

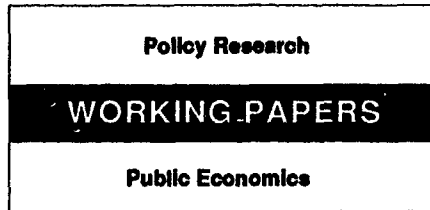
Policy Research Department  
The World Bank  
March 1993  
WPS 1122

# **Fiscal Decentralization and Intergovernmental Relations in Transition Economies**

## **Toward a Systemic Framework of Analysis**

**Richard Bird  
and  
Christine Wallich**

**Designing a well-functioning intergovernmental fiscal system is essential to the success of all the transitional economies' major reform goals: privatization, macroeconomic stability, more efficient performance and economic growth, and an adequate social safety net.**



WPS 1122

This paper — a joint product of the Public Economics Division, Policy Research Department, and the Infrastructure Division, Technical Department, Europe and Central Asia, and Middle East and North Africa Regions — is part of a larger effort in both departments to analyze issues relating to decentralization, and in particular, the role of subnational governments in the reform process. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Bonnie Pacheco, room H11-065, extension 37033 (March 1993, 85 pages).

The decentralization of government in Eastern Europe represents a reaction both from below (to tight central political control) and from above (to privatize the economy and relieve the central government's fiscal stress).

In all transitional economies, the developing structure of intergovernmental relations is intimately related to such critical policy issues as privatization, stabilization, and the social safety net. In the fiscal sphere, tax reform, deficit control, and intergovernmental finance are a tripod. Unless each leg is set up properly, the whole structure could collapse.

The present strategy of devolving *expenditures* downward while holding back on revenue flows and transfers to balance the central budget is unlikely to succeed for more than a year or two at best.

Net spending reductions at the subnational level may be difficult to achieve. From 10 to 40 percent of outlays go to the subnational sector, and in many countries local governments provide much of the social safety that makes the pain of the economic transition politically tolerable. And, most housing and many enterprises have been shifted to local ownership, with the maintenance and subsidy cost this implies. Since the revenue sources assigned to local governments cannot finance expected levels of local activity, the result of shifting spending downward is likely to be strong demands for increased, rather than decreased, transfers. Alternatively,

subnational governments may look to "coping mechanisms" such as holding onto their enterprises (which provide vital social services), developing extrabudgetary revenues, or borrowing. These coping mechanisms threaten privatization, reduce budgetary transparency, and impede stabilization policies.

Bird and Wallich describe the risks to privatization, to macroeconomic stability, and to an adequate social safety net that present policies toward local government may imply. Its themes are that the subnational sector needs to be more realistically factored into national plans — and that subnational expenditures be more clearly assigned and revenue needs more realistically assessed. Such assessments are likely to acknowledge a larger sphere for subnational governments and the need for access to more robust revenue sources. Giving local government a share in the personal income tax is one possible and perhaps desirable approach to meeting these revenue needs.

Careful attention needs to be paid to the design and implementation of the intergovernmental fiscal transfers likely to remain prominent features of the intergovernmental landscape for years to come. Caution is also needed on borrowing by subnational government. Consolidating and integrating extrabudgetary funds at the subnational (and national) levels is crucial to enhanced budgetary transparency and macrostability.

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Acknowledgements

*We would like to thank those who commented on this paper, or who otherwise shared their insights on subnational finance in the various countries, including Felix Jacob; Zelko Bogetic, Robert Van Pulley, Tim Condon, Gabor Peteri, Shankar Acharya, Anwar Shah, Heng-fu Zou, Tony Pellegrini, Jim Hicks, Luca Barbone, Thanos Catsambas and Amaresh Bagchi. Research assistance of Ritu Nayyar is gratefully acknowledged. Susheela Jonnakuty provided expert word processing. This is the first in a series of papers under RPO BB67770M.*

**FISCAL DECENTRALIZATION AND INTERGOVERNMENTAL RELATIONS IN TRANSITION  
ECONOMIES:  
TOWARD A SYSTEMIC FRAMEWORK OF ANALYSIS**

"... A change of government is not a change of system, merely one of the political conditions for it. The change of system is a historical process that seems likely to require a long period of time."<sup>1/</sup>

**I. INTRODUCTION AND SUMMARY**

**Why "Local" Finance Matters.**

1. An important and unduly neglected aspect of the process of transition in Eastern Europe is the extensive decentralization, both political and fiscal, that is taking place in many of the countries newly emerging from behind the socialist veil. Decentralization represents both a reaction from below to the previously tight political control from the center and an attempt from above to further the privatization of the economy and to relieve the strained fiscal situation of the central government. The aspirations of, and the role of, local government are becoming stronger in most of the transitional economies.
2. The on-going reforms in subnational finance in these economies are much more important than seems generally to be recognized. In some countries in transition, the subnational governments (broadly defined) are quantitatively significant, accounting for a large, and often growing, share of public sector activity. In all the transitional economies, the developing structure of intergovernmental relations is intimately related to such critical policy issues as privatization, the social safety net, and stabilization. Within the fiscal sphere, tax reform, deficit control, and intergovernmental finance constitute a tripod: unless each leg is set up properly, the entire structure may collapse.
3. Our assertion is that the design of a well functioning intergovernmental fiscal system is key to almost all of the transition economies' major reform goals. Intergovernmental finances will have a major impact on the efficiency with which the transition economies perform; on their macroeconomic stability; on the social safety net and on the success of their privatization policies.
4. Fiscal balance at the subnational level is key to macroeconomic stability. Given the paramountcy of stabilization goals in almost all of the countries, the central governments have used all the tools in their meager arsenal to bring stability to the macroeconomy.<sup>2/</sup> One such tool has been to shift the deficit down, ensuring an adequate revenue flow to the center -- either by shifting expenditure responsibilities down or by retaining additional revenues, even where budgets at the subnational level are severely impaired (Hungary and Russia come to mind, but there are others).
5. The results of this policy, ironically, could contribute to further instability: the budget constraint in these countries is still so "soft" that subnational governments may respond by accumulating arrears, borrowing (strong-arming their enterprises to finance public expenditures -- since enterprises have easier access to bank credit than do the governments themselves) or developing extrabudgetary sources of revenue. Pushing the deficit down may not reduce it, but may merely repress it. Worse, some of these "coping mechanisms" also reduce the transparency of budgetary operations, and make the pursuit of appropriate national budgetary policies even more difficult than it is now.

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<sup>1/</sup>Janos Kornai, The Socialist System; (Princeton University Press, 1992), p.577.

<sup>2/</sup>The terms "subnational" and "local" are used more or less interchangeably, unless speaking of a three tier, or federal system, in which case subnational refers to all levels below the federal, and local refers to the lowest level.

6. A well-functioning social safety net -- responsibility for which has been transferred "downstairs" in a number of countries -- cannot be effectively carried out by an underfunded subnational sector. Where the safety net is critical for the success of the transition to a market economy, and is therefore a national policy objective, --as in Russia, and arguably, in Poland and other countries -- the burden of financing the safety net should not be on local governments, even though, being closer to the people, subnational governments might administer it.

7. From an allocative perspective, the system of intergovernmental fiscal relations will also determine in a major way the efficiency with which these economies perform, and their future economic growth. Local government ownership of enterprises -- and local interests in their revenues -- will inevitably encourage domestic protectionism (e.g. "domestic purchase requirements" and inter-jurisdictional trade barriers to protect local monopolies) harmful to economic growth.

8. Finally, because some countries --notably Russia-- are, so to speak, "nation-building," with significant centrifugal forces emanating from the subnational level, intergovernmental finance is also crucial to future national cohesion. In Russia it may be crucial even to the continued existence of the Federation. Even where national cohesion is not at risk, demands for greater "participatory democracy" have heightened demands from the subnational level. The strong desire for local political control and unfettered local autonomy is a natural outcome of the end of central planning. Combined with an inadequate fiscal base, however, local aspirations and fiscal capabilities are increasingly at odds, which is giving rise to growing tensions in a number of countries.

9. Even privatization is complicated by the current environment. Following the transfer in many countries of a significant number of enterprises to subnational ownership, responsibility for privatization now also rests with subnational governments. Their interests here are unclear at best: they still rely on "their" enterprises for profits and tax revenues, and if privatized, subnational governments will have to assume the substantial "non-production" expenditures -- for nurseries, housing, schools, etc.-- that will be spun off by the enterprises as they privatize. A system of intergovernmental finances that does not accommodate these shifts in expenditure responsibilities and provide corresponding revenues, will impede the process of privatization.

10. In sum, intergovernmental fiscal relations -- far from being merely a "local matter" -- are key to almost all of the transition economies' reform goals.

### Traditional vs Systemic Frameworks

11. The traditional analysis of intergovernmental finance examines the fiscal functions of local and central governments in terms of their respective roles and responsibilities for stabilization, income distribution, expenditure provision, the appropriate assignment of tax functions, and the design of a transfer system that provides appropriate incentives. The "benefit model" of service provision suggests that local governments -- whose role in this analysis is essentially that of service provider -- should be financed to the extent possible by charging for the services they provide, with local taxes making up the remaining gap, supplemented as appropriate by transfers and, in limited degree, borrowing.

12. This perspective is of course important in the transitional economies also. But it misses several key features of the roles, responsibilities and economic functions of subnational governments in the former socialist economies. First, the emphasis in traditional analysis on the local government as a service provider ignores its important roles as producer and as owner, as well as the complicated relationships between enterprises and local government in most transitional economies. The important role of local governments as owners means that they have a major role to play, either as potential impediments to, or supporters of, privatization. Moreover, the asset stock recently transferred to them in the decentralization process represents a potential source of revenue (or, in some instances, of losses). The interaction of subnational finance and privatization thus merits careful attention in the transitional economies.

13. Second, the traditional approach ignores the shrinking role of government: in most transitional economies, government, both local and central, played a major production role and was the major investor in the economy, and the expenditure side of the budget is cluttered with expenditures -- not only subsidies, but direct investment, inventory finance and wages -- which in a market economy, are not the responsibility of government. Unfortunately, in all these countries government revenue is declining more rapidly than governments are able to divest themselves of these expenditure responsibilities, thus contributing to stabilization problems. One response in many countries has been to try to shift the deficit downwards by making local governments responsible for more expenditures, while simultaneously reducing central transfers to the subnational sector.

14. The obvious need for flexibility in today's rapidly changing environment has led many central governments to attempt to preserve some degrees of freedom by continuing with the "negotiated" tax sharing systems of the past. But this approach is less and less acceptable in countries where demands for "fair" treatment and equalization are strong and where local governments are seeking greater autonomy. It is also incompatible with the efficient provision of local public services. It is therefore especially important to replace the present "bargained" outcomes with an intergovernmental fiscal framework - of transfers, of local revenues, and of local expenditure responsibilities - that is both firm enough to serve as a basis for action and flexible enough to be compatible with the on-going structural changes and reform.

15. The present strategy of devolving expenditures downward while holding back on transfers is unlikely to prove successful for more than a year or two at best. Indeed, net expenditure reductions at the subnational level may prove very difficult to achieve. The subnational sector is significant in expenditure terms in many transition economies --in Russia, and the CSFR, it accounts for over 40% of total outlays. Elsewhere they account for 10-30% of total outlays. At present, for example, state enterprises provide a wide range of social sector outlays: with privatization, many of these outlays will have to be taken over by local governments. Moreover, in most countries, the local government sector plays a critical role in terms of providing a "social safety net" which makes the pain of the wrenching economic transition more politically tolerable. Since the revenue sources assigned to local governments simply cannot finance the level of expected local activity in the immediate future, the result of shifting expenditures downward is likely to be strong demands for increased, rather than reduced, transfers. In sum, as and when expenditure assignments become clearer, and decentralization develops further, the likelihood is that the subnational share in other transition economies will also grow. This means that the intergovernmental system will have to be sensitive to these developments: Notable across the transition economies is the fact that there has been a general absence of concrete empirical estimates of "correspondence" between tax and expenditure assignments and need for transfers. Legislation on intergovernmental finance relations has typically been developed with no quantitative assessment of its implications.

16. Despite all the talk about "autonomy" and fiscal "independence", few of the countries surveyed offer their subnational governments much in the way of fiscal discretion on the expenditure side. Indeed, most recent legislation has focussed on codifying the revenue side of the equation --before deciding what expenditure responsibilities of subnational governments should be, putting the cart before the horse, so to speak. Expenditure "autonomy" is enshrined in legislation, but not really effective: there are still central "norms" which govern allowable expenditures in virtually every sector, and central spending mandates remain in place.

17. The new subnational governments will also need substantial help and guidance in developing adequate local revenue systems. The local "autonomy" that has been enshrined in recent legislation has often meant separating the spheres of responsibility to the greatest extent possible, so that each level of government reigns in its own sphere: in revenue terms, this translates into a pre-disposition towards "tax assignment" models, and a goal of reduced "transfer dependence" on the center. The fact that in the pre-reform system, most subnational governments received revenues from "their" enterprises has led to a strong bias towards derivation-based sharing models in which revenues go to the jurisdiction in which they are collected.

18. It is critical that subnational revenue needs and possibilities be realistically factored into national plans for tax reform. Failure to look at intergovernmental dimensions of national tax policy changes can lead to problems.



In Russia and Hungary, a share of major national taxes has been assigned to the subnational level, and recent national tax policy changes have wrought havoc with the aggregate subnational revenue base, with very erratic effects across subnational jurisdictions. Second, any thought of "assignment", when the tax itself is undergoing continuous definition, is problematical. In many transition economies, however, local governments have come out strongly in favor of revenue assignment under which they get "all" the revenues from "their" taxes. This seeming revenue independence leaves them with significant residual vulnerability to tax policy changes, however, a fact that seems generally not to have been recognized. If this vulnerability were to be taken into account, as it should be, national fiscal policy reforms would of course be constrained. Recent tax reforms at the national level, administrative weaknesses and other factors have meant significant revenue volatility, with significant over and undershooting of budgetary targets. This situation obviously has implications for the desirability of "tax assignment" models *per se*, and the design of sharing/transfer systems.

19. In most countries, for example, the principal "local" tax is some form of property tax: but in many cases, national governments have hamstrung the revenue potential of this tax by granting exemptions to newly privatized land, housing, and enterprises. In other instances, local governments are supposed to receive a share of certain national taxes, often on a derivation basis (e.g. origin, or residence): but such provisions raise both technical and allocative problems, in addition to biasing national tax policy decisions in often undesirable ways. Even when the local tax base is feasible and adequate in principle, in practice it will generally take some years before the system can be expected to produce sufficient revenues to meet perceived local needs.

20. Despite all the talk about "autonomy" and fiscal "independence", none of the countries surveyed offer their subnational governments any fiscal discretion, even over the minor taxes they are assigned: rates and bases continue to be set by the center, in the context of the unitary tax system. The paucity of locally-controlled tax resources in most transitional countries, when combined with the universal reluctance of politicians to tax constituents too directly and openly, makes it inevitable that hard-pressed local governments will turn to other avenues for revenue: they will demand increased transfers, they will try to borrow, and they will try to exploit to the full the new assets they have acquired as part of the decentralization-privatization process.

21. The level, design and effects of intergovernmental fiscal transfers thus constitute key elements in the emerging intergovernmental and local finance systems of the transitional economies. There is a general absence of "formula"-based transfers. These remain negotiated in aggregate and by individual localities. Critical decisions must be made with respect to the overall size of such transfers (the "distributable pool") as well as with respect to the distribution formulas to be employed, taking into account both the severe fiscal pressures on the central government and the vital tasks to be performed by the local governments in the emerging new structure of the public sector. Practical measures of "tax capacity", "expenditure need" and perhaps "fiscal effort" need to be developed for use in such formulas. Institutions must be developed at both the central and local levels to ensure that transfers (or subsidized credits) are put to the best possible use: such institutions may include, for example, at the center, agencies concerned with monitoring the performance of local governments and with providing them with needed technical assistance and support and, at the subnational level, various intermediary bodies, particularly with respect to the many very small municipalities that have been created in most countries.

22. As noted above, careful attention has to be paid to the design and implementation of the intergovernmental fiscal transfers that seem likely to remain prominent features of the fiscal landscape in most countries for years to come. Caution is even more necessary with respect to borrowing by subnational governments. A number of countries in transition have granted virtually unlimited borrowing powers to local governments without taking adequately into account the macroeconomic necessity of monitoring and controlling such borrowing. As yet, however, the relatively undeveloped state of financial institutions in most countries makes abuse of the borrowing power more a potential than a real problem.

23. The same is not true of the potential misuse of "locally owned" state assets, unfortunately, since in every country such misuse is already visible. Such local assets may represent a windfall - at least in those cases where they are not accompanied by central policies (e.g. rent or price control) that turn them into a liability. But they may

also often be misused, whether they are privatized or not. A local heating plant that is privatized, for example, but remains a (local) "natural monopoly" obviously raises regulatory problems: who deals with these problems, and how? What should be done with the proceeds of asset sales? Under what (very limited) circumstances should such proceeds be used to finance current local expenditures? If an asset is not privatized, but is used to generate ongoing revenues for the local government (and perhaps some foreign partner, with the municipality using its ownership of land or assets as its contribution to equity), the temptation to sustain and strengthen any monopoly position is obviously again a problem, as is that of regulation. Even more damaging is the high probability that more speculative ventures - examples include tourist lodges and bakeries - are likely to fail. Equally damaging may be the dissipation of scarce local managerial skills on trying to squeeze money out of such entrepreneurial gambits rather than focusing on the more essential task of trying to provide local public services efficiently.

24. A special problem arises with respect to the prices charged by those local public enterprises to be retained in the public sector. In the past, central governments in the socialist countries used low and fixed prices (including rents and other urban user fees) and wage controls, as part of their distributional tool kit. The new governments in these countries are now being asked, in a reform environment, to get the prices right and to use tax policies and targeted subsidies instead. There are two important dimensions in the transition economies: First, changes in public sector prices (user charges) clearly need to be coordinated with wage reform on the one hand and with more general price reforms on the other hand, in order to avoid undue impact on income and major distributional shifts (as well as on profits and hence government revenue). Second, central government price mandates - prices were typically centrally administered - need to be devolved to the subnational level.

25. Finally, in some countries, (Russia, China, and others) price reform and other structural shifts will continue to have effects on the tax base and its distribution across regions. Coal and energy price changes, for example imply potentially large shifts in the various tax bases, both within a tier of government in the tax bases of different regions within a country (e.g. a gain in value added in a primary-product producing area after price liberalization and a corresponding loss in the consuming jurisdiction) and between levels of government depending on how taxes have been assigned or shared. Such shifts must be taken into account when designing the intergovernmental fiscal system: they may well constrain the reform of intergovernmental relations, eliminating options that might be feasible in other countries. At the very least, greater flexibility is needed than in countries where economic structures are more fixed. Intergovernmental fiscal reform clearly must be viewed as an ongoing process in countries in transition.

### Organization of the Paper

26. This paper addresses these issues of intergovernmental finance in transitional economies. It argues that a broader framework than is customary is needed to analyze decentralization and intergovernmental fiscal issues in such economies. This framework must incorporate such elements as the likelihood of continuing structural changes in the economy and continuing political shifts, the need to undertake intergovernmental reforms while coping simultaneously with stabilization pressures and the increased importance of the social safety net, the likelihood of continued (local) public ownership on a significant scale, the financial implications of such ownership and its possible conflicts with the overall privatization objective, and continued vestiges of price and wage controls and other rigidities. A comprehensive and accurate analysis of decentralization must take these elements into account.

27. The analysis in this paper is based on detailed recent studies of local and intergovernmental finance in Hungary, Poland, Russia, Romania, and China, and on less detailed information for the Czech and Slovak Federal Republic (CSFR - especially the Czech Republic), Bulgaria, and Vietnam. Salient characteristics of the local and intergovernmental system in each of these countries<sup>2</sup> are presented in the main text for illustrative purposes.

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<sup>2</sup>See also the following working papers: Bird and Wallich, "Financing Local Government in Hungary," No. 869, March 1992; Bahl and Wallich, "Intergovernmental Finance in China," No. 863, February 1992; and Wallich, Christine, "Fiscal Decentralization: Intergovernmental Finance in Russia" Additional source materials are cited in the bibliography at the end of the paper.

Although the principal focus of the discussion is on the central and east European countries (especially Hungary, Poland, and Romania), similar tendencies and problems are visible in all the countries mentioned and may well also be manifest in the other republics of the former Soviet Union and former Yugoslavia, as well as in similar countries elsewhere. Kornai (in The Socialist System) lists 26 "socialist" countries in 1987. If we add to this list the 15 republics of the former Soviet Union and the 5 of former Yugoslavia (and deduct the now-vanished East Germany), there would appear to be at least 43 countries which only five years ago had more or less "socialist" systems. By 1992, however, is probably fair to say all but two of these countries (Cuba and North Korea) are now in some "transitional" stage, so that some or all of the analysis of this paper should be applicable. This paper therefore represents essentially an interim report on what is sure to prove an on-going and important problem in all the transitional economies.

28. The paper is organized as follows: Section II reviews a number of general issues with respect to the reform of governmental structure that have arisen in the transitional economies. This section elaborates many of the points made above about the importance of the changing context within which questions of local government roles, responsibilities, and finances are being decided. Section III then outlines briefly what appears to be the appropriate role of subnational government in such countries, with special attention to its expenditure responsibilities. The remainder of the paper then discusses the issues relating to each of the possible methods of financing subnational government in transitional economies: user charges (Section IV), subnational taxes (Section V), intergovernmental transfers (Section VI), subnational borrowing (Section VII), and the use of subnational government assets (Section VIII).

29. The matrix below summarizes some of the salient features found across the transition socialist economies.

<u>Intergovernmental Fiscal Relations in Transition Economies</u>	
<u>Salient Characteristics</u>	
<u>Political/Overall Structural Reform Context</u>	
●	Intergovernmental finances reforms are taking place in a context of <u>political decentralization</u> .
●	<u>Government reorganization</u> is also taking place throughout the transition and socialist economies, and striving for "local autonomy", many countries appear to be eliminating the "middle tier" of government in their constitutional reforms.
●	Intergovernmental finances reforms are taking place in context of overall <u>shrinking role of government</u> .
●	Intergovernmental finances reforms are taking place in context of a <u>changing role of government</u> .
●	Intergovernmental finances reforms are being undertaken simultaneously with overall <u>national tax reforms</u> .
<u>Stabilization</u>	
●	Intergovernmental finances reforms are taking place in context of macroeconomic instability and inflation, a <u>weak fiscal position of federal/central government</u> , and a shrinking revenue base at national level.

Rox ... (continued)

- **Stabilization** and overall macro concerns dominate the agenda so that intergovernmental financial reform needs to take place in this strained context, but care needs to be taken to prevent the stabilization objective from fully dominating the redesign of the intergovernmental finance regime.
- Stabilization concerns lead the center to deal with budgetary strain by "pushing the deficit down", and hoping the subnational level can do the cutting.

Expenditures

- **Expenditure assignment:** In some cases, the center has shifted (potentially large and open-ended responsibilities for "social welfare" down to local level in an attempt to balance its budget.
- Expenditure "autonomy" is enshrined in legislation, but not really effective: there are still central norms and mandates in place, and transfer dependence also impedes autonomy.
- Subsidies represent a major item in the subnational budgets due in part to central price setting on public sector prices.
- Use of "norms" to define how a service should be provided limits expenditure autonomy.
- Central "mandates" on wages, and other expenditures limits expenditure autonomy and continue to be important.

Tax Assignments and Transfers

- Attempts to make the subnational sector "independent" are desired by the subnational level and the center: center wants "each tub to sit on its own bottom", to assign taxes and be done with it, and to reduce "transfer dependence"; This is generally not possible, because the tax instruments are not sufficient, and user charges not yet at a level to contribute significantly to cost recovery.
- Subnational governments want to shake off central control, and be masters in their own house, and see appeal in the apparent autonomy that "transfer independence" provides.
- Tax assignments typically under-fund local sector: low-yielding revenue sources are assigned or those which will bear fruit only in the very long term (property tax).
- There is a general absence of concrete empirical estimates of 'correspondence' of tax and expenditure assignments and need for transfers and legislation on intergovernmental finances relations is typically developed with no quantitative assessment of its implications.
- General absence of "formula"- based transfers; they remain negotiated in aggregate volume and by individual localities.
- General absence of transparency in allocation of investment grants/capital financing.

Box .... (continued)

### Privatization and Ownership

- Major continued role of subnational governments in ownership ventures at a time when center/national priorities support privatization. This relates to the inadequate revenue base given to localities and their continued financial dependence on enterprises and transfers for revenue sources.
- Potentially significant negative consequences for the budget of privatization (in some countries) as enterprise social expenditures go "on budget," and newly privatized enterprises become harder to tax. Subnational governments may not want to let go of this reliable financing source.
- How to use the transitory revenues from privatization (debt repayment, investment finance, current expenditures). How to take advantage of the asset stock held by local governments.

### Borrowing

- In most transition and socialist economies, there is generous legal access of subnational governments to unlimited borrowing, sometimes even foreign borrowing.

### Extrabudgetary Funds

- Extrabudgetary funds continue to play a major role, complicating budgetary transparency and macro-stabilization.

### Institutional Framework

- In many transition economies, the institutional arrangements needed for dialogue on intergovernmental issues is missing, even though the need for such dialogue is, as noted above, greater than in market economies.

### Tax Administration

- "Inverted" administrative systems in many countries where the local administration offices may have greater loyalties to local government than to central administrative systems.

## II. DECENTRALIZATION IN PROCESS: TRENDS AND THEMES

### A Time of Transformation

30. Perhaps the most important thing to remember about the process of political and fiscal decentralization now engaging the countries under review is how very recent it is. Apart from China, which took the first tentative steps in this direction in 1979, the subnational systems now emerging in the transitional economies are of very recent origin, as indicated by the dates of some of the relevant basic laws:

Poland -	Local Self-Government Act, 1990
Hungary -	Local Self-Government Act, 1990
Romania -	Local Government Act, 1991
Bulgaria -	Local Self-Government and Local Administration Act, 1991
Russian Federation -	Law on the Budgetary Rights of Local Self-Government, 1991.

In most cases, additional important legislation came even later - e.g. to set out subnational revenue sources (such as Poland's 1991 Act on Taxes and Local Fees) - and in many countries is still to come (e.g. with respect to the precise ownership and control of some important local assets). Key elements of the legal framework needed for efficient local government are still missing in most countries.

31. Moreover, once the basic structure of local government was established, local elections still had to be held, new local governments established, and a myriad of important administrative details determined. In Romania, for example, the first local elections were not held until February 1992 and the new mayors did not take office until April 1992. In the Russian Federation, the first local elections were held in November 1990, and in Hungary in April 1991. Even after a year or two's experience, as in Hungary, Bulgaria and the Czech Republic, some mayors and other local officials, particularly in the smaller communities, still have little idea of what their real powers, responsibilities, and limitations are<sup>4</sup>. Nor are matters much better at the central government level where, in most countries, no one really seems to be in charge of decentralization, with the result that some key issues appear to have been decided (or left undecided) more by accident than design, particularly issues concerning the interaction of the new local governments with such other elements of the transitional reforms as privatization, tax reform, financial reform, price reform, subsidy reform, and budgetary reform. This neglect is now causing trouble in a number of countries not just for the local government sector but also, to varying degrees, for the success of all these ambitious reform plans.

### The End of Central Planning: Filling The Abhorred Vacuum

32. Unless more systematic attention is paid to these problems in the near future, matters are likely to get worse rather than better. Up to now, many of the potential difficulties have been kept in check largely by the continuance, de facto if not always de jure, of the pre-reform system, under which subnational governments received most of their funds from central government budgetary transfers which were basically allocated on the basis of negotiation and bargaining. In this process, the central government always has the upper hand, controlling as it does not only the total amount of such transfers, but also who gets them, and when. When combined with the continued central control in most countries of such critical determinants of local outlays as wage structures, enterprise prices, and so

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<sup>4</sup>In Bulgaria for example, laws passed early in the reform process only specified that local governments are responsible for "local matters". This vagueness in the law allowed local authorities to claim all or no responsibility on convenience. This deficiency is now being corrected, and Bulgaria is now in the process of preparing a series of new Acts covering territorial division, local self-government and administration, and finance to replace the 1991 Act.

on, and the ingrained habit of local dependence on central guidance, the persistence of this system has played an important role in preventing local expenditures from exacerbating the generally tenuous fiscal situation of the central government.

