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# Making Decentralization Work: The Case of Russia, Ukraine, and Kazakhstan

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# **Making Decentralization Work The Case of Russia, Ukraine, and Kazakhstan<sup>1</sup>**

Era Dabla-Norris, Jorge Martinez-Vazquez, and John Norregaard

*The objectives of this paper are to discuss key aspects of the ongoing decentralization process in three important transition economies, Russia, Ukraine, and Kazakhstan; to identify areas where the present systems have clear adverse impacts on efficiency and—potentially—macroeconomic performance; and to offer a roadmap for future reform.*

## **1. Introduction**

Russia, Ukraine, and Kazakhstan have all carried-out comprehensive reforms of their inter-governmental fiscal systems in the decade since the inception of transition; and all three countries are in the process of considering or implementing far-reaching “second-generation” reforms in this area. In retrospect, the combination of efforts aimed at consolidating macroeconomic stabilization during the early years of the transition, together with the fundamental structural changes in the economy, in some cases strong centrifugal forces, and political and ethnic conflicts, created an extremely complex setting for fiscal decentralization. This goes a long way in explaining why the fiscal decentralization process in the three countries has been rapid, haphazard and largely non-transparent, with the emerging system of federalism having important implications for budgetary developments.<sup>2</sup>

When discussing fiscal decentralization reform it is important to keep in mind that rarely, if ever, is the structure of intergovernmental fiscal relations in a country the sole outcome of a rational optimization process, based on sound principles of public finance. The financial relations between governments at different levels most often reflect mainly historical, political, ethnic, geographic, and other factors. Notwithstanding the importance of these non-economic factors, the potentially very significant impact of intergovernmental fiscal structures and policies on economic performance cannot be disregarded. The surge in reform initiatives around the world aimed at devolving service implementation to lower levels of government have provided ample evidence of the significant impact that decentralization

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<sup>1</sup> This paper is based on a comprehensive study by the three authors, “Fiscal Decentralization and Economic Performance: The Case of Russia, Ukraine, and Kazakhstan” (IMF Forthcoming).

<sup>2</sup> See Bird et.al (1995) and Wallich (1994) for a discussion of fiscal decentralization during the early years of transition. In all three countries, there has been significant progress made towards achieving some measure of fiscal and macroeconomic stabilization since the transition—progress which has importantly changed the environment in which decentralization is taking place.

may have on macroeconomic management and stabilization. Concurrently, the virtually global trend towards fiscal decentralization has prompted a rapid growth in the particular branch of the economic literature that deals with multi-tier government, seeking to analyze or empirically measure the impact of fiscal decentralization on macroeconomic performance, on economic growth, on the size of government, and on the level of corruption.

The “traditional” theory of fiscal federalism as well as the new wave of theoretical and empirical contributions all rest on the—explicit or implicit—assumption that the design and implementation of a multi-tier system of government can significantly affect overall resource allocation in the economy and, hence, stabilization, growth, and welfare. The causal relationships between decentralization and macroeconomic conditions underlying the different approaches differ, however, substantially, some emphasizing pure economic factors while others point to political economy or institutional factors as the key determinants.<sup>3</sup>

This paper discusses key aspects of the decentralization process in these three important transition economies. With the complexities of the problems at hand, the analysis presented here cannot but be selective with regard to the issues addressed.<sup>4</sup> With the potentially significant impact of decentralization on macroeconomic management and performance, it is crucial to identify and rectify adverse incentive mechanisms to ensure a sound and effective decentralized fiscal system. In the underlying analysis, particular attention has been accorded to identifying *adverse incentive mechanisms* inherent in the design of intergovernmental fiscal relations. A common theme that runs through the analysis is that greater autonomy and accountability at the subnational level is a *sine qua non* of successful decentralization.

The paper proceeds as follows: we identify three critical principles of sound decentralization—which are then contrasted with actual policies in the three countries (section 2). On that basis, the paper offers views on the best way to proceed for the three countries (section 3). Section 4 concludes.

## **2. Basic principles of “good” decentralization**

The traditional literature has focused on the economic efficiency considerations of decentralization, relating allocation as a primary function of subnational governments with stabilization and distributional considerations falling mainly under the purview of the central government. From this narrow efficiency aspect, as mentioned above, newer research has considerably widened the approach, by pointing to the importance of political economy

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<sup>3</sup> Martinez-Vazquez and McNab (1999), Ter-Minassian (1997), Tanzi (1995), Bardhan and Mookherjee (1998, 1999), Fisman and Gatti (1999), Davoodi and Zou (1998), Fornasari, Webb, and Zou (1999).

<sup>4</sup> See Dabla-Norris, Martinez-Vazquez, and Norregaard (IMF forthcoming).

factors and institutional arrangements as well as democracy at the local level as a prerequisite for an effective system of multi-tier government.

In addition, based in part on the traditional literature, and partly on actual country experiences, a number of practical “guidelines” have been developed for the way that decentralization can technically be carried out with respect to expenditure assignment, tax assignment, transfers, and borrowing.<sup>5</sup> Notwithstanding the usefulness of these basic principles and guidelines, it is important to note that even countries at comparable levels of development have put in place very different system of intergovernmental finance. Clearly there is no “best” fiscal decentralization design, but many different blueprints that may best fit the governments objectives of equity, efficiency, macroeconomic stability, and growth. Nevertheless, it is also apparent that there are better and worse ways to implement decentralization reform.

We contend—in the context of this paper—that three basic principles should guide decentralization reforms in transition economies (and other countries)—principles that capture some key aspects of sound incentive mechanisms needed for successful decentralization, and that at the same time are considerably broader in scope than the traditional, technical guidelines referred to above. The overarching objective is to ensure *accountability and transparency* at all levels of government:

- **The need for clarity of roles** between levels of government. Clarity, transparency, and stability are paramount for achieving the accountability at the administrative as well as the political levels that efficient governance requires. Much too often, overlapping responsibilities accentuated by expenditure dumping or unfunded mandates combine with frequent legislative and regulatory changes to create a diffuse system of expenditure responsibilities that compromise efficient service provision.
- **A measure of autonomy** for subnational governments at both the expenditure and revenue side is crucial for realizing the efficiency potential of decentralized government. On the expenditure side, this would require providing subnational governments with budget flexibility to decide—within limits—expenditure priorities, the service levels offered in accordance with local preferences, and the best means to deliver those services. On the revenue side, a minimum of subnational autonomy to set tax rates on at least one significant tax source assigned to the subnational level, in order to allow subnational the powers to raise revenue, is required to ensure accountability. Generally, subnational governments should not be allow the powers to define tax bases. Sustainable autonomy and economic efficiency, however, also requires some equalization of opportunity so that local councils have an approximate “level playing field” to offer services to their residents. This points to the crucial importance of equalization transfers in fiscal decentralization design. While autonomy should be explicit and well-defined, it must also

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<sup>5</sup> See chapters 2, 3, 4, and 7 in Ter-Minassian, ed. (1997)

be circumscribed in important respects, first of all with respect to the access to borrowing by subnational governments.

- **Institution building** is the last of the three pillars. A prerequisite for successful decentralization is that local governments possess the administrative infrastructure required to effectively carry-out the responsibilities assigned to them, with regard to the number and of quality of staff, and equipment. Administrative capacity is part of the necessary institutions, but there are others equally, or more, important. Democratic representation, sound budget processes and institutional arrangements to ensure coordination and cooperation between different levels of government—both at the political and the technical level—are crucial for a multi-tier system of government to work efficiently. This reflects the fact that even if the structure of intergovernmental fiscal relations is very well-designed, there will be a need to address the technical, administrative, and political issues that invariable will arise in any system.

In the remainder of this section we provide an overview from the three countries to illustrate how these principles have been violated with adverse impacts on economic efficiency, macroeconomic management or stabilization, and growth.<sup>6</sup>

### **i) Clarity of roles**

#### *The legal and institutional structure*

In all three countries, the evolution of the legal and institutional framework has been subject to a fairly continuous series of revisions, reversals, and shifts in focus and has reflected political compromises rather than consistently applied rules and principles. In Russia, strong opposition from ethnic regions and a weak and divided federal government led to the proliferation of bilateral arrangements between the center and individual regions, resulting in the creation of asymmetric federalism. Until very recently, regions have also claimed greater de facto legal and regulatory authority, largely in the absence of effective federal instruments necessary to monitor and regulate regional fiscal behavior. In Ukraine and Kazakhstan, a “top heavy” system of intergovernmental finance has been created, in part reflecting their status as unitary states.

