.

### *Targeted Transfers for Social Protection*

In 1992, the transfer of social protection responsibilities has placed a great burden on subnational budgets and has put vulnerable groups at risk. Because the protection of socially vulnerable groups during economic transition is a priority of the federal government, it is appropriate that the federal budget resume financing these expenditures. After prices have been liberalized, the subsidies will no longer take the form of producer price subsidies, but will be cash subsidies. Reaching truly needy persons will require that these cash benefits be targeted. The administration would continue to operate through the rayons, which would be reimbursed on the basis of actual payments made by the federal level in a program of "cost-reimbursement." The rationale for financing federal-level capital investments at the central level was discussed in chapter 3.

### *Special Treatment for Special Areas*

The design of fiscal federalism in Russia is made more complicated by the fact that some territories are demanding political autonomy, greater devolution of responsibility for expenditures, or special tax regimes. Such demands have arisen in three situations. First, areas inhabited by non-Russian *ethnic* groups (which form the majority of the population only in Tatarstan) claim the right to greater autonomy given their different history and culture. Second, some areas rich in *natural resources* feel entitled to special financial arrangements that allow them to derive greater benefits from their resources. Some of these regions note that development in their area has not benefited from the presence of natural resources; in fact, their area has suffered severe environmental damage in the light of resource exploitation. These first two categories overlap where territories inhabited by ethnic minorities are resource-rich. Third, areas that are currently *more developed*, and can grow more rapidly than others, may prefer greater fiscal autonomy or special fiscal arrangements in order to benefit from their stronger economic position.

*Ethnic "Separatism."* Separatist sentiments expressed by areas that contain ethnic minorities have manifested themselves in disturbing ways. Some oblasts (most notably Tatarstan) have declared a state of quasi-independence from the

Russian Federation. Reportedly, some regions are insisting that a "single channel system" be established, whereby all revenue flows initially to subnational governments, and then through a negotiated single payment to the federal government. Bashkiria has already negotiated such an agreement with MOF, although it has not been approved by the Supreme Soviet. In other cases, such as Tatarstan and the reportedly 20 oblasts that have determined their own sharing rates unilaterally, this approach is being implemented in a de facto and presumably illegal manner.

*Resource-Rich Areas.* Whether resource-rich regions should receive an extraordinary share of the resource taxes depends, conceptually, on the nature of the Russian Federation (whether "we" represents the citizens of the Russian Federation or the citizens of a smaller jurisdiction). The draft law on ethnic minorities appears to accord substantial property rights to the native populations of resource-rich areas. Moving beyond the claims of native populations to resource revenues, it is not obvious which level of subnational government should benefit from resource rents and which should not. Nevertheless, natural resource-rich areas are demanding greater benefits from their resources than they have received in the past.

*Industrially Well-Endowed Regions.* The claims of territories whose industrial bases are large and efficient are similar to those of resource-rich areas: the previous totalitarian regime left an "industrial endowment" akin to the natural-resource endowments. Should the local populace or the people of Russia benefit from this industrial endowment? This issue is complicated somewhat by the possibility that areas whose industrial bases are strong might be best able to utilize public revenues to invest in infrastructure that support production and thus fast-growing enterprises. Given the non-transparency of the present system, and the perception that tax sharing works against the better-off oblasts, many rich oblasts perceive that they are subsidizing the poor. This perception may encourage the wealthier republics or oblasts to demand special treatment that permits them to benefit more fully from their own endowments.

#### *Addressing Special Areas*

These demands for special treatment can be addressed in three ways: "ad hocery," special fiscal

regimes, and the proposed four-legged fiscal system that incorporates a comprehensive distribution formula.

*Ad-Hocery.* In the past, the Russian central government has dealt with disgruntled areas in an ad hoc fashion, primarily by providing intergovernmentally negotiated subventions. This solution is not transparent, and some oblasts perceive that others are striking deals with the central government, creating a sense of injustice. The need for transparency is particularly great in Russia at this time, when people, many of whom are skeptical, are testing out democracy.