33. But this situation is unstable and will not long persist in the absence of strong central political control.<sup>2</sup> Already, many countries are finding that the combination of the manifestly strong desire for local political control and the unbalanced mandate - virtually unfettered "local autonomy", but a totally inadequate fiscal base - legally bestowed on the new local governments is causing trouble. In the Czech Republic, for example, central authorities are properly concerned about the national implications of both local government business activities and local borrowing as well as the fragmentation of the national education system. In Hungary, where local governments can spend their budgets, most of which come from national transfers, any way they want, similar problems are emerging. And in Russia, which is with the CSFR the only formally "federal" transitional country, separatist tendencies fueled in part by fiscal pressures and imbalances are raising fundamental political problems.

34. The CSFR, of course, has already decided to split into two separate republics, effective in 1993. Even more dramatic, although of course largely motivated by forces stronger than those discussed here, is the case of former Yugoslavia. These two are by no means the only countries in central or eastern Europe to be ethnically heterogeneous. It may well be that in the end the only way such countries will be able to hold together in a democratic fashion will be by reconstituting themselves as very "loose" federations - like Switzerland or Canada, in which the subnational units (cantons or provinces, respectively) are also "sovereign" states in some important respects. In these circumstances, central-subnational negotiations become as much or more exercises in diplomacy as in the design and implementation of efficient and equitable governmental structures.<sup>3</sup> In contrast, the discussion in the present paper assumes, as does the legal framework in every country considered here except Russia (and the soon-to-vanish CSFR), that the transition countries are organized essentially as unitary states, and that the essential role of local governments is to ensure the efficient provision of local public services and to act, where it is efficient to do so, as agents of the central government.

35. At present, in most of the countries under review, those local officials who are not simply waiting more or less passively, either for orders to come down from above as they have for decades or, more hopefully, for their future to be unveiled for them, have understandably been using their energies primarily to attempt to wheedle more money out of the central government. In Romania, for example, where the entire 1992 transfer budget was spent by the middle of the year - largely on centrally-mandated subsidies to enterprises - it is not surprising that Bucharest city officials were to be found two or three times a week at the Ministry of Finance trying to secure more funds. Other local officials, fortunate enough to possess clear title to significant assets, have been selling them off and using the proceeds for current expenditures (as in some towns in the Czech Republic) or trying to use their assets as equity in joint ventures with foreign investors (as in other towns in both Hungary and Romania).

36. On the whole, however, there is as yet little evidence at the local level of wide deviations from desired national standards in the provision of essential services, other than that resulting from the general fiscal penury afflicting all these countries. Similarly, perhaps partly reflecting the relatively undeveloped financial sector, there is also no evidence of either significant budgetary deficits at the local level or of excessive (or often, any) local borrowing. As it gets harder to squeeze money out of the center, however, and as it gets more difficult to get easy finance from selling off assets, subnational governments in the transition economies are going to find it increasingly tempting to move in both these directions.

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<sup>2</sup>China, where such control largely remains in place, is of course an exception to this generalization, although even there many of the problems discussed in this paper are manifest.

<sup>3</sup>For analysis relevant to such federal states, see Shah, "Perspectives on the Design of Intergovernmental Fiscal Relations," Working Paper No. 726, 1991, and Bird, Federal Finance in Comparative Perspective (Toronto, 1986).

37. With respect to education, for example, the financial incentives in the present Hungarian system may in the future, unless changes are made, lead to larger towns with secondary schools being unwilling to accept students from smaller towns without such schools. The completely unconditional nature of intergovernmental fiscal transfers in Hungary makes it very difficult to penalize such actions. Similarly, national education standards have vanished in the Czech Republic but have not as yet been replaced by either guidelines or rules: totalitarian education was undoubtedly an evil, but it is not obvious that anarchy is better. For the first time in decades there is clearly a possibility that wide variations in the quality of education will emerge depending on the fiscal resources available to the municipality in which a student lives. Similarly wide variations may equally arise in health, in social welfare expenditure, and in other areas of local government activity as the power of the center to command vanishes. This outcome is unlikely to be considered desirable by most citizens.

38. It is one thing for local expenditure choices to reflect the wishes of local officials who have been democratically elected and who are spending funds secured from the citizens who elected them. But it is quite another when services with substantial jurisdictional spillovers are underprovided in poor areas owing solely to lack of fiscal resources, or when transfer monies provided by taxpayers as a whole for specific national purposes are misspent by local officials responsive only to their own local electors. Yet both of these outcomes are all too probable over time, given the virtually unrestricted "local autonomy" conferred by some of the new local government laws (e.g. in Hungary). For much the same reason, the almost unrestrained borrowing authority bestowed on new and untried local authorities by some of these laws carries with it the potential of eventual fiscal disaster.

39. As yet, the subnational system is too new in most countries for most of the bad things that might happen to have occurred. But there are enough signs to be worrying, and it is critical to use this time of transformation and reform to continue to develop the local government structure in a more positive direction in a number of important respects. It is, for example, important to clarify exactly what is, and is not, meant by local autonomy and to flesh out more clearly the role envisaged for local governments. It is also important to develop adequate institutions at the central level to support the many new, and often small, local governments that have been created. Moreover, the role and nature of institutions intermediate between the central government and the local governments has also turned out to be both a critical issue in many countries, and an important differentiating factor from country to country. These questions are discussed further in the balance of this section.

### Political Decentralization

40. The reform of local and intergovernmental finance is taking place in the context of political decentralization and in particular a strong commitment to decentralization of certain responsibilities and revenue to self-governing local administrations<sup>2/</sup>. In reaction to decades of over-centralized public administration (and related party control), most Eastern and Central European countries are engaging in a process of extensive decentralization, gradually reducing the role of government in general and the powers of central government institutions, and especially their planning and control apparatus, in particular.

41. In line with this tendency, autonomy and control over "local matters", and accountability for them, is being increasingly devolved to the newly-elected local governments. The central government wants "each tub to sit on its own bottom", to assign taxes and be done with it, and to reduce "transfer dependance". Local governments want to shake off central control and be masters in their own house, and see appeal in the apparent autonomy that "transfer independence" provides. For these and other reasons, the principle of "local autonomy" is now enshrined

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<sup>2/</sup>In Bulgaria however, the pace of the former exceeds (and precedes) the latter. There is a risk at present of increasing fragmentation in the number of self-governing units in Bulgaria because of the perception of local governments that "self-governing status" will lead to greater budgetary transfers from the center. In order to counteract this trend, it is important that aspirations for local autonomy be tempered by specifying a threshold for self-financing/own source revenue mobilization.



in the legislation of most transitional countries. As a rule, this legislation affirms decentralization, local financial autonomy and the administrative "independence" of the subnational level from central control. The language differs, but the general intent is clearly to free subnational governments from the "dead hand" of centralized control and to let local democracy flourish.

42. These political reforms are paralleled by decentralization of fiscal responsibilities. Some form of subnational government structure had existed in most of the transition economies under the socialist regime. However, the fiscal system of this regime was essentially "unitary," with the sub-national level being little more than an administrative unit or "department" of the center, with no independent fiscal or legislative responsibility. Kornai (1992, op cit) sets out the former socialist system in considerable detail. It is revealing that this lengthy study hardly refers to the existence of subnational state administrations, noting only that they are tightly controlled in all respects by the central bureaucracy. In effect, local governments were basically "deconcentrated" units (or branch offices) of the central government and had little or no financial autonomy. This was true even of those countries such as the USSR, and Czechoslovakia which were formally called "federations". It was also true in the Russian Federation, despite the fact that Russia's 31 autonomous republics and national regions were said to be "autonomous" and to have independent budgetary rights. Policy-making was hence very controlled and centralized, and local government had virtually no independent tax or expenditure powers – part of a larger picture in which the budget itself was seen only as the handmaiden of the Plan.

43. Reorganizing Government. Now, however, virtually every transitional country is to varying degrees decentralizing, deconcentrating, and delegating functions and responsibilities.<sup>27</sup> Decentralization has many merits, both in political and economic terms. It has, for example, the potential of improving the efficiency of local government by subjecting its actions to the scrutiny of the local electorate. Autonomy over local decision-making and expenditures also frees local governments from the heavy hand of central control. As yet, however, these benefits have not been attained for two quite distinct reasons: the persistence of the old ways and certain flaws in the new dispensation.

44. In Romania, for example, there are at least three important reasons why local autonomy has little meaning in reality as yet. First, although the Public Finance Law clearly says that every local government is supposed to have budgetary autonomy, it also gives power to the central government to change local budgetary allocations.<sup>28</sup> Moreover, as noted above, the habit of deference to central commands, even if no longer legally binding (or enforceable) still persists in many areas. Secondly, at the present time local governments in Romania actually deliver very few services themselves. Instead, their basic role is to contract with regies autonomies (local public enterprises) for the delivery of most local public services. These regies, like all enterprises in pre-reform Romania, were of course just another part of the public sector under the previous regime. Under a 1990 Law on the Restructuring of State-owned Economic Units, these enterprises are now financially independent. Although they are legally responsible to a board comprised of members of the relevant local government, they appear to be acting both more independently and at the same time more in response to the many central controls and regulations to

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<sup>27</sup>Deconcentration refers to dispersion of responsibilities within the central government structure from the center to regional "branch offices", and differs from "delegation" in which local government may execute certain functions on behalf of the central government (and be accountable to it for their performance), and "decentralization", in which full decision making and implementation authority is transferred to local government, which is accountable only to its own constituents.

<sup>28</sup>Art. 51 of the Public Finance Law states that "the distribution of the revenues and expenditures or categories of local budgets ... is established by the decision bodies of each county [district] and of the city Bucharest." But Art. 22 of the same law states explicitly that the central government has decisive power in the formation of local budgets. Each year, local budgets are submitted to the Ministry of finance no later than July 1. The Ministry of Finance examines the draft budgets and has ten days in which to "ask for the necessary modifications" in order to establish budget balance. Most importantly, "in case of divergence the [central] Government is to decide".

which they are still subject than at the behest of local governments. Finally, as in most of the transitional economies, Romania has created a large number of small, poor local governments with almost no resources of their own. "Autonomy" does not mean the same thing to a small, poor rural commune as it does to a large, rich city.

45. Local institutions are more developed in countries such as Hungary, but these three problems - conflicting legal interpretations, tangled relations with enterprises, and considerable diversity in the capability of local governments - exist almost everywhere, and cast some doubt on the real significance of "local autonomy." Moreover, even where such implementation problems do not exist, the fundamental problem with the way local autonomy is being approached in the transition economies is that such autonomy is not meaningful if it is not accompanied by capacity, and it is not desirable unless it is accompanied by responsibility.

46. To make local autonomy meaningful, local governments need adequate locally-controlled revenues. Not only must decisions about the provision of government services with local benefits be made by local governments, but such governments must have the resources to carry out such decisions. As developed further below, local expenditure discretion is still limited in important ways: some such limitations may be good; others clearly are not. Moreover, the fundamental inadequacy in most countries of the local revenue base (see later discussion), and the resulting continued dependence of local finance on ad hoc transfers means that revenue capacity is also inadequate. Greater expenditure discretion in those expenditures fully assigned to the subnational level and greater flexibility for sub-national governments to raise their own revenues seem needed in most countries. Such revenue flexibility and autonomy is a crucial step to making local government more accountable to local residents, and to improving the efficiency with which local public services are delivered.

47. One meaning of local autonomy is thus that local governments should be able to raise and spend revenues from their own revenue sources in any way they wish - subject to certain limitations on the revenue bases to which they have access (see below). Since local governments are responsible to local taxpayers for what they do with the funds they raise, in principle it is neither necessary nor desirable for the central government to tell local governments what they can do with their own money. If those who pay for local services financed from local revenues, the local taxpayers (and voters), are unhappy with what their locally-elected authorities do with their money, they may dismiss them.

48. On the other hand, if the central government is unhappy with what some local government does with the money raised from local taxpayers, its unhappiness may be unfortunate from some perspectives, but it is unavoidable. What local autonomy means is precisely that there is nothing that the central government can or should do to alleviate any such distress it may feel - barring extreme cases such as corruption or when other national laws are breached.

49. Local autonomy emphatically does not mean, however, that local authorities should be able to do whatever they want with other people's money - that is, with taxes paid by other than local residents. True local democracy - presumably the ultimate reason why "local autonomy" is considered desirable - means "responsible" democracy, which in turn requires full and explicit political accountability to the source of local government resources for what is done with those resources. Local autonomy in this sense is thus not only consistent with, but also requires, that two important conditions be satisfied:

1. The access of local authorities to taxes that may be "exported" to non-residents should be severely restricted.
2. Subnational governments should as a rule be accountable to central government (that is, to taxpayers in general) for the use made of central government transfers.

Acceptance of these conditions, as is necessary if efficient resource use is to be achieved, has strong implications both for the design of the local tax system and for the design of transfer systems, as developed below.

50. The essential economic role of subnational government is to provide to local residents those public services for which they are willing to pay. As already noted, local governments must be accountable to their citizens for the actions they undertake to the extent those citizens finance those actions. Similarly, local governments must be accountable to the central government to the extent they are in effect acting as "agents" and are financed by transfers. Accountability in this sense is the public sector equivalent of the "bottom line" in the private sector.

51. Such accountability clearly requires that subnational governments should, whenever possible, charge for the services they provide, and, where charging is impracticable, they should finance such services from taxes borne by local residents, except to the extent that the central government is, for reasons discussed later, willing to pay for them. Public sector activities are unlikely to be provided efficiently unless the lines of responsibility and accountability are clearly established along these lines.

52. On the one hand, then, local governments need to be given access to adequate resources to do the job with which they are entrusted. On the other, they must be held responsible to those who provide these resources -- local residents or central governments, as the case may be -- for what they do with them.

53. In principle, local governments should therefore not only have access to those revenue sources that they are best equipped to exploit -- such as residential property taxes and user charges for local services -- but they should also be both encouraged and permitted to exploit these sources as fully as possible, subject to certain limitations. Unless local governments are given some degree of freedom with respect to local revenues, including the freedom to make mistakes for which they are accountable to their constituents, the development of responsible and responsive local government in the transition economies is likely to remain an unattainable mirage. On the other hand, if local governments are given carte blanche to spend other people's money, the allocational, distributional, and macroeconomic consequences will almost certainly be undesirable.

54. There are of course dangers in permitting local governments even limited freedom. One danger in the eyes of some is that they will not utilize fully all the revenue sources open to them, thus allowing the level and quality of public services in some areas to deteriorate below the standard considered desirable. But this is not a real problem. If the service in question is really one of national importance (e.g. research) or one in which there is a strong national interest in maintaining standards (e.g. poverty alleviation), it should be nationally funded at least in part and its achievement monitored correspondingly. If it is not a matter of national interest, why should the national government be concerned? If the local electors do not like what their local government does, or does not do, they can "throw the rascals out" at the next election. As noted above, the freedom to make mistakes, and to bear the consequences of one's mistakes, is an important component of local autonomy.

55. Another danger, more salient from an economic perspective, is that local governments may attempt to extract revenues from sources for which they are not accountable, thus obviating the basic efficiency argument for their existence. To counter this inevitable tendency, central governments should in principle deny or limit access to taxes that fall mainly on nonresidents such as most natural resource revenues, pre-retail stage sales taxes and, to some extent, nonresidential real property taxes.

56. Another way to counter this problem to some extent may be to establish a uniform set of tax bases for local governments (perhaps different for different categories such as big cities, small towns, and rural areas - although this may not be politically acceptable in all countries), with a limited amount of rate flexibility being permitted in order to provide room for local effort while restraining unproductive competition and unwarranted exploitation. It is especially important to provide adequate flexibility to exploit good local tax bases to avoid creating a situation in which the only flexibility available to local governments in their struggle to cope with budgetary pressure is by exploiting such economically undesirable sources of revenue as local business taxes or, even worse, local business enterprises. As emphasized later, the business of government is not business, and enterprising municipalities should not be encouraged to develop local enterprises in order to secure the revenue they need to function.

### The Size and Scope of Government: How Many Levels?

57. In the pre-reform period, virtually all the countries under review had a multi-tier organization, with the central level implementing its control over the local level through an intermediate tier of government. The central government was responsible for the overall plan and budget, and the intermediate level, variously called "Oblast" (in the Russian Federation); "Judet" (Romania); County Council (Hungary), and "Voivod" in Poland, was the administrative, control and surveillance agency through which the center effected control and implemented policy.<sup>19</sup> This middle tier oversaw the expenditures of local governments and was the channel for central fiscal flows to the localities. Substantively, however, none of the countries discussed here was organized, from a fiscal perspective, as a federation. Although the Russian Federation gave nominal autonomy to its 31 "autonomous" (or national) regions, okrugs and republics, these sub-national governments too were neither fiscally independent nor able to determine their own expenditure and tax policies. At the other extreme in some respects is China, a unitary country with a very decentralized administration.

58. At present, only Russia and Czechoslovakia have a three tier federal system of government, comprising the federal government, republics, and regions - and the Czech and Slovak Federal Republic, as it is formally called, is scheduled to separate shortly into its two component parts. All the other countries discussed here have a unitary system of government. A first look at the legal structure suggests that Poland, Hungary, and Romania have a two-tier level of government (central and local), Russia, China and Bulgaria a three-tier structure (central, provinces/county/regional and local), and Vietnam a four-tier level of government (central, provincial, municipal/district and commune/neighborhood) as shown in Table 1. In fact, however, matters are not so simple anywhere. Romania, for instance, has two tiers of local government (the old judets and municipalities): all of the area of a judet is divided into municipalities, but in principle each type of local government is independent of the other. In Hungary, on the other hand, while the old counties still exist, they really have no functions, so that there are in effect only two levels of government, central and local. On the other hand, in Budapest (as in the cities of the Czech Republic) there are "subcity" (district, or ward) councils and governments with elected councils and their own budgets and assets, so that the "local" level of government itself has two tiers - as indeed it does in the largely unreformed structure of Vietnam. In Bulgaria, the municipalities are the basic unit of self-government, but they have contiguous borders and therefore both urban and rural. The municipality itself has an elected Council and Mayor, but urban settlements within the municipality also have an elected Mayor (no Council) with delegated executive powers from the municipality (ie. county). This lower level is therefore a deconcentrated level of local government.

59. As a rule the "middle tier" of government continues to exist in vestigial form in most transitional countries, but it is struggling both for a role and for legitimacy. Most countries seem to want to shed this intermediate tier, associated with the former control economy, as if to put their past behind them. In some countries the role of the intermediate tier is now limited largely to overseeing the constitutionality and legality of local government operations. In others, its role has become one of coordinating central government policy at the regional level. In most, however, there are few questions more in flux than the present and future role, if any, of intermediate levels of government.

60. In Hungary, for example, there are now 8 regions, 19 counties, and 3070 localities. The regions, headed by a central official called the Commissioner of the Republic, have two functions: (1) information and dissemination, which involves collecting data on local government activities and providing information to local governments to facilitate the implementation of national policies; and (2) to ensure that local government actions (e.g. on taxes) are constitutional. The functions of the 19 counties, formerly the main territorial control instrument of the state, have also been severely restricted: counties retain some minor fee revenues and are supposed to be

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<sup>19</sup> These are, strictly speaking, decentralized branches of the central government administration, not an independent tier. There are 88 oblasts in Russia; 9 oblasts in Bulgaria; 19 County Councils in Hungary; 49 Voivodships in Poland; and 41 Judets in Romania.

responsible for functions of an interjurisdictional nature that serve several localities. In contrast, the local governments (almost twice the number of the former 1563 local councils) have considerable expenditure responsibilities, the right to spend national transfers and shared taxes as they see fit, and almost unlimited power to borrow, own and dispose of property, and to manage, establish, or sell public enterprises.

Table 1  
Trends in Decentralization: Government Organization

Country	Unitary/Federal	# of Tiers (pre-reform)	Emerging Structure	# of Tiers (present)
Hungary	Unitary	3: central/county/ local	Unitary	2: central/local
Poland	Unitary	2: central/local	Unitary	2: voivodships/ gminas
Romania	Unitary	3: central/regional// local	Unitary	2: central/local
Bulgaria	Unitary	3: central/regional/ local	Unitary	3: central/oblasts (regions) obshtina (municipalities)
CSFR	Federal	3: central/state/ local	2 countries	2: republics/local
Russia	Federal	4: central/oblast/ rayons/village soviet	Federal	3: federal/oblast/ rayons
China	Unitary	3: central/province/ local	Unitary	3: central/ province/ local
Vietnam	Unitary	3: central/province/ local	Unitary	4: central/ province/ municipal/ commune.

61. The situation in Romania is quite different. Although the 41 judets continue to exist, there are now two completely different administrative structures in each judet. The first, headed by an appointed prefect, is essentially the deconcentrated territorial administration of the state. The second, headed by the elected president of the judet council, is the local government at the judet level of local government, which is responsible for "works of regional interest" but which has no hierarchial authority over the 2,948 other local governments<sup>11/</sup>.

<sup>11/</sup>The situation where a local government jurisdiction coincides territorially with a deconcentrated echelon of the central government administration can be found in other countries. The Romanians have basically borrowed the French local administration system as it emerged from the 1982 decentralization reform, at least as far as the roles of the departments (judetse) and the communes (comune si orase) are concerned. (They did not copy the truly new feature which that reform brought about, namely the creation of the region as an additional intermediate layer of

62. In Poland, the 49 vovoidships are essentially deconcentrated public service intermediaries for certain central expenditures (mostly in health and social welfare), although other central expenditures are carried out locally by line ministries. All local government functions are carried out directly by the 2383 gmina governments. Present plans, however, are for a new intermediate tier of local government (probably about 300 units called "powiats") to be put in place in 1993. Similarly, in the Czech Republic, where there are at present over 5000 local governments, there are also 7 regions and 75 districts essentially left over from the previous regime, and plans are being considered for creating anything from 3 to 20 to 75 "second-tier" local governments.

63. Finally, in the Russian Federation, a slightly different pattern is emerging, with the oblast level taking on a larger role and emerging as an important unit in its own right. Indeed, if the fiscal reforms at the subnational level proposed in recent legislation are implemented, the Russian Federation will have decentralized expenditure responsibilities and to a lesser degree, revenues, to the oblast level and will take on the character of a true federal state.

#### Size of Government Units: Efficiency and Other Concerns.

64. Although the initial reaction against the previous "intermediate" governments as undesirable reminders of the old regime is understandable, so is the obvious concern in many countries to put something more acceptable in their place. As shown in Table 2, most of the east European countries have created a large number of small, and probably not viable, local government units. In Hungary, for example, the average population of local governments (excluding Budapest) is only less than 3,000. In Romania, half the population lives in local government units with a population of less than 4,000, such units account for 90% of all local governments, and the average population of all local governments is only 7,500. Poland's local governments are similarly fragmented, with an average population of only about 16,000. The Czech Republic, a compact country with a little more than 10 million people, has over 5000 local governments. In Bulgaria there are 3,984 elected local government units (settlements) with the average population of 1500. At the more aggregate level, there are 273 municipalities with the average size of around 30,000.

65. Such extensive fragmentation may be good for getting government close to the people, but it also substantially complicates intergovernmental relations - it is, for example, impossible for the central government to maintain direct bilateral relations with so many units -, reduces the political voice of local government as a whole, and in many cases yields localities that are simply too small to provide efficiently all the public services demanded from them. At the very least, even if it is decided not to create a formal intermediate tier of government, some mechanism for coordination and consultation is likely to prove necessary. Possible models abound in the world, e.g. the "municipal federations" that exist in many of the Nordic countries, under which localities organize on a voluntary basis to provide certain local services, or the Nordic "secondary communes", county-like bodies with their own elected officials responsible for providing services of an interjurisdictional nature.

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local (regional) government). Similar situations exist in other countries, for instance, in Germany (Bavaria) where the landkreise are both local governments (Gebietskörperschaften) and the lowest echelon of the State administration.

Table 2  
Decentralization: Scale and Size of Government

Country	# of units of local government	Average Size
Hungary	3070 municipalities	2,834
Poland	2383 gminas	16,000
Romania	2940 urban and rural municipalities 41 judetse	7,500 537,804
Bulgaria	273 municipalities	30,000
CSFR	2843 cities in the Slovak Republic 5500 cities in the Czech Republic	1,867*
Russia	2000 rayons 88 oblasts	125,000 2,840,909
China	30 provinces	33 million
Vietnam	44 provinces	1.47 million

Note:\* For the CSFR as a whole.

Supporting Subnational Government: The Institutional Setting for Subnational Governmental Reform

66. The lack of an appropriate central government structure to monitor and support the new local governments is a common problem in central and eastern Europe. In Poland, Hungary, and Vietnam for example, there exists no institution or designated person "in charge" of the decentralization of the localities and the Ministry of Finance still plays a lead role in the budgetary function and other fiscal issues at the local level. In Russia the formation and implementation of fiscal policy is done by the central government and three Parliamentary commissions. The budget is submitted to the Parliament for approval, the collection of revenue is done by the State Tax Service, and expenditure authorization is under the control of the MOF. In Bulgaria, the Ministry of Regional Development, Housing Policy and Construction is responsible for formulating the policy on territorial division and local administrative functions and guiding the reform program while the Ministry of Finance retains primary control over the linked issues of local government finance and budgeting. In Romania the formulation of decentralization policy and implementation of local government reform is the responsibility of the Department of Local Government Affairs of the Office of the Prime Minister and the Department of Tax Administration and Local Budget Management of the Ministry of Finance and Economy. Similarly, in the Czech Republic, both the Ministry of Finance and the Ministry of Economic Policy and Development are involved in shaping the intergovernmental finance system.

67. Despite (or perhaps because of) the involvement of a number of central government institutions in a number of countries, quite a lot that should be done seems to be going undone. Among the tasks for which responsibility must be clearly established are monitoring and assessing subnational finances both in total and individually. This task might be located in the Ministry of Finance, in a special local government department, or it might even be given semi-independent status with some local government involvement (like the US Advisory Commission on Intergovernmental Relations or the similar body in Australia). There are pros and cons of each possible location that need to be considered carefully. But what is beyond dispute is the need to ensure that the central authorities have a better understanding of both the existing situation and the likely effects of any proposed changes than is true at present.

68. In addition, regular and detailed financial data should be maintained on subnational governments. Ideally, this requires:

- (1) the establishment of uniform financial reporting (and budgeting) systems - perhaps with different degrees of complexity for different categories of local governments; and
- (2) the designation of an agency responsible for collecting and processing these data in a timely fashion (which will probably, in a large and complex country, require use of some sampling techniques as well as occasional census exercises to provide the needed "frame").

The first of these requirements in turn requires the development of such systems and, much more difficult, their implementation, which will generally require substantial training and follow-up efforts. Developing such "infrastructure" is neither quick nor cheap, but it is essential if substantial and important public sector activities are to be decentralized - for whatever reason - without losing sight of what is going on in these important parts of the public sector. Implementation of this recommendation may require additional central government-supported institutions (1) to develop and maintain the reporting systems, (2) to train and support local government officials, (3) to develop independent auditing procedures for local administrations and their revenue-earning enterprises, and (4) to run the statistical side of the operation - with the latter being a main input into the work of the institution referred to in the first recommendation above.

69. Additional training efforts are clearly needed to upgrade the technical capacity of subnational governments to carry out efficiently and effectively the expenditure functions for which they are now responsible and others with which they may be entrusted in the future, whether in exercise of "local autonomy" or as delegated agencies of the central government. In some instances (e.g. education) the necessary support should probably come from the relevant central ministry, while in other instances (e.g. road and waterworks) it may come from the ministry, regional agencies, universities, private sources, or some mixture of the preceding. In view of the heterogeneous nature of both the services that are (or may be) decentralized and of most countries, it is unlikely the same solution will be appropriate in all cases, but it is clearly a high-priority item to work out in detail exactly who is going to support the new local role in each functional area and how that support is going to be delivered. Each functional area - including the budgeting and financial reporting discussed earlier - has different needs, problems, and possibilities, and will likely have to be treated differently.