While the respective constitutions along with a panoply of supplementary laws and decrees, provide for constitutionally mandated interactions between different levels of government, the current legislation contain many inconsistent and conflicting provisions. In all three countries, to varying degree, the distribution of functions to local governments remains ambiguous, with important gaps in the legislation arising from the lack of well-defined

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<sup>6</sup> As noted earlier, we are forced to be selective in the number of issues covered. A comprehensive description is contained in the book referred to above.

criteria to determine the assignment of functions and powers across different levels of government.

Overlapping and poorly defined roles, asymmetric fiscal relations in the case of Russia, and unclear divisions of power between different levels of government in all three countries created confusion about the functions and modes of interaction of different parts of government, distorted incentives for prudent fiscal management at the subnational levels and, in the case of Russia, encouraged creative accounting, including reliance on tax offsets and extrabudgetary funds. The practice of resolving contradictions between the various legislation in ad hoc manner, with crucial provisions often decided in the annual budget laws, has imparted a measure of unpredictability and instability to the system of intergovernmental relations in Russia, Ukraine, and Kazakhstan.

Budgetary relations between regional and local governments as specified in current legislation also continue to suffer from ambiguities.<sup>7</sup> In Ukraine, for instance, despite legislation to the contrary, interactions between local state administrations that represent the central government and democratically elected local self-government councils leave the latter fiscally dependent on the state. In addition, the appointment of executives at the regional and local levels in Kazakhstan and at the regional level in Ukraine has served to undermine the accountability of local officials.

#### *Expenditure assignment*

A common feature shared by the three countries during most of the transition has been the absence of a formal, legal assignment of expenditure responsibilities. Expenditure assignments until very recently were a continuation of the de facto assignments of the FSU, with ad hoc changes implemented through the annual budget laws. In the early years of the transition, the attempt to shift expenditure responsibilities, in particular on capital and social outlays, onto subnational governments imposed considerable pressures on subnational budgets. In Russia, while federal government expenditures (including intergovernmental transfers) contracted by more than 10 percentage points of GDP over the 1992-98 period, those of subnational governments increased from 12 percent of GDP in 1992 to nearly 15 percent in 1998 (Table 1), reflecting *de facto* changes in expenditure responsibilities. The decline has also been marked in Ukraine, where total government expenditures have fallen from 40.3 percent of GDP in 1993 to 32.9 percent in 1998, largely due to a sharp contraction in central government expenditures. In many instances, this ad hoc shift in expenditures

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<sup>7</sup> In Russia, until the introduction of the Budget Code, activities of the local governments were regulated by a number of often inconsistent federal laws and laws on local government passed by the relevant regions.

created disincentives for prudent fiscal management and resulted in the accumulation of payment arrears by subnational governments.<sup>8</sup>

In recent years, while some progress has been made in clarifying expenditure assignments, in a number of respects the assignment of expenditure responsibilities falls short of what is required of a clear, stable and transparent arrangement for effective decentralization. In all three countries, the presence of many different and often conflicting laws, decrees, regulations, and departmental orders has affected the clarity of expenditure assignments. Moreover, sectoral laws (on education, health, social assistance) have not always helped clarify expenditure responsibilities to the necessary degree. This problem is especially pronounced in the areas where there are concurrent or overlapping responsibilities among different levels of governments. In Ukraine, for instance, the proposed Budget Code complicates expenditure assignments further by failing to adequately distinguish “delegated expenditures” from “own expenditures” at the subnational level. Lack of clarity in expenditure assignments have detracted from accountability at all levels of government and undermined the efficiency of public expenditures. Moreover, it has reduced incentives to prioritize budgets, lower costs of service delivery, eliminate excess physical capacity, and properly maintain capital infrastructure at the subnational level .

The most important source of ambiguity continues to be in the assignment of the responsibility to regulate and issue norms. In particular, the role of line ministries and central and federal agencies has not been adequately clarified or adapted to meet the needs of a decentralized system of government. This has resulted in central agencies continuing to regulate and issue declarative norms that directly affect the expenditure positions of subnational governments.<sup>9</sup> In all three countries, as discussed below, unclear delineation of responsibilities over regulation, financing and implementation in the case of concurrent responsibilities, in particular for social expenditures, and the absence of effective institutions

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<sup>8</sup> The increase in subnational share of government spending in all three countries resulted, in part, from the divestiture of social expenditure responsibilities by state enterprises, including housing, health clinics and other facilities, during the early years of the transition, many of which were subsequently assumed by local government budgets.

<sup>9</sup> For example, federal norms for housing and utility service provision in Russia use physical standards (such as provision per square meter of floor area) as budgetary norms to characterize minimal standards of social services guaranteed by the federal government. These norms are, however, not obligatory in nature. In other areas, such as education, the existing legislation is unclear as to whether federal norms determine the minimum expenditure requirements for all levels of government, or only for federal educational establishments (Ministry of Finance of the Russian Federation (1999)).

for coordination have resulted in the proliferation of unfunded mandates, expenditure requirements imposed on subnational governments in the absence of adequate funding.<sup>10</sup>

In addition, subnational governments have been slow to rid their budgets of private market interventions, with subsidies for housing and communal services, including public utilities, accounting for a large proportion of their expenditures. Subnational governments in Russia in 1997-98 spend close to one-third of their total resources in subsidies to consumers and to producers. In Kazakhstan this figure is 10 percent and in Ukraine it is about 8 percent. In Russia more than half of the housing stock has been privatized, but local governments continue to be responsible for maintenance and also pay over two-thirds of utility costs.<sup>11</sup> All three countries have also been slow in contracting with private enterprises to supply services, such as maintenance of infrastructure, garbage collection or water and sewerage treatment.<sup>12</sup> In Russia, local governments also have considerable authority over licensing and registration of firms, protection from bankruptcy, guarantees for commercial loans, and direct participation in the capital of many private businesses. These market oriented activities are clearly outside—and distracts political attention and financial resources from—the core tasks of local governments, they potentially expose local governments to considerable financial risks and to pressures for financial support for specific enterprises or commercial activities, and obscure the division of expenditure responsibilities among level of governments.

The problem of unclear expenditure assignments been especially acute at the regional-local level, with regional governments enjoying a high degree of discretion over assignments to their subordinate local governments. In Russia, while regional governments in reality have a great degree of discretion with respect to the assignment of expenditure responsibilities to their local governments, the formal system leaves local governments with expenditure responsibilities which the regions generally appear to respect. Local governments in Kazakhstan, however, lack a formal assignment of expenditure responsibilities which may negatively affect the accountability of both regional and local governments to taxpayers and

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<sup>10</sup> Unfunded mandates arising from norms for social welfare benefits, the setting of wages and pensions, and norms and standards of service provision in many other areas, accounted for ...{**Check OECD report**}

<sup>11</sup> A World Bank (1998) study found that subsidies to the housing sector are by far the largest single component of subnational budgets in Russia, accounting for over 3 percent of GDP (and 40 percent of local government expenditures) in 1996.

<sup>12</sup> There are some exceptions. Part of housing maintenance in Ukraine is contracted out and the quality of the services has increased noticeably, see World Bank (1999).

subject local governments to added budget uncertainty. The same problem has existed in Ukraine.<sup>13</sup>

In all three countries, the assignment of capital expenditure responsibilities at different levels of government has been a particularly murky issue under the *de facto* assignments that have developed during the transition. Despite the recent formal assignments of expenditure responsibilities provided by the Budget Code in Russia and Kazakhstan's Budget System Law, the lack of clarity regarding the responsibilities for subnational infrastructure expenditures has not been appropriately resolved. In Ukraine and Kazakhstan, central governments have continued to finance infrastructure projects that ought to have been the responsibility of subnational governments.

The ambiguity in capital expenditure assignments has created an adverse incentive which, together with other factors, has contributed to the failure to maintain existing infrastructure by subnational governments in all three countries. It also appears that subnational expenditures on capital infrastructure, in addition to that on maintenance, have been low, in part resulting from budgetary expediency under severe financing constraints. Subnational governments have found it easier to cut capital and maintenance expenditures than to cut other items of current expenditures, such as wages and salaries. In addition, institutional failures, negative incentives for subnational governments stemming from the non-transparency of central government expenditures, and the lack of access to long-term credit have also played important roles.

