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“Centralization and Local Public Finance in Russia”

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Abstract

In this paper, we consider the effects of the 2003 local government reform (Law 131) on the budgetary systems of local governments in Russia, paying special attention to the allocation of functions and tax resources between different levels of government. An evaluation based on the standard theory of fiscal federalism and an international comparison indicated that Russia's institutional characteristics exhibit two parallel and contradictory tendencies. On the one hand, they tend to normalize according to the theory of public finance, but, on the other hand, the administrative and budgetary systems become centralized, which contradicts the global trend of decentralization.

Key words: Russia, centralization, public finance, local self-government, tax distribution

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Introduction

Eighteen years have passed since the fall of the Soviet Union. After the liberalization and the confusion in of the 1990s, the Russian economy seems to have settled down in recent years into a type of capitalism with strong influence of the government. This change was accompanied by the centralization of its politics. At the beginning of the transition, local self-government was an idea which was embraced enthusiastically by people as a base element of the formation of civil society, as well as the market economy. However, unlike Eastern and Central European countries, which have achieved EU membership and are heading for the European mainstream of the decentralization, Russia after 2000 shows a strong tendency toward re-centralization (Чернявский, Вартапетов, 2004). It is said that local governments are being “nationalized” and turned into branch offices of a national administrative structure¹, and that a centralized system rather similar to the Soviet model is being reproduced².

The author’s main interest is to clarify how the public service delivery mechanisms in the local community, so inseparably related to the residents’ lives, are reorganized under the market economy in Russia³. It is well known that in the Soviet era social services such as education, medical treatment, and housing and community services were provided to the people almost free of charge, and the state-owned enterprises played a key role in this effort. As the privatization of state-owned enterprises started after the collapse of Soviet Union, Russian society faces the challenges of how to reorganize such social functions between enterprises and municipalities. This question is important from the viewpoint of the establishment of a social safety net, and depends much on the fiscal situation of the local governments which have to finance these social facilities (Лексин, Швецов, 2000). Therefore, this article focuses on the finance of local governments and analyzes the institution building of local finance systems during the re-centralization process in Russia.

The administrative structure in Russia is