70. Finally, an especially high-priority task for the needed central unit monitoring local finance is to analyze and evaluate intergovernmental fiscal transfers. As indicated later in this paper, there are many questions that must be raised about the objectives, the design, and the effects of such transfers. There is also much to be said for encouraging much more informed and open discussion of these matters than is common in many countries, especially when the whole process is as novel as it is in the transitional economies. Regular publication of data will of course help, but one cannot rely solely on an interested party - the central government - to carry out, and certainly not to publish, all the analysis that is really needed in any country in which intergovernmental financial issues are important, whether in political or economic terms, or both. For this reason and others, there is much to be said for establishing as soon as possible in most countries one or more small non-governmental research institutes focusing on local government problems.

#### The Changing Role of Government: From Ownership to Service - Provision

71. Decentralization and intergovernmental fiscal reforms are taking place in the context of a major change in the role of government in the transitional economies. In the past, governments at both the national and subnational levels have been involved in almost every aspect of economic activity. The state owned all enterprises, from the steel plant on the "commanding heights" of the economy to the local laundry. The state organized production, allocated labor, planned exports, and so on. The first stage of decentralization in some countries began in the 1970's, when the ownership of some smaller industrial units and the retail sector were transferred to subnational



governments. By the late 1980's, local governments in countries such as China owned a substantial part of the economy – light industry, and some manufacturing.

72. More recent reforms aim to decentralize ownership to the private sector. The transition is still far from complete. Although all the east European countries are committed to privatizing state assets, to liberalizing prices, and to withdrawing from the role of the state as direct producer and provider of economic goods, many productive assets - industrial assets, agricultural and urban land, the housing stock, commercial property - remain in government hands, sometimes local, sometimes national.

73. While everything is in flux in most countries, as a rule at the local level the status quo contrasts starkly with the role local governments generally play in market economies. In the latter, local governments provide basic urban infrastructure and local public services (sometimes through local public enterprises) and often act as local administrators of national policies in such areas as education, health, and social services. In the former socialist pattern, on the other hand, enterprises owned by local governments had their investments financed from local budgets, and local budgets in turn derived revenues from "their" enterprises. Government-enterprise relationships were close, and the distinction between enterprise functions and government functions often murky. Localities often asked enterprises to construct and finance such facilities as roads and schools, clinics and even sports stadia and clubs; 'donations' to the budget for one-off outlays were also common. It made little difference whether such outlays were directly undertaken by the enterprise or via the more circuitous route of profit transfer, and funding via the government budget: the burden on the enterprise and the net budgetary position was the same. All this has now changed, or is in the process of change.

74. Until recently, for example, most local government revenue from enterprises came from "profit: remittances". As a result of reforms to the national tax system, and especially of the enterprise tax system, however, these remittances have largely been replaced by taxes on "their" enterprises<sup>12/</sup>. Some countries still provide explicitly for such "ownership" rights to enterprise taxes: in Romania, for example, local governments (judets and municipalities) have the right to both profits and dividends taxes levied (by the central government) on their public enterprises. In Poland, prior to the recent tax reform, both profits and dividend taxes similarly went to the "founding" subnational government, and in addition these governments (vovoidships and gminas) got specified shares of the similar taxes levied on state enterprises which had significant activities in their territories. This process was so complicated that the Polish tax administration spent almost as much time allocating enterprise taxes among jurisdictions as it did collecting them.

75. Even where more modern systems of tax administration have been adopted, as in Hungary, there is still a strong tendency for local governments to feel they have a primary claim on the tax revenues generated within their jurisdiction. This "source entitlement" approach to the allocation of fiscal revenues is of course familiar in such contexts as international taxation and the taxation of natural resources. But it is seldom so visible at the local level as it is in some of the transition economies, in part because of the obvious gross inequities that would result from allowing local governments to keep large shares of the revenues levied on firms producing for a national or world market. Of course, exactly the same problem arises, or will arise, in the transition economies, as noted below.

76. Ownership versus Service Provision. The fundamental change in the role of subnational governments represents a major challenge which has as yet not been fully realized in most countries in transition. The key role of local governments is no longer as owners but as service providers and regulators. The wrenching reforms most countries are undertaking in order to achieve macroeconomic stabilization and to compress the state budget may easily produce perverse effects at the local level. As noted below, some central governments, for example, have shifted additional expenditure responsibilities downwards in the hopes of improving their budgetary position. Revenue assignments and/or transfers to local governments are generally tightly budgeted for the same reason. The

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<sup>12/</sup> See Tanzi, Fiscal Reforms in Socialist Economies in Transition, IMF, 1991, for a full discussion of the national tax reforms that are in process in most countries.

result is inevitably that local governments are sorely tempted to rely on enterprises for continued budgetary outlays, and consequently to protect locally-owned enterprises to ensure their profitability. Unless a workable framework for intergovernmental finance is put in place, budgetary stringency is thus likely to create additional hurdles to disassociating local governments from their enterprises.

77. The regulatory tasks facing both local and central governments are also very different from the past. "Administrative interventions", such as the detailed regulation of prices, the administration of waiting lists for housing, and the allocation of land and material supplies are no longer appropriate. Instead, what is now needed is to develop and implement an entirely new regulatory structure to provide the conditions within which the market can do its job e.g. regulation to avoid monopoly, prevent food adulteration, curtail financial fraud, and so on. In this vein, one essential task of the national government will be to set up an adequate and clear legal framework not only for the private sector but also for the decentralized local public sector. Local governments face their own unfamiliar regulatory tasks, particularly with respect to land use, environmental problems, and retail trade.

78. Not only is the role of government changing, but its size is changing. Intergovernmental fiscal reforms are taking place in the context of an overall shrinking role of government, with all the stresses that a smaller pie imposes on decision-makers. As shown in Table 3, the size of government was much larger in the transition economies than in market economies. In many cases, reforms have already had a major influence on the overall "size" of the government sector, although much more so than in others. In China, for example, the government budget declined from 40% of GDP in 1979 to less than 20% of GDP in 1989; in Hungary, the similar decline was from almost 70% of GNP to about 60% examples. In Russia, the general budget was over 60% of GDP in the late '80s; the target for 1992 is only 35%.

79. Although the figures are not always clear, on the whole it appears plausible that the shrinking of the national level has been generally paralleled by a shrinking of the subnational level of government: in Hungary, for instance, subnational expenditure fell from 14.3% of GDP in 1988 to only 10.4% in 1991. Predicting future trends is difficult because of the changing nature of the intergovernmental system in most of these countries.

80. On one hand, as already mentioned, central governments continue to shift important expenditure items "downstairs" in an attempt to balance the central budget. It is not clear if the final result of this process will be reduced total expenditures, increased central transfers, or increased local taxes - although some combination of the first and second possibilities seems most likely in most countries. On the other hand, as a rule public enterprises continue to provide a number of basic local public services: they support the construction and maintenance of housing, keep kindergartens and pre-schools, and so on. Larger enterprises may even have their own hospitals, retail outlets, and other non-production facilities. As privatization reforms impinge increasingly on the enterprise sector, pressures to replace some of these activities by local budgetary outlays will undoubtedly be strong.

81. Thus, at the same time that localities may be reducing expenditures by shedding unnecessary and unproductive subsidies (for example, to housing) as part of the economic transition to a market economy, they may have to take on some expenditures previously carried out by enterprises. Whether such enterprise functions will accrue to national or subnational budgets is hard to predict: it is equally difficult to predict the net change, in the short term, in the size of the local government sector. In Russia, as one example, the non-production responsibilities of enterprises are, virtually across the board, likely to be taken on by the subnational sector, thus substantially increasing its expenditure responsibilities. Indeed, such a transfer is de facto already taking place owing to the financial difficulties of many enterprises. Unfortunately, no one has either quantified the dimensions of this problem or envisaged any workable solution for it. In principle, however, the shift in expenditure responsibilities from enterprises to local government should be matched, at least to some extent, by a corresponding change in the revenue base of the local government. Otherwise, the budgetary consequences of privatization are likely to be very negative. But as a rule, that revenue base is already inadequate for the tasks demanded of it, as discussed below.

Table 3  
Reform and the Size of the Government Sector  
(Expenditure as % of GDP)

Country	Total Exp as % of GDP	Sub-national Exp. as % of GDP	Sub-national Exp. as % of total	Total Exp. as % GDP	Sub-national Exp. as % of GDP	Sub-national Exp. as % of Total Exp.
Pre-1989				Post-1989		
Hungary	62.7 <sup>3</sup>	14.3 <sup>4</sup>	25.4 <sup>5</sup>	57.4	10.4	18.1 <sup>5</sup>
Poland	49.7 <sup>6</sup>	14.7	35.3	40.1	4.00 <sup>7</sup>	11.0 <sup>5</sup>
Romania	45.1 <sup>6</sup>	3.6 <sup>4</sup>	11.4 <sup>4</sup>	24.6 <sup>7</sup>	6.07 <sup>2</sup>	10.8 <sup>3</sup>
Bulgaria	55.2 <sup>8</sup>	N.A.	N.A.	43.0	25.0	23.0
CSFR	58.4 <sup>6</sup>	20.5 <sup>9</sup>	34.5	60.1	20.2 <sup>2</sup>	34.3 <sup>2</sup>
Russia*	51.0 <sup>10</sup>	20.7 <sup>13/</sup>	16.0 <sup>13/</sup>	41.0 <sup>11</sup>	17.0	43.0
China*	27.1 <sup>4</sup>	14.3	53.0	22.8	N.A.	N.A.
Vietnam	11.0 <sup>3</sup>	3.4	31.0	12.3 <sup>12</sup>	3.9	33.0

Notes: (See end of paper).

82. In the past, governments in the socialist countries employed fixed prices (including rents, and other urban user fees) and wage controls, as essential elements in their distributional tool kit. Now, however, as part of the reforms currently under way, the transitional economies are required instead to "get the prices right" and to use tax policies and targeted subsidies instead. As a rule, replacing consumer price subsidies by targeted subsidies (with a much smaller budgetary impact) will require the development of new information and tracking systems.<sup>12/</sup> Some observers think that the targeting problem will be relatively easy in the transition economies because of the existence of a large "control" data base in such countries. This hope is probably naive, however, given (1) the flaws in that data base (e.g. in Poland several million people exist "off the books" as far as officialdom is concerned; in Hungary and especially Romania, there are important low-income ethnic groups that are similarly elusive); (2) the dependence of official information on a local control system that is disintegrating rapidly, if it has not already disappeared; and (3) the increasing growth of the euphemistically-labelled "informal sector."

83. Indeed, since the breakdown of central planning, central governments in most countries have surprisingly little information even about the activities of local governments. Only in a few countries (e.g. Hungary, Poland) do local governments now appear to provide detailed financing reports to the center. Reporting of data on extrabudgetary funds and borrowing is also deficient.

84. Public sector pricing is likely to be one of the last areas to be reformed in most countries. While national price reforms have liberalized most private sector prices,<sup>14/</sup> at the subnational level governments are having a much harder time adjusting prices for public services, even for private goods provided by the public sector, such as housing rents (and such ancillary services as water and heating) and transport fares. Adjusting these prices is of

<sup>12/</sup> For useful discussions of some of these problems, see the following papers presented at the recent World Bank Conference on "Public Expenditures and the Poor: Incidence and Targeting": Milanovic, "Distributional Incidence of Cash and In-Kind Transfers in Eastern Europe and Russia;" and Jarvis and Micklewright, "The Targeting of Family Allowance in Hungary."

<sup>14/</sup> There has been much discussion about the "big bang" vs gradual approach to price reform, but even in countries as committed to gradualism as China there has been major price liberalization.

course essential both for efficiency and to enhance local revenues. Doing so, however, implies major changes in the cost of living and in welfare, so that changing such public sector prices will entail major, and undoubtedly very unpopular, distributional shifts if not properly coordinated with other reforms. Such shifts, if too wrenching, or too quick, could upset the fragile democracies that have only just emerged in most countries.

#### Simultaneous National and Intergovernmental Fiscal Reforms.

85. At the same time that fiscal decentralization is going on, national tax systems are also undergoing major changes. Major national tax reforms have been initiated in almost every country in an effort both to make their tax systems more compatible with those of a market economy and to provide a secure source of revenues to finance essential state budgetary outlays in the face of privatization. While there are considerable variations of detail from country to country, as a rule tax reform involves: (i) the replacement of profit remittances to government as owner with corporate income taxation (CIT) to the government as tax collector; (ii) the introduction of a value-added tax (VAT) to replace the classical socialist "turnover tax", which is best described as consisting of thousands of commodity-specific rates, or wedges between administratively-set retail and wholesale prices; (iii) the introduction of personal income taxes (PIT) - wage controls were the "implicit tax" in the pre-reform era; there were also payroll taxes, which are generally retained; (iv) the introduction of property and land taxation in rudimentary form; and (v) the elimination of a number of taxes aimed basically at regulating enterprise behavior (such as the excess wage tax, wage bonus tax, excess profits tax).<sup>12</sup>

86. As these national level taxes are being revamped, the system of local financing is simultaneously being changed, both intentionally and to some extent unintentionally. In Hungary, for example, the VAT and PIT were introduced in 1990, the year the Local Self-Government Act was passed. In Russia, the CIT was introduced in 1991, and the VAT in 1992, the same year that the redesign of the intergovernmental fiscal system was to be implemented. In Romania, preparations are underway for the introduction of the VAT in 1993, and of a global personal income tax in 1994, with initial local government reforms having taken place already in 1991. In the Czech Republic, the VAT is also scheduled to come into effect in 1993, the same year in which a new system of intergovernmental finance is supposed to be put in place. In Bulgaria, the current VAT implementation date is July 1, 1993<sup>16</sup>. In all of these cases, there appears to have been almost no consideration in the basic national tax reform of the fiscal needs of the local governments, even though it is clear that, given the fundamental inadequacy of the revenues specifically assigned to local governments in most countries (see below), these governments are likely to be dependent on some form of "tax sharing" in some form for years to come.

87. As these pressures become manifest, further reforms are assigning to, or sharing with, local governments taxes whose design is new, whose operation is untested, and whose administration is inevitably weak, as discussed later. Moreover, even though the national level reforms are often intended to be "revenue neutral", there is little basis for revenue estimation, and hence little certainty as to expected yields. The potential volatility of taxes shared or assigned to the subnational sector is compounded by these countries' overall economic cyclicity<sup>17</sup>. The difficulty of ensuring correspondence between the expenditure responsibilities of the local governments under the new systems, and their assigned revenue base or share, is self-evident.

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<sup>12</sup>For fuller discussion, see Tanzi, Fiscal Policies in Economies in Transition.

<sup>16</sup>In Bulgaria a comprehensive tax reform under preparation comprises draft profits tax law, VAT, tax administration, territorial division, and excises.

<sup>17</sup>See D. Go, "Revenue Uncertainty in the Transition," CECPE, RPO# 27118, forthcoming, 1992.

### Stabilization: The Macroeconomic Context for Decentralization

88. The economic reform programs in the transitional economies have had to address both stabilization and liberalization concerns. Intergovernmental fiscal reforms are taking place in the context of a weak overall macroeconomic position and often a weak central government fiscal position. The move to private entrepreneurship has contributed to a more vital economy, but has accentuated the problem of a shrinking revenue base at the national level, as many of the smaller new private enterprises elude the grasp of the tax net and present major challenges to compliance and tax administration. The failing state-owned enterprise sector no longer provides the revenue base of earlier days. The tax reforms described above are undoubtedly desirable for market efficiency, but until experience with the new system is gained, revenue shortfalls seem all too likely. The expenditure side of the budget continues to be burdened by heavy outlays for both consumer and producer subsidies, as well as often generous cash benefit programs and new and sometimes large outlays to support failing enterprises and to restructure or recapitalize banks.

89. In Hungary, the consolidated deficit of the general government reached 4.3% of GDP, with inflation of 32%, in 1990, the year the new system of local self-government was introduced. In the Russian Federation the fiscal deficit is variously measured as either 15% or 30% of GDP in 1991<sup>19</sup>, and a likely deficit of over 10% of GDP is expected for 1992; inflation is soaring. In Romania, the measured budget deficit has been rather small, but an inflation rate of 161% in 1991 reflects an unstable macro-economy, and suggests that the fiscal accounts understate the deficit: the central bank carries out heavy quasi-fiscal operations, and the banking system finances expenditures that are fiscal in nature. Only in China, with its gradual economic reform (and continued tight political control), is there rough budgetary balance and comparatively moderate increases in the price level (See Table 4).

90. For these reasons, stabilization and overall macro-economic concerns often dominate the national agenda. Reducing fiscal imbalances – both those at the center, and those potentially emerging at the subnational level, is invariably a fundamental requirement of the adjustment programs to which most transitional countries have agreed.<sup>20</sup> The current situation provides a sharp contrast with public finances in the pre-reform period, when the unitary fiscal system imposed close adherence to the Plan in the implementation and execution of the budget, which, together with strict controls over the finances of enterprises helped ensure broad balance in public sector finances.<sup>21</sup> In particular, under the old regime, the finances of subnational government had few macroeconomic consequences. Revenue sharing served only as an administrative device to simplify a system of central resource allocation. Expenditures were guided by planning norms. The result was that in an accounting sense at least the budgets of the subnational governments were always in balance, with any necessary adjustments being made simply by accounting transfers.

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<sup>19</sup>The difficulty in measuring the Russian deficit relates inter alia to the treatment of the Union expenditure responsibilities taken over by the Russian Federation beginning in November, 1991, following the dissolution of the USSR. The higher number cited refers to a 'notional' deficit, which assumes that Russia had financed Union expenditures for the full year.

<sup>20</sup>As discussed in the present section, there are clearly potential macroeconomic problems that may arise from subnational finance. Nonetheless, it is important to note that subnational governments cannot on their own cause such problems since they cannot "print money" (unless the central government lets them do so e.g. through locally-controlled banks): in the end, it is invariably the validation of subnational deficits by central governments that is the proximate cause of national deficits and the ills that so often ensue. In this, as in many other ways, national governments ultimately get the local governments they deserve.

<sup>21</sup>Of course, one should not exaggerate the robustness of the budget in pre-reform times, since there were clearly many fiscally unsustainable elements from a long-term perspective in most countries.

Table 4  
Macroeconomic Indicators

Country	Deficit as a % of GDP (1990)	Subnational Deficit as a % of GDP	Inflation (1991)*	Current Account Balance as a % of GDP (1990)	M3 growth (1991-2)
Hungary	-4.3	-.4	32.0	+1.0 1/	29.3
Poland	-2.4	N.A.	249.0	+4.8	45.0
Romania	+0.9	+ .3	161.1	-12.4	100.8
Bulgaria	-13.0 4/	-.8	334.0	-2.7	N.A.
CSFR	-2.0 1/	+ .0	54.0	+2.7	26.7
Russia	-20.6	N.A.	382.0	-7.2 3/	75.6 3/
China	-1.8	N.A.	5.3	+3.7	26.7
Vietnam	-4.1	N.A.	36.4 2/	-2.0	19.6

Source: Recent Economic Indicators, IMF.

1. For 1991; 2. Average inflation for 1990. The end of period inflation for 1990 = 67.2%; 3. For 1992.
  4. For Bulgaria a more meaningful measure is the cash deficit (net of foreign interest arrears) which was 8.5%.
- \* Most recent year after price liberalization.

91. Shifting Expenditure Responsibilities "Downstairs". Current stabilization concerns have led the central government to view fiscal decentralization as an opportunity to reduce central expenditures. This is being done in two ways: First, by "spinning off" expenditure responsibilities to the subnational level, thereby reducing its own deficit, and second, as an opportunity to reduce fiscal transfers, purportedly to make local governments more "independent," but with the welcome side effect of reducing central outlays. In particular, a number of countries are transferring increasing responsibility for social expenditures and the social safety net to local government. In Hungary, for example, the responsibility for "welfare" expenditures was transferred to the localities. In Russia, the central government transferred social expenditures equivalent to some 6% of GDP (1992) to the local level by this means, with the objective of "pushing the deficit down", presumably in the hope that the subnational governments would perform the politically painful cutting required - even though the demand for these services is likely to grow with the worsening economic situation. More recently, responsibility for key national, interjurisdictional investments (e.g. in transport) has also been transferred to the subnational sector.

92. Even some of the extensive asset transfers to local governments that have taken place in most countries appear to have been partly motivated by budgetary concerns. Some of the "assets" transferred - notably housing and some enterprises - are really liabilities given the heavy burden of maintenance and operation of these units and the fact that rental income (last adjusted in the Russian Federation in 1928!) does not cover even a small part of these costs.

93. Reducing Intergovernmental Transfers. The fiscal difficulties at the national level have also led some Finance Ministries to focus on reducing intergovernmental transfers as one way out. Transfers have been seen as the "compressible dimension" of the federal budget. The principle of "budgetary independence" mentioned above has been interpreted to mean that subnational governments should be financially self-sufficient, which in turn implies that direct transfers should be reduced and even eliminated. In reality, however, in most of the transition economies central transfers to local government sector are very large, reflecting both the rudimentary tax base available to local governments and the center's reluctance - again to avoid fiscal vulnerability - to part with any of the major tax

bases and to assign them to the subnational level. As a rule, however, the amount and distribution of these transfers is determined each year on a discretionary basis in accordance with central fiscal exigencies.

94. While such budgetary flexibility is clearly desirable from the central government's short run view, it is a mistake to view transfers as a completely "compressible" portion of the national budget, as appears to be the case in countries such as Hungary and Romania. Many of the services provided by subnational governments, particularly in view of the "pass-down" phenomenon already discussed, constitute essential expenditures for political stability or for future economic development. There is no way that the many small local governments that have been created in most countries can finance the provision of these services at an adequate level out of their own resources. Even from a short-run stabilization perspective, an underfunded subnational sector in the current environment is all too likely to result in a situation in which the only way local governments can cope with budgetary pressure is by using economically undesirable sources of revenue such as profits derived from the exploitation of income-earning assets transferred to them and from direct public ownership of local businesses. At the same time, local governments' open-ended expenditure responsibility for "social assistance" is likely to result in emergency recurrence to the central government for additional funds, or simply the unsustainable accrual of arrears through short-term borrowing. Arrears have been a problem in China in the recent past and are currently a major problem in Russia. One way or another, intergovernmental transfers are thus likely to be an important component of the central budget for years to come in most transitional countries.

95. **Deficit Controls.** Placing limits on the subnational deficits is of course an obvious way in which central governments can ensure that the subnational sector does not give rise to additional or unexpected macroeconomic pressures. Such limits are in place in Russia and China, for example. In an overall framework of hard budget constraints, such provisions may make sense, but this is unlikely to be true when budget constraints are still "soft" in other sectors, notably the enterprise sector.

96. The combination of controls and soft constraints may give rise to perverse outcomes.<sup>21/</sup> In response to the apparent surplus in overall local budgets, for example, Russia has, as already mentioned, sought to squeeze the subnational sector by transferring expenditures downwards, re-adjusting tax shares and minimizing transfers.<sup>22/</sup> Since local governments by law cannot run deficits, however, nor for the time being can they borrow even for liquidity reasons, there is almost by definition a "surplus" at least sufficient to meet the "cash on hand" requirements of monthly local outlays. Reduced revenue shares or transfers can never eliminate this surplus: on the contrary, since the system cannot be in deficit, such measures will only lead to measured expenditures far below normal levels and increasing cumulative arrears.

97. **Budgetary "Autonomy".** Although local governments in most transitional countries (Poland, Hungary, Czechoslovakia, Bulgaria and Romania, for example) have their own budgets, quite separate from the state budget, this nominal independence by no means implies the absence of central controls. In Romania, local budgets are subject to the central government's implicit approval<sup>23/</sup>. The central government has the final say, especially if

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<sup>21/</sup>For examples of dysfunctional incentives for economic liberalization as a result of fiscal decentralization policies in earlier Chinese experience, see e.g. Wong, "Fiscal Reform and Local Industrialization," *Modern China*, April 1992, and "Central-Local Relations in an Era of Fiscal Decline," *China Quarterly*, December 1991.

<sup>22/</sup>The budget surplus, measured on the reported "cash basis" for the subnational sector amounted to 1.2% of GDP in the first quarter of 1992. See Wallich et al; "Intergovernmental Finance in the Russian Federation"; forthcoming, 1992

<sup>23/</sup>According to both the Law on Local Administration and the Law on Public Finances the authority that approves local budgets is the municipal council for municipal budgets, and the district (judet) council for the district budget. Budgets have to be balanced by law. The role of the prefect, as representative of the State, is to ascertain, ex-post, that local governments abide by this legal requirement. There is a disguised direct control of local government

the budget is unbalanced. In contrast, in Russia such budgetary approval is implicit in the system of negotiated tax sharing and transfers, whose levels are conditional on an approved level of expenditures. On the other hand, China and Vietnam still have a unified budget, in which central and subnational plans and accounts are jointly presented. In China the local budget must be approved by the provincial government, and the budget of the provincial government must be approved by the center.

98. More generally, even though the local governments have been given autonomy in principle, in practice they lack it in many areas. The lack of transparency or clarity of laws further exacerbates the problem. The real degree of expenditure autonomy of localities is often limited. In China, for example, local governments have little formal or legal independence with respect to either local taxes or the level and composition of expenditures. In almost all the countries under review, central expenditure norms and central spending and wage mandates continue to carry weight in many areas. Indeed, in Romania these factors still weigh so heavily that there is hardly any real local expenditure discretion as yet. In the Czech Republic and Hungary, on the other hand, there appears to be much looser control on the expenditure side. On the other hand, the lack of revenue autonomy is severe everywhere. The center usually stipulates "caps" on local taxes and in some cases even specifies the tax rates and tax base.

99. Tax Administration as a Source of Vulnerability. Fiscal decentralization, and the political decentralization that accompanies it in this new environment has left some central governments macroeconomically vulnerable for another important reason. To ensure macroeconomic stabilization, the federal government must be able to contain its budgetary deficits, which means relying on its own budgetary revenues. In some transition economies, however, tax administration is decentralized, that is, subnational governments collect revenues on behalf of the center, and transfer them upwards (see Table 5).<sup>24</sup> In Russia, in the CSFR, in China, and Vietnam, all revenues other than customs and trade taxes are collected by local administrations. As the experience of the former USSR (and the former Yugoslavia) suggests, delegation of collection responsibility, with its potential for non-compliance, or worse, reliance on contributions from member republics, are only viable means of financing the central government so long as central political control remains strong (as in China and Vietnam). The potential withholding of tax revenues from the federal budget threatens Russia today; even in China non-compliant local administrations, and the revenue contracting system this gave rise to, have been the source of macroeconomically cyclical federal revenues.<sup>25</sup>

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expenditure management because all expenditure involving the use of central government resources requires the ex-ante approval of the Ministry of Finances' local treasury office, and, since fiscal transfers represent up to 90% of local resources, the Government, legal arrangements notwithstanding, continues to actually exert a close to total control.

<sup>24</sup> Strictly speaking, the tax administrations are deconcentrated arms of the federal or central administration. De facto, however, tax officials may have strong ties and loyalties to the local governments which often provide their housing and fringe benefits: there is considerable evidence in some countries (e.g. Russia) that local tax offices respond to local policy.

<sup>25</sup> See Szapary and Blejer, "The Evolving Role of Fiscal Policy in Centrally Planned Economies under Reform: The Case of China," IMF Working Paper 407, 1989; and Bahl and Wallich, "Intergovernmental Finance in China". World Bank Working Paper Series No.863, 1992.