*Special Fiscal Regimes.* The current trend in which some disgruntled oblasts are deciding unilaterally to implement a "single channel system" is dangerous, potentially threatening the financial (and political) viability of the Russian Federation. (This trend contributed to the financial bankruptcy of the Soviet Union and hastened its political demise.) These developments call into question whether special fiscal status should be granted to some territories within the Russian Federation. A few countries (for example, Spain, Australia, and the Philippines) do provide "special regimes" within otherwise uniform systems (see Box 4.5). One possible regime in Russia could call for eligible localities to share an amount equivalent to a multiple of the per capita national average remittance. Alternatively, a smaller proportion of revenues could be shared as soon as a certain level of remittance had been reached.

While widespread single-channel systems could threaten the viability of the Federation, insistence on totally uniform fiscal treatment in the face of strong forces that demand preferential treatment could also threaten the political existence of the Federation if disgruntled groups decide to opt out. While the need for special treatment should not be taken lightly, special fiscal regimes should be granted judiciously. Once granted, demands for special treatment will spread rapidly (ideally, special regimes should not exist, unless serious political conflict would exist without them). When granted, special treatment is virtually impossible to claw back.

*Flexible Comprehensive Formulas.* The third way to address demands for special fiscal treatment is consistent with the four-legged fiscal framework. Many oblasts—those rich in natural and industri-

#### Box 4.5 Special Fiscal Treatment for Special Areas?

Complicating the process of expenditure assignment, and the design of fiscal federalism in general, are the demands for autonomy and pressures for political devolution aired by territories inhabited by ethnic minorities. These demands have been "louder" when disputes about the rights to oil and other mineral resources are involved. This conflict calls into question whether special fiscal status should be granted to some territories. Several decentralized systems of intergovernmental relations allow for special regimes within the unified system. Such regimes may be appropriate when regional diversity is significant, and when the uniform fiscal status of all provinces vis-à-vis the federation is not manageable.

In *Spain*, the fast switch from a strongly unitary state to a semifederal structure of government in the late 1970s was made partly in response to deep-seated cultural differences and was conceived as a way to strengthen the return to democratic rule. As in Russia today, addressing regional autonomy was the most difficult task for the designers of the new constitution in Spain.

One of the most interesting lessons from the Spanish experience is that a nonuniform approach to decentralization and local autonomy can work. Special treatment was granted to territories that claimed special status for historical and cultural reasons, including the Basque Country, Navarre, Catalonia, and Galicia. This special treatment did not create important problems with the rest of the regions, because their demands for autonomy were much less pronounced.

While most regions rely on central government transfers of centrally collected taxes for their finances, Navarre and the Basque country acquired the right to levy and collect all taxes, except for customs taxes and excises on petroleum products and tobacco. From the revenues collected from all other taxes, the regional authorities in the Basque country and Navarre must make an annual lump-sum payment to the central government for the services still provided at the central level. These payments are agreed upon for a period of five years, but annual payments can be adjusted for inflation.

In the *Philippines*, the Muslim Mindanao and Cordillera have demanded and received more self-government due to their different religious and cultural heritage. Insurrection and calls for secession led the government to proclaim greater autonomy for these regions in 1989. The Organic Act for Muslim Mindanao provided a new financial structure for the region by devolving significant fiscal powers and responsibilities to the autonomous region.

Most expenditure functions were devolved to the local governments, and central approval of expenditure level and composition was eliminated. (Only national defense-type functions were kept for the central government.) The revenue base for the autonomous region was defined differently from the rest of the country, and the regional government was given broad taxing powers. Income taxes and customs duties may not be levied by the regional government; however, the region may impose other taxes, levy fees and charges, and share in the revenues generated by public utilities within the region. The region may also retain 60 percent of internal revenue collections, to be divided equally between the regional and provincial governments. Legislation has also ensured that all corporations engaged directly in business in the autonomous region pay the regional government a portion of their annual tax on net business income in their region.

In *China*, beginning in 1979, Guangdong province was accorded special rights and privileges. *Fiscal contracting*—under which the province delivered a fixed nominal revenue amount to the center annually—allowed Guangdong to retain a growing share of revenues collected in the province over a five-year period (a system similar to the system that Bashkyria has negotiated with the federal government in Russia). The fiscal contract was revised twice, and the basic "delivery" was increased by 9 percent a year. It was highly beneficial to Guangdong (and the other provinces that had this special regime), but damaging to the central government in that the contract impaired macroeconomic stabilization policy, and prevented the center from sharing in the revenue growth of one of the revenue-richest provinces.