#### *Tax assignment*

The period up to 1994 in Russia, 1999 in Kazakhstan and—with a brief interruption during 1997-98—to the present day in Ukraine, has been characterized by a revenue assignment system which was non-transparent and unpredictable owing to very frequent changes in basic sharing parameters, and assignments which were ad hoc and negotiated with individual regions. The “regulation” approach basically aimed at designing tax sharing arrangements such that individual regions had sufficient resources (in combination with their “own” revenues and transfers) to finance a set of defined “minimum” expenditures. The lack of clearly defined, stable and uniform revenue assignments between the center and subnational governments inherent in this approach weakened budgetary management at the subnational level and created perverse incentives for subnational governments to either hide locally mobilized revenue sources in extrabudgetary funds, or to simply reduce their efforts to mobilize revenues locally.<sup>14</sup>

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<sup>13</sup> Recent attempts to inextricate local governments from the control of regional governments in Ukraine have their origin in the arbitrariness used by the regions vis-à-vis the local governments in expenditure and revenue assignment issues.

<sup>14</sup> See Lavrov, Litwack, and Sutherland (2000) for a discussion on extrabudgetary funds.

While some progress has been made in Russia and Kazakhstan to formalize revenue sharing arrangements with the adoption of stable and uniform sharing rates at the central-regional level, in all three countries, revenue sharing arrangements between regional and local governments continue in large measure to be based on the “regulating” approach, with customized and yearly changing sharing rates and compensations through non-transparent transfers. Punitive “extractions” by higher level governments in the form of clawing back any additional revenues raised by lower level governments through reduced sharing rates and, as the case may be, through a reduction in transfers, have also created perverse incentives for revenue mobilization, at the local levels in all three countries.<sup>15</sup> This has fostered a culture of bargaining between regional and local governments and increased non-transparency in intergovernmental relations. The resultant non-uniformity in revenue sharing and the absence of stability has undermined sound fiscal management at the local level.

### *Transfers*

The evolution of the systems of equalization transfer regimes in Russia, Ukraine and Kazakhstan to a large extent parallel that of revenue assignments described above. The dominant form of equalization transfers during the transition years has been gap-filling, often negotiated, “subventions” from the central government to regions in which the minimum expenditure budget exceeded own plus shared (regulated) revenues. This type of equalization transfer was in use in Ukraine from 1992 to the present, in Kazakhstan from 1992 to 1999, and in Russia during 1992-1993.<sup>16</sup> In Russia, the while the present system of formula-based equalization transfers represents a significant improvement over the previous system, the continued use of other ad hoc and non-transparent transfers, such as mutual settlements, which accounted for over 75 percent of all non-equalization transfers in 1998, have provided

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<sup>15</sup> Martinez-Vazquez and Boex (1999) and Shleifer and Treisman (1999). A recent study of 35 cities in Russia between 1992 and 1997 estimates that 90 percent of all increases in income at the local level were siphoned off by regional governments in the form of lower sharing rates for regulated taxes or in a corresponding reduction of transfers. (Zhuravskaia (2000)).

<sup>16</sup> Russia introduced a new system of formula-based equalization transfers, the Fund for the Financial Support of Regions (FFSR) in 1994 along with the adoption of stable and uniform revenue assignments with the regions. Kazakhstan attempted to do so in 1999 also in parallel to the adoption of stable and uniform tax sharing rates with the regions but, with mixed success. Ukraine attempted, in 1997, to move towards the use of uniform and stable tax sharing rates with the regions, but without introducing formula-based transfers. The current reforms in Ukraine in parallel with the proposed Budget Code envisage the introduction of formula-based equalization grants.

a disincentive for sound budgetary management at the subnational level.<sup>17</sup> In all three countries, but to varying degrees, transfers between regional and local governments have been negotiated, gap-filling, and ad hoc in nature, although there have been some improvements in recent years.

The gap-filling nature of the transfers provided negative incentives for revenue mobilization and the efficient provision of public services as any increase in regional own revenues or budgetary savings in the provision of public services triggered reductions in the level of transfers. In addition, as transfer levels were determined in a discretionary and non-transparent manner in annual budgets, subnational governments were deprived of revenue predictability and stability, thus decreasing their abilities to budget and plan expenditures.

## **ii) A measure of autonomy**

### *Expenditure autonomy*

Effective expenditure autonomy at the subnational level has been limited in the three countries. Norms and regulations emanating from central government agencies have interacted with unfunded mandates to severely constrain the authority of subnational governments to adjust current expenditures. The outcome has been considerable burdens imposed on subnational budgets which, in turn, have undermined accountability at the subnational level.

While many of the expenditure norms developed by central government agencies are merely indicative in nature, other regulations directly affect the expenditure positions of subnational governments.<sup>18</sup> Local governments in both Russia and Ukraine have virtually no flexibility in setting wages, or the wage fund of public employees, which accounts for nearly a quarter of budgeted expenditures of local governments in Russia (Ministry of Finance of the Russian Federation (1999)). The lack of effective autonomy over expenditures has encouraged the accumulation of payments arrears by subnational governments as a means of deficit

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<sup>17</sup> Mutual settlements, which consist largely of unbudgeted transfers to compensate regional governments for mandates or the delivery of federal programs, emergency transfers, as well as other negotiated and discretionary funds, are typically allocated during the process of budget execution.

<sup>18</sup> For example, federal norms for housing and utility service provision in Russia use physical standards (such as provision per square meter of floor area) as budgetary norms to characterize minimal standards of social services guaranteed by the federal government. These norms are, however, not obligatory in nature. In other areas, such as education, the existing legislation is unclear as to whether federal norms determine the minimum expenditure requirements for all levels of government, or only for federal educational establishments (Ministry of Finance of the Russian Federation (1999)).

financing, and eroded fiscal discipline and accountability. In Kazakhstan, local governments are also subject to national norms and limits on payrolls, and this combined with the absence of a separate assignment of expenditure responsibilities at the local level, has undermined local autonomy and accountability vis-à-vis local electorates.

In all three countries, local autonomy has also been constrained by the shifting down of subsidies and social services to local governments since the beginning of the transition. Minimum expenditure requirements for social services imposed by the central governments, as is the case in Kazakhstan, impinge upon the budgetary autonomy of local governments. In Russia, this problem has been compounded by the existence of regional norms and regulations in conjunction with federal norms and mandates, and the failure of local governments to distinguish between funding for each. While existing laws in Ukraine and Russia grant local governments the right to limit the execution of decisions made by higher-level governments to the amount of funding transferred to them, in practice, expenditure requirements associated with mandates exceed their financing. In Russia, courts have continued to view the financing of these mandates as obligatory, largely due to ambiguous wording in federal budget documents stating that federal transfers account for existing mandates (Ministry of Finance of the Russian Federation (1999)). This results, in part, from the failure of local governments to disentangle funding received from higher-level governments for mandates from that intended for other expenditures.

“Unfunded mandates”, or expenditure requirements imposed on subnational budgets without central governments having secured adequate funding, have emerged as a major problem in all three countries. These mandates have served to limit the effective budgetary autonomy of subnational governments and added demands on their already strapped budgets.

In Russia, a recent study by the Ministry of Finance finds that the estimated burden of the 25 most important unfunded federal mandates, if fully implemented, is 8 percent of GDP. This represents nearly half of the share of the consolidated subnational budgets in GDP in 1998. In reality, however, subnational governments only implemented about 31 percent of these mandated expenditures in 1998. The combined estimated burden of all federal mandates identified as existing by at least one region in a 1999 survey of 68 Subjects of the Federal is over 20 percent of GDP (Lavrov, et al. (2000)). To date, there appear to be no comprehensive studies of the pervasiveness and cost of unfunded mandates in Ukraine or Kazakhstan.

#### *Revenue assignment/tax autonomy*

The regulating approach to revenue assignments deprived subnational governments of any measure of revenue autonomy during the early years of transition, as revenue autonomy and the “regulation” of taxes are intrinsically contradictory concepts. In recent years, while regional governments in Russia have acquired some measure of tax autonomy, subnational autonomy over revenues in Kazakhstan and Ukraine is virtually nonexistent. Revenues from taxes shared on a derivation basis, whose structures can only be changed at the central level, continue to account for the largest share of regional revenue receipts. In Russia, however,

there has been a steady increase in the importance of “own-revenues” in subnational budgets.<sup>19</sup> Own-revenues increased from 13.5 percent of total subnational revenues in 1992 to over 46 percent in 1998 (Figure 1), with most subnational revenues coming from three sources: property taxes, natural resource tax, and the turnover tax (for housing and militia maintenance). In Ukraine, while local self-governments have some discretion to set rates for local taxes and fees, revenues from these sources only represented 3 percent of subnational revenues in 1998.<sup>20</sup>

Closely related to the issue of subnational tax autonomy is the widespread use of tax sharing arrangements in Russia, Ukraine, and Kazakhstan. Revenues from taxes shared on a derivation basis continue to account for well over 50 percent of regional revenue receipts. The minimal subnational autonomy to raise revenues and decide tax policies at the margin and the resultant mismatch between expenditure responsibilities and the real tax base, has important implications for accountability and responsibility at the subnational level. In addition, there are weaknesses in the choice of taxes that are shared between the center and subnational governments and how the shared tax revenues have been apportioned among subnational governments.