**Table 5**  
**Tax Administration in Transition Socialist Economies**

Country	"Inverted"	Centralized
Hungary		x
Poland		x <sup>1</sup>
Romania		x <sup>2</sup>
Bulgaria		x <sup>2</sup>
CSFR	x	
Russia	x <sup>3</sup>	
China	x	
Vietnam	x	

Notes:

1. In Poland, all national domestic taxes, and some local taxes and fees are collected by treasury offices and then transferred to state and local budgets. Other local taxes and fees are paid directly to Gminas.
2. In Romania and Bulgaria, the local governments do not have their own administration. All local taxes are collected by local branches of the MOF.
3. The State Tax Service is in the process of centralizing.

100. Implications for The Longer Term Intergovernmental System. Although intergovernmental fiscal reform is necessarily taking place in this strained macroeconomic context and hence inevitably reflects changing short-term fiscal needs and pressures, care must be taken to prevent the stabilization objective from fully dominating the redesign of the intergovernmental finances regime. A major challenge facing the transitional economies is to develop an intergovernmental fiscal system which is an optimal combination of rules and discretion - one that will be both flexible enough to be compatible with macroeconomic stabilization and the major structural shifts which are taking place in the economy, and at the same time provide a stable framework for the effective operation of both central and sub-national governments in the longer term.

101. One solution along these lines that has been adopted in some market economies, for example, pivots around a system of intergovernmental transfers in which the total is flexible with changing macroeconomic circumstances - for example, some percentage of total central taxes - while the distribution of this total among different subnational governments is "formula-driven", with the amount received by different localities depending on such factors as potential "fiscal capacity" and assessed "need." This approach represents a compromise, in which the center gives up some degree of control over its revenue but also insulates itself from ad hoc and possibly escalating demands from localities, while localities avoid discretionary cutbacks in local transfers to meet stabilization objectives, with all the expenditure dislocations that this implies. In most of the countries under review, thus regularizing the overall size and distribution of the transfer, like strengthening local finances by broadening the local tax base to improve local tax yields, represent high-priority reforms. This point is developed further below.

### III. WHO DOES WHAT? THE ASSIGNMENT OF EXPENDITURES

#### The Efficiency Case for Decentralized Local Government.

102. While local governments may have some effect on stabilization policy and some role in distributive policy<sup>26/</sup>, their major economic role is clearly with respect to the allocation of resources. From an efficiency point of view, the basic rule of expenditure assignment is to assign each function to the lowest level of government consistent with its efficient performance. So long as there are local variations in tastes and costs, there are clearly efficiency gains from carrying out public sector activities in as decentralized a fashion as possible - and these gains are larger the lower the price elasticity of demand for these services.

103. In principle, therefore, the only services that should be provided centrally - or, in some instances, regionally - are:

- services for which there either are, or are for overarching political reasons presumed to be, no significant differences in demands in different localities (e.g. national defense; public health);
- services with substantial "spillovers" between jurisdictions that cannot be handled in some other way such as by contracting, or by grant design (e.g. interlocal transportation; air and water quality); and
- services for which the additional costs of local administration are sufficiently high to outweigh its advantages (e.g. administration of income taxes).

Apart from the last of these three cases, even these services can often be delivered most efficiently at the local level, although they may well be financed in whole or part by central transfers. In short, in principle, most public services should be delivered at the local level, with local decision-makers deciding what services are provided, to whom, and in what quantity and quality. To put this the other way, the only services that should be provided centrally are those for which there are no differences in demands in different localities, where there are substantial "spillovers" between jurisdictions that cannot be handled in some other way, or those for which the additional costs of local administration are sufficiently higher to outweigh its advantages.

#### Expenditure Assignment in Practice

104. As noted earlier, under the previous socialist regime, since local governments basically acted as units of the centralized administration, local expenditures were included in the unified budget of the central government. There was no question as to who did what: the central government did everything, sometimes directly and sometimes through its local administrative units. Under the new local government laws in most of the countries under review, however, specific expenditures have been assigned to the local level of government as shown in Table 6. In the Czech Republic, Hungary and Poland, for example, local governments have detailed expenditure responsibilities in the area of education (primary and kindergarten), transportation (local or urban streets), environment (garbage collection, disposal, industrial waste), housing and related services, and health and welfare. In Russia, on the other hand, there is no legal definition of expenditure assignments at the local level, except for

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<sup>26/</sup>Since local governments are governments as well as service agencies, they are inevitably interested in the distributive as well as the allocative effects of their policies. Income redistribution at the local level may be severely limited by the openness of the local economy, but if a government is not concerned with distribution, it is not a government at all but simply a service agency. Nonetheless, within-jurisdiction distribution is ignored here as unimportant relative to the importance of setting up the basic rules of the local finance game so that each local government is fully accountable for its actions.

Table 6  
Expenditure Assignment to Subnational Authorities

	Hungary	Poland	Romania	CSFR	China	Vietnam	Bulgaria	Russia
Defence	No local responsibility	No	No	No	No	No	No	Military housing
Justice/internal security	Enforcement of rights of national and ethnic minorities	No	Public security is provided by local branches of the Ministry of Interior	-	No	No	Security of farming estates	-
Foreign Economic Relations	-	-	-	-	No	-	No	-
Education	Primary and secondary only including day care and high schools	Kindergarten and pre-elementary schools only	None	Partial responsibility in the Czech Republic	All schools primary through university level. Local governments cover all salaries, maintenance of school facilities, administration and scholarships	-	All expenditures (capital and current) of primary and secondary schools. Some kindergartens. Some technical and vocational schools	Several special vocational schools. Wages, operation construction and maintenance of all primary and secondary schools. Local enterprises build some facilities
Culture and parks	Supporting cultural activities	-	Over-lapping responsibility for cultural activities	-	Cultural activities such as cinemas and broadcasting	-	No	Some museums with oblast significance. All recurrent expenditures of all sport and park facilities and all other cultural facilities.

	Hungary	Poland	Romania	CSFR	China	Vietnam	Bulgaria	Russia
Health	Basic health and social service	No	None	No	Hospitals and clinic expenditures including all salaries		Tertiary care and psychiatric hospitals. Polyclinics. Some primary care and drugs.	Paramedics, Medicines. Primary health clinics, Secondary hospitals. Also tertiary hospitals, psychiatric hospitals, veteran hospitals, diagnostic centers, and special service hospitals (oncology, etc.)
Roads	Maintenance of local public roads	Only local or urban roads/street	Maintenance	No	All roads under local jurisdiction		Improve traffic safety. Maintenance of III and IV class roads and urban streets.	Maintenance of oblast, rayon and city and commercial roads
Public transportation	Local mass transport	Construction and maintenance of bridges	Public transport investment	Urban transport only	Building and maintenance		All modes of city transport.	Most public transportation facilities (earlier assigned to federal government). Also subway systems.
Fire protection	Local fire protection		None	No			Most fire protection services.	Most fire protection services. Voluntary, military and enterprise services are also possible at the rayon level.

	Hungary	Poland	Romania	CSFR	China	Vietnam	Bulgaria	Russia
<b>Libraries</b>	-	Partial responsibility	No (books purchased through the budget of the Ministry of Culture)	No	No	-	Local libraries	Special library services at the oblast level and most local library services at the rayon level.
<b>Police services</b>	-	-	-	No	-	-	Sofia has a signed contract with the National Militia; other municipalities get the service free.	Road (traffic) police
<b>Sanitation (garbage collection)</b>	Garbage collection	Ownership and provision of cold water at all levels	-	-	Refuse collection	-	-	Part of garbage collection at both oblast and rayon levels.
<b>Sewage</b>	Garbage collection and settlement cleaning	Ownership and provision of sewage service	Sewage collection	-	-	-	Garbage collection and sanitation in the settlement	Most of the operational expenditures at the rayon level and some operational expenditures at the village level.
<b>Public utilities (gas, electricity, and water)</b>	Water management and maintenance of public cemeteries	Supply street lighting	District heating and water	-	-	-	Water supply infrastructure.	Subsidies to households (not enterprises) at the rayon level

	Hungary	Poland	Romania	CSFR	China	Vietnam	Bulgaria	Russia
Housing	Housing management	Shared responsibility	Housing services	No	Building maintenance	-	Management of common pastures and other municipal property. Financing, building and subsidizing for residential housing.	Maintenance is the responsibility of the level of government or enterprises owning the housing. Capital expenditures are included unless otherwise noted.
Price and other subsidies	Rent subsidies	Rents	Energy subsidies to households and public transport subsidies	Direct subsidies to agricultural cooperatives, and subsidies to enterprises that are not involved in the production of local public goods	Yes	-	Mass transport and drugs. Subsidy to inter-village bus service within municipalities. Heating subsidy since 1992.	For fuels, mass transport, and food such as bread, milk and medicines at the rayon level. Also rent subsidies
Social Welfare	Social care facilities such as old age and handicapped homes	Voivodship responsibilities	-	-	Welfare expenditures for elderly who are childless, orphanages, the disabled etc.	-	Homeless, disabled and orphans.	Part oblast government responsibility, and the rayon level management of programs funded by upper level governments
New Public enterprises (productive sectors)	Can establish new domestic joint ventures	Can establish new domestic joint ventures	Can establish new domestic joint ventures	Can establish new domestic joint ventures	Can establish new domestic joint ventures	Can establish new domestic joint ventures	Can establish new domestic joint ventures	Capacity to invest in joint ventures (keeps 50 percent of privatization proceeds if rayon subordination). At the rayon level this also includes 10 percent of any other subordination

	Hungary	Poland	Romania	CSFR	China	Vietnam	Bulgaria	Russia
<b>Environment</b>	Protection of the environment	-	-	-	Environment protection outlays.	-	Measures to improve and rehabilitate the environment	Responsible for local environmental problems, e.g. preservation of forests
<b>State-owned Enterprises</b>	Major local ownership responsibilities	Local ownership responsibilities	Local ownership responsibilities	Major local ownership responsibilities	Major ownership responsibilities of light and heavy industries. Provide subsidies to enterprises for technical upgrading and building of temporary warehouses	Local ownership responsibilities	-	"Group C" enterprises, e.g. local light industry, housing construction and food industry. Rayon responsibility exists only if the enterprise is transferred to the local level

**Notes:**

1/ In Vietnam, local governments are responsible for all of the above activities if they fall under their jurisdiction. That is, each level of government is responsible for those activities which falls under their jurisdiction. 2/ '-' implies no information. 3/ 'No' implies not applicable to subnational governments.

social programs (which account for a major part of expenditure). In effect, tradition and inertia have established expenditure assignments in Russia which in many cases roughly correspond to "best practice" (benefit) areas. Unfortunately, perhaps owing in part to the lack of legal clarity in this area, it appears that these principles are being increasingly violated in the course of the on-going changes in the intergovernmental finance system.

105. Although in some ways it is not typical, Romania provides an interesting example of some of the things that are going on in the area of expenditure assignment in the transitional economies. At first glance, for example, the new local government law appears to assign local governments exclusive technical and financial responsibility for many more functions (e.g. policing) than those that are actually exercised. In fact, however, this assignment is only on condition that national laws or "[central] government decisions" do not specify otherwise. That is, in practice, local governments do only what the central authorities want them to do. The main financial responsibilities so far actually assumed by local governments in Romania are basically for various minor activities in social assistance, municipal service, culture and arts, public investment, and maintenance. As regards local transportation and district heating, local governments simply serve as conduit for the channelling of central government subsidies to the public service enterprises (regie autonome) delivering these two services. With the gradual elimination of consumer subsidies (to be completed in 1993) and the transfer of legal ownership of these enterprises to the local governments (to be completed in 1992) the situation may change, though it is far from clear how, financially, the local governments will handle the problems stemming from the new responsibilities.

106. Romania is thus unusual in the extent to which some important expenditures usually considered to have strong "local benefit" characteristics are still at the central level. In particular, and in contrast to most other transitional countries, education and health remain the sole responsibility of the central government in Romania, reportedly to ensure a minimum standard in the provision of these important services. Recently, however, increasing financial pressure on the central government has led to the proposal for some of these expenditures be delegated to localities. As is not uncommon in the transition economies - though highly unusual in western countries - both public security and fire protection are also provided throughout Romania by local branches of a central Ministry.

107. Overlapping responsibilities between the center and localities with respect to culture and social assistance, on the other hand, are common to many countries. For example, local museums are often financed by local budgets and national museums financed by the central government budget; but books for both local and national libraries are purchased by the Ministry of Culture. Similarly, both local and central governments fund programs related to children. Such "expenditure sharing"—i.e., with different levels of government responsible for different subfunctions of particular expenditure activities, or with more than one level of government playing an important role in financing, regulating, and providing particular services—is a common characteristic of multi-tiered governmental structures: it may sometimes be efficient, but it almost always obscures the key question of precisely who is responsible, and accountable, for what.

#### Local Public Enterprise Ownership

108. Romania also provides an extreme instance of a problem found to varying degrees in most of the transitional countries: the importance and complexity of the triangular relations between the new local governments, the public enterprises providing local services, and the central government. In some ways, it is not too much of a caricature to characterize the local government system now functioning in Romania as amounting to little more in fiscal terms than a conduit between central government and these enterprises (or *regies autonomes*, as they are called in Romania). If one asks: "What do local governments per se do in Romania?", the answer at the present time is: "Not much." Excluding the *regies*, local government expenditures appear to consist of little more in most cases than minor outlays on social assistance, culture, and general administrative expenditures. Most service delivery activities have been hived off to the various *regies*, leaving the local government as a place that does little more than collect dog licenses and register marriages. These may be essential activities, but they do not require a large revenue base - and indeed in many instances would best be financed by fees and charges (as discussed later).



109. In principle, of course, there is nothing necessarily wrong with having local governments that do not themselves deliver out of their own resources many services to local residents, just as there is nothing wrong with having local governments deliver nationally-financed and nationally-determined services to local residents (see later discussion) or with having most local service activities carried out by local public enterprises with separate budgets and managements. All these systems can be found in one country or another and may work perfectly satisfactorily. Indeed, given the extreme degree of centralization characterizing the transitional economies in the past, the present system in Romania, one of the last of these countries to reject the old system, may be not only acceptable but desirable.

110. Nonetheless, it is critical to the financial health of both the local governments and local public enterprises that the precise relationship between the two should be set out clearly. At present, in a number of countries the lines distinguishing activities that should be performed by local governments, local public enterprises, and commercial enterprises are undesirably confused. Unless these questions are disentangled, serious problems may occur both in setting up properly functioning local governments and local public enterprises and with respect to privatization more generally. A few examples from field work in several countries illustrate the point:

In some areas, local governments are responsible for certain activities (e.g. parks); in others, local enterprises;

Some activities (e.g. bakeries) are commercial in some areas; others are run as adjuncts to local public enterprises;

It is also important to clarify the relationships between different public enterprises e.g. at regional and local levels as well as between enterprises and governments, especially when an enterprise is located in one area and serves other areas as well.

111. On the whole, municipal enterprises should be confined to traditional local public service activities (water and sewer, heating [traditional in eastern Europe, at least], transit, perhaps solid waste collection and disposal). All essentially commercial activities now conducted by such enterprises such as bakeries, laundries, and construction companies should be sold off as soon as possible. Finally, in some instances certain activities (e.g. parks) for which there seems no apparent rationale for adopting the enterprise form of organization should probably be folded back into the local government proper.

112. Where it is decided to organize some local public service in the form of a public enterprise, any subsidy paid from general local government revenues should be set on an ex ante basis to establish the hard budget constraint needed for efficient operation. Moreover, such enterprises should be subject to all normal tax laws (central and local), and in general they should be run like commercial enterprises e.g. setting prices and terms of services - although presumably within a nationally-established regulatory framework (which as yet does not exist in most countries). At present, local authorities essentially have either no guidance in setting enterprise prices, or too much guidance in the sense that these prices are still being set by central authorities.

113. The budgets of local public enterprises should also not be consolidated with local government budgets per se: only any explicit subsidy and any profits transfer should appear in the government budget. Of course, enterprise budgets should be annexed to the local budget and submitted - not for approval but for information - to the appropriate central agency, as noted earlier. The numerous somewhat anomalous decentralized institutions found in many transitional economies (e.g. "Houses of Culture") should either be organized as enterprises and treated like other enterprises or, if they are to be treated as component parts of local governments, consolidated with other local expenditures and revenues.

114. It is especially important, both for good government and for good business, that local governments should get out of commercial business activities as soon as possible. The business of local government is not business, and the sooner local governments begin to concentrate on their central task of providing as efficiently as possible the

local public services their inhabitants desire the better it will be for both business and the local inhabitants. Although intentions in this respect are clearly good in most countries, there does not appear to be adequate recognition of the danger of decentralization becoming an obstacle to the privatization process, as is already happening to some extent in Hungary, Bulgaria, Russia, and perhaps elsewhere (see later discussion).

115. As emphasized earlier, countries that decentralize substantial expenditure responsibilities to local governments that either do not have access to adequate local tax sources, or that are not capable (technically or politically) of administering those taxes to which they have access, run this risk, especially when severe fiscal crises reduce central transfers to local governments. When the major source of government revenue has traditionally been, and is still to a large extent, enterprises, the temptation for local governments to extract more revenue from those enterprises in their control can be overwhelming - and will invariably be most unfortunate from an efficiency point of view.

#### Provision of Social Services: Shifting the Safety Net "Downstairs"

116. Most public enterprises are engaged in providing such "hard" services as water, electricity, and transport. In addition, however, particularly close attention needs to be paid to the role of local governments in the transition countries in delivering and financing services in at least three important "people" areas - social assistance, health, and education.

117. First, while the present role of municipalities with respect to social assistance varies from country to country, being quite restricted in Romania, for example, but much broader in Hungary, this area is all too likely to become a major problem in all countries in the future as a result of two unpleasant but likely developments - the weakening of the national capacity to maintain social protection at the present level and the growing need for such assistance as a result of economic restructuring. Even if the need for this bottom layer of the social safety net becomes greater, however, it is far from obvious that the municipal level - while it may be the appropriate executing agency - should be responsible for financing such assistance. In many western countries, for example, it was precisely the unsustainably heavy load on municipal welfare systems resulting from the interwar depression that led to social welfare becoming mainly a national, rather than a local, responsibility. It is thus ironic, and potentially dangerous, that so many transitional countries seem to be moving in the opposite direction just as the need for such services is rising sharply as part of the adjustment process.

118. Second, health and education are already controlled in large part at the local level in a number of transitional countries. Experience in many countries around the world shows that people are willing to pay local taxes to have their children educated. Hence, carrying out some education at the local level is one instance in which a devolution of expenditure responsibility may, at least in principle, be matched by a corresponding devolution of financial responsibility. On the other hand, there are also strong reasons for central involvement both in ensuring adequate investment in human capital throughout the country, regardless of local fiscal capacity, and to some extent in financing a higher level of such expenditure than localities would be likely to do on their own (See also the later discussion of transfers).

#### Expenditure Assignment in Principle

119. . In the long run, a desirable assignment of expenditures to local governments in many transitional economies might be something along the lines shown in Table 7, perhaps with the "local" share being further divided between different "tiers" of local government along "benefit area" lines. As Table 7 indicates, there are only a very few functions - national defense, purely local services - that should be clearly assigned to one level of government or the other. Most expenditure functions are likely to be shared between levels of government, as indicated to some extent by the breakdowns shown for a few of the functions in the table: similar detailed subfunctional categories could of course be set out for e.g. health and transport.

120. It is also important to understand that Table 6 refers to the level of government that delivers a particular service. Who finances it is a different question. Moreover, there is no presumption that any or all of these services must be produced by public sector agencies, although it is assumed that the public sector must indeed to some extent be responsible for the provision of such services if anything close to the optimal amount is to be provided. What matters to people is what services are provided, not who provides them. Indeed, many "public sector" services are actually carried out by non-government entities in different countries.

**TABLE 7**  
**A Possible Expenditure Assignment**

	Local	Center
<b><u>Culture and Arts:</u></b>	X	
National Museums		X
Local Museums		X
Community centers	X	
Social Assistance	X	X
Municipal Services	X	
Transportation	X	X
Telecommunications		X
Health	X	
<b><u>Educatic-:</u></b>	X	
Kindergartens	X	
Primary Schools	X	
Secondary Schools	X	
Higher Education		X
<b><u>Protection:</u></b>		
Local Police	X	
Fire Protection	X	
National Police		X
National Defense		X

121. To illustrate, alternatives to direct public production by general-purpose local governments that may be found in one country or another include:

- Various forms of contracting with private firms e.g. competitive bidding for time-limited franchises (often with the local government continuing to own the assets, but turning to private sector firms - or possibly cooperatives of former public sector workers - to manage them);
- Establishing standards for required service and leaving it up to consumers to select private vendors and to purchase the required level of service;
- Issuing vouchers to (some or all) citizens and allowing them to purchase the required service from any authorized supplier;
- Contracting with other government units (e.g. districts, other municipalities, enterprises, central government) to provide the service;

- Producing some services, while purchasing others from other government agencies or private firms;
- Establishing on a voluntary basis limited ("neighborhood") governments employing user charges (and possibly limited tax powers) to generate revenue;
- Establishing limited-purpose independent governmental units covering more than one general-purpose local government (special districts) financed by beneficiary charges of one sort or another;
- Establishing special tax (improvement) areas within a given general-purpose local government to provide services to areas which are willing to pay for them.

122. Of course, the mere possibility of such varied arrangements to provide particular services does not imply either that these arrangements will be easier to manage than a more conventional organization of public sector activities or that they will yield efficient and equitable service delivery. Nonetheless, one of the more striking omissions in the on-going discussion of local governments in the transition economies is the failure to keep straight the critical distinctions between who owns what, who pays for what, and who does what. Contrary to the message many countries in transition seem to have absorbed from their prior experience, namely, that "ownership" is everything, in the public sector who owns an asset does not necessarily determine who regulates the use of the asset, who operates it, or who finances it - and these facts are, as a rule, much more important in determining both what is done, and what the fiscal and other implications are, than is ownership alone.

### Extrabudgetary Funds

123. A striking feature of local government finances in most transitional economies is the proliferation of extrabudgetary funds (EBFs). In Hungary, in addition to the large national-level EBFs for social security, housing and "solidarity", there are a large number of off-budget accounts at the local level to which earmarked funds devolved. Such "inherited earmarking" is also a prominent feature in the CSFR. In Russia, the right to set up these funds was accompanied by the assignment of a number of non-tax revenue sources to local governments. Bulgaria and China also permit such funds to be set up, and in the latter they constitute an important parallel budget at the subnational level.

124. The genesis of these extrabudgetary funds is complex. In part, they represent an attempt to escape the "control mechanisms" of the central government. Inasmuch as local budgets in some countries are not really autonomous and remain subject to scrutiny from above, EBFs evade this scrutiny on the expenditure side. In countries where the local governments are transfer-dependent, and where transfers are allocated not by formula but by bargaining and negotiation, putting resources off-budget into EBFs is a means of concealing the true resource base of the locality from the center. Some local governments themselves claim that extrabudgetary funds reduce the uncertainties of the budgetary process. Moreover, to the extent the revenue system remains basically unitary - that is, the tax base and tax rate of most, if not all, taxes are defined by the center, with revenues allocated to the local level, EBFs may provide the only window for any local revenue initiative. Lastly, in countries such as Russia and China, where local governments must share any revenues they collect with higher level governments, EBFs, being off-budget, are not thus shared, a fact which gives them considerable added attraction from a local point of view.

125. On the other hand, such funds present serious problems for effective budgetary management at the macroeconomic level. They also reduce the transparency of budgetary operations and complicate assessment of the impact of fiscal policy. In practice, extrabudgetary funds function as parallel accounting systems which, for all intents and purposes, basically constitute full parallel budgets not subject to the strictures of conventional budgetary procedures. In addition to being a clearly inefficient budgetary practice that permits public sector operations not legally approved through the proper channels, the loss of control and information arising from the presence of such multiple budgets is bound to undermine the ability of the government to use fiscal policy as an efficient macroeconomic instrument. Without discussing the specific merits of each EBF, as a general rule legitimate revenue

sources should be fully incorporated into the regular budget to provide full accountability of fiscal operations, and if this is not possible, full information about the sources and uses of extrabudgetary funds at sub-national levels should be provided to the central fiscal authorities.

#### IV. FINANCING LOCAL PUBLIC SERVICES THROUGH USER CHARGES

126. The previous section noted that in most transitional economies many local public sector activities are carried out through public enterprises. Such enterprises are common, for example, in transport, in housing, in garbage collection, in water and sewage, in electricity, and so on. Even with privatization, many such enterprises are likely to continue to exist in most countries. The question of how local public enterprises are to be financed is therefore of critical importance to the health of the local public sector. The answer suggested by the benefit approach to local government finance outlined earlier is that as a general rule, such enterprises should be self-financing, that is, they should be paid for by those who receive the services they provide. To put this another way, the first rule of local finance should be: "Wherever possible, charge." For efficiency, charges should be levied on those who receive the benefits: the direct recipients, whether businesses or "things" (real property) should therefore be charged.<sup>27</sup>

127. Although the ultimate incidence of such charges is of no more interest in principle than the ultimate incidence of the price of cheese, studies in different countries have shown that the distributive consequences of charging for local public services is not necessarily regressive. In any case, attempting to rectify fundamental distributional problems through inefficiently pricing scarce local resources is almost always a bad idea, resulting in little if any equity being purchased at a high price in efficiency terms. As noted earlier, however, particular care will need to be taken in adjusting local public service prices (including rents) in the transitional economies because of the important role such prices played in effecting distribution policy under the old regime.

128. While user charges are most likely to be viewed by hard-pressed local officials as a potential additional source of revenue, their main economic value is actually to promote economic efficiency by providing demand information to public sector suppliers and by ensuring that what the local public sector supplies is valued at least at (marginal) cost by citizens. This efficiency objective is particularly important at the local government level since the main economic rationale for local government in the first place is, as noted earlier, to improve efficiency. There is thus a presumption that, whenever possible, local public services should be charged for rather than given away (unless, of course, they are pure local public goods or the explicit intention is redistributive).

129. For example, when local governments provide services through local public enterprises such as water, power, gas, and public transit, these services should generally be charged for at prices that will recover the cost of providing the service from the users or buyers of the service either immediately or over time.<sup>28</sup> The price of water should reflect the cost of piping it to the homes (or standpipe) as well as the cost of maintaining the pipes, treating the water, and so on. Bus fare should cover the cost of purchasing buses and maintaining and operating them. In principle, such prices should be set at the competitive private level, with no tax or subsidy element included - except when doing so is the most efficient way of achieving public policy goals (and even then, as noted earlier, it is best if the tax-subsidy element is accounted for separately).

130. Unfortunately, in most countries much less use is made of charging at the local level than seems desirable, and many of the charges that are levied are poorly-designed from an efficiency point of view. Weak accounting

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<sup>27</sup>In view of the substantial importance of locally-provided intermediate goods to business, some limited local taxation of business may thus be warranted, but, as emphasized elsewhere, it is important to constrain the ability of local governments to "export" tax burdens to non-residents.

<sup>28</sup>There are, of course, many well-known qualifications to this statement, but it is sufficiently accurate for present purposes.

systems that do not clearly identify costs is one reason for the prevalent under-pricing of these services. Another reason is the historical hangover of the previous distributional role of such prices. And a third is the simple political difficulty that newly-elected local governments have in imposing substantial increases in service prices on those who have just elected them.

131. Local governments also obtain revenue from "service fees" such as license fees (marriage, business, dog) and various small charges levied essentially for performing specific services - registering this or providing a copy of that - for identifiable individuals. In effect, such fees constitute cost reimbursement from the private to the public sector: indeed, in some budgetary systems, such cost recoveries are netted out and only net (of recoveries) expenditures are shown. Charging people for something they are required by law to do may not always be sensible - for example, if the benefit of (say) registration is general and the cost is specific - but on the whole there is seldom much harm, or much revenue, in thus recovering the cost of providing the service in question.

132. Another category of charge revenue encompasses what may be called "specific benefit taxes (or charges)." Such revenues are distinct from service fees and public enterprise prices because they do not arise from the provision or sale of a specific good or service to an identifiable private individual. Unlike "prices" which are voluntarily paid - although like "fees" which are paid for services that may be required by law - taxes represent compulsory contributions to local revenues. Nonetheless, specific benefit taxes are (at least in theory) related in some way to benefits received by the taxpayer. In contrast to such general benefit taxes as fuel taxes levied on road users as a class or local taxes in general viewed as a price paid for local collective goods (see below) - specific benefit taxes relate to the specific benefits supposedly received by specific taxpayers.