In *Australia*, beginning in 1978, the Northern Territory became a "self-governing" territory, with expenditure responsibilities and revenue-raising powers approximating those of a state. The Northern Territory (Self-Government) Act provides that its revenues, loans, and other moneys received constitute public moneys available to defray its expenditures. The Australian "Grants Commission" also gave special assistance to the Northern Territory, given its high proportion of aboriginal people, and their special problems: higher expenditures were granted to enable the aboriginal peoples to manage their own affairs. In addition to the general revenue assistance provided on the basis of a formula, "additional assistance," "special assistance," and "specific purpose revenue grants" can be issued to the Territory on an annual basis. Each year, the Grants Commission reviews such requests and recommends action.

al resources, for example—resent the (perceived) cross-subsidies inherent in the present system and want to opt out. However, if one oblast is granted a special regime, others whose economic strength is almost on par could demand similar status, leaving only the poorer oblasts in the system. Ironically, then, too much emphasis on equalization at this stage may be a stimulus for the wealthier to withdraw from the pool, thus compromising the system's potential for implementing any equalization. The framework proposed herein for a new intergovernmental system can help address this tension by providing a transparent division of revenue-sharing between equalization (the formula grant component of the divisible pool) and derivation-based sharing. The possibility that an independent, objective Grants Commission would decide on the distributions would enable the nation at large to participate in determining the size of the two components.

The equalization formula can also address the demands for other special treatment, by incorporating specific factors that are assigned higher weights. For example, the politically sensitive state of Punjab in India receives additional government funding from a component of their tax devolution formula that recognizes the difficulty of being a border state. Moreover, as part of India's grant formula, "backward" areas are assigned a extra weight that gives them extra compensation. In Russia, the distribution in formula might assign a higher weight to areas that contain a large concentration of ethnic minorities, thus giving them more revenues. These areas could perhaps assume even greater expenditure responsibilities than others, thus giving them greater autonomy than other areas while allowing them to retain their participation in the common pool. The formula could also be structured to compensate areas rich in natural resources that have suffered from underdevelopment and environmental degradation.

#### *Special Treatment under the Proposed System*

The idea of using a formula to meet special needs is appealing for several reasons. While the formula is an objective distribution method, once established, its component parts permit special treatment where deemed appropriate by policymakers. The components of the formula would appease disgruntled groups, while the formula overall would maintain the transparen-

cy necessary to prevent the sense of injustice. The perceived fairness of the formula would encourage areas to stay within the system, rather than to opt out (thus reducing the common pool). Moreover, while disgruntled areas could still demand special treatment in the formula (rather than via a special regime outside the system), formula decisions would be fixed by an objective commission for a period of, say, five years, thus insulating itself from political pressure.

As Russia searches for national definition after the dissolution of the Soviet Union, the immediate need for political unity may be as great as the need for equity. Rather than allowing oblasts to negotiate individually for special fiscal regimes or decide unilaterally to opt out of the federal system, the government should encourage widespread participation by establishing a distribution system that does not overemphasize regional equalization and which incorporates special circumstances within its distribution formula. Formula-based distribution can promote democracy, engender patience with economic reforms through its transparency, pacify disgruntled areas and keep them in the equalization pool as the notion of "we" becomes grounded more solidly in the nation, and changes with the times—a very relevant issue given the pace of economic and institutional change in Russia.

The intergovernmental system can play an important role in defusing the centrifugal forces arising in well-endowed or natural-resource-producing regions by containing them within an agreed-upon framework. Unless a transparent system of intergovernmental relations is developed, based on the consensus of all parties with something at stake, the risk to the federal level will probably continue in a negotiated system. Without rules, subnational governments will bargain for the best package they can get; they will create their own "asymmetrical federalism" and special regimes. If localities perceive that they are being treated fairly by the uniform system of intergovernmental relations, they may cede demands for "asymmetrical federalism." In particular, a formula-based regime that addresses their needs may be able to respond to the demands for "special treatment" more objectively—but treatment will be accorded by virtue of the formula, not on the basis of ad hocery. A flexible formula that responds to shorter-term fiscal goals while also promoting the nation-building

is necessary for longer-term fiscal health. More generally, a system that is perceived to be fair, is transparent, and is developed in the course of an institutional process in which all oblasts have participated, is itself likely to improve consensus on revenue sharing and improve the system of fiscal federalism.