### *Transfers*

As noted earlier, meaningful and sustainable autonomy at the subnational level and avoiding the inefficient geographical reallocation of resources requires a “level playing field” in the sense that local and regional councils are offered the same opportunities to provide reasonably uniform service levels at reasonable levels of tax effort. This is possible only when effective and well-designed equalization transfers are put in place.

The relative size of equalization transfers is significant in determining the ability of central governments to equalize fiscal disparities. Given the larger fiscal disparities existent in Russia, the on-going level of funding for equalization transfers in Russia (1.1 percent of GDP in 1998, (Table 3)) appears to be insufficient to bring about a significant level of equalization. Although the overall funding for equalization transfers in Ukraine and

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<sup>19</sup> However, autonomy over taxes which are permanently assigned to subnational governments, such as the land tax, individual property tax, advertisement tax, inheritance tax, and local licensing fees is limited by federal restrictions over tax bases and rates.

<sup>20</sup> There are currently 16 local taxes and fees in Ukraine. However, a majority of these are nuisance taxes with very little revenue potential, such as taxes on advertisements, gambling and dog tags.

Kazakhstan is also quite limited have less pronounced fiscal disparities at the subnational level and the level of funding as percent of GDP is also higher than in Russia.<sup>21</sup>

In all three countries the allocation of transfers, in practice, has remained uneven and subjective, with a tendency for transfers to not get implemented entirely as budgeted or, if they do, the actual flows have been unpredictable and subject to long delays. The instability in transfer allocation impacts the ability of subnational governments to budget and plan expenditures, thereby undermining subnational investment and growth. One source of budgetary uncertainty for transfers is related to unforeseen revenue shocks to the budget. For example, increasing budget deficits at the central level in Ukraine in 1998 forced the government to cut equalization transfers to the regions by 55 percent. Because transfers were still determined on the basis of an ad hoc methodology, the central government allowed some regions to receive all the budgeted transfers, while others were subject to cuts of as much as 80 percent of the budgeted amounts. Instability and unpredictability of transfer flows have also resulted from institutional weaknesses and the implementation of rules.

### *Subnational Borrowing*

While subnational autonomy should be explicit and legally and politically well-defined, it should also be circumscribed and regulated in some important respects. One such obvious area with clear ramifications for macroeconomic management and control is that of subnational borrowing.

From the time of independence until very recently, subnational governments in all three countries were granted the right to borrow with very few restrictions. In particular, no explicit limits were imposed on the level of annual borrowing or on indebtedness and subnational governments were allowed to borrow for all purposes, including, in Russia, for the financing of current expenditures. The absence of a legal and regulatory framework was in part a reflection of a lack of private lending sources. As a result, most of the borrowing took the form of loans from the Ministry of Finance at the regional level and from regional finance departments at the local level and ad hoc adjustments in transfers, which provided subnational governments with a soft budget constraint.

In recent years, concerns about the lack of responsible fiscal management at the subnational level and its impact on macroeconomic stability at the national level have prompted the introduction of limits and control regulation for subnational borrowing in all three countries. While Russia and Kazakhstan have enacted legislation limits on overall debt as well as limits of the budget deficits of regions as a shares of their budget revenues and require control and supervision of all subnational bond issues, restrictions on subnational borrowing are much

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<sup>21</sup> However, both Ukraine and Kazakhstan will have to rely more heavily on equalization transfers in the near future as they switch permanently from regulating revenue assignments to uniform tax sharing rates across regional governments.

weaker in Ukraine.<sup>22</sup> However, despite the existence of a regulatory framework for subnational borrowing, the lack of effective monitoring and enforcement and the absence of adequate bankruptcy procedures and financial emergency controls for defaulting governments poses important risks.

While the overall level of subnational borrowing remains low, there is an increasing trend towards greater subnational deficits, accumulation of debt, and loan guarantees. In Russia, this resulted in the insolvency of a large number of regions in the aftermath of the August 1998 crises. One important threat to subnational budgetary discipline in all three countries is the moral hazard or impression of a soft budget constraint created by the practice of granting loans by the central government that are eventually forgiven. In Ukraine, for instance, central government loans are not centrally recorded with loans often written off through loan reclassification. In addition, official measures of regional budgetary deficits fail to reflect the reliance on expenditure sequestration, in particular for capital infrastructure, or the accumulation of sizeable budgetary payment arrears as important sources of deficit financing. In Russia, budget arrears at the subnational level were estimated at {... percent} in GDP; while in Ukraine general government arrears in 1999 amounted to 3.9 percent of GDP.

In comparison to Ukraine and Kazakhstan, commercial bank debt in Russia has become an important source of deficit finance, particularly since promissory notes (veksels) were disallowed since 1997. As in the case of Russia, subnational governments have used veksel or bills of exchange as important means of financing.<sup>23</sup> However, these transactions are often non-transparent and are subject to abuses as in many cases the loans are procured from commercial banks owned by regional governments.<sup>24</sup>

### **iii) Building institutions for fiscal decentralization**

No matter how technically well conceived is the system of intergovernmental fiscal relations, experiences from most countries have taught the important lesson that effective

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<sup>22</sup> Legislation introduced in Russia in 2000 disallows subnational governments from borrowing abroad in foreign currency. This amendment to the budget code was motivated by defaults and subsequent restructuring of eurobonds by several regional governments. Subnational governments in Kazakhstan are prohibited from incurring foreign debt, while Ukraine's present practice and the draft Budget Code allow subnational governments to borrow abroad..

<sup>23</sup> In 1998, over 16 percent of all subnational tax collections in Ukraine were in the form of veksel and 17 percent were collected in the form of tax offsets.

<sup>24</sup> Despite the prohibition on veksel, subnational governments have continued to issue promissory notes or switched to alternative instruments, such as veksel issued by commercial entities including public companies under control of subnational governments.

implementation requires the presence of a comprehensive institutional framework. This holds in a number of important respects.

*Representative institutions.* While subnational governments in Russia are led by democratically elected councils and governors/mayors, the heads of subnational governments in Kazakhstan and Ukraine are appointed by the central governments.<sup>25</sup> The lack of democratic representation at lower levels of government may importantly affect the responsiveness of these governments, since conflicts between policies implemented and the preferences of local taxpayers are politically inconsequential. Furthermore, a system of appointed officials may imply that central political or other interests dominate local policy making, again adversely affecting the responsiveness of subnational governments to the interests of local citizens. Ultimately, the objective of enhanced accountability of regional and local governments will be negatively affected.

*Cooperative institutions.* International experiences have shown that a basic requirement for efficient multi-tier governments is the presence of intensive cooperation between the main stakeholders – the different levels of government. Countries have chosen very different ways of securing the required cooperation, but common experiences seem to indicate that an efficient system is characterized by transparent, regular, and comprehensive exchanges of information and discussions, and that cooperation must take place at the political as well as the technical level.<sup>26</sup> Very few republics of the Former Soviet Union have established such consultation mechanisms or cooperative bodies, with Estonia and Latvia being important exceptions.

At present, there is a clear lack of interaction and coordination between central government agencies (ministries of finance and line ministries) and regional government agencies (finance departments and sectoral departments) in Russia, Ukraine and Kazakhstan. The lack of communication and cooperation is more pronounced in sectoral areas with a high weight in subnational budgets, including education, health, and social assistance. This lack of dialogue has occasionally led to unrealistic regulations, the proliferation of unfunded mandates, ineffective supervision and weak support and absence of performance evaluation

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<sup>25</sup> In Kazakhstan, the legislative branches of oblast and rayon governments, the maslikhats, are elected, but local and regional administrations are headed by centrally appointed akims. In Ukraine, on the other hand, local self-governments co-exist with centrally-appointed executives at the regional level.