133. For example, if as a result of a new road, better street lights or a new sewer system, property values increase, or business sales rise, a "benefit levy" might be introduced. This could take several different forms; (a) a "special assessment"; (b) a "land value increment tax"; (c) an "improvement tax"; and (d) a "supplementary tax", etc. Most such charges are imposed either on the assessed value of real property or on some characteristic of that property - its area, its frontage, its location. A common benefit-related charge is the development charge (or "betterment tax") - a lump-sum charge designed to recover the cost of infrastructure development from beneficiaries. Thus, those whose land is near newly-installed street lighting would be charged to help pay for the cost of the installation. 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. Such a method of financing may be not only efficient but equitable, since those who benefit from development pay for its cost. Two particularly successful systems of development charges are land readjustment in East Asia and the "valorization system" in Latin America. While such schemes are most obviously useful in rapidly-growing urban areas, there may nonetheless be some role for them in at least some cities in the transitional economies.

134. In any case, the importance of charging for public services in these various ways is, as emphasized earlier, much greater than the relatively small amounts of money most countries can or do collect from such levies. To the extent that a local government is viewed primarily as a provider of services, as it should be, and the benefits of those services can be attributed specifically to individual citizens, properties, or businesses, the appropriate policy is clearly to charge the correct (roughly, marginal cost) price. Only thus will the correct amounts and types of service be provided to the right people, that is, those willing to pay for them. Correct pricing in this way helps public officials make sensible judgements as to how to match scarce resources with rising demand. When the true cost (and the related user charge) rises so high that demand falls, the costs of the service exceed its benefits in the opinion of the public. The signal is quick and clear. A decision is then needed as to whether to: (a) increase the price and serve fewer people; (b) cut back on the cost and standard of service to keep it affordable; or (c) subsidize the service from general revenues. In the absence of such price-generated demand information, supply decisions can only be made by bureaucratic rather than market-oriented processes.

## V. THE CHOICE OF SUBNATIONAL TAXES

135. The essential purpose of local taxes is to finance locally-provided collective public goods for local residents. If such goods are truly "public" in the sense of accruing equally to all residents of the jurisdiction, and if redistribution to other than national standards is not an aim of local public policy, and if administrative (and compliance) costs are left out of account, the best source of local revenue might perhaps be an equal per capita levy such as the poll tax, which also has the virtue of being economically neutral or efficient in the sense of giving rise to no excess burden.

136. At least one country, Hungary, actually has introduced a form of local poll tax, called the communal tax. In view of the high proportion of public housing in Hungary - a proportion that will undoubtedly decline but is likely to remain significant - an argument can indeed be made for levying some form of local poll tax on public housing tenants.<sup>29</sup> Although this tax may prove more difficult to administer in Hungary's increasingly mobile society than seems to be generally realized, such a tax, while it is never likely to yield much revenue, may thus have a minor role to play in local finance. From this perspective, however, it would be preferable if the rate of such a tax were set locally rather than imposed uniformly by national legislation, as in Hungary. Although such differential local poll taxes are easy to evade by moving, this possibility may be viewed as creating a not undesirable check on their rates. Of course, even those who do not flee may be hard to tax: the low efficiency costs of the poll tax seem likely to be purchased at the expense of high administrative and compliance costs.

137. More fundamentally, there is good reason to believe that in many cases some local residents - property-owners, people with school age children, or whoever - benefit more than others from the provision of local public goods. That is, while there may be no reason to levy specific benefit taxes there may be good reason for some local residents to pay more than others.

138. If, for example, the demand for local public goods is income elastic, a benefit case can be made for a local income tax - or, more feasibly perhaps given the high administrative costs of separate local income taxes, a local surcharge on the central income tax.<sup>30</sup> If the enjoyment of such goods is associated with consumption (rather than residence), a benefit case can similarly be made for a local tax on consumption, which would in practice almost certainly have to take the form of a retail sales tax. And finally, if the benefits of local public goods are enjoyed in proportion to the value of real property there is obviously a case for a local property tax.

139. Under-funded and Fiscally Dependant? In practice, the fiscal situation facing most central governments in transitional countries is such that virtually no major revenues are ceded to subnational governments. Many countries - especially those with a strong regional tradition such as Russia and the former republics-- assign the tax revenues (other than the corporate tax) from locally owned enterprises to the local government, giving them strong mercantilistic incentives to protect and maintain the monopoly position of their enterprises. This is likely to have consequences for future economic growth, especially where localities are successfully "protectionist". In many of the countries surveyed, the strong financial interest of local government in locally owned enterprises remains. This is a holdover from the old fiscal system under which enterprise profits accrued to the level of government that owned them (i.e. profits of locally owned enterprises went to the local government; profits (and later, taxes) of centrally owned enterprises went to the central government; and provincial governments received the profit of "their" enterprises).

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<sup>29</sup>It is of course assumed that any desired general income support is provided primarily through national sources: as argued earlier, local governments should not misprice their services for distributive reasons.

<sup>30</sup>Such a surcharge is, for example, proposed in Bird and Wallich, "Financing Local Government in Hungary." and in Wallich, "Fiscal Decentralization: Intergovernmental Finance in the Russian Federation." See also the later discussion in this section.

140. Of all the countries surveyed, only Hungary and Russia give subnational governments as large share of certain non-enterprise revenues. In Hungary, local governments get a share of the personal income tax (PIT) – initially 100%, then 50%, now 25%. In Russia, subnational governments get some 20% of VAT, 100% of PIT and 60% of the corporate profits. More generally, in most of the former USSR republics –the present CIS – the personal income tax is assigned to the subnational level, a holdover of the old Union days in which the PIT was a "local tax", assigned to the oblast level and passed through to rayons/cities. Generally, subnational governments in transition economies are under-funded, and overly transfer dependent (See Tables 8 and 9).

141. The only potentially (but not presently) significant tax these countries have assigned directly to local governments is usually the property tax, as in Hungary, Bulgaria, Poland, Romania, and Russia. In Romania, for example, the property tax is levied on all privately owned real estate. The tax rates are differentiated and, in an undesirable carry-over from the old regime, varied with the "social characteristics" of the property owners: 1% on the value of the property in the urban area owned by workers and employees of commercial societies; 1.5% on the value of property owned by individual business like independent professionals, self-employed individuals, and family associations of no more than ten employees; a lower rate of 0.75% is levied in rural areas. The taxable value of property is reportedly based on insurance assessments, sales contracts and construction costs and appears as a rule to be grossly underestimated. Moreover, all buildings owned by public institutions are exempted from this tax and, in another feature seemingly guaranteed to keep the yield of this tax low in a country privatizing its housing stock, all houses and apartments bought by individuals from the state are exempted for ten years. Even apart from this serious structural defect, the difficult and costly task of updating property valuations (and keeping them current) means that while this tax may become an important source of local revenues in the long run, it would appear mistaken to rely on it for substantial revenue in the near future.

142. Matters are not much better in Hungary, where the property tax is levied at a more uniform rate - 3% of "corrected sales value" (which usually means about 25% of market value) - or, alternatively, at a flat rate per square meter. As a rule, the only information local governments seem to have in practice on which to base such taxes is the area - and even with respect to area the exemptions specified in the law (and carried over from the old system) ensure, as in Romania, that not much revenue is likely to be collected from this source for some years.<sup>21/</sup> Substantial national assistance in developing an adequate valuation base seems necessary if the property tax is to become an important component of Hungarian local finance.

143. Another tax granted to local governments in some countries has been the old tax on individual business, essentially an income tax on small private enterprises. This tax has been assigned to localities in Romania, for example, on the grounds that it is easier for them than for the central government to check and collect such a tax. With increasing privatization in urban and rural areas, it might appear that considerable revenue might be expected from this tax. In fact, however, even in cases where, as in some larger cities, there are already computerized systems of information on tax bases, tax rates, exemptions, population and family structures, it is by no means clear that it will be easy to keep these data bases up to date, as economic activity moves increasingly out of the direct control of the government. For small communes in rural areas, family visits by tax collectors are now the most common way to collect direct taxes in many transitional countries. Again, however, it is unclear how much weight this system - which grew up under and was long supported by the totalitarian regime - will be able to sustain in the more democratic, and less controlled, circumstances now prevailing. In any case, with the growth of the private, and especially the informal, economy, the level of evasion with respect to local taxes seems more likely to rise than to fall over the next few years. In reality, experience throughout the world suggests that the only kind of business taxes local governments can collect efficiently are low-rate and relatively crude levies.

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<sup>21/</sup> There is little to be said for using area as a basis for urban property taxes. The case is different in rural areas, however, where taxes such as that in Romania - a differentiated rate ranging from 35 lei to 400 lei per hectare, depending on fertility and location - may make sense, provided the present fixed per hectare levies are adjusted annually (or more often) in accordance with an appropriate price index. Unfortunately, those who have received land under the land reform are exempt from land taxes for 8 years in Romania, thus severely weakening this potential source of local revenue.



Table 8  
Revenue Assignments to Subnational Authorities

	Hungary (1991)	Poland (1991)	Romania (1991)	Czech R. (1991)	Slovak R. (1991)	China <sup>7/</sup> (1985)	Vietnam <sup>2/</sup> (1991)	Bulgaria (1991)	Russia (1992)
Turnover tax (or VAT)	0	0	0	N.I.	N.I.	100%	100%	0 <sup>6/</sup>	20%
Corporate income tax	0	5%	0	N.I.	N.I.	100%	100%	50% <sup>8/</sup>	60%
Personal Income tax	25% <sup>1/</sup>	30% <sup>5/</sup>	0	N.I.	N.I.	100%	100%	70%	100%
Tax on Property of Locally Owned SOEs <sup>3/</sup>	0	100%	95% <sup>2/</sup>	50%	100%	0	0	N.I.	100%
Excises	0	0	0	N.I.	N.I.	0	0	0	61.1%
Wage tax	0	30% <sup>4/</sup>	0	0	13%	0	0	0	0
Small and Medium Ent./ Collectives income tax	N.A.	50%	0%	N.I.	N.I.	100%	N.I.	N.I.	N.A.
Local Taxes:									
- real estate tax	100%	100%	100%	100%	100%	N.I.	N.I.	100%	100%
- auto/road tax	100%	100%	100%	N.I.	N.I.	N.I.	N.I.	N.I.	100%
- small business taxes	100%	100%	N.A.	N.I.	N.I.	N.I.	N.I.	N.I.	N.A.
- agricultural tax	0%	100%	100%	N.I.	100%	100%	100%	100%	N.A.
- poll tax	100%	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Natural Resources Tax	N.A.	N.A.	N.A.	N.A.	N.A.	100%	N.A.	N.A.	100%
Other	tourism & misc.	misc.	misc.	N.A.	N.A.	N.A.	N.A.	N.A.	21 misc. taxes

Source: Misc. IBRD documents. See bibliography.

Notes: <sup>1/</sup> Reduced from 100% (1990); 50% (1991).; <sup>2/</sup> Until 1992 tax reform.; <sup>3/</sup> Also considered as property income tax.; <sup>4/</sup> To be abolished in 1992.; <sup>5/</sup> To be transformed into a more effective PIT in 1992 and shared according to a 85% (central) - 15% (local) ratio.; <sup>6/</sup> To be introduced in 1993.; <sup>7/</sup> 100% of each tax accrues to the level of government owning the enterprise; eg. VAT paid by provincially owned SOEs accrues to the provincial budget.; <sup>8/</sup> 40% from municipal enterprises and 10% from state enterprises.; N.I.: No information.; N.A.: Not applicable.

144. Just such a tax has been created in Hungary in the local tax on business turnover. Unfortunately, this is a bad tax. Although the present low rate (3 per mill) on business turnover is not likely to do much economic damage, such a cumulative business tax of course produces precisely the same kind of tax cascading as Hungary has tried to eliminate at the national level by adopting a VAT. This problem will become more serious if, as is likely, the increasing pressure on local finance leads to increases in tax rates in the future. Moreover, as presently designed (with the explicit exclusion of retail sales from the tax base) this tax encourages both tax exporting and local attempts to manipulate the tax system for incentive reasons. Tax exporting is of course the antithesis of rational local finance, and local fiscal incentives to production have a dismal record throughout the world, so neither of these features of the turnover tax is desirable.

145. Another bad tax that has appeared in a number of countries is some form of local tourist tax. Tourist establishments (including second homes and cottages) should of course be subject to general local business and property taxes. And of course should be charged fully for the costs they impose on the environment and on local public services. But there seems no reason to encourage fiscal irresponsibility by making it especially attractive for local governments to impose taxes on nonresidents: as a rule, they need to be restrained from such actions, not encouraged<sup>22</sup>.

146. Another possible local government tax, in contrast, deserves more attention than it seems to have so far received in most transitional economies: the taxation of motor vehicles. At present, it appears that only about 7% of vehicles in Hungary, for instance, are subject to the relatively small and not particularly well-designed "duties" levied by local governments.<sup>23</sup> Many countries similarly have widespread exemptions from their existing vehicle taxes e.g. exempting not only all vehicles used by public institutions financed by the state but those used by war veterans and so on. None of these exemptions, of course, makes any sense given the basic benefit rationale of this tax. As vehicle ownership becomes more widespread vehicle taxes (redesigned to be less vulnerable to inflation and perhaps more in line with environmental needs) might in time become an important revenue source for at least the larger localities. In principle, all vehicles should be subjected to taxes designed to some extent to offset the social costs attributable to vehicles. While such taxes should probably be designed and imposed uniformly throughout the nation to avoid obvious administrative problems, there is no reason why these revenues should not be assigned in whole or in part to the local governments in which the vehicles are registered.

147. Although both vehicle taxes and especially the property tax clearly have significant long-term revenue potential, particularly in larger urban areas, on the whole the local tax package bestowed on local governments in most transitional economies leaves much to be desired. Often, for example, local tax rates and tax bases are established in central government tax law, and at most a range of rates is provided within which local governments can choose. Many of the taxes thus established have rates fixed in nominal currency, thus making them highly vulnerable to erosion through inflation. Others are minor nuisance levies which may well yield less in revenue than they cost to collect. None provides an adequate fiscal foundation for an active and viable local government.

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<sup>22</sup>It has been argued that tourism taxes (kurtaxen or taxes de tourisme) should be seen more as a globalized user charge than a fiscal levy. Resorts with annually widely fluctuating populations have to assume expenditure, both for operations and capital investment, of a type and amount that cannot and should not be recovered from the (often few) permanent residents but from the actual beneficiaries of these services. If not, the unavoidable consequence is that resort areas turn to the central government with a demand for increased fiscal resource transfers and that at the end tourism activities get, in one way or another, subsidized by the central government as, for instance, happens in Turkey.

<sup>23</sup>In Romania, in another undesirable hangover from the old regime, initially, some motor vehicle taxes (levied at flat rates, by type of vehicle) went to the central government, depending on the nature of the taxpayer. Since August 1992, these now go to municipalities (individually owned cars) or to districts (cars owned by corporations).

148. In some countries (see Table 5) at present, all the central government taxes are collected by a decentralized tax administration. Although such dual loyalties can obviously cause problems, it seems unlikely that having local taxes collected by local governments will help matters much in the near future, given the severe shortage of trained tax administrators. In Vietnam, the MOF has established a General Tax Department to oversee the activities of all provincial tax departments. In China there are two organizations: the Tax Bureau and the Finance Department which have separate departments with detailed functions at each level of city, county and province. Romania is also in the process of creating two organizations to handle finance and tax administration at the local as well as national level. In Russia, tax administration is the responsibility of the State Tax Service (STS) which has an organizational structure at all three levels of government, and is an autonomous agency with ministerial ranking.

149. A "truly local" tax might perhaps be defined as one (i) assessed by local governments, (ii) at rates decided by local governments, (iii) collected by local governments, and (iv) with its proceeds accruing to local governments. In the real world, however, many taxes possess only one or two of these characteristics. In some cases, for example, a tax accrues in whole or in part to local governments, but its rates are set by the national government, which also assesses and collects it. Instead of a "local" tax, for many purposes such a tax might be considered to be really a central government grant allocated to local governments in proportion to the amount of national income tax collected locally. On the other hand, what looks like a central tax and a related transfer program may really be a local tax. Some intergovernmental transfers, for example, in effect simply return taxes to the regions in which they were collected in the first place. If the local government determines the tax base and rate and receives all the revenues, the only role the central government plays is as a collection agent: it may even be reimbursed for its work, for instance, by being allowed to retain a small percentage of collections. Presumably, the central government has a comparative advantage in tax collection, and the local government has contracted for its services in this respect. In this case, there is no intergovernmental transfer at all, except in the narrowest accounting sense.

#### Characteristics of a Good Local Tax

150. The following are among the characteristics that may be sought in an "ideal" local tax:

- [1] The tax base should be relatively immobile, to allow local authorities some leeway in varying rates without losing most of their tax base.
- [2] The tax yield should be adequate to meet local needs and sufficiently buoyant over time (i.e., it should expand at least as fast as expenditures).
- [3] The tax yield should be relatively stable and predictable over time.
- [4] It should not be possible to expose much, if any, of the tax burden to non-residents.
- [5] The tax base should be visible, to ensure accountability.
- [6] The tax should be perceived to be reasonably fair by taxpayers.
- [7] The tax should be relatively easy to administer efficiently and effectively.

Not everyone would agree that all these characteristics are necessarily desirable - e.g. is it unequivocally good that local governments should be insulated from either the tax base consequences of their tax rate choices or from inflation? In any case, it is unlikely that sufficient taxes possessing most of these characteristics will be made available for local use. In fact, as already noted, the so-called "local" taxes in most transition countries are controlled in varying degrees by central governments e.g. with respect to the determination of tax base, tax rates, and/or tax administration. Nonetheless, unless there is a significant degree of local freedom of choice with respect to some or all of these matters - so that local governments can change the level and composition of their revenues - it is not very meaningful to talk about "local autonomy."

### Local Property Taxes

151. How does the property tax score in these terms? In the first place, as experience in a number of countries has shown in recent years, there is often widespread resistance to the property tax when too much revenue is sought from this source. One reason is precisely because it is a very visible tax, for several reasons. First, unlike the income tax, the property tax is not deducted at source but generally has to be paid directly to the municipality by taxpayers in periodic lump sum payments. Taxpayers who pay taxes directly to government tend to be more aware of the size of their tax bill than those whose take-home pay is reduced by weekly or monthly tax deductions. The need to make such periodic large payments may well add to the accountability and responsibility of local governments, but it also greatly increases the sensitivity of taxpayers to even nominal increases in taxes.

152. Secondly, the inelasticity of the property tax has a similar effect. Since the base of this tax does not as a rule increase automatically over time, the periodic nominal increases in property tax bills needed to maintain real revenues when price levels rise require increased tax rates. In terms of political accountability, this need to confront the people with the cost of government again represents a virtue of the property tax; again, however, the downside (from the local government's point of view at least) is the heightened visibility of nominal tax increases and the accompanying political resistance.

153. Thirdly, local property taxes of course finance such municipal services as education, roads, and garbage collection. The quantity and quality of these services (or their absence) is thus readily linked to the property tax. When potholes develop in their street, taxpayers are understandably quick to question the taxes that supposedly finance street repair. Once again, the very feature that makes the property tax a good source of local government revenue in principle makes it especially vulnerable to political resistance in practice.

154. Other problems result from property tax administration. As a rule, property is supposed to be assessed on the basis of its market value, usually defined as the price struck between a willing buyer and a willing seller in an arm's length transaction. Exactly how this is to be implemented in countries in which private property is in the process of being established in law for the first time in decades is not entirely clear. At the very least, there is a substantial valuation task required before much fiscal yield can realistically be expected from property taxes in most transitional economies. Moreover, even in countries with well-developed property tax systems, discrepancies usually arise between assessed values and market values within classes of property, between classes of property, and across municipalities for both political and technical reasons. Since taxpayers can easily compare their property taxes with those of similar properties in their neighborhood, such discrepancies lead both to specific assessment appeals and to general pressure for tax relief.

155. In short, worldwide experience suggests that there are at least three substantial constraints on the use of property taxes for local finance:

\*First, although the administration of the tax can certainly be improved in the transition countries, there will always remain severe problems in administering it in a horizontally equitable fashion, particularly when prices are changing rapidly.

\*Second, the temptation to the inevitably rather fragile new local governments to indulge in politically painless but economically inefficient "tax exporting" means that severe constraints should be placed on the degree to which local governments are permitted to tax businesses more heavily than residential taxpayers if the property tax is to be an economically desirable source of local revenues.

\*Third, both because of its faults and its virtues, heavy reliance by local governments on the property tax probably ensures that, as is the case in most countries where the property tax is the main local tax, they will either continue to be heavily dependent on intergovernmental grants to finance their activities, or they will not carry out many activities.

156. Despite these political and administrative problems, the property tax remains a potentially significant source of revenue for local governments in transitional countries. Moreover, there are good reasons for taxing real property both as a local tax and as a tax in general. A tax on real property may, for example, make good sense as part of the tax system as a whole: although relatively expensive to administer, such a tax scores quite well in terms of both its efficiency and its equity aspects. Moreover, if levied at the local level, a property tax can, as emphasized above, serve as a good means of financing local public goods - subject, however, to three important provisos:

- (1) An adequate national framework law is established (to prevent unwarranted local manipulation of the base and rate structure and in particular undue loading of the tax burden on nonresidents).
- (2) Local governments are provided sufficient technical support to carry out their end of the administrative process (which should probably not include valuation).
- (3) Local governments are permitted (within the parameters set out in the framework law) to vary the tax rate annually. Such rate flexibility is essential if the tax is to be adequately responsive to local needs and decisions.

Unfortunately, none of the property taxes recently created in the transition economies appears to satisfy these criteria.

#### Own Subnational Taxes versus Shared National Taxes

157. On the whole, if there is an obvious alternative (or supplement) to property taxes it is likely to be some form of local income tax, probably levied as a supplement to national income taxes. The case for relying on property taxes, especially taxes on residential property, as an important source of local government finance remains strong. Since, however, property taxes can only be pushed so far, if more local "own-source" revenue is desired - either to expand the size of local activities or to make local governments more self-reliant - there is much to be said for supplementary ("piggybacked") local income taxes.

158. Of course, property taxes do not even come close to financing the needs of the subnational sector where these have significant expenditure responsibilities. Thus, in some countries, notably Russia - where the subnational sector finances close to 50% of public expenditure - access to major national taxes, probably the personal income tax, will be needed.

159. Like the property tax, such a tax, if appropriately designed, would be visible and hence in principle satisfy the criteria of political responsibility and accountability. However, the fact that income tax revenues tend to grow with less political fuss, while presumably good news for local officials, suggests that increased reliance on local income taxes might be viewed with mixed feelings by some. On the other hand, since an income tax is usually perceived as more progressive than a property tax, it scores higher than the latter on equity grounds.

160. The principal argument against local income taxation is administrative. Most of the other arguments sometimes raised against this proposal have no merit. One such argument is that there is something inherently "bad" in efficiency or equity terms about allowing local governments direct access to the income tax. Some local governments, for example, probably have no income tax base. It might therefore be argued that it is somehow unfair or inequitable to let those local governments that have such a base exploit it. But the logic of this argument is not apparent (and of course the basic unequal distribution of local tax resources is precisely what the equalization grants discussed later are designed to deal with).

161. Similarly, arguments that local income taxes reduce national fiscal flexibility or induce inefficient fiscal competition or inefficient resource allocation are at best incomplete and in general misleading. The functions local governments are supposed to carry out are essential, these expenditures have to be financed somehow, and the local

income tax approach seems more likely than most alternatives to free the national government from the responsibility of financing some such services while still leaving it a free hand to alter its own tax system as it sees fit.

162. Moreover, assuming the "benefit" model of local government postulated above is followed, such taxes simply constitute the price of local public services and have no adverse effects on resource allocation or on fiscal competition. On the contrary, their allocative effects are desirable as is any competition they may induce among local governments in lower-cost provision of desired public services (including the intermediate services entering into production functions).

163. Whatever merits such arguments may have, the prevalence of plans for local "shares" in national income tax revenues in countries such as Hungary and Russia probably reflects more the influence of the historical pattern under which the revenues (like the expenditures) of both levels of government were unified than of economic logic. In Hungary in 1991, for example, localities received 50% of the revenues collected from the personal income tax, allocated on the basis of residence. These funds accounted for about 13% of total local revenues.

164. An alternative to the Hungarian system would be to allow local governments to impose their own income taxes in the form of a surcharge on the national tax.<sup>24</sup> This option has two unique advantages:

\*It is likely to lower the level of income taxes in Hungary without exacerbating the budget deficit.

\*It is also likely to induce more efficient local expenditure than would otherwise be the case.

Such advantages do not come costlessly, however. The major argument against this approach is undoubtedly that it would be relatively costly administratively and in particular would render the already difficult task of efficiently administering the national tax system even more difficult. Nonetheless, the prospect of achieving both a more efficient (and democratic) system of local revenues and expenditures and a more efficient (and lower) level of total expenditures and taxes is sufficiently attractive to suggest that this option deserves careful consideration.

165. This proposal could be simply implemented in Hungary: for example, cut the national income tax by 50% - the share going to local governments in 1991 - and allow local governments to impose a flat-rate surcharge on the (remaining) national income tax, to be collected by the national government and remitted to the local government in question. Local governments would thus continue to have access to PIT revenues, but now they would have to face local voters and justify their local income tax rates. In all likelihood, many local governments would initially choose to levy lower taxes (surcharges of less than 100%). The result would then be to lower both total taxes and total expenditures, since the total amount local governments have to spend would be lower to the extent they levy less than a 100% surtax.<sup>25</sup> In order for local governments to justify levying taxes as high as (or higher than) those foregone by the national government, they would presumably have to be able to demonstrate to their voters that they are spending the money efficiently and in a desired way. Such a check on local spending seems especially desirable in a situation like that in Hungary today in which central transfers are likely, for political reasons, to remain basically unconditional.

166. Allowing local governments to impose such income tax surcharges has at least two major advantages:

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<sup>24</sup>See Bird and Wallich, "Financing Local Government in Hungary."

<sup>25</sup>Of course, this exposition abstracts from the possibility of local borrowing as well as local exploitation of business enterprises. As noted elsewhere, however, local borrowing should in any case be tightly regulated and controlled, and local recourse to business enterprises for revenue purposes should be heavily restricted.

- (1) Local governments - at least the richer ones - will have access to a broad tax base so that they can more adequately finance out of local resources the extensive range of services they are supposed to provide.
- (2) Whether taxes go up, down, or stay the same, the accountability of local governments, and the efficiency of their expenditures, should increase.

Assuming the functions local governments are supposed to carry out are essential, the local income tax approach seems more likely than most alternatives to free the national government from the responsibility of financing some such services while still leaving it a free hand to alter its own tax system as it sees fit. The alternative of local surcharges on value-added taxes or on enterprise income taxes are much less desirable on both technical and economic grounds.

## VI. THE DESIGN OF INTERGOVERNMENTAL TRANSFERS

167. Russia, China and Vietnam are the only transitional countries with no explicit arrangement for intergovernmental transfers. In all three countries, there exist "upward transfers" from provinces to the central government. In most other transitional economies, while transfers are generally the most important source of local government revenue, most such intergovernmental fiscal flows are basically discretionary and "negotiated" in nature. The exception is Hungary, where there is an explicit formula for the so-called "normative grant." A somewhat similar grant formula is currently under consideration in the Czech Republic. In Russia, where there is an ad hoc intergovernmental grant, there is no evidence that it is equalizing.

168. In themselves, transfers are neither good nor bad: what matters from a policy perspective are their effects on the outcomes of interest, such as allocative efficiency, distributional equity, and macroeconomic stability. An additional essential element of an adequate system of transfers from the point of view of both central and local governments is transparency, as when the transfer system is driven by rules or a formula rather than by discretionary political decisions. It is clear from Table 9 that in most countries subnational governments are highly transfer-dependant. On average, some 70% of revenues, and often more, comes from transfers. Generally speaking, the concept of grants for capital finance, matching grants and other standard approaches are little known.