### **Data Requirements for Fiscal Management**

Developing and quantifying any options for redesigning Russia's system of intergovernmental relations will require detailed empirical work. Designing (and, later, monitoring the performance) of the new system of intergovernmental relations will be a data-intensive exercise. The necessary data are not currently available. For example, investment data for the Russian oblasts have not been published since 1975. The central government, oblast-level organizations, and the League of Cities must begin to develop several data bases. These data should include tax collection and tax base statistics, expenditure composition and needs measures, socioeconomic population characteristics, and the stock of physical infrastructure and its state of maintenance.

The tasks ahead for data collection are formidable. Ideally, the central government, in coordination with the subnational governments, should work to put together a "Census of Governments." Subnational governments whose record of data collection is poor and which lack tradition illustrate the need for bold action at the top level of government.

Designing the new system of intergovernmental relations requires an explicit and detailed accounting of the costs to be borne by subnational governments for both newly transferred responsibilities and traditional responsibilities. Without a rigorous effort on this front, the adequacy of subnational revenue assignments will remain at a conjectural level. Similarly, designing a system of intergovernmental transfers whose objective is to equalize opportunities across oblasts will require accurate information on expenditure needs, tax bases, and subnational government tax efforts. Most industrial countries have standardized data sets that are used regularly for policy and research purposes. Experience elsewhere could be useful to the Russian government, and this area may be a rewarding one for technical assistance.

### **Intra-Oblast Fiscal Relations**

The oblast Soviet is responsible for allocating financial resources among the rayons and municipalities within the oblast. It determines the share of taxes that may be retained by each rayon government (and by the oblast government). Because it may choose to allocate an additional subsidy to rayon governments, it determines the level of spending by each local government.

In making these decisions about intra-oblast fiscal relations, the oblast Soviet is locked into some constraints:

- The tax rates and tax bases are fixed by the center and may not be adjusted.
- Some minor taxes and charges are prescribed as fully local.
- A national law, passed in April 1992, prescribes revenue sharing from oil and specifically mandates the local (rayon) share. In Tyumen oblast and Khanti-Mansiysk okrug, the prescribed sharing is okrug (30 percent), rayon (30 percent), federal (20 percent), and oblast (20 percent).

These constraints have three advantages. First, they get the central government out of the business of having to make fiscal decisions about the revenue needs of thousands of local governments. Second, they make the oblast Soviet more accountable to the local population for the results of its fiscal decisions. Third, they clearly represent a step toward fiscal decentralization, in that they bring government "closer to the people." However, the system also raises several issues and problems.

### *Issues and Problems*

*Disparities among Rayons.* The economic well-being and fiscal capacity, within each oblast vary widely. Thus, each oblast must make some very difficult decisions about fiscal equalization. The oblast Soviet cannot simply extend the central-oblast revenue-sharing scheme based on the derivation principle, because it would exacerbate the economic disparities among the local governments. For example, within Ryazan oblast (which has 13 rayons and 2 cities), per-capita expenditures were more than three times larger in the highest-spending locality than in the lowest. Per-capita expenditures were 50 percent to 100 percent greater in the city of Ryazan and in Skopin than the average for all Ryazan's rayons.

#### Box 4.6 Intra-Oblast Revenue Sharing

Based on field work in Tyumen, Nizhny Novgorod, Ryazan, and Moscow oblasts and in Khanti Mansisk okrug, it appears that the manner in which oblast governments allocate revenues among local governments varies widely. However, all of these oblasts use a derivation principle as their primary of revenue-sharing mechanism.

After the central government changed its revenue-sharing program on the VAT to a flat 20 percent, and increased the locally retained share of CIT from 15 to 19 points on the 32 percent rate, all the oblasts visited in the course of field work also adjusted the oblast-rayon sharing formulas. All three of the oblasts visited after the change switched to flat-percentage sharing for all rayon governments. These shared taxes were supplemented with various types of subventions. The examples in the following table give some idea of the variety of sharing arrangements as of July 1992.