<sup>26</sup> Australia and India provide examples of a coordinating body, such as a grants commission, with a relatively limited mandate, but which nevertheless is extremely influential. In Denmark, fora have been established at both the political and technical level to deal specifically with issues relating to intergovernmental fiscal relations. A highly structured system of consultations and coordination between levels of governments is also in place in Austria and Germany.

of subnational programs. More generally, it has encouraged conflicts and frictions in intergovernmental relations.

*Tax administration.* The lack of a modern tax administration has hampered both the day-to-day implementation of revenue assignments, and adversely affected general government revenue collections in Russia and, to a lesser extent, in Ukraine and Kazakhstan. In all three countries, the tax administration is a central government agency exclusively responsible for collecting taxes at all levels of government. Regional and local governments do not have their own tax administrations. In Russia, the main problem has been the lack of effective control over the regional and local offices of the Ministry of Taxation (formerly the State Tax Service). In Ukraine and Kazakhstan, the central authorities have also experienced difficulties in controlling the territorial offices of the tax administration, but the problem has never had the seriousness of the Russian case.

Following independence, the three countries created national tax services with exclusive subordination to the central authorities. Staff of the regional offices were, however, recruited primarily from members of the regional administrative bureaucracy and old official and personal allegiances to local officials remained. Regional and local tax administrators have also continued to be supported by the subnational governments, including through subsidized housing and utilities, and occasionally through pay bonuses. The result has been a *de facto* dual subordination of tax administrators to the central tax authorities and to subnational government officials, with an important impact on tax collections at all levels of government.<sup>27</sup> In the case of Russia, these problems have in some cases been accentuated by the existence of “single channel” tax collection arrangements with certain regions.

*Budget process.* The existing budget process at the subnational level is deficient in all three countries, in a number of important ways. A key issue in this regard is the lack of a meaningful autonomy for the subnational governments to set priorities as well as to choose the most effective methods of service delivery. The prolific use of extra-budgetary funds in Russia and Ukraine (Kazakhstan eliminated these funds in 1999) have severely affected fiscal transparency and limited sound budgetary prioritization. Other critical aspects of the budgetary process includes systemic inaccuracies in revenue forecasts (for a long while intentional); the pervasiveness of budget arrears and sequestration; and the weak ex post audit control together with the absence of budget performance criteria.

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<sup>27</sup> Regional and local officials may be more interested in preserving the economic viability of local enterprises which provide employment and a tax base for subnational taxes than ensuring that federal taxes get paid. They may, therefore, pressure tax officials to be selective in their collection efforts. Furthermore, subnational officials may press tax administrators to employ more resources to the collection of subnational taxes than the low yield of these taxes may warrant.

### 3. A roadmap for reform

As is demonstrated by the most recent developments (see Box 1), all three countries are in a crucial stage of their respective reform processes, being—as the case may be—in the midst of considering or implementing comprehensive reforms of their intergovernmental fiscal systems. Building efficient multi-tier fiscal systems with a critical mass of popular consensus is a daunting task, indeed, that requires in-depth technical analysis and preparations as well as painstaking political negotiations. We focus in this section on the issues that in our view must be addressed up front to ensure an orderly and successful reform.

#### Recent Reforms in Intergovernmental Relations in Russia, Ukraine, and Kazakhstan

##### Russia

- A presidential decree of May 2000 sought to replace the 89 presidential representatives to the regions (“subjects of the federation”) with seven plenipotentiary representatives (polpredy) overseeing the newly drawn federal districts. Recently introduced legislation (in summer 2000) seeks to circumscribe the power of regional governors by attempting to restructure the composition of the Federation Council, and granting the president the authority, to dismiss regional governors and local officials for repeated violations of federal law and, in certain cases, to dissolve regional legislatures, while increasing presidential control over local governments.
- The *Law on the Principles of Demarcation of Jurisdictions and Powers* of 1999 establishes supremacy of federal legislation and decrees over areas of joint federal-regional responsibility. In addition, Article 85 of the Budget Code amended in 2000 requires that joint expenditure responsibilities have to be separated in the annual budget laws for each type of activity. To address the problem of unfunded mandates, earmarked transfers for federally mandated programs in the 2001 budget will be increased. The annual budget law will include a list of mandates that will be stricken due to a lack of funding.
- Part II of the Tax Code envisages a reduction and eventual elimination of subnational turnover taxes, which provide a substantial share of own source revenues for local and regional governments. The VAT will be reassigned to the federal level as of 2001, and the progressive structure of the federal personal income tax traditionally assigned to regions will be replaced with a flat rate of 13 percent. As of January 1, 2001, municipalities will have the option of introducing a local “piggy –back” corporate income tax up to a maximum of 5 percent.
- [Methodological Recommendations on Regulating Intergovernmental Relations in the Regions of the Russian Federation,] (Ministry of Finance, 1999) provides guidelines for the introduction of objective, formula-based transfers at the regional-local levels. In addition, earmarked federal transfers will be allocated to pay for federal mandates in regions, financed by an increase in the centralization of revenues.

##### Ukraine

During 2000, the government prepared a radical reform of the system of intergovernmental fiscal relations embodied in the draft Budget Code. However, the new Code has not yet been approved in the third reading and a presidential approval now is not expected. The Budget Committee of the Verkhovna Rada is now attempting to use a water down version of the draft Code for the 2001 budget proposal.

- The most significant departure in the draft Code from the current system is that the budgets of municipal (local) governments will be fully separated from the budgets of the regions, as opposed to the hierarchically linked budgets in existence, with the municipalities having an independent direct relationship with the central government
- On expenditure assignments, the draft Code specifies responsibilities at the central, regional, municipal, and villages or settlements levels. Municipal expenditure responsibilities would be subdivided into “delegated” and “own” responsibilities. For the latter, the central government reserves the authority to norm and regulate and

assumes the obligation to ensure the sufficiency of funds to deliver those services.

- On revenue assignments, to finance delegated municipal responsibilities the Budget Code defines a “basket” of revenue sources (on a derivation basis) including the personal income tax, the land tax, stamp duties, license fees and other fees. However, twenty-five per cent of the revenues in the basket would go up to the regions and at least twenty-five percent would go down to the villages/settlements. Own municipal responsibilities would be financed with local taxes and fees.
- The Code envisages the introduction of formula-based equalization grants using population size and a percentage of the difference between municipal per capita expenditure needs and per capita revenue capacity. In addition to equalization transfers, targeted subventions will be provided to regions for investment purposes.
- The draft code introduces conditions, limits, and allowable resources for subnational borrowing.

#### **Kazakhstan**

- As of January 2001, Astana, the new capital will lose its status of “special economic zone” which allowed it to retain 50 percent of all taxes collected.
- The Budget System Law was amended to introduce a uniform single budget classification across different levels of government. As of this year, regional representative bodies as opposed to centrally appointed executives, have sole authority to approve tax sharing rates and transfers to local governments.
- The first explicit assignment of expenditure responsibilities appeared in the 1999 *Budget System Law*.
- In 2001, the social tax and personal income tax will be reassigned to subnational governments and the unified land tax and other smaller taxes will be assigned to local budgets.
- As of 2000, subnational governments are prohibited to borrow from abroad and legislation was introduced that prohibits the Ministry of Finance from assuming any debt obligations of subnational governments.

While previous sections have discussed an array of technical, administrative, and political or institutional aspects, all of which in their own right are crucial to the reform process, it is important in the discussions of all these elements that what has been lacking in the past is a decision on what ultimately should be the roles of subnational governments. In other words, what has been lacking is a vision of the responsibilities that subnational governments eventually should take on in order to promote the effective working of general government. When this vision has been clarified and agreed upon, reform planning and implementation will be much better guided, and the reform process less haphazard and subject to short-term political bickering and trade-offs.

#### ***Specific elements of a reform agenda***

A basic objective of any future reform initiatives with regard to the system of inter-governmental fiscal relations in Russia, Ukraine, and Kazakhstan should be to eliminate or at

the least alleviate the negative incentives inherent in the present systems.<sup>28</sup> Key strategies and objectives to support this policy are summarized in what follows.

### *The legal and institutional structure*

Incentives for sound fiscal management and local accountability could be substantially enhanced through a clear, consistent and stable legal and regulatory framework which assigns roles to the different levels of government in a much more transparent and predictable way. This would require preparation and implementation of a variety of new laws (such as the proposed Budget Code in Ukraine and full implementation of Part II of the Tax Code in Russia) amendments to existing legislation to eliminate inconsistencies between the main fiscal laws (Tax and Budget Codes and Law on Local Self-Governance, Law on Financial Foundations of Local Government), as well as improvements in the legislative framework for subnational borrowing.