### Closing the Fiscal Gap

169. Intergovernmental fiscal transfers play several distinct roles in most countries. In the first place, such transfers generally constitute the principal way to achieve what is sometimes called "vertical fiscal balance", that is, ensure that the actual income and outlay of subnational levels of government are approximately equal. For various reasons, both economic and political, central governments usually have much greater revenue-raising capacity than do local governments. One way to transfer some of the revenues accruing to the center to finance the deficits of lower levels of government is through intergovernmental transfers. Of course, such fiscal "gaps" may also be closed, and vertical fiscal balance restored, by transferring revenue-raising power to local governments, by transferring responsibility for expenditures to the central government, or by reducing local expenditures or raising local revenues. In virtually all countries, however, there invariably remains sufficient mismatch in the revenues and expenditures assigned to different levels of government for an important "balancing" role to be assigned to intergovernmental fiscal transfers.

### Equalization

170. Equally important in determining the role and design of transfers is what is called "horizontal fiscal balance" or equalization. This is a controversial policy objective in many countries, and the design of such transfers requires careful thought. The basic economic case for such "equalization" transfers should be understood clearly. On the one hand, such a transfer may be needed to enable "poorer" local governments -- "poorer" in terms of their capacity to raise resources out of local taxes imposed on local residents (and not in terms of how high the private

**Table 9**  
**Structure of Subnational Government Finance**  
**(recent year)**

	Hungary	Poland	Romania	Czech R.	Slovak R.	China*	Vietnam	Bulgaria	Russia
Own Resources	18%	50%	25% 2/	9%	71%	15%	N.I.	4.4%	-
Shared Tax	13%	25%	0%	6%	4.7%	85%	N.I.	49.4%	95%
Total Local Resources	31%	75%	25%	15%	76%	100%	N.I.	53.8%	95%
Transfers from Central Government	68.5% 1/	25%	75%	85%	24%	0%	N.I.	46.2%	5%

Source: Misc. IBRD documents. See bibliography.

Notes: 1/ 51.4% as grants and 17.1% as Social Security Funds transfers.; 2/ Expected to decline to 20% in 1992.; \* For 1985. Also transfers not separate from aggregate figures; deemed negligible.; N.I.: No information.



incomes of those residents or the output of the locality may be) -- to respond adequately to central transfers intended to generate the appropriate level of public goods (as discussed below). On the other hand, an equalization transfer may be needed to enable governments that are poor in the sense just defined to provide an adequate "minimum bundle" of local public services to citizens. The argument in this case, similar to the familiar "basic needs" argument, is broadly that all citizens should be entitled to some basic level of such services, regardless of where they happen to live.

171. If horizontal fiscal balance is interpreted in the same "gap-filling" sense as vertical fiscal balance, equalization implies that sufficient transfers are needed to equalize revenues (including transfers) and the actual expenditures of each local government. Such "fiscal dentistry" makes no sense, however. Making up all gaps between actual outlays and actual own-source revenues for all local governments, like equalizing the actual outlays of local governments in per capita terms (that is, raising all to the level of the richest local government), ignores differences in local preferences for public and private goods and thus vitiates the basic economic rationale for local government in the first place. Moreover, such extreme equalization ignores local differences in needs, in costs, and in own revenue-raising capacity. Finally, equalizing actual outlays clearly discourages both local revenue-raising effort and local expenditure restraint, since under this system those with the highest expenditures and the lowest taxes would get the largest transfers.

172. For these reasons, in all countries with formal systems of equalization transfers, the aim is either to equalize the capacity of local governments to provide a certain level of public services or the actual performance of this level of service by local governments. The performance criterion, which adjusts the transfer received in accordance with the need for the aided service (and which may also allow for cost differentials) is in principle more attractive to central governments -- or those concerned primarily with the provision of certain services such as education or social assistance -- since the level of service to be funded is determined centrally and the transfer can be made conditional on the provision of that level of service. Unfortunately, this approach suffers from the same disincentive effect on the revenue side as equalizing actual outlays, since that government which tries least again gets most -- unless adjustment is made for differential fiscal capacity.

173. In principle, then, any sound design for equalization transfers pivots on some notion of revenue capacity. At one extreme, the aim might be to provide each local government with sufficient funds (own-source revenues plus transfers) to deliver a (centrally) predetermined level of services. Because such capacity-based transfers are generally based on measures of potential revenue-raising capacity and not on actual revenues, no disincentive to fiscal effort is created by this approach. Differentials in the cost of providing services may or may not be taken into account. Of course, transfers based solely on capacity measures do nothing to ensure that the recipient governments will in fact use the funds they receive as the central government might wish - unless, as noted above, receipt is conditioned on performance (and compliance is monitored in some way).

### Fiscal Effort

174. While the evidence on the effects of transfers on local fiscal effort is far from clear in any country, there is some empirical evidence that transfers often tend to discourage such effort. Nonetheless, it is generally not a good idea to include an explicit fiscal effort element in a transfer formula. Suppose, for example, that a transfer is made directly dependent on the relation of the effective tax rate in the recipient municipality to the average national effective tax rate. One problem with this proposal is that the measurement of fiscal effort is considerably more complex than usually seems to be realized -- even if, as suggested earlier should be done, local governments are largely restricted to non-exportable taxes. If, for instance, tax bases are sensitive to tax rates, then the usual measures overestimate capacity in low tax-rate areas (and hence underestimate the effort needed to increase tax rates) because the base will decline if the rate is increased.

175. More importantly, putting too much weight on fiscal effort in allocating grants unduly penalizes poorer areas, in which, by definition, a given percentage increase in effort (as usually measured) is more difficult to achieve. The problem giving rise to the need for equalization in the first place is that the capacity (tax base) of poor

areas is too low, not that their tax rates are too low. Most fiscal effort measures inevitably reward the richer recipient governments, which find such tests easier to meet. Imposing such an additional penalty on poor regions in a transfer program that almost invariably falls far short of fully equalizing fiscal capacity seems hard to justify.

### Matching Grants

176. A final component of many transfer systems is what is called a matching (conditional) grant, in which the central government pays only part of the cost of certain expenditures carried out by local governments. (At the extreme, where the central government pays all the cost of work carried out by a local government acting as its agent, what is really happening is of course simply cost reimbursement.) Several rationales for such transfers may be distinguished, each with different implications for program design, as discussed below.

177. Matching grants in principle have important economic and fiscal advantages in terms of both allocative efficiency (spillovers) and the efficient use of scarce central government resources to attain desired levels of certain services. In addition, while of course rendering local governments more susceptible to central influence and control, matching grants may have the important political advantage of introducing an element of local involvement, commitment, accountability, and responsibility for the aided activities. Moreover, properly-designed matching grants may contribute to equalization (horizontal fiscal balance) and, like all other transfers, they help to resolve any basic fiscal mismatch (vertical fiscal balance) problem. Such grants may be particularly important with respect to capital investment projects (where they may substitute for, or supplement, subsidized loans).

178. The rationale for matching grants with the strongest basis in the economic literature is that the benefits from the local activity in question may spill over to other jurisdictions, that is, provide benefits to localities other than those which decide whether to undertake the activity. Since such external benefits will not be taken into account by any particular local government in deciding how to spend the funds at its disposal, in general too little such externality-intensive activity will be undertaken unless the local government receives a unit subsidy just equal to the value at the margin of the spillover benefits.

179. The correct matching rate ( $m$ ), or the proportion of the total cost paid by the central government, is thus in principle set by the size of the spillovers. This rate may decline as the level of expenditure rises, if the externalities diminish. It may also vary across localities if there are reasons to expect greater externalities in some places than in others or if there is reason to expect a higher local price elasticity of demand for the service in question in some areas as opposed to others. Basically, however, a matching grant program designed to encourage the optimal provision of public services would be expected to vary primarily with the nature of the activity, that is, depending on the level of associated externalities.

180. Since no country has achieved full equalization of local fiscal capacities, a uniform matching level offering, in effect, the same "price" to different local governments will discriminate against poor regions. Indeed, even if revenue bases were fully equalized, there might still be grounds in terms of need or cost differentials for including an equalization element in matching grant formulas. For example, per capita grants for roads in sparsely populated and mountainous regions should generally be larger because the per capita cost of achieving any particular standard of road service will obviously be higher.

181. A quite different rationale for matching grants may arise from the existence of a central government budget constraint. If the central government wishes to use its scarce budgetary resources to attain given standards of expenditure on certain services provided by local governments, it should pay only as much of the cost as is needed to induce each local government to provide that level of service. With a grant of  $m$  percent of cost, the effective price to the locality is  $1-m$ . To ensure maximum total (local plus central) expenditure on the service in question, given the size of the central government contribution, the optimal way to allocate a given total transfer among localities will then be inversely to the price elasticity of local demand for the service (assuming no cross-price elasticity effects).

182. Matching grants should as a rule be inversely correlated to the income level of the recipient government. The purpose of such transfers is essentially to ensure that all local governments, regardless of their fiscal capacity, provide a similar level of certain specified public services to their residents. The idea is simply to set the price of the service  $(1-m)$  to each local government in such a way as to neutralize differences in capacity by varying the matching rate  $(m)$ . The higher the income elasticity, the higher the matching rate needed for low-income recipients (to offset the higher local expenditures on the aided service in higher-income areas), and the higher the price elasticity, the lower the matching rate needed to achieve a given level of total expenditures. In practice, there is thus a case for varying matching rates inversely with income levels even when only the incentive effects (and not the distributional effects) of matching grants are considered.

183. Unfortunately, neither theory nor available empirical studies provide clear guidelines to determine the precise matching rate appropriate for particular expenditure programs, let alone how those rates should be varied in accordance with the characteristics of different local governments. Nonetheless, a possible approach might be to consider the matching rate for each program as having two components. The basic matching rate for each service would then reflect the degree of central government interest in the provision of that service whether that interest is motivated by concern over spillovers, the "merit good" nature of the activity, or simply the desire to implement some plan). This basic rate could then be increased inversely to a uniformly determined measure of capacity. The matching rate faced by any particular locality for any particular program would then be higher the greater the degree of central interest and the lower the (expected) degree of local enthusiasm (price-elasticity) and ability (income-elasticity) to support that program. Though data limitations mean that such refinements are most unlikely to be relevant in any transitional economy for many years, these principles should nonetheless be kept in mind in developing an intergovernmental transfer system - or any system of subsidized municipal credit, where exactly the same considerations are relevant.

#### Other Objectives of Transfers.

184. In addition to the economic arguments for transfers discussed above, there are of course also important political arguments for transfers in all countries:

- \* It may be necessary, for example, to transfer some resources to jurisdictions that do not, strictly speaking, need them in order to make it politically feasible to transfer needed amounts to other jurisdictions.
- \* It may also be essential to transfer resources simply in order to keep some economically non-viable local governments (e.g., small rural governments) alive for political reasons -- to salvage regional pride, to provide jobs for local supporters, or for some other reason.

In both these cases, the main design problem is to minimize any collateral damage to the presumed economic objectives, both by achieving the political ends in as cost-effective a way as possible and by trying to ensure that the design of such transfers offsets the good features of other transfers as little as possible.

185. In summary, the main substantive aim of a well-designed transfer program is to "get the prices right" in the sense of facing local decision-makers with the full consequences of their actions. The first step in getting the right incentives from intergovernmental transfers is, as argued earlier in this paper, to establish the local public finance system itself as much on a benefit basis as possible. Ideally, local own-source revenues should come entirely from local taxpayers. Local governments should not have access to taxes that they can export to non-residents (except to the limited extent such taxes may offset the provision of local public goods that lower production costs).

### A Case for Conditionality?

186. Given such a system, the next step is to recognize that (in a non-federal system) local authorities must fundamentally be responsible to the central authorities or, more accurately, to taxpayers at large, when they are spending central funds. There is thus in principle little role for completely unconditional transfers -- except, perhaps, to the extent that such "transfers" are not really transfers at all but rather simply central reimbursement for locally-executed central projects or else result from central collection of local taxes (for example, because it would not be cost-effective to set up separate local tax administrations). Since any other unconditional transfers in this system are essentially motivated by politics, the concern in these cases is primarily to limit the damage done to policy outcomes -- for example, transfers that simply finance local deficits or that are entirely discretionary in nature are invariably bad.

187. On the other hand, transfers intended to encourage spending on a specific local service, whether because it generates externalities or because it is more efficient to a certain extent to provide the service locally, should generally require some local contribution (matching) and should of course be conditional on the performance of the service in question in accordance with specified standards.<sup>26</sup> Both the determination of the appropriate matching rates and the extent of central support and monitoring of local performance (see also the earlier discussion of this subject) require close study with respect to each substantive area in which such grants (or their analytical equivalent, subsidized loans) are to be established.

188. So far there appears to have been little consideration in the transitional economies of what would appear to be a strong case for some degree of conditionality in central transfers. In Hungary, for instance, which has by far the best-developed transfer system, the normative grant has three important characteristics. In the first place, the total to be distributed to local governments through this grant is entirely discretionary. Secondly, the formula for distributing this total in turn contains two components. The first component, which may be thought of as the equalization component of the grant, is essentially an equal per capita transfer. The second, and larger, part of the grant, however, is distributed basically in accordance with a measure of expenditure "needs", particularly with respect to education. Finally, the grant is completely unconditional: local governments can spend the money however they see fit.

189. In principle, there seems little rationale for bestowing such large unconditional grants on so many small local governments. As with some other features of the Hungarian local government finance system, it appears that the understandable desire to reject completely the centrally-dominated model of past intergovernmental relations may have resulted in, so to speak, throwing out the baby with the bathwater. The central government - that is, taxpayers in general - have a legitimate interest in what is done with grants to local governments. Moreover, the country as a whole also has a legitimate concern to ensure that services such as education and health are available throughout the country at least at minimum standards. There is therefore a strong case for at least limited conditionality, for instance, by requiring that the grant funds should be spent on e.g. education or health<sup>27</sup> or requiring local governments receiving such grants to provide services of at least a specified quality and level.

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<sup>26</sup>No matter how closely supervised, the inherent fungibility of financial transfers means, of course, that there is no guarantee that conditional transfers will not in whole or part simply replace locally-financed expenditures that would have been made in any case. On the other hand, the available empirical evidence in a number of countries suggests that to at least some extent conditional funds do indeed "stick", that is, result in an increase in total spending on the aided function.

<sup>27</sup>Of course, such legal requirements are inevitably to some extent only pro forma. The fungibility of money and the ability of local governments to alter other expenditures and taxes mean that requiring a grant to be spent on a particular activity does not necessarily imply that total (centrally-funded plus locally-funded) expenditure on the activity has gone up proportionally. Indeed, in most cases it will not.

190. Compliance with any such conditions could be monitored, as suggested earlier, through requirements for uniform and timely local financial reporting and through periodic national inspections and audits of local facilities. Although in the current situation in Hungary it is probably politically inadvisable to alter the present unconditionality in any important way, at the very least the national government should make every reasonable effort to improve local financial reporting - for example, making the provision of such reports a condition for receiving grants - as well as attempting to improve its information base on what is going on with respect to the provision of local public services.

#### Determining the Size of the Grant.

191. Another feature of the normative grant that requires further consideration is the determination of the total size of the grant. At present, this determination is in effect entirely up to the central government. While budgetary flexibility in this respect is obviously desirable from the central government's short-run point of view, it is a mistake to view central transfers to local governments as constituting an entirely "compressible" portion of the national budget. On the contrary, many of the services provided by local governments constitute essential infrastructure for future development. Moreover, since it is unlikely that most of the small local governments created in Hungary can ever finance the provision of such services at an adequate level out of their own resources, either now or in the foreseeable future, central grants to local governments will remain an important, and largely non-compressible, expenditure item in the central budget of Hungary, as of most transitional countries.

192. In these circumstances, there may be much to be said in favor of establishing a formula-driven total e.g. as a specified percentage of national revenues or of some particular national tax or taxes. This procedure has substantial advantages from the point of view of both central and local budgeting. Since the amount of the local transfer is determined, the central government is to some extent insulated from pressure to increase its support of local governments. On the other hand, local governments can budget with much greater certainty when they know that the total level of central support will vary with e.g. income tax collections (distributed in accordance with a known formula) than when they are totally at the mercy of discretionary central policy. Again, in the transition socialist economies, the grants are typically fixed in an ad hoc way, both in aggregate volume, and in terms of the allocation across individual government units, which are negotiated and bargained between center and locals. Hungary is the only exception here: the grant volume is determined annually by MOF, but its allocation is by a complex (some might say overly complex) formula. This complexity can be explained in part as a reaction to the imprecision and bargaining by which the previous allocation system worked: over-precision is an attempt to move as far as possible from this approach.

#### Distribution of the Grant.

193. However these two points - the unconditionality of the grant and the determination of its total - are settled, the distributive formula of the grant also needs to be addressed. As noted above, at present there are two elements in the present Hungarian formula: equalization (per capita) and needs. As argued above, a third essential element in any general grant formula is to make some explicit allowance for the revenue-raising capacity of local governments. That is, the basic formula of the normative grant should be altered to some version of the following general formula:

$$G_i = eE_i - tR_i$$

where  $G$  is the amount of the grant,  $i$  refers to a particular municipality,  $E$  to some measure of "need" (for example, the present normative grant formula, population, or anything else that seems appropriate),  $e$  is an assumed level of expenditure for each unit of measured need,  $R$  is a measure of revenue capacity, and  $t$  is the assumed rate at which this capacity is tapped (or taxed).

194. Assuming for the moment that the total  $G$  to all  $i$  is equal to the present normative grant and that the "needs" measure is that used in the present formula - as noted earlier, both of these assumptions can be changed

in any desired way without affecting the general argument<sup>38/</sup> - the introduction of the capacity element has three important effects. First, it will shift grant funds from "high-capacity" to "low-capacity" recipients. Second, it will stimulate all recipients, regardless of their estimated capacity, to tax that capacity at the assumed rate (for example, the national average rate), because if they do not do so, the grant they receive will be reduced precisely by the amount they fall below the assumed rate. Finally, on the other hand, if any recipient chooses to levy higher taxes than those assumed in the grant formula it gets to keep all the extra revenues - that is, it is not "taxed" by having its grant reduced.

#### Measuring Capacity and Expenditure Need.

195. Clearly, the most critical element in this formulation is the measurement of capacity and need. Such calculations are difficult in any circumstances and perhaps particularly difficult in the changing circumstances of the transitional economies. Nonetheless, some relevant information exists: for example, on collections from the old duties, on PIT liabilities, and on the "turnover" basis for the business tax. Moreover, there appears to be considerable information in some countries - notably Hungary and the Czech Republic - on the basic characteristics of the new local governments: their population, its demographic characteristics, their economic bases, and so on. It should therefore be possible to construct a number of estimates of revenue capacity (defined so that the estimate is not subject to local manipulation)<sup>39/</sup> and expenditure need in order to experiment with variations of this formula and to determine whether the resulting distribution of the grant makes sense in light of needs and the aims of the new local finance system.<sup>40/</sup>

196. In contrast to the relatively well-developed Hungarian grant system, in Romania, for example, the present transfers to local governments are entirely discretionary and negotiated. The same is true of Russia, and most of the former union republics, now the CIS. On the other hand, like the Hungarian case, this transfer appears to be lump-sum, that is, it would appear that local governments can spend it, once they get it, free of all conditions and constraints. In fact, however, as under the old regime, the local branches of the Ministry of Economy and Finance continue to supervise the implementation of local budgets closely and to make sure that the targets specified in local budgets are achieved. Most of the transfer has in recent years been used to cover the losses incurred by the regies owing to the large heating and transportation subsidies. In 1991, for example, these two subsidies accounted for more than 32 billion lei out of a total transfer of 65 billion lei. By September 1993, however, these two subsidies are supposed to be gradually phased out, following a 25% subsidy cut on May 1 1992, and similar cuts on September 1, 1992, May 1, 1993 and September 1 1993. Corresponding to the cut in subsidies, the central transfer to local governments will apparently be cut proportionally, although that this would happen was by no means clear to some local government officials.

197. The basic criticisms that may be made of the present transfer system in Romania (and other countries as well) are thus three. First, it encourages recipients to be wasteful and lax - and thus run bigger deficits and get bigger transfers. Second, the system may of course also be criticized for its lack of transparency and for the considerable amount of negotiation that may (at least potentially) be hidden in it. Third, even if these defects were corrected - as they largely have been in Hungary - it would basically deliver funds derived from taxpayers in general

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<sup>38/</sup>The same is true with respect to the expenditure level per unit of measured base: it may, for example, be taken as the average national level of expenditure on the chosen item, or as some desired or minimum level of expenditure.

<sup>39/</sup>Note that the estimates of tax capacity required for implementing a grant formula such as that suggested in the text are estimates of the ability of localities to raise revenue and not necessarily estimates of the ability of local residents to pay taxes. Both the "richness" of the locality relative to others and its taxing power are critical to such calculations.

<sup>40/</sup>For preliminary explorations along these lines, see Bird and Wallich, "Financing Local Government in Hungary."

to officials in particular localities to spend as they see fit, thus vitiating the essential democratic (and efficiency) principle of accountability.

198. In reality, of course, the existing Romanian system offers almost no room for local incentive effects since in fact it is still the old central control system in a slightly different guise. That is, instead of unconditional transfers - set in some undetermined but apparently "gap-filling" way - in fact up to now local governments have (regardless of what the law appears to say) acted as though their expenditures too were fixed (e.g. with respect to salaries, number of employees, levels of services provided, and so on). If the level and composition of local expenditures is, de facto, determined centrally, it does not matter that the level and composition of local revenues is similarly determined: there is no effective local autonomy. As such autonomy begins to become real, however, and there is evidence that this is now happening in at least some areas of Romania, the bad design of the present transfer system will become increasingly unsatisfactory.

199. For this reason, it is important that the future development of transfers in Romania (and other transitional economies) should take more explicitly into account the basic principles of a good transfer system. For example, the size of the total transfer to local governments from the central government (the "distributable pool") might be set as a fixed percentage of total central taxes. This is desirable to provide both budgetary stability - to insulate the central budget to some extent from local problems and to provide a "hard" budget constraint for local governments - as well as sufficient budgetary flexibility over time to accommodate the reasonable growth of local finances. Moreover, experience suggests that it may be preferable to set the size of the "distributable pool" with reference to all taxes rather than as a percentage of a particular tax or taxes in order to avoid distorting central tax policy decisions.

200. In addition, as suggested above, the distribution formula should in principle be based on some feasible, and acceptable, measures of capacity and need, and the transfer payments should be made conditional on performance. Although in the end the extent to which any transfers are "equalizing" in any country is inevitably essentially political, it is critical to have an adequate quantitative base in order both to be able to design such equalization features properly (e.g. with respect to matching grants) and especially to assess their probable effects. A critical research need in most transitional economies is therefore to derive such measures of capacity and need and to develop a system for monitoring performance. Close attention must be paid to the supervision, accounting, and monitoring of transfers, and associated local expenditures. This question is also important with relation to both local borrowing and any use of matching funds e.g. for investment purposes. As noted earlier, a transfer formula properly designed in terms of needs, capacity, and performance will also encourage local fiscal effort. Finally, although for political reasons, it may prove necessary to base distribution in part on derivation or to make the transfers payments partly or wholly unconditional, it is essential from the point of view of both efficiency (in resource allocation) and accountability (in public sector decision-making) that these elements be minimized.

## VII. BORROWING

201. In most transition economies, a striking feature of subnational finances is the generous legal access of subnational governments to unlimited borrowing, sometimes even foreign borrowing. In Hungary, the Local Self-Government Act permits unrestricted domestic borrowing (for current and capital expenditures) to all local governments. In the Russian Federation, the law on Rights of Local Self-Government permits the same for oblast and rayon level governments. In Bulgaria, the municipalities can borrow from banks, and in addition, under the existing law they have an unrestricted right to issue bonds. In Poland, borrowing authority is more limited: by law, localities are not allowed to borrow more than 5% of current budgeted expenditures. In Romania, local governments can borrow in unrestricted fashion, as an element of their "autonomy", provided they can prove their creditworthiness and amortization capacity. In China, provincial governments have until recently had unrestricted access to foreign borrowing through provincially-owned development banks; this access has recently been reduced through a new law on foreign exchange management and debt registration. Local governments in China cannot

borrow domestically, however, at least directly, although they do so indirectly through enterprises they own and through local financial intermediaries which float bonds designated for local government projects<sup>41/</sup>. In the CSFR, the two republics have restricted access to borrowing through T-bills issued on an agreed basis and amount by the Federal Ministry of Finance. By and large, however, despite these liberal provisions, local government borrowing has so far not been significant, as table 9 shows.

Past Borrowing Practices.

202. In some countries, however, the heritage of debt from the previous regime has become a problem. In the pre-reform situation, in which the national credit plan was designed to finance investment and other expenditures called for in the Plan, to the extent that in the unified framework of the Plan, local governments required loans, borrowing was not only permitted, but indicated. The loans were made by one or another of the State Banks, whose lending was wholly plan-directed. In Hungary, for example, many localities borrowed under the credit plan in the pre-reform period, with each loan being guaranteed by a higher-level authority. In the Slovak Republic the indebtedness of the local (municipal) government to the banking sector is especially high: some 30 municipalities have been able to pay neither principal nor interest on these loans. In Poland, it has been reported that almost 900 geminas (40% of all local governments) are in debt, as a result of borrowing, mainly from banks, under the pre-reform regime.

203. The facilities for borrowing provided to local governments in the post-reform legislation thus have roots in the planning period. In present day circumstances, however, such generous and virtually uncircumscribed access by local governments to loan finance seems out of place. Such access is restricted even in most western countries for several reasons. First, the central government uses debt finance as a stabilization tool, and it does not want local governments acting in such a way as to counter its policies. Second, local borrowing may in some circumstances crowd out private sector borrowing which may be more economically beneficial to the country. Third, to the extent central governments wish to avoid local governments becoming bankrupt they in effect implicitly guarantee local government debt, so that local government borrowing becomes a potentially open (and destabilizing) door to the national treasury.

Table 10  
Subnational Government Borrowing

Country	Local Borrowing Authority	Borrowing % of total revenue in recent years
Hungary	Yes (unlimited in law)	some municipalities have past debts
Poland	Yes (limited in law)	1.4%
Romania	Yes <sup>1/</sup>	N.A.
Bulgaria	N.A.	N.A.
Czechoslovakia	Yes	significant past debts outstanding
Russia	Yes (unlimited in law) <sup>2/</sup>	
China	No <sup>3/</sup>	0
Vietnam	N.A.	N.A.

Notes: <sup>1/</sup> Even though local governments in Romania are permitted to borrow in principle, in reality there exists no borrowing - just arrears (non-payment of bills); <sup>2/</sup> This was suspended in 1992; <sup>3/</sup> Sometimes borrowing takes place through enterprises (see text).

<sup>41/</sup>See "China: Revenue Mobilization and Tax Policy", World Bank Country Report, Washington DC, 1990, and "China: External Trade and Capital", World Bank Country Report, Washington, DC, 1988.



204. For these reasons in virtually every developed country local government access to capital markets is strictly controlled. Among the methods used to control local borrowing are: (i) permitting borrowing only for approved capital projects; (ii) requiring prior approval of local taxpayers for borrowing above a certain amount; (iii) requiring prior approval of central authorities for borrowing; (iv) restricting the amount of debt to some percentage of local revenues; and (v) permitting borrowing only from a central "municipal fund." All such restrictions obviously reduce local autonomy. On the other hand, it is also common to provide some capital assistance to local governments, in the form of matching grants (as discussed earlier) or in the analytical equivalent of explicitly or implicitly subsidized borrowing conditions.