##### Revenue Sharing in Three Oblasts: July 1992

(Percent of revenues accruing to each level)

Tax	<u>Moscow Oblast</u>		<u>Tyumen Oblast</u>		<u>Khanti-Mansisk Okrug</u>	
	Rayon	Oblast	Rayon	Oblast	Rayon	Okrug
PIT	100	0	100	0	92.5	7.5
CIT	63	37	74	26	53	47
VAT	0	100	75	25	75	25

Moreover, the oblast government must allocate a share of retained revenues for its own functions. Thus, the oblast Soviet must incorporate equalization features in its revenue-sharing system. But doing so raises some tension with the better-off local governments—particularly the urban centers—which perceive that they are unduly discriminated against as equalization proceeds. The situation is exacerbated because urban areas have very pressing needs for public services. At present, at least some oblast governments have opted to use flat-rate tax sharing (which is counterequalizing) in tandem with equalizing subventions (see Box 4.6).

*Revenue-Raising Efforts.* A second, closely related problem is that equalization may tend to dampen efforts to increase the rate of revenue mobilization. STS staff is closely linked with the subnational governments (rayon and cities), and assessment and collection efforts at the local level may be less successful (perhaps less vigorous) if the local community believes that it will not receive an adequate return from its increased revenue effort.

Both issues point to a major underlying concern—that the decisions of oblast Soviets may not be reinforcing the economic policy of the central government. One can best illustrate this concern with an example. Suppose that the central government decided to base its economic

growth strategy for the next ten years on the development of urban centers and on the development of industries that require skilled labor and infrastructure at a certain level of provision. Under the current system, the central government could not implement this strategy easily. The oblast Soviet could still choose to allocate resources away from urban areas and toward rural areas, and could choose whatever focus on education that it wanted. The existence of this option illustrates a major problem with strong subnational governance. In truly decentralized systems, the central government loses considerable control over how such national strategies are implemented.

*Planning Certainty.* A third problem with the present system is certainty. Oblast and rayon governments must be able to ascertain the flow of revenue to them in order to plan their budgets. The current revenue-sharing system has changed markedly during 1992, and efficient fiscal planning has virtually been impossible. And because taxes are shared on a derivation basis, the oblast Soviets have changed the intra-oblast fiscal arrangements each quarter.

*Subnational Autonomy.* Fourth, even if decisions about fiscal distribution were left to the oblast Soviet, it would not be enough for the strongest ad-



vocates of fiscal decentralization. They would argue that greater autonomy be granted to the local (rayon and municipal) Soviets. After all, the population of the oblast may consist of several millions of persons, and the oblast Soviet is far removed from the needs of the local population. The local Soviets are closer to their people and the problems, and to those who must ultimately pay the taxes to support government expenditures. Thus far, the lowest-level Soviets have not been given much say in determining the level of the local budget.

Finally, a special problem is associated with the allocation of the individual income tax. The tax currently accrues to the place of collection—where the job is located. Because none of the revenue accrues to the place of residence, a mismatch exists between the rayon where a worker uses services and the rayon that receives the tax paid by him.

#### *Reform Possibilities*

The government is at the crossroads of decision about intra-oblast relations. The Basic Principles law is ambiguous about this issue. Allocation choices currently rest with the oblast governments, and some have opted to redistribute a substantial amount of revenue away from the urban centers to less-developed rayons. The issue has become contentious, and calls have been made for a federal formula that identifies the share of each local government, either to enhance the position of the rural rayons or to protect the larger revenue base of the cities.

In principle, there are three ways to deal with this issue. The first is complete centralization—that is, making intra-oblast relations a function of the central government. Second, the situation could be left as is, allowing each oblast to work out its own difficulties. Third, the oblast Soviet could be left to decide its basic fiscal structure, but required to conform to a prescribed set of central mandates to constrain its decision whereby it conforms to central objectives. Each of these three strategies has its advocates. In other words, an intra-oblast intergovernmental system could in principle operate in three ways:

- A traditional federalism could be created whereby taxes are assigned to either the federal or the oblast level, and the oblast could then decide on their distribution among the local governments.

- An exact allocation of fiscal resources could be prescribed to oblasts, cities, and rayons.

- General guidelines could be established for the distribution of fiscal resources within the oblast.

Centralization may be the least desirable of these alternatives. In a country as large and diverse as Russia, it is unrealistic to believe that the public service needs of each local area can be assessed properly from the center. Moreover, the central government is ill-equipped to undertake this task. Data that describe the fiscal situation in local government areas are unavailable, and local areas do not have the capacity to monitor fiscal outcomes. Perhaps the greatest drawback is that centralization would be a move away from fiscal decentralization, which would make oblast-level officials less accountable for their fiscal decisions.