In Russia, developing supporting federal regulations for regional and local governments in the areas of budget classification, information disclosure, debt registration, etc. would allow for greater harmonization of standards across regions. Subnational governments also need to adopt regional and local laws and regulations that are consistent with federal laws (for instance, in the areas of tax sharing and transfers to municipalities), thereby, enhancing the accountability and transparency of the budget process. Laws and regulations in all three countries, and particularly in Ukraine, should also clarify responsibilities within regional and local governments and legislatures for budget preparation, approval, implementation, and control.

### *Expenditure assignments*

Increasing accountability and the overall efficiency of decentralized expenditures will require greater clarity in the assignment of expenditure responsibilities, in particular at the regional-local level, and by establishing primary responsibility or paramountcy in the case of concurrent responsibilities. Clarity would also be enhanced by explicitly assigning responsibility for regulation, financing, and implementation in cases where there is no exclusive assignment. This would also serve to control several sources of unfunded mandates. An important first step would be to achieve a greater coordination and harmonization of the rules in the budget codes or budget system laws and set out clear principles for regulatory powers, responsibility for financing, and responsibility for the

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<sup>28</sup> The *Concept on Reform of Inter-Government Fiscal Relations in the Russian Federation in 1999-2000* outlines the authorities comprehensive agenda for reform of the fiscal decentralization system. While many of the proposals discussed in the *Concept* correspond closely to those suggested in this paper, in general, it proposes a strategy of reform that is stronger on the reform of the system of equalization transfers and budgeting and fiscal management institutions, but weaker on expenditure and revenue assignment issues.

delivery of the public services in the various sectoral laws (education, health, environment, etc.).

The system of expenditure assignments should also allow for greater subnational autonomy in setting service levels in accordance with local needs. However, since social assistance and welfare services have a distributional objective, regulatory and financing responsibilities should be assigned at the federal level and responsibilities for implementation assigned to the subnational level, with some matching fund arrangements in order to provide subnational governments with proper incentives for expenditure management. Responsibilities over capital expenditures could also be clarified by making subnational governments responsible for the capital infrastructure needed to provide those services assigned to them.<sup>29</sup>

The scope of the subnational public sector should be rationalized by reducing untargeted subsidies for housing and public utilities, and reducing or eliminating the direct involvement of subnational governments in commercial activities. Federal policies to encourage regional reforms in this area should include some combination of legislation that imposes a hard budget constraint on subnational budgets, including imposing limits on borrowing conditional on fiscal behavior, and positive incentives such as aid conditional on demonstrable reform.<sup>30</sup> Expenditure control at the subnational level would be also enhanced by improving institutions for budgetary management, including the adoption of a treasury function at the subnational level.

#### *Revenue assignments*

Elimination of the current perverse incentives for revenue mobilization at the subnational level would require a reform of the current system of revenue assignments in favor of a more stable and predictable framework and one that provides further autonomy to subnational governments. At the regional level, such reform would entail scaling back significantly the use of tax sharing arrangements, which reduce accountability and distort local voters and taxpayers perception of the fiscal costs of local services, and lead to excessive negotiations. Regional and local governments should be assigned at least one major source of revenue, for which they could determine the rate, in order to increase accountability and responsibility. The best option for developing subnational tax autonomy would be the introduction at the regional level of a personal income tax (on a residence basis) with a flat rate that piggybacks on a national progressive personal income tax, and second, the introduction at the local level

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<sup>29</sup> This would require central authorities to provide prudent limits to subnational borrowing, monitor compliance, and facilitate the supply of long-term credit for well-planned and responsible capital expenditures by subnational governments.

<sup>30</sup> This is being tried in Russia by the Ministry of Finance in connection with a World Bank project.

of a real estate property tax.<sup>31</sup> Given that the introduction of more significant autonomous revenue sources will not lead to revenue sufficiency of subnational governments in the near term, it is important to address remaining problems with tax sharing, including considering reassigning the enterprise profits tax at the federal level.<sup>32</sup> In the absence of a permanent assignment of these taxes to the center, reforms should focus on implementing the apportionment formulas for the enterprise profits tax.

At the local level, reforms will require abandoning the “regulatory” approach to revenue assignments in favor of a more stable, uniform and transparent system, with pre-defined sharing rates for local governments that are fixed for at least a three year period. Moreover, for reforms of revenue assignments to be effective, they must be accompanied by reforms in the transfer system. In particular, the use of formula-driven transfers to replace the current gap-filling negotiated transfers along with the enforcement of hard budget constraints on subnational budgets would help to eliminate the disincentives to revenue mobilization.

### *Transfers*

While considerable progress has been made over the last year in Russia to improve the formula of the equalization fund, reform efforts should continue to aim at developing an efficient and formula based equalization grant based on accurate measures of tax capacity and expenditure needs. This is imperative in Ukraine and Kazakhstan. Stability in the funding of equalization transfers could be enhanced by shifting to a rule that fixes the level of funding as a percent of central government revenues for a period of three years. In addition, there is an urgent need to get rid of the current ad-hoc and non-transparent system of mutual settlements, forgiven loans and special subventions. These should be replaced by a system of transfers that have explicit objectives, are implemented as categorical or conditional grants, are explicitly budgeted ex-ante and allocated according to objective and transparent criteria.

At the regional-local level, there is an urgent need to reform the system of gap-filling transfers by introducing norm-based formulae based on tax capacity and expenditure needs rather than past economic performance. While some regions have already initiated such reforms, they need to be undertaken in a wider framework of reform of the system of intergovernmental relations, including revenue and expenditure assignments.

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<sup>31</sup> In both cases, autonomy could be limited to choosing a flat rate up to a maximum rate legislated in the enabling legislation.

<sup>32</sup> Russia is reassigning the VAT to the federal level in 2001 as are Ukraine and Kazakhstan.

### *Borrowing*

There are several basic approaches for bringing discipline and responsibility to subnational government borrowing, from reliance on market discipline to a rules based approach to direct central government controls. Given that financial markets and institutions are not sufficiently developed in the three countries to exert effective discipline on subnational borrowing, the best approach would be to rely on a combination of central legislation and regulation with appropriate central monitoring and enforcement. Regional and local borrowing should be limited in accordance with clear and transparent principles that take into account the debt servicing capacity of subnational governments. While Kazakhstan and Russia have implemented measures to impose limits and regulate subnational borrowing, the legislative framework for subnational borrowing in Ukraine remains weak.

Improvements in monitoring and enforcement of the legislated borrowing limits, however, require immediate attention in all three countries. For instance, regulations requiring the centralized registration of all subnational borrowing and their disclosure in annual budgets would make it easier to monitor debt levels. In addition, assessing the present level of subnational debt is complicated by the widespread use of nonmonetary sources of borrowing, loan guarantees and budget arrears. Continued efforts should be made to phase out noncash forms of budget execution and existing arrears restructured in order to improve debt management at the subnational level.

### *Institution building*

The problems created by the *de facto* subordination of tax authorities to subnational governments has created conflicting incentives for tax collection. One way to address this problem is to strengthen and modernize the central tax administration , while paving the way for creation of tax administrations at the subnational level charged with the enforcement and collection of regional and local taxes. An effective way to proceed would be to adopt pilot programs with separate tax administrations in some regions and large cities with taxes well suited for local enforcement, such as the real estate property taxes. In the longer term, the development of a tax administration capacity at the subnational level should also take into account the significant institutional limitations of subnational governments.<sup>33</sup>

## **4. Conclusion**

The reform agenda for intergovernmental relations should involve an explicit recognition of the substantial *de facto* authority that already exists at the subnational level in several areas, and should, therefore, attempt to balance the objectives of granting greater budgetary

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<sup>33</sup> In light of these limitations, in some cases the administration and enforcement of local taxes should be kept at the regional or central level. For instance, piggyback taxes, such as a regional PIT could continue to be administered by the central tax administration.

autonomy with that of improving capacities for regional and local budget management and control, while improving cooperation and coordination between the different levels of government. Clearly, reforms in each of these areas will have to be prioritized in light of their feasibility over the short and medium term, including their political feasibility.

Notwithstanding these practical and political constraints, the importance of a **vision** for the ultimate responsibilities of subnational governments cannot—as noted above—be overemphasized: a first step must be to establish consensus on what should be the core functions of regional and local governments—to guide the ensuing reform process.