205. The precarious macroeconomic situation in many transitional economies makes the case for limiting local access to capital markets even stronger than usual. Additional reasons to be concerned with problems that might arise because most of the new municipal governments have no experience with financing and are in many instances not yet capable of preparing and presenting complete and meaningful projects. Nor, for that matter, are most of the financial institutions in transitional economies capable of evaluating long-term risks or handling long-term financial instruments.

206. Nevertheless, to the extent that benefits from some projects are enjoyed in the future, it seems both fair and efficient that future residents share in the cost of financing such projects. Borrowing for local capital projects may thus have a sound theoretical base. Moreover, borrowing may sometimes be the only practical way to finance large capital outlays without huge, and undesirable, variations in local tax rates from year to year. There is thus, in principle, a strong case for financing capital projects at the local level through debt finance.

#### Sources of Borrowing.

207. In the short term, however, there should probably be limited or no local borrowing in most such economies for macroeconomic reasons. In the longer run, however, some facilities for limited sub-national borrowing will be needed. Long-term borrowing by local governments should be restricted to the financing of capital projects, perhaps with regional governments and large cities having a little wider discretion in using debt. At all times, borrowing from the central bank should be prohibited.

208. A common view in some of the transitional economies appears to be that local governments should be tapping the financial markets for capital funding, thus serving the dual aims of developing capital markets and financing long-gestation projects. However, only the very largest such governments are ever likely to be able to access financial markets directly. Moreover, only in the U.S. are financial markets the major source of debt finance for local governments. Commercial banks are a more likely source of funds in transitional economies - and they may well remain the main source, as in Germany. Bond issues might come later, if ever, once markets for such financial instruments are developed, and sub-national governments establish creditworthiness.

209. For most local governments, however, the only way to access capital markets may be through some such device as municipal development banks, especially if they are not set up by the central government, but spring up as cooperative efforts of, for instance, groups of cities. Such banks (or funds) could give technical assistance to the individual governments in this new field of borrowing, would take up deposits from them and lend them the necessary amounts. Local governments should not, of course, receive subsidized credit through any such source (except when the national government explicitly wishes to subsidize particular types of municipal investment, for reasons similar to those discussed earlier in conjunction with matching grants). In view of the tangled relations between governments and enterprises discussed elsewhere, it is equally important that such credit not be extended indirectly through borrowing by government enterprises.

210. The history of special "Municipal Development Funds" in other countries is in some respects not very encouraging (Columbia is an exception). Few of these funds have developed a capacity for sustained (continued)

assistance to municipal government and investment on the scale needed.<sup>42</sup> Most have been undercapitalized. As a rule, they have tended to play a narrow and passive financing role, applying little technical or financial appraisal to the schemes they have funded, and offering little positive assistance to municipalities other than capital finance. Those designed to provide technical assistance have tended to concentrate skills and resources on the direct execution of capital works, which are handed over to municipalities for operation and debt service. While this approach has added to the stock of urban infrastructure, it does little to promote the capacity or commitment of municipalities to operate or expand that infrastructure effectively, or to recover costs. Too many municipal development funds have tolerated substantial arrears, with poor repayment records leading to weak institutions and incentives for localities not to repay. For all these reasons, care must be exercised in setting up special municipal financing institutions in transitional economies.

## VIII. PRIVATIZATION AND OWNERSHIP

211. A striking feature of the fiscal landscape in the transitional economies is the continued significant ownership role of subnational governments at a time when center/national priorities support privatization. One reason is of course the transfer of assets to them in the process of "decentralization of ownership" described earlier. Another reason arises in some degree from the inadequate revenue base given localities and their continued financial dependence on enterprise revenues. If the privatization process is to be completed, getting local governments out of business, and into the "business of government" is crucial. In the course of this process, important questions remain to be answered, relating to the use of the transitory revenues from privatization, and how best to take advantage of the asset stock held by local governments.

### Asset Transfers

212. One of the most important initial features of fiscal decentralization has been the transfer of assets to local governments. Local governments are increasingly becoming owners of enterprises, housing, vacant urban land and retail establishments, as these assets are transferred from the center. In Hungary, the 'Act on Property Transfer' (1991) gave local governments ownership of the housing stock previously owned by the central government. In Romania, local governments have been given all formerly "state" (centrally) owned properties within their territories, ranging from public domain property (parks) to private domain property such as enterprises. In Russia, enterprises have long been owned by each level of government, and housing and land has been transferred to municipal and rayon level governments beginning in 1991. In China, decentralization of enterprise ownership from the state to provincial and local ownership was a key feature of the overall decentralization of economic decision making, and took place as early as the mid-1980's. Housing has always been a municipal or enterprise responsibility (See Table 10).

213. Such asset transfers can be a mixed blessing. While consistent with decentralization and rhetoric about local autonomy, such transfers also fit with the center's aim of reducing its involvement in the economy. Indeed, one motivation for transfers of enterprises, land and public housing, has likely been to avoid the fiscal burden (such as subsidies, maintenance and repair) that ownership responsibilities carry. Local governments will thus be faced with these major maintenance and subsidy burdens, unless costs can be quickly recovered. Privatization of the housing stock in particular is a priority (see discussion below on timing of sales) as is sale of locally-owned enterprises.

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<sup>42</sup> See Ken Davey, 1990; *Municipal Development Funds and Intermediaries*; PPR Working Paper No 32; World Bank

Table 11  
Privatization Revenues: Ownership and Disposition  
Recent Transfers of Ownership

Country	Housing	Retail Units	Domestic Industrial Enterprises
Hungary	Local	Local	Central, Local
Poland	Local	Local	Central, Local
Romania	Local*	Local*	Central, Local
Bulgaria	Local 1/	Local*	Central, Local
CSFR	Local	Local	Central, Local
Russia	Local,Enterprise	Local	Local*
China	Local,Enterprise	Local, Central	Central, Local
Vietnam	Local,Enterprise	Local, Central	Central, Local

Notes: 1/ In Bulgaria only 10-15% of the total housing stock is in the hands of local authorities. The remaining 85-90% is now privately owned.; \* almost exclusively local.

#### Privatization vs Entrepreneurialism

214. Unfortunately, in at least some countries just the opposite appears to be taking place. There is considerable evidence that this process of property transfer is giving broader scope to the entrepreneurial ambitions in the local governments as they use their new property rights to "activate" idle property. A worrisome pattern in virtually all transition economies has been the involvement of governments at different levels in joint economic ventures in purely private market oriented activities. Romania's law puts it best, but is not exceptional: " Local governments are authorized to create, contribute equity and or take shares in commercial enterprises formed with their assets belonging to or transferred to their ownership, including the possibility of forming joint ventures with foreign or domestic partners."

215. Localities appear to be excessively optimistic about their abilities to enhance revenue from this source. One vehicle some hope to use is to establish joint ventures with a domestic or foreign partner, or another state enterprise, using local assets as the locality's equity share. In those localities well endowed with land, this appears to be the preferred equity contribution, and localities appear also to see potential in developing and servicing empty land so as to enhance its value as equity. Of course, real estate development and financing is of course one of the riskiest business areas in market economies, and it is not likely to be a better bet in the transitional economies. In Hungary, tourism lodges, recreational facilities and golf courses were cited as examples of such ventures-in-process, and in localities which inherited important real properties similar potential was seen in developing these as contributions to industrial joint ventures such as bakeries, construction firms, and food processing. In Russia, virtually all rayon governments visited in the course of field work indicated the need to develop and exploit their asset base through domestic joint ventures, and looked forward to the revenue flow from the projects, once completed. Similarly, in Poland, the provision of private services as a means of earning additional revenues appears to have strong support, with housing and real estate development, food and furniture manufacture cited as examples.

216. From the perspective of local government, there are good reasons for government involvement in these new market ventures. With available land that can only with difficulty be privatized, the cost to government of contributing this resource to a joint venture may be perceived as very low. Also many local public officials understandably wish to create business employment opportunities in their jurisdictions, which are often economically

depressed and lacking private entrepreneurship.<sup>42</sup> However, the hope for profits from such ventures may quickly turn into demands on government budgets to cover losses. Experience everywhere shows that the perspectives and goals of public officials tend to make them poor business managers. In particular, it is very hard for a government to close a failing business, especially when the local employment situation is far from healthy. There is also the risk that the local governments and their locally-owned businesses will undercut private competitors, possibly by playing regulatory games to protect local monopolies, with the result that the role of government in the economy will not diminish. And, of course, if local governments own businesses, they may fall prey to the risks of ownership. In the industrial market economies, the rate of small business failure is high: only one in five of such businesses survive their first three years. There is no reason to expect that the transitional economies can beat these odds.

217. More importantly, in addition to being risky, entrepreneurial activity by local governments is fundamentally inconsistent with the privatization drive, and represents a bottleneck to true decentralization—that is, decentralization, not from the state to local governments, but from government to the private sector. Local entrepreneurial activity is neither privatization nor true decentralization. Such "entrepreneurialism" slows down, even reverses, the process of privatization - the long-term goal of getting government out of those activities that can be handled by the private sector.

218. It is thus critical in reforming socialist economies to provide adequate revenue instruments and flexibility at the subnational level. If the only flexibility available to local governments in their struggle to cope with budgetary pressure is by using economically undesirable sources of revenue such as profits derived from direct public ownership of local businesses, they will do so. Municipalities should not be encouraged to develop local monopoly enterprises in order to secure the revenue they need to function, just as they should not be forced to establish small taxes on a wide range of products and activities which are expensive to administer, generate widespread public resistance, and typically yield little. Some local access to a robust national tax base (through transfers), the ability to levy local surcharges on certain national taxes where appropriate, and especially some significant revenue sources under local control are thus essential, if the struggle for local revenue is not to delay and perhaps destroy privatization reforms.

#### Timing of Asset Sales: Sales vs Give-aways

219. Potentially, selling the assets (housing, enterprises, land) held by local governments could yield significant revenues. There is, however, considerable controversy over how this process should take place, and even over whether assets should be sold or given away. The methods being employed in different countries range from auctions to "spontaneous privatization" to voucher systems. In most of the countries under study, at the local level assets are being sold, not given away: In Hungary, such sales are the responsibility of the State Property Management Company (for large enterprises). For small enterprises as well as locally owned housing, in both Hungary and Poland, local governments have responsibility. In Russia, the housing stock and locally-owned factories are all subject to sale. CSFR's privatization program combines give-aways (through vouchers for all citizens) with revenue-generating sales. Most enterprises will be sold by the two republics; the role of the local governments within these republics is not clear. Bulgaria, and Romania have yet to devise concrete privatization programs, but they are likely to include both give-aways through vouchers and sales.

220. Maximizing the yield from asset sales is a major challenge. Should they be sold now or later? Selling assets now, when markets for ownership and property rights are underdeveloped, may mean that they do not bring a good price for the local government -- a process, as one analysis put it, "akin to using the best furniture to fuel

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<sup>42</sup>A note of caution is also needed with respect to the apparent desire of many local governments to use fiscal incentives to bolster private business in their jurisdictions. The record of such "local development policies" is not very encouraging in any country, and efforts in this direction are all too likely to degenerate into a zero-sum game for local governments unless great care is exerted. On the whole, this is yet another area in which a national "framework law" - a binding cartel arrangement - seems needed.

the boiler on a ship running out of fuel". But at the same time, government needs revenues now. Selling assets later may improve yields, but such yields will come at a time when other local financing sources will also be available. Complicating this decision is the fact that many locally-owned properties are presently costing much more to operate and maintain than they are realizing in rents and hence constitute a major drain on subnational public finances. Getting rid of this burden is a high priority. Unfortunately, in almost all countries, the process of selling locally-owned enterprises, and especially housing, is slow, impeded by the absence of credit (especially mortgage finance), and the absence of a legal framework.

### Revenues from Privatization

221. What should local governments do with the proceeds from the privatization of public enterprises and the sale of other assets? First, it is important to remember that these revenues are "non-recurring" and do not represent permanent sources of financing for any local government. Efforts thus have to be made to develop adequate tax sources in addition to user charges for the future, when the revenues from asset sales disappear. That said, should such asset revenues be capitalized in special funds or invested on capital projects, or should they be used to finance current expenditures?

222. In practice, there appear to have been no special strings attached to the use of revenues from privatization. The unsurprising result is that the most common practice appears to be the use of these funds as an additional source of revenue in the recurrent budget. This is not all bad: indeed, it may be both distributionally attractive as well as economically efficient (less dead-weight loss) to raise revenues from privatization than from taxes. But, as noted earlier, one cannot live forever by selling the furniture. Sometimes such revenues have been kept in extrabudgetary accounts. In Hungary, for instance, rents from locally-owned housing accrue to off-budget accounts, while sales proceeds from locally-owned housing accrue to the general budget, but are not earmarked for any particular purpose. In the case of privatization of locally-owned enterprises, the proceeds also accrue to the budget, with no restrictions on use. In Poland and Russia, revenues accrue to the budget, with no restrictions on their use.

223. A more conservative principle of public finance would call for the investment of these proceeds in long-term assets to allow local governments to draw income from assets over a long period of time. Alternatively, revenues could be used to repay debt.<sup>44</sup> In Hungary, revenues from privatization involving foreign joint ventures and generating foreign exchange are channeled through the State Property Management Agency (SPMA) to repay Hungary's external debt. In the Russian Federation, where most privatization has been domestic, it has been recommended that the stock of domestic government Treasury debt should be reduced this way. In Poland, revenues from privatization are being used to finance current operations, and to compensate for inadequate tax yields. In China, no commitment to privatization is as yet apparent.

## IX. CONCLUSIONS

224. Subnational finance and local government policies are emerging as crucial elements of the ongoing reforms in transitional economies. Subnational governments play a large role in overall economic activity, account for a large share of public sector outlays, and own a significant share of public enterprises and the public housing stock. Recent attempts to streamline government budgets have led to increased local government responsibility for such crucial matters as health, education and safety net expenditures, including unemployment and enterprises.

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<sup>44</sup>See Newbery, D. "Reform in Hungary: Sequencing and Privatization," European Economic Review, No 35, 1991, pp 571-580. Newbery argues against a rapid, "fire-sale" or giveaway approach because many of the assets may have been financed with debt (as noted earlier, many local governments in transitional economies have substantial liabilities), in which case the proceeds should be used to pay off this debt, rather than burdening present and future local taxpayers with debt service.

Underfunded local governments are seeking coping mechanisms, not all of them constructive, to meet these new challenges.

225. This paper has described the risks to privatization, to macroeconomic stability, and to an adequate social safety net that present policies towards local government may imply. Our themes are that the subnational sector needs to be more realistically factored into national plans, and that subnational expenditures be more clearly assigned and revenue needs more realistically assessed. Such assessments are likely to acknowledge a larger sphere for subnational governments and the need for access to more robust revenue sources. Giving local government a share in the personal income tax is one possible and perhaps desirable approach to meeting these revenue needs.

226. Careful attention also needs to be paid to the design and implementation of the intergovernmental fiscal transfers that are likely to remain prominent features of the intergovernmental landscape for years to come. Caution is also needed with respect to borrowing by subnational government. Consolidation and integration of extrabudgetary funds at the subnational (and national) levels is crucial to enhanced budgetary transparency and macro stability.

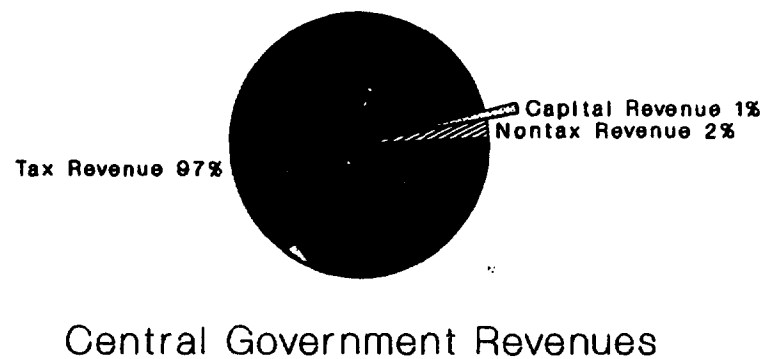
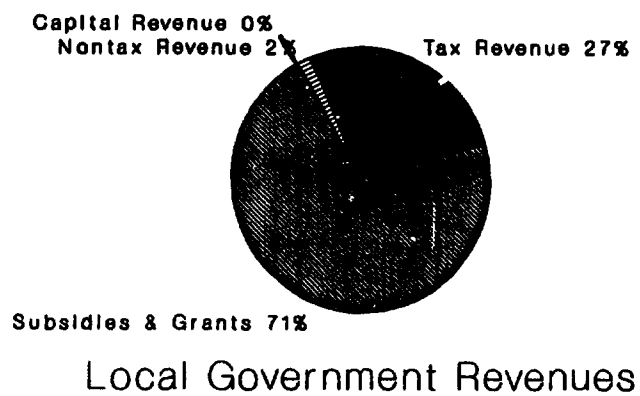
227. Finally, proper funding of the subnational sector is a necessary (albeit perhaps not sufficient) condition for the successful privatization of enterprises now held by local governments. In its absence, local governments will continue, as at present, to seek gains from keeping these enterprises, and to add to their revenues by setting up new commercial enterprises and impeding privatization.

228. In short, local government finance is not a "local matter", but is crucial to almost all of the key reform goals of stabilization, safety net and private sector development.

## **APPENDIX TABLES**

# GOVERNMENT REVENUES

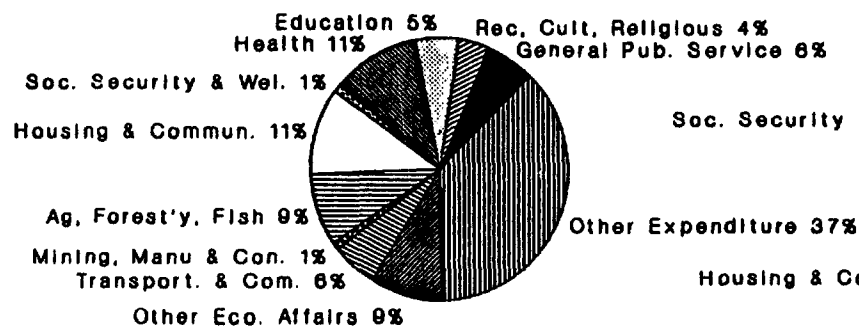
## ROMANIA 1991



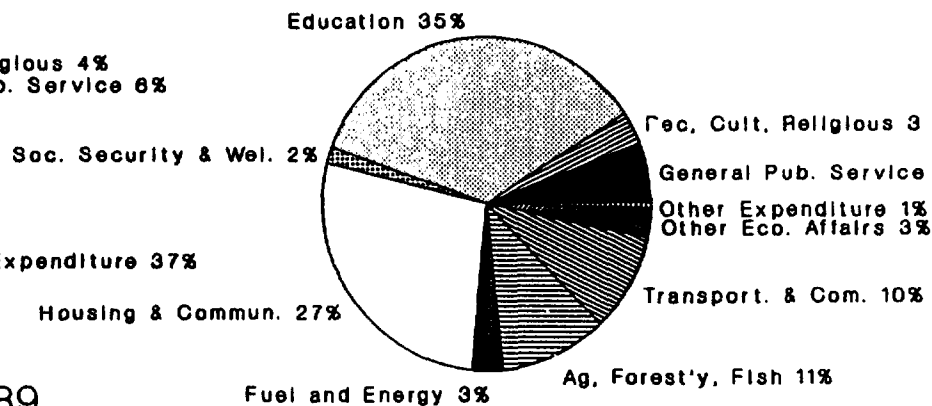


# LOCAL GOVERNMENT EXPENDITURES BY TYPE

## ROMANIA 1989 and 1990.



Expenditure by Type 1989



Expenditure by Type 1990

**Public order & safety, Health and Mining, Manufc and Construction had zero expenditure in 1990.**

KOMMIVA TABLE ONE: EXPENDITURES  
Budgetary Central and Local Government Expenditures by Service

Expenditure as	Budgetary Central Government (Janr)				Local Government (Munirata)				Local Govt. as % of Total Local				Local Govt. as % of Total Central						
	1988	1989	1990	1991	1988	1989	1990	1991	1988	1989	1990	1991	1988	1989	1990	1991			
<b>PUBLIC SERVICES</b>																			
General Public Services	1.8	1.9	3.8		1.9	2	3		6.09	6.22	5.85	0.00	105.56	105.26	78.95	0.22	0.25	0.36	
Public Order and Safety	0	0	4.5	a 19.46	0	0	0		0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	
Rec., Culture and Religious Affairs	0.2	0.2	1.2		1.2	1.2	1.6		3.85	3.76	3.12	0.09	600.00	600.00	133.33	0.14	0.15	0.19	
<b>SOCIAL EXPENDITURE</b>																			
Education	14.5	15.3	7.2	77.81	1.7	1.7	18.1		5.45	5.30	35.28	0.00	11.72	11.11	251.39	0.28	0.21	2.14	
Health	15	16.2	24.4	82.11	3.5	3.5	0		11.22	10.90	0.00	0.00	23.33	21.60	0.00	0.41	0.44	0.00	
Social Security and Welfare	65.8	71.2	85.9		0.3	0.3	0.8		0.96	0.93	1.56	0.00	0.46	0.42	0.93	0.04	0.04	0.09	
Housing and Community Amenities	26	25	0		3.2	3.4	14		10.26	10.59	27.29	0.07	12.31	13.60	0.00	0.37	0.43	1.66	
<b>PRODUCTIVE ECONOMIC SERVICE</b>																			
Fuel and Energy	27.2	26.5	18.2		0	0	1.5		0.00	0.00	2.92	0.00	0.00	0.00	8.24	0.00	0.00	0.18	
Agriculture, forestry and Fishing and Hunting	19.8	18.6	30.4	b 35.82	3.8	2.8	5.4		12.18	8.72	10.53	0.00	19.19	15.05	17.78	0.44	0.33	0.64	
Mining, Metallic and Construction	36.8	35.9	31.9		0.2	0.3	0		0.64	0.93	0.00	0.00	0.54	0.64	0.00	0.02	0.04	0.00	
Transportation and Communication	19.7	19.5	10.8	c 32.38	1.8	1.8	4.9		5.77	5.61	9.55	0.04	9.14	9.23	45.37	0.21	0.23	0.58	
Other Economic Affairs and Services	13.6	10.1	10.3		1.8	2.9	1.4		5.77	9.03	2.73	0.00	13.24	28.71	13.59	0.21	0.36	0.17	
<b>OTHER EXPENDITURE</b>																			
	2.9	2.9	9.6		11.4	11.8	0.3		36.54	36.76	0.58	0.00	393.10	406.90	3.13	1.33	1.48	0.04	
<b>TOTAL EXPENDITURE</b>	271.6	272.9	268.7	1537.87	31.2	32.1	51.3		100.00	100.00	100.00	100.00	11.49	11.76	19.09	10.866	3.66	4.02	6.07

Notes:

- a/ Public Order only
- b/ Agriculture only
- c/ Transportation only

A. All data for 1988-1990 was obtained from the Government Finance Statistic, IMF  
 B. Data for 1991 was obtained from the Ministry of Finance and the Economy

ROMANIA TABLE TWO: EXPENDITURE  
Local Government Expenditure By Intermediate and Final Services

Expenditures	Local Government (Amounts)				Local Govt. as % of Total Local				
	1988	1989	1990	1991	1988	1989	1990	1991	1991
<b>INTERMEDIATE SERVICES</b>									
General Public Services	1.9	2	3		6.09	6.23	5.85	0.00	
Public Order and Safety	0	0	0		0.00	0.00	0.00	0.00	
Fuel and Energy	0	0	1.5		0.00	0.00	2.92	0.00	
Agricult., Forestry Fishing and Hunting	3.8	2.8	5.4		12.18	8.72	10.53	0.00	
Mining, Metallic and Construction)	0.2	0.3	0		0.64	0.93	0.00	0.00	
Transportation and Communication	1.8	1.8	4.9	0.03	5.77	5.61	9.55	0.04	
Other Economic Affairs and Services	1.8	2.9	1.4		5.77	9.03	2.75	0.00	
Other Expenditure	11.4	11.8	0.3		36.54	36.76	0.58	0.00	
<b>FINAL SERVICES</b>									
Rec., Cult and Religious Affairs	1.2	1.2	1.6	0.06	3.85	3.74	3.12	0.09	
Education	1.7	1.7	18.1	0.00	5.45	5.30	35.28	0.00	
Health	3.5	3.5	0	0.00	11.22	10.90	0.00	0.00	
Social Security and Well- Being	0.3	0.3	0.8		0.96	0.93	1.56	0.00	
Housing and Community Amenities	3.2	3.4	14	0.04	10.26	10.59	27.29	0.07	
<b>TOTAL EXPENDITURE</b>	<b>31.2</b>	<b>32.1</b>	<b>51.3</b>	<b>58.45</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>

ROMANIA TABLE THREE: REVENUE AND EXPENDITURE

Revenue and Expenditure	Budgetary Central Government (Amounts)				Local Government (Amounts)				Local Government as % of Total Local				Local Government as % of GDP						
	1988	1989	1990	1991	1992	1989	1990	1991	1992	1989	1990	1991	1992	1989	1990	1991	1992		
	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr		
<b>TOTAL REVENUE</b>																			
Own Revenue	1315.95	1332.29	2865.26	494.78	371.4	31.7%	30.23	52.03	17.22	50.43	100.0	100.0	100.0	100.0	100.0	100.0	100.0		
Current	1315.95	1332.29	2865.26	494.78	371.4	28.21	27.7%	41.27	17.22	50.43	82.6	83.5	79.3	83.5	83.5	83.5	83.5	83.5	
Tax	80.85	85.25	247.07	479.4	349.5			16.09	16.09	16.09	27.4	17.5	27.4	17.5	17.5	17.5	17.5	17.5	
Monies	235.1	247.06	15.66	11.23	17			0.95	0.95	0.95	1.6	1.2	1.6	1.2	1.2	1.2	1.2	1.2	
Capital	0	0	2.55	6.15	4.9			0.18	0.18	0.18	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2	
Subsidies and Grants	0	0	0	n.a.	n.a.			41.41	46.8	46.8									
<b>TOTAL EXPENDITURES</b>																			
Current	271.4	272.95	268.72	537.87	377.7			31.2	32.18	32.18	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	
Goods and Services	62.62	60.87	67.52	254.42	n.a.			17.03	17.26	17.26	n.a.	n.a.	54.6	53.6	64.0	37.1	27.2	28.4	48.7
Wages and Salaries	26.04	26.97	33.47	159.36	n.a.			4.75	4.9	4.9	n.a.	n.a.	15.2	15.2	44.3	15.8	18.2	18.2	48.0
Other goods and services	33.24	30.4	30.63	104.06	n.a.			12.28	12.36	12.36	n.a.	n.a.	39.4	38.4	19.7	21.2	36.9	40.7	33.0
Subsidies and other transfers	68.03	75.13	151.09	204.83	n.a.			11.39	11.8	11.8	n.a.	n.a.	36.5	36.7	5.5	40.3	16.7	15.7	1.9
Capital	140.95	104.95	46.3	78.42	32.8			2.78	3.12	3.12	n.a.	n.a.	8.9	9.7	30.5	22.6	2.8	2.3	33.9
<b>OVERALL BALANCE</b>	44.35	59.34	-3.46	-41.09	-4.3			0.54	1.05	1.05	n.a.	n.a.	8.9	9.7	30.5	22.6	2.8	2.3	33.9
<b>FINANCING</b>	-44.35	-59.34	3.46	41.09	4.3			-0.54	-1.05	-1.05	-2.9	-2.9	-0.43	-0.43	-0.43	-0.43	-0.43	-0.43	-0.43

Source:

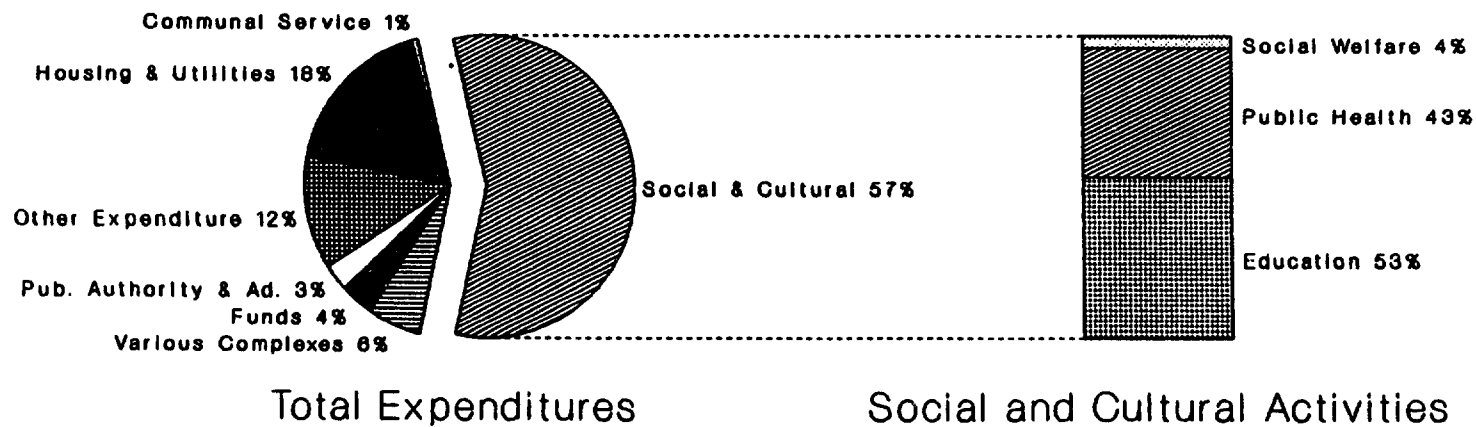
Ministry of Finance and Economy for 1991 and first quarter of 1992  
 Government Finance Statistic, International Monetary Fund for 1988-1990.  
 GDP values for 198-1992 are 854.9, 797.9, 844.0 respectively

Note:

Since new reforms were initiated in 1989 and again in 1990, it may not be meaningful to consider data before 1991.