Thus, the report recommends that federal-subnational fiscal relations *not* go below the oblast level, for two reasons. First, it would imply a federal program that, in one single effort, would purport to equalization of almost 2,000 rayons among 91 oblasts. Second, it would necessitate applying the same formula to all sub-oblast equalization, nationwide. A better route would be to leave the distribution to each oblast. If Russia sees itself as a federation, such center-rayon relations would be inappropriate. In sum, the federal government should concentrate on finding a proper relationship with its oblasts and regions, and leave intra-oblast matters to the subnational councils.

Continuing with the present framework would seem to be a reasonable option. It would impose less shock on the system at a time when the system is fragile and undergoing major changes. It would continue to give accountability for fiscal decisions to the oblast Soviet. It would be consistent with the reality that certain republics will be given greater autonomy. Oblast Soviets are in a position to shape an equalization program for the rayons, and can assign the oblast government those services for which major externalities or economies of scale exist.

The central government may believe that the problems with oblast autonomy in this area are severe enough to require some adjustments. In fact, a new draft law—Budgetary Rights of Local Self-Governments—spells out the relationships among levels of government, and proposes some important changes in revenue sharing and expenditure autonomy.<sup>9</sup> One basic principle in this law is to give “structure to the relationship



between the rayon government and its oblast government." The proposal is that the oblast guarantee funding for 70 percent of the amount necessary to provide a "minimum" level of public services in each rayon.

The advantage of this proposal is that it would allow the central government to set minimum standards in the delivery of some services. It would also give the rayon and city governments some degree of certainty in planning their budgets, since the 70 percent guarantee would be for five years. The disadvantage of the proposal is that it would restrict the autonomy of the oblast to plan its own economic development, thus constraining efforts to define needs in a "reasonable" manner.

The problem of finding the proper fiscal relationships among the central, oblast, and local governments is one that plagues countries around the world. Many different solutions have been found. The United States gives autonomy to the states in decisions about the proper relationship between state and local governments, much as the present-day Russian system does.<sup>10</sup> Both Nigeria and Brazil have defined the specific role of local versus state governments in the system, and many European countries (for example, France and Great Britain) take a unitary approach, whereby the central government plays a direct role in determining local fiscal outcomes.

Some "framework law" —perhaps a variant of the law currently under discussion—may be appropriate, in which oblasts are required to "pass through" part of their revenues to the rayon or city level, according to some agreed-upon guidelines—perhaps on the minimum amount of the tax sharing that must be passed through. The United States used guidelines to distribute revenue-sharing assistance to state and local governments during the 1970s and early 1980s.

### **User Charges, Fees, and Other Benefit Charges**

User charges are currently applied in Russia to some extent. User charges are assessed for water consumption, and are levied on enterprises and on private households. For public utilities such as gas, user charges do not exist, or are levied at very low rates. It is not likely that the existing user charges cover marginal costs precisely. MOF recently raised the ceiling on urban transport fees from 10 kopecks (the original 1956 price) to 50 kopecks. But these fares are projected

to cover only about 30 percent of the operating cost. Many housing rents are still at their nominal levels of 13 kopecks per square meter (set in 1928). A recent law allows subnational governments to fix rents at any level. Many other user charges are also set by the central government, without consideration of the cost differences among localities. Subnational governments have no discretion to set rates.

User charges do not contribute a large amount to overall budgetary revenue. In 1990, nontax revenues such as fees and fines accounted for about 3 percent of total revenue (see table 4.2). Most of the local revenue proposed in the Basic Principles of Taxation is essentially user charges, and they cannot be expected to create any significant amount of revenue. However, user charges should be used much more widely in Russia, both to create revenue and to increase efficiency.

Since subnational governments are in the business of providing services that benefit the local population, they must be able to maintain the strength of local finances by recovering the costs of providing such services, and to the extent possible assessing those costs to the users of those services. The first rule of local finance should be: "Wherever possible, charge."