The implementation of this vision must be guided by the principles of sound decentralization reform, as enumerated in this paper, that is, the focus must be on clarity of roles, on a reasonable degree of subnational fiscal autonomy, and on building the institutions conducive to the effective working on multi-tier governments, including the crucial need to establish cooperative procedures to address legitimate concerns about overall macroeconomic stability and sound fiscal management. The principles should be applied to all aspects of the intergovernmental fiscal system, that is, to the institutional and legal framework, to the systems of expenditure and revenue assignments, to the system of transfers, and to the provisions that govern subnational debt. In the preceding section, we have offered our views on what specifically should be done in these areas.

For practical, technical, administrative, and political reasons, a comprehensive reform cannot be implemented in a “big-bang” fashion—a gradual approach is called for, as also reflected in the reform processes underway in many other countries. In many developed countries, the systems of intergovernmental fiscal relations have developed gradually, over decades or even centuries. This point emphasizes the need for careful sequencing of the reform process. While the specifics of sequencing are beyond the scope of this paper, it should be noted that sequencing can be carried out in numerous different ways, albeit under two key common requirements: first, is the need for securing the crucial political and popular support prior to the launch of any reform initiatives, as well as the need for careful technical analyses and preparations; second, in whichever way the devolution of fiscal powers are designed and carried out, the devolution of responsibilities to lower levels of government should—at each and every phase of the reform process—be carefully calibrated to the financial resources assigned to these governments in the form of taxes, transfers, and borrowing. Only when these requirements are met can the fiscal decentralization process take place in an orderly and transparent manner.

**Table 1. Distribution of Expenditures Between the Levels of the Government for Kazakhstan, Russia and Ukraine, 1992-1998**

|                                | 1992 | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  |
|--------------------------------|------|-------|-------|-------|-------|-------|-------|
| (As a percentage of GDP)       |      |       |       |       |       |       |       |
| <b>Kazakhstan</b>              |      |       |       |       |       |       |       |
| Central Government             | ...  | ...   | ...   | 9.2   | ...   | 10.5  | 11.1  |
| Consol. Subnational Government | ...  | ...   | ...   | 9.7   | ...   | 8.6   | 8.9   |
| Total                          | ...  | ...   | ...   | 18.9  | ...   | 19.1  | 20.0  |
| <b>Russia</b>                  |      |       |       |       |       |       |       |
| Central Government             | 27.0 | 20.2  | 23.2  | 18.6  | 20.9  | 19.0  | 16.6  |
| Consol. Subnational Government | 12.0 | 15.7  | 17.9  | 15.3  | 15.6  | 16.8  | 14.8  |
| Total                          | 39.0 | 35.9  | 41.1  | 33.9  | 36.5  | 35.8  | 31.4  |
| <b>Ukraine</b>                 |      |       |       |       |       |       |       |
| Central Government             | ...  | 24.5  | 40.4  | 28.8  | 28.9  | 23.7  | 17.6  |
| Consol. Subnational Government | ...  | 15.8  | 18.0  | 19.0  | 14.9  | 15.8  | 15.3  |
| Total                          | ...  | 40.3  | 58.4  | 47.8  | 43.8  | 39.5  | 32.9  |
| (As a percentage of total)     |      |       |       |       |       |       |       |
| <b>Kazakhstan</b>              |      |       |       |       |       |       |       |
| Central Government             | ...  | ...   | ...   | 48.6  | ...   | 55.1  | 55.4  |
| Consol. Subnational Government | ...  | ...   | ...   | 51.4  | ...   | 44.9  | 44.6  |
| Total                          | ...  | ...   | ...   | 100.0 | ...   | 100.0 | 100.0 |
| <b>Russia</b>                  |      |       |       |       |       |       |       |
| Central Government             | ...  | 56.8  | 54.4  | 54.9  | 57.3  | 53.0  | 52.8  |
| Consol. Subnational Government | ...  | 43.2  | 45.6  | 45.1  | 42.7  | 47.1  | 47.2  |
| Total                          | ...  | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| <b>Ukraine</b>                 |      |       |       |       |       |       |       |
| Central Government             | ...  | 60.7  | 69.2  | 60.3  | 66.0  | 59.9  | 53.4  |
| Consol. Subnational Government | ...  | 39.3  | 30.8  | 39.7  | 34.0  | 40.1  | 46.6  |
| Total                          | ...  | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Sources: Ministries of Finance; and IMF staff estimates

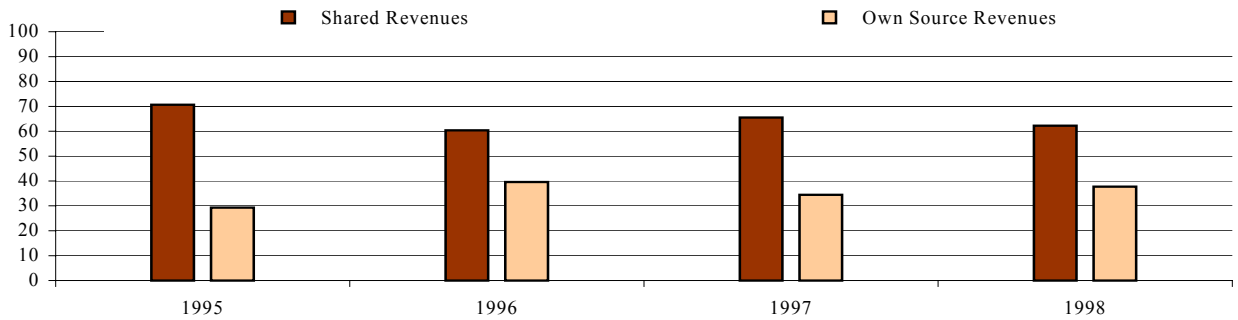
**Table 2. Distribution of Revenues Between the Levels of the Government for  
Kazakhstan, Russia and Ukraine, 1993-1998**

|                                | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  |
|--------------------------------|-------|-------|-------|-------|-------|-------|
| (As a percentage of GDP)       |       |       |       |       |       |       |
| <b>Kazakhstan</b>              |       |       |       |       |       |       |
| Central Government             | ...   | ...   | 9.64  | ...   | 6.71  | 7.2   |
| Consol. Subnational Government | ...   | ...   | 7.24  | ...   | 6.74  | 6.4   |
| Total                          | ...   | ...   | 16.88 | ...   | 13.45 | 13.6  |
| <b>Russia</b>                  |       |       |       |       |       |       |
| Central Government             | 13.7  | 11.8  | 12.9  | 12.5  | 12.0  | 10.7  |
| Consol. Subnational Government | 14.2  | 14.0  | 12.9  | 12.4  | 13.4  | 12.3  |
| Total                          | 27.9  | 25.8  | 25.8  | 24.9  | 25.4  | 23.0  |
| <b>Ukraine</b>                 |       |       |       |       |       |       |
| Central Government             | 18.4  | 31.8  | 23.8  | 24.7  | 19.5  | 16.7  |
| Consol. Subnational Government | 16.6  | 16.7  | 16.9  | 14.0  | 12.9  | 13.8  |
| Total                          | 34.9  | 48.5  | 40.7  | 38.7  | 32.3  | 30.5  |
| (As a percentage of total)     |       |       |       |       |       |       |
| <b>Kazakhstan</b>              |       |       |       |       |       |       |
| Central Government             | ...   | ...   | 57.13 | ...   | 49.86 | 53.2  |
| Consol. Subnational Government | ...   | ...   | 42.87 | ...   | 50.14 | 46.8  |
| Total                          | ...   | ...   | 100   | ...   | 100   | 100.0 |
| <b>Russia</b>                  |       |       |       |       |       |       |
| Central Government             | 49.2  | 45.7  | 49.9  | 50.2  | 47.3  | 46.6  |
| Consol. Subnational Government | 50.8  | 54.3  | 50.1  | 49.8  | 52.7  | 53.4  |
| Total                          | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| <b>Ukraine</b>                 |       |       |       |       |       |       |
| Central Government             | 52.6  | 65.6  | 58.4  | 63.8  | 60.2  | 54.9  |
| Consol. Subnational Government | 47.4  | 34.4  | 41.6  | 36.2  | 39.8  | 45.1  |
| Total                          | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