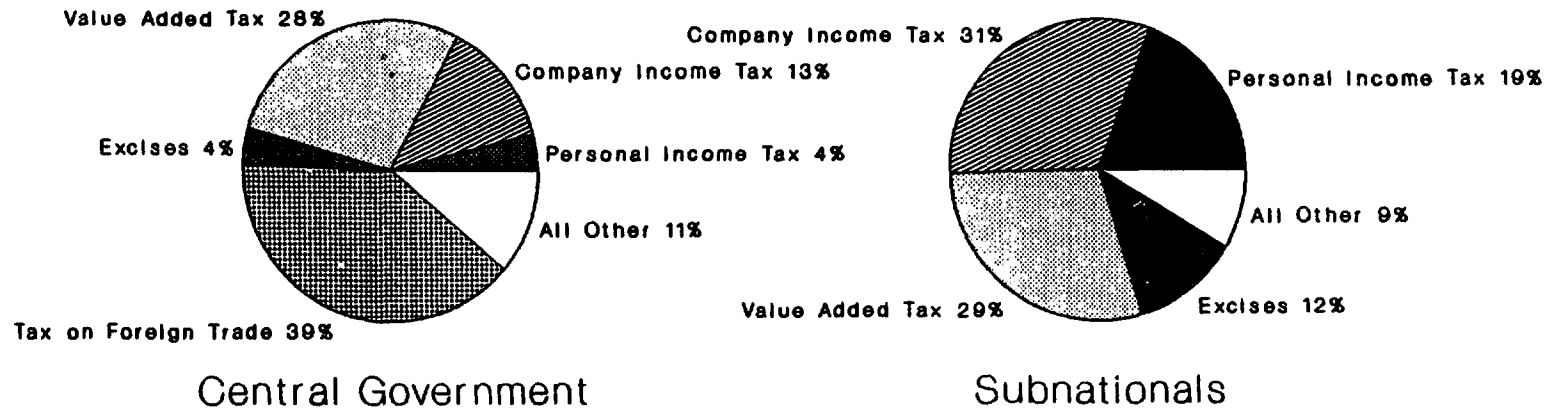
# BUDGETARY EXP. AT THE SUBNATIONAL LEVEL

## Russian Federation, 1990



Source: MOF and Bank Staff Calculations

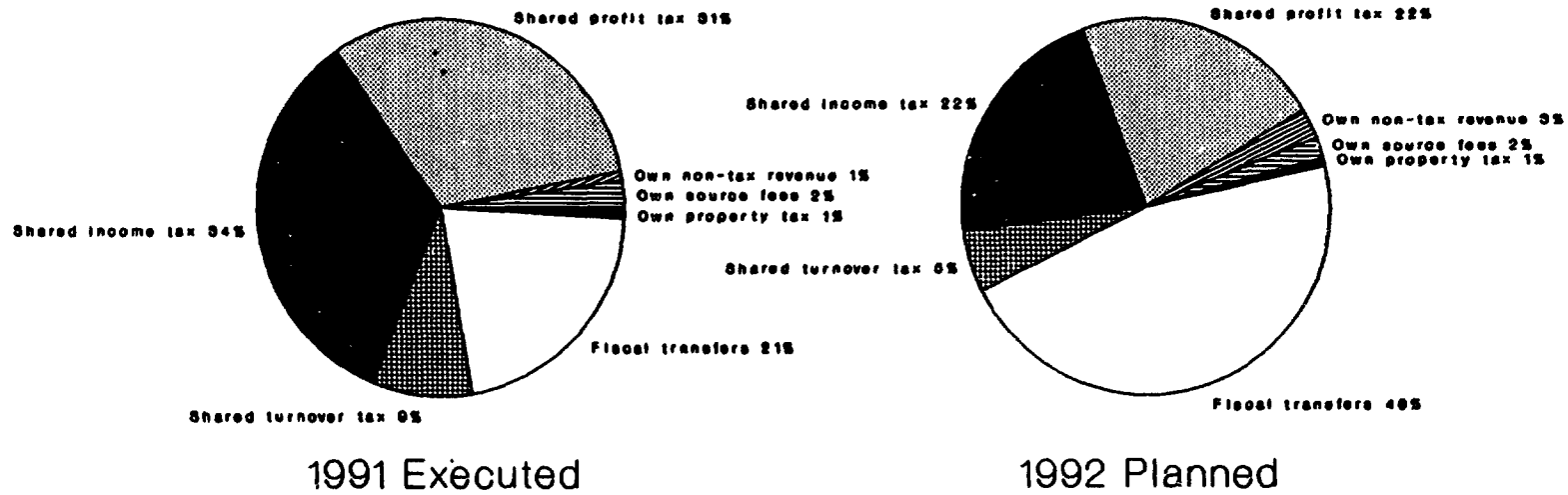
# REVENUE STRUCTURE AND REVENUE SHARING FOR Q1 1992 (estimates) RUSSIA



Different values were reported for each month of Jan, Feb and March 1992. Thus estimates should be viewed with caution.

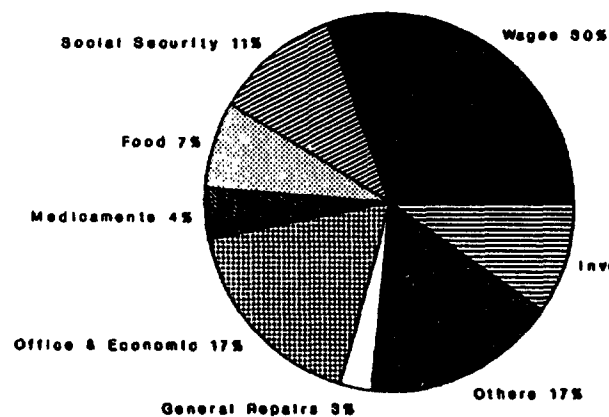
# AGGREGATE LOCAL REVENUES IN BULGARIA

## 1991 and 1992

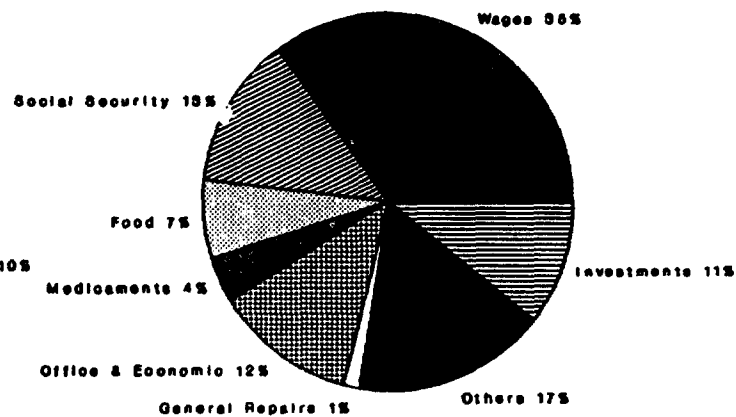


# LOCAL GOVERNMENT EXPENDITURES - BULGARIA

## 1991 and 1992



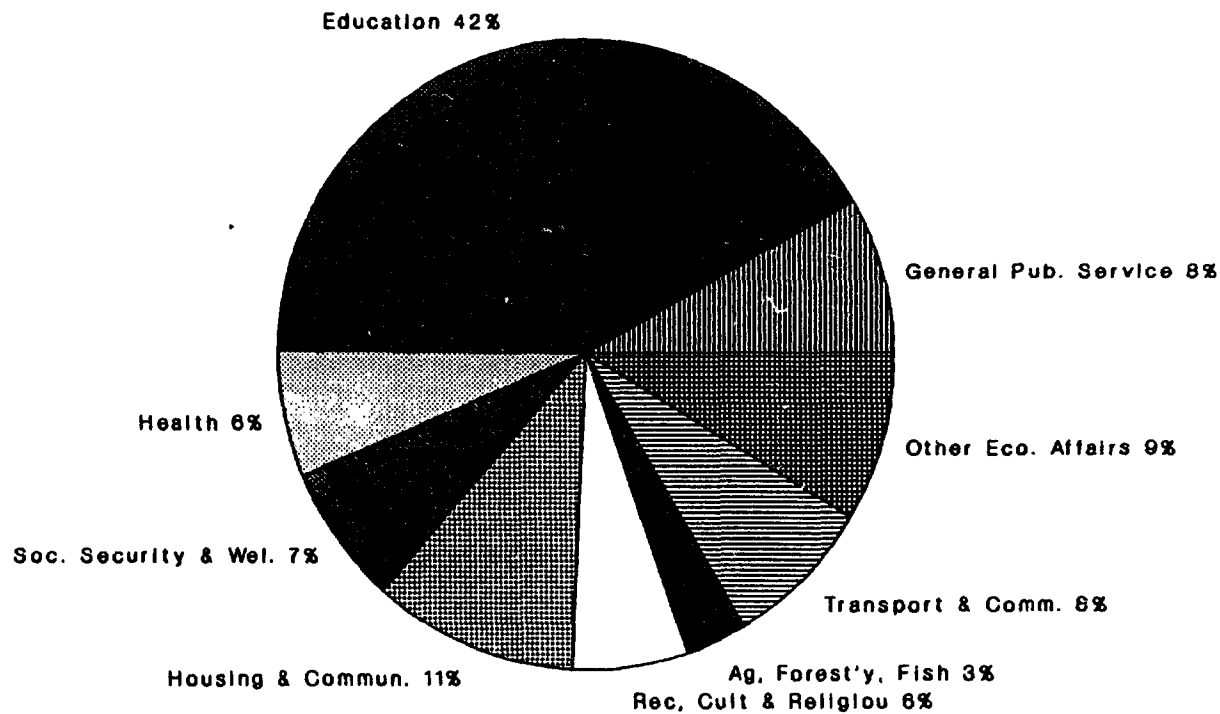
1991 Executed



1992 Planned

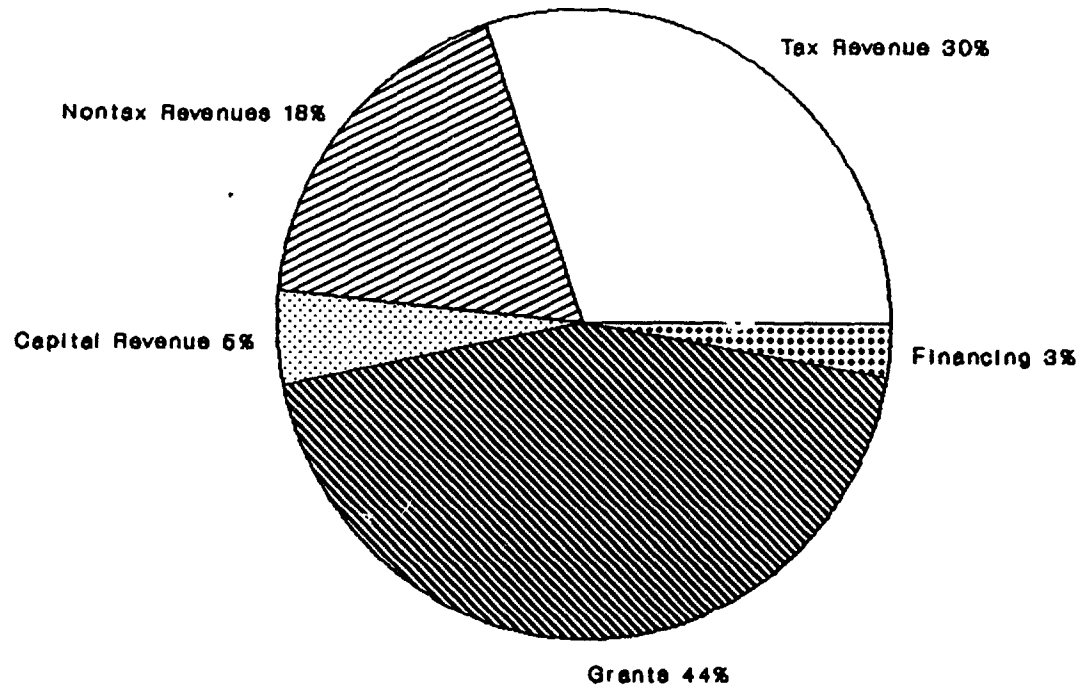


# LOCAL GOVERNMENT EXPENDITURE BY TYPE HUNGARY 1990



There was no exp. on Pub. Order and Safety, Fuel and Energy, Mining, Manu & Construction.

# LOCAL GOVERNMENT REVENUES HUNGARY 1990



**Tax Revenue is only comprised of  
tax on income, profit and capital  
gains**

BUDGETARY TABLE ONE: EXPENDITURES  
 Budgetary Central and Local Government Expenditures by Service :for Int., Billions

Expenditures	Budgetary Central Government (Aust)				Local Government (Aust)				Local Govt. as % of Total Exp.				Local Govt. as % of GDP			
	1988	1989	1990	1991	1988	1989	1990	1991	1988	1989	1990	1991	1988	1989	1990	1991
<b>PUBLIC SERVICES</b>																
General Public Services	137.8	112.6	143.6	137.8	13.6	13.3	20.8	13.6	6.75	5.26	8.10	0.00	1.72	1.39	1.91	0.97
Public Order and Safety	0	30.1	36.5	0	0	3	0	0	0.00	1.19	0.00	0.00	0.00	0.31	0.00	-0.00
Recreation, Culture and Religious Affairs	14.2	18.6	19.7	14.2	4.5	12.8	15.8	4.5	2.23	5.06	6.15	0.00	0.57	1.34	1.45	0.32
<b>SOCIAL EXPENDITURE</b>																
Education	16.2	23.6	33.1	16.2	18.2	79.4	107.3	18.2	33.86	31.40	41.77	0.00	8.61	8.29	9.85	4.84
Health	13.4	19.4	16.5	13.4	36.6	48.4	16.5	36.6	18.17	19.14	6.42	0.00	4.62	5.05	1.52	2.60
Social Security and Welfare	0.6	3	9.5	0.6	8.8	17.7	18.3	8.8	4.37	7.00	7.12	0.00	1.11	1.85	1.68	0.62
Housing and Community Amenities	9.8	13.6	15.7	9.8	32.3	16.5	27.4	32.3	16.04	6.52	10.67	0.00	4.08	1.72	2.52	2.29
<b>PRODUCTIVE ECONOMIC SERVICE</b>																
Fuel and Energy	11.6	21.1	28.9	11.6	4.1	1.3	0	4.1	2.04	0.51	0.00	0.00	0.52	0.14	0.00	0.29
Agriculture, Forestry, Fishing and Hunting	47.3	39.7	43.1	47.3	0.4	2.7	8.3	0.4	0.20	1.07	3.23	0.00	0.05	0.28	0.76	0.03
Mining, Manufacturing and Construction	84.4	27.7	25.8	84.4	0.5	3.7	0	0.5	0.25	1.46	0.00	0.00	0.06	0.39	0.00	0.04
Transportation and Communication	28.4	23.7	33.1	28.4	13.6	27.9	20.2	13.6	6.75	11.03	7.86	0.00	1.72	2.91	1.86	0.97
Other Economic Affairs and Services	62.6	87.9	68.5	62.6	12.8	20.7	22.3	12.8	6.36	8.19	8.68	0.00	1.62	2.16	2.05	0.91
<b>OTHER EXPENDITURE</b>																
	64.3	104.3	98.4	64.3	6	5.5	0	6	2.98	2.17	0.00	0.00	0.76	0.57	0.00	0.43
<b>TOTAL EXPENDITURE</b>	530.8	560.5	611.8	530.8	201.4	282.9	254.9	201.4	100.00	100.00	100.00	0.00	25.43	26.40	23.59	14.30

Notes:

- A. All data for 1988-1990 was obtained from the Government Finance Statistic, IMF
- B. Total Government Expenditure for 1988-1990 was 792, 957.8 and 1088.8 respectively
- C. GDP values for 1988 and 1989 was 1408.8 and 1706 respectively.

HUNGARY TABLE TWO: EXPENDITURE  
Local Government Expenditure By Intermediate and Final Services  
For Int., Billions

Expenditures	Local Government (Amounts)				Local Govt. as % of Total Local			
	1988	1989	1990	1991	1988	1989	1990	1991
<b>INTERMEDIATE SERVICES</b>								
General Public Services	13.6	13.3	20.8		6.75	5.26	8.10	
Public Order and Safety	0	3	0		0.00	1.19	0.00	
Fuel and Energy	4.1	1.3	0		2.04	0.51	0.00	
Agricult., Forestry Fishing and Hunting	0.4	2.7	8.3		0.20	1.07	3.25	
Mining, Manuff. and Construction	0.5	3.7	0		0.25	1.46	0.00	
Transportation and Communication	13.6	27.9	20.2		6.75	11.03	7.86	
Other Economic Affairs and Services	12.8	20.7	22.3		6.36	8.19	8.68	
Other Expenditure	6	5.5	0		2.98	2.17	0.00	
<b>FINAL SERVICES</b>								
Rec., Cult and Religious Affairs	4.5	12.8	15.8		2.23	5.06	6.15	
Education	68.2	79.4	107.3		33.86	31.40	41.77	
Health	36.6	48.4	16.5		18.17	19.14	6.42	
Social Security and Welf.	8.8	17.7	18.3		4.37	7.00	7.12	
Housing and Community Amenities	32.3	16.5	27.4		16.04	6.52	10.67	
<b>TOTAL EXPENDITURE</b>	<b>201.4</b>	<b>252.9</b>	<b>256.9</b>		<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	

MARGARY TABLE THREE: REVENUE AND EXPENDITURE

Revenue and Expenditure	Subsidiary Central Government (Accounts)				Local Government (Accounts)				Local Government as % of Total Local				Local Government as % of Rev				Local Government as % of GDP			
	1988	1989	1990	1991	1988	1989	1990	1991	Jan-Apr	1992	1988	1989	1990	1991	1992	1988	1989	1990	1991	1992
TOTAL REVENUE	573.9	613.5	724.9	724.9	205.2	243	249.9	249.9			26.0	26.2	22.6		14.6	14.2				
Own Revenue	573.9	613.5	724.9	724.9	42.8	49.4	51.1	65.2			5.4	5.3	4.6		3.0	2.9				
Current	573.9	610.3	724.9																	
Tax	503.6	518.2	580.9																	
Donations	70.3	92.1	144																	
Capital	0	3.2	0																	
Subsidies and Grants	0	0	0		97.6	123.3	113.3	189.3			4.6	50.7	45.3		6.9	7.2				
TOTAL EXPENDITURES	530.8	560.5	611.8		201.4	252.9	256.9				25.4	26.4	23.6		14.3	14.6				
Current	483.2	503.2	582.4		146.7	194.3	201.1				18.5	20.3	18.5		10.4	11.4				
Goods and Services	166.5	185.6	274.2		136.5	184.9	156.9				17.2	19.3	14.4		9.7	10.8				
Wages and Salaries	62.5	70.7	68.1		60	69.9	89.1				7.6	7.3	8.2		4.3	4.1				
Other goods and services	104	114.9	206.1		76.5	115	67.8				9.7	12.0	6.2		5.4	6.7				
Subsidies and other transfers	275.7	263.2	246		10.2	9.4	43.2				1.3	1.0	4.0		0.7	0.6				
Capital	46.2	55.8	27.9		54.7	58.6	55.8				6.9	6.1	5.1		3.9	3.4				
OVERALL BALANCE	43.1	53	113.1		3.8	-9.9	-7													
FINANCING	-43.1	-53	-113.1		-3.8	9.9	7													

Source:

Government Finance Statistic, International Monetary Fund for 1988-1990.

GDP values for 1988 and 1989 are 1408.8 and 1705 respectively

Note:

	1988	1989	1990	1991	1992
Total Revenues	789.9	926.6	1105.9		
Total Expenditures	792	937.8	1088.8		

CEEROSLOVAKIA TABLE ONE: EXPENDITURES  
 Budgetary Central and Local Government Expenditures by Service :koruny, billions

Expenditures	Budgetary Central Government (Am)				Local Government (Amunts)				Local Govt. as % of Total Local				Local Govt. as % of Total Exp.			
	1989	1990	1991	1992	1989	1990	1991	1992	1989	1990	1991	1992	1989	1990	1991	1992
Public Services	10	10.9			6.5	7.2			4.21	4.35			1.46	1.49		
General Public Services																
Public Order and Safety	11	11.5			0.9	0.9			0.56	0.54			0.20	0.19		
Rec., Cult and Religious Affairs	5.2	6.4			10.5	9			6.80	5.42			2.35	1.86		
SOCIAL EXPENDITURE																
Education	7	8.5			29.2	32.2			18.92	19.37			6.54	6.64		
Health	2.1	1.9			35.2	40.8			22.81	26.55			7.68	8.42		
Social Security and Unif. Amerties	92.4	112.9			7.9	8.8			5.12	5.29			1.77	1.82		
Housing and Community Amerties	6.8	9.5			37.8	38.3			26.50	23.04			8.46	7.90		
PRODUCTIVE ECONOMIC SERVICE																
Fuel and Energy	3.4	4.2			0	0			0.00	0.00			0.00	0.00		
Agricul't., Forestry Fishing and Hunting	38.9	43			0.5	0.5			0.32	0.30			0.11	0.10		
Mining, Handic and Construction	36.9	38.1			1.7	1.3			1.10	0.78			0.38	0.27		
Transportation and Communication	5.2	6.6			21.2	22.8			13.74	13.72			4.75	4.70		
Other Economic Affairs and Services	57.3	39.8			2	2.1			1.30	1.26			0.45	0.43		
OTHER EXPENDITURE	60.3	57.3			0.5	2			0.32	1.20			0.11	0.41		
TOTAL EXPENDITURE	373.3	380.8			154.3	166.2			100.00	100.00			34.55	34.30		

Notes:

A. Data for 1989-90 was derived from the Government Finance Statistics, 1992

1989 1990

Total government expenditures 446.6 484.6

Gross Domestic Product 750.69 818.97

CZECHOSLOVAKIA TABLE TWO: EXPENDITURES  
Local Government Expenditure By Intermediate and Final Services  
Koruny, Billions

Expenditures	Local Government (Amounts)				Local Govt. as % of Total Local			
	1989	1990	1991	1992	1989	1990	1991	1992
<b>INTERMEDIATE SERVICES</b>								
General Public Services	6.5	7.2			4.21	4.33		
Public Order and Safety	0.9	0.9			0.58	0.54		
Fuel and Energy	0	0			0.00	0.00		
Agricult., Forestry Fishing and Hunting	0.5	0.5			0.32	0.30		
Mining, Manufic and Construction	1.7	1.3			1.10	0.78		
Transportation and Communication	21.2	22.8			13.74	13.72		
Other Economic Affairs and Services	2	2.1			1.30	1.26		
Other Expenditure	0.5	2			0.32	1.20		
<b>FINAL SERVICES</b>								
Rec., Cult and Religious Affairs	10.5	9			6.80	5.42		
Education	29.2	32.2			18.92	19.37		
Health	35.2	40.8			22.81	24.55		
Social Security and Welf.	7.9	8.8			5.12	5.29		
Housing and Community Amenities	37.8	38.3			24.50	23.04		
<b>TOTAL EXPENDITURE</b>	<b>154.3</b>	<b>166.2</b>			<b>100.00</b>	<b>100.00</b>		

CZECHOSLOVAKIA TABLE THREE: AND EXPENDITURE

Revenues and Expenditure	Budgetary Cen. Gov. (Amounts)			Local Govt. (Amounts)			Local Gov. as % of total			Local Gov. as % of GDP		
	1989	1990	1991	1992	1989	1990	1991	1992	1989	1990	1991	1992
	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr	Jan-Apr
TOTAL REVENUE AND GRANTS	370.8	380.1			100.0	100.0			35.9	34.3		
Total Revenue	370.8	380.1			62.5	61.5			22.4	23.5		
Current	370.8	380.1			62.4	61.4			22.4	23.5		
Tax	324	359.4			49.5	49.2			17.8	18.8		
Monetary	43.5	220.6			12.9	12.2			4.6	4.7		
Capital	0	0			0.1	0.1			0.0	0.0		
Subsidies and Grants	0	0			37.5	38.5			13.5	14.7		
TOTAL EXPENDITURES	373.3	383.8			100.0	100.0			34.5	34.3		
Current	326.8	330.6			80.6	81.0			27.8	27.8		
Goods and Services	80.3	83.5			64.1	64.5			22.1	22.1		
Wages and Salaries	17.6	17.5			22.4	22.5			7.7	7.7		
Other goods and services	62.7	66			41.7	42.0			14.4	14.4		
Subsidies and other transfers	246.3	245.4			16.5	16.5			5.7	5.7		
Capital	44.2	52.3			19.4	19.0			6.7	6.5		
OVERALL BALANCE	-2.5	-3.7			0.5	-0.9						
FINANCING	2.5	3.7			-0.5	-0.9						

Source:

Government Finance Statistic, International Monetary Fund for 1989-1990

GDP values for 1989 and 1990 were 750.49 and 818.97 respectively

Note:

Since the break up of Czechoslovakia into the Czech and Slovak Republics it has not been possible to get recent data. Also old trends may no longer be meaningful.

1989 1990

Total Revenue 431.2 432

Total Expenditures 446.6 484.6



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Notes for Table 3

1. Data for total expenditure as a percent of GDP was obtained from the Recent Economic Developments of the IMF.

Hungary: SM/92/52, March 12, 1992  
Poland: SM/91/70, April 11, 1991  
Romania: SM/92/96, May 8, 1992  
Bulgaria: SM/91/52, March 7, 1991  
CSFR: SM/92/65, March 23, 1992  
Russia: SM/92/26, February 6, 1992  
China: SM/91/17, January 28, 1991  
Vietnam: SM/91/234, December 5, 1991

2. Expenditure data are for a consolidation of the budget of the central government and the financial operations of provinces, counties, municipalities and townships. Extrabudgetary financial operations of the various levels of government are not included. Data is based on budgeted values, not actuals.

3. Data for 1987.
  4. Data for 1988.
  5. Data for 1991.
  6. For 1986.
  7. For 1992.
  8. For 1985.
  9. For 1989.
  10. 1988 data for the USSR.
  11. Data for the first quarter of 1992, the Russian Federation.
  12. Data for 1990.
  13. As % of USSR expenditure; USSR GDP.
- \* Provincial (not local) expenditures.

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