### **Cost-Benefit Signals**

The importance of user charges, benefit levies, and fees goes beyond the revenue collected from them. To the extent that a subnational government is viewed primarily as a provider of services and that the services benefit specific individual citizens, properties, or businesses, the appropriate policy is to charge the correct price. Only with correct pricing will the right amount and type of service be provided to the right people, that is, those willing to pay for them. User charges are thus based on the principle that, whenever possible, local public services should be charged for, rather than given away. Correct pricing helps public officials make sensible judgments about how scarce resources can be balanced against rising demand. When the true cost (and related user charges) rises so high that demand falls, it is clear that the costs of the services exceed their benefits from the users' perspective. The signal is quick and clear. A decision must then be made to (1) increase the price and serve fewer people, (2) cut back on the cost

**Table 4.2 Nontax Budgetary Revenue, Fees and Fines, 1990**

	<i>Amount (mil. rbl.)</i>	<i>Percent of total revenues</i>
Proceeds from Fines	167.0	0.26
Tax Evasion Fees	2.5	0.00
Proceeds from Claims Outside the Statue of Limitations 123.0	0.19	—
Fines on Officials	0.2	0.00
Proceeds from Sales of Public Property	69.0	0.11
Proceeds from Public Auctions	5.9	0.01
Proceeds from Sobering Houses	95.0	0.15
Special Fund of Budgetary Institutions	26.0	0.04
Unused and Returned Funds from Institutions and Organizations 138.0	0.21	—
Fees from Boarding Schools	6.8	0.01
Other Proceeds	408.0	0.63
Proceeds by Services Rendered by Budgetary Organizations 5.4 0.01		
Sales from Damages and Outlet Products	5.1	0.01
Proceeds from Purchase Discounts	0.1	0.00
Dues from Public Inspectorate	4.7	0.01
Proceeds from Wholesale Discount Purchases	1.1	0.00
Rental Revenues	54.0	0.08
Proceeds from the Sale of Goods at Negotiable Retail Prices 500.0	0.77	
Fines from Nonmaintenance of Quality Standards	4.8	0.01
Payments from Profits of Councils on Tourism	3.1	0.00
Proceeds from Sales of Apartments to Citizens	85.5	0.13
Payments for Delays in Commissioning of Projects	12.0	0.02
Proceeds from Economic Sanctions for Inappropriate Use of Material Resources	0.7	0.00
Water Usage Fees from Enterprises (USSR subordination) 231.0 0.36		
Water Usage Fees from Enterprises (Russian Federation subordination)	30.0	0.05
Water Usage Fees from Enterprises (local subordination) 7.6 0.01		
Tax on Owners of Motor Vehicles	6.5	0.01
Land Rental Fees	0.4	0.00
<b>Total Nontax Budgetary Revenues</b>	<b>1,994.0</b>	<b>3.08</b>
<b>Total Revenues</b>	<b>64,793.0</b>	<b>100</b>

Source: Ministry of Finance, mission calculations

and standard of service to keep it affordable, or (3) subsidize the service from general revenues.

An exception to this general principle pertains to income redistribution policies. However, attempting to correct fundamental distributional problems with inefficient pricing is essentially an unsound idea, and, consequently, many governments have encountered serious budgetary problems (and little redistribution). Some services *are* difficult to charge for—because their benefits are diffused (spread over a large population) or because they benefit difficult-to-reach groups. Water delivery to a standpipe is an example. In these cases, the service can be financed with indirect charges (property taxes) or general taxes (discussed below). Unfortunately, in most countries, user charges are used much less at the local level than seems desirable.

### *Cost Recovery*

User charges are similar to prices: they charge users of a particular service provided by the subnational government. For efficiency, user charges should be levied on those who receive the benefits—direct recipients, businesses, or property. The charges should be related to the amount of the service each individual consumes or benefits from. For example, when subnational governments provide goods through local public service enterprises, such as water, power, gas, and public transit, the goods should generally be charged for on a cost-recovery basis. Thus the cost of providing the service should be recovered from the users or the buyers of the service either immediately or over time. The price of water should reflect the cost of piping it to the homes or standpipe, as well as the cost to maintain the

pipes, treat the water, and so forth. Likewise, a bus fare should cover the cost of bus purchase, maintenance, gas, drivers, insurance, and so forth.