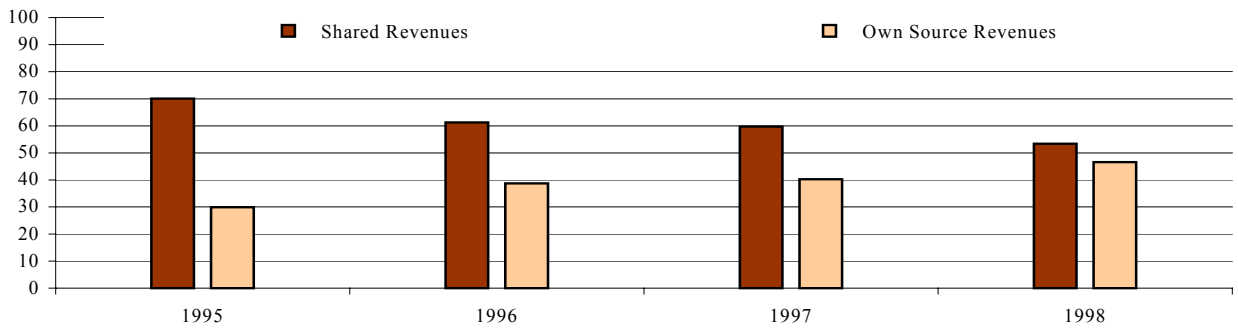
Sources: Ministries of Finance; and IMF staff estimates

**Figure 1. Own Revenues and Shared Revenues  
1995 - 1998  
(As a percentage of consolidated subnational collections)**

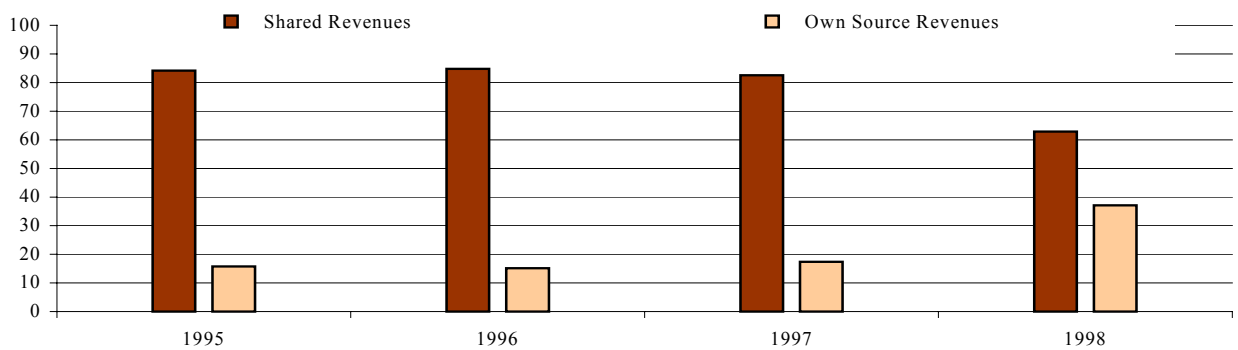
**Kazakhstan**



**Russia**



**Ukraine**



Source: Ministries of Finance, IMF staff estimates.

**Table 3. Central Transfers to the Regions for Kazakhstan, Russia and Ukraine, 1993-1998**

|                                  | 1993  | 1994  | 1995  | 1996  | 1997  | 1998  |
|----------------------------------|-------|-------|-------|-------|-------|-------|
| (As a percentage of GDP)         |       |       |       |       |       |       |
| <b>Kazakhstan</b>                |       |       |       |       |       |       |
| Total transfers                  | n.a.  | n.a.  | 0.0   | n.a.  | 1.7   | 2.4   |
| <b>Russia 1/</b>                 |       |       |       |       |       |       |
| Total transfers                  | 2.6   | 4.2   | 1.8   | 2.1   | 1.9   | 1.9   |
| FFSR                             | 0.0   | 0.9   | 1.2   | 1.1   | 1.3   | 1.1   |
| Other transfers                  | 2.6   | 3.3   | 0.6   | 1.0   | 0.6   | 0.8   |
| <b>Ukraine</b>                   |       |       |       |       |       |       |
| Total transfers and budget loans | 1.8   | 2.7   | 2.3   | 2.5   | 2.9   | 2.1   |
| Subventions                      | 0.0   | 1.6   | 0.7   | 0.9   | 2.3   | 2.0   |
| Other transfers                  | 1.8   | 1.1   | 1.6   | 1.6   | 0.5   | 0.1   |
| (As percent of total transfers)  |       |       |       |       |       |       |
| <b>Russia 1/</b>                 |       |       |       |       |       |       |
| Total transfers                  | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| FFSR                             | 0.0   | 20.4  | 66.8  | 51.7  | 67.9  | 58.6  |
| Other transfers                  | 100.0 | 79.6  | 33.2  | 48.3  | 32.1  | 41.4  |
| <b>Ukraine</b>                   |       |       |       |       |       |       |
| Total transfers and budget loans | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Subventions                      | 0.0   | 58.7  | 30.8  | 36.4  | 81.6  | 97.6  |
| Other Transfers                  | 100.0 | 41.3  | 69.2  | 63.6  | 18.4  | 2.4   |

Sources: Ministries of Finance; and IMF staff estimates  
1/ Excluding budget loans

**Table 4. Fiscal Accounts of Central and Subnational Governments in  
Russia, Ukraine, and Kazakhstan, 1993-1998**

|   | 1993 | 1994  | 1995 | 1996 | 1997 | 1998 |
|---|------|-------|------|------|------|------|
| (As a percentage of GDP)                    |      |       |      |      |      |      |
| <b>Russia</b>                               |      |       |      |      |      |      |
| <i>Federal Government</i>                   |      |       |      |      |      |      |
| Revenues                                    | 13.7 | 11.8  | 12.9 | 12.5 | 12.0 | 10.7 |
| Expenditures                                | 20.2 | 23.2  | 18.6 | 20.9 | 19.0 | 16.6 |
| Balance. after transfers                    | -6.5 | -11.4 | -5.8 | -8.4 | -7.0 | -5.9 |
| <i>Consolidated Subnational Governments</i> |      |       |      |      |      |      |
| Revenues                                    | 14.2 | 14.0  | 12.9 | 12.4 | 13.4 | 12.3 |
| Expenditures                                | 15.7 | 17.9  | 15.3 | 15.6 | 16.8 | 14.8 |
| Balance. after transfers                    | -1.5 | -3.9  | -2.4 | -3.2 | -3.5 | -2.6 |
| Balance. before transfers                   | -4.1 | -8.1  | -4.2 | -5.2 | -5.4 | -4.5 |
| <b>Ukraine</b>                              |      |       |      |      |      |      |
| <i>Central Government</i>                   |      |       |      |      |      |      |
| Revenues                                    | 18.4 | 31.8  | 23.8 | 24.7 | 19.5 | 16.7 |
| Expenditures                                | 24.5 | 40.4  | 28.8 | 28.9 | 23.7 | 17.6 |
| Balance. after transfers                    | -6.1 | -8.6  | -5.1 | -4.2 | -4.2 | -0.8 |
| <i>Consolidated Subnational Governments</i> |      |       |      |      |      |      |
| Revenues                                    | 16.6 | 16.7  | 16.9 | 14.0 | 12.9 | 13.8 |
| Expenditures                                | 15.8 | 18.0  | 19.0 | 14.9 | 15.8 | 15.3 |
| Balance. after transfers                    | 0.7  | -1.3  | -2.1 | -0.9 | -2.9 | -1.6 |
| Balance. before transfers                   | -1.1 | -4.0  | -4.3 | -3.4 | -5.8 | -3.1 |
| <b>Kazakhstan</b>                           |      |       |      |      |      |      |
| <i>Central Government</i>                   |      |       |      |      |      |      |
| Revenues                                    | ...  | ...   | 9.6  | ...  | 6.7  | 7.2  |
| Expenditures                                | ...  | ...   | 9.2  | ...  | 10.5 | 11.1 |
| Balance. after transfers                    | ...  | ...   | 0.5  | ...  | -3.8 | -3.9 |
| <i>Consolidated Subnational Governments</i> |      |       |      |      |      |      |
| Revenues                                    | ...  | ...   | 7.2  | ...  | 6.7  | 6.4  |
| Expenditures                                | ...  | ...   | 9.7  | ...  | 8.6  | 8.9  |
| Balance. after transfers                    | ...  | ...   | -2.5 | ...  | -1.8 | -2.6 |
| Balance. before transfers                   | ...  | ...   | -2.5 | ...  | -3.5 | -2.6 |

Sources: Ministries of Finance; and IMF staff estimates