Russia relies little on these charges at the household level, and their future use may be constrained by the difficulties of metering usage. Nonetheless, at the industrial level, these constraints do not generally apply, and such charges should be used more widely wherever possible. Finally, to the extent that weak accounting systems that do not identify these costs clearly lead to underpricing these services, accounting needs to be strengthened. More generally, the central government should not, as it presently does, set ceilings on these fees or prices, and should allow subnational governments to set them at cost-recovery levels. (It has been argued that the central government is much more likely than the subnational government to raise prices. If so, then the center should develop estimates of appropriate level of fees in different services according to broad orders of magnitude, and use them as an indicative "floor" for such fees.)

#### *Other Charges: Service Fees and Benefit Levies*

Subnational governments can also obtain revenue from "service fees" from providing services such as registrations and licenses. Vehicle registration, business licenses, vendor licenses, marriage registrations, and property-title registrations are a few examples. As with user fees, subnational governments should use these charges more extensively.

*"Benefit Charges."* These fees are yet another source of revenue for the subnational governments of many countries. These taxes recover benefits received by specific citizens due to public expenditures. For example, if a new road, better streetlights, or a new sewer system increase property values or increase business sales, a "benefit levy" might be introduced. The levy could take several different forms: (1) a special assessment, (2) a land-value increment tax, (3) an improvement tax, and (4) supplementary tax. These terms pertain to slightly different ways to design the charge. A common benefit-related charge is the development charge (or "betterment tax"): a lump-sum charge to recover the cost of infrastructure development from beneficiaries. Thus, those whose land is near newly installed street-

lighting would be charged to help defray the cost. A development charge may cover only one project—for example, a neighborhood road paving scheme or the construction of a sewage canal—or it may cover the full development of a new area. Development charges can be an equitable tax, because those who benefit from development pay for its cost. Two particularly successful systems are land readjustment in East Asia and the "valorization system" in Latin America.

While benefit charges will be important for Russia, the absence of private ownership will pose a significant constraint against developing them. Exacerbating the difficulty is the quality of data on land values. A properly functioning property tax is an administrative prerequisite to introducing development charges; when this tax is introduced in key, pilot cities in Russia, serious attempts should also be made to supplement subnational revenues with development charges.

#### *Notes*

1. While the rapid pace of change in Russia may seem head spinning, some of the changes in the intergovernmental fiscal system may be more apparent than real. For example, the substitution of negotiated VAT shares under the old system (first quarter 1992) has been replaced by fixed VAT shares and negotiated subventions (second quarter 1992). Thus, despite the changes in fiscal *mechanisms* used each quarter, a detailed analysis of the fiscal outcomes of any one quarter is likely to carry lessons that go beyond that quarter.
2. For example, Bashkyria received R 627 per capita under the first-quarter transitional system, but would have received only R 592 under the Basic Principles. The loss—R 35 per capita—is equivalent to 5.6 percent of Bashkyria's first-quarter revenue under the current system. The results in Table 4.1 simulate the outcome of the Basic Principles for all oblasts, based on revenue data from the first quarter.
3. Of course, the negotiated sharing rates could be based on some ad hoc notion of expenditure needs, and could thus be equalizing. However, empirical analysis (reported below) indicates that this has not been the case in Russia.
4. These figures were reported to a Bank mission by the MOF Territorial Department in July 1992. Ex post executed budgets, including transfers and ex post adjustments, show a surplus. More generally, the concept of a "deficit" at the subnational level is questionable, given that expenditures are approved by the center (for oblasts in deficit), and subnational revenues are deter-

mined quarterly by the center through subventions and tax sharing policy.

5. Special regimes could deal with the special problems of ethnic minorities, and other special cases that cannot be accommodated with this general framework. This possibility is not recommended in this report. Issues associated with natural resource tax sharing are discussed in chapter 5.

6. MOF's July budget estimates show a revenue total of R 3,585 billion for these four taxes for 1992. Of this amount, the subnational governments are budgeted to retain R 1,300 billion, and to receive R 250 billion in "subventions." The subnational share is thus 1,550/3,585—43 percent, including subventions, and 39 percent including shared taxes alone.

7. In Canada and Australia, provincial governments are responsible for property valuation and administration. In Germany and New Zealand, valuation is national, and rate setting and administration local. In the United States, both rate setting and valuation are local responsibilities in most states.

8. Subnational authorities should not have unrestricted access to taxes that may be "exported" or shifted forward to nonresidents.

9. The Draft Law passed a first reading in the Supreme Soviet in July 1992.

10. However, in the United States, the states and the local governments have considerable freedom to determine their tax rates and tax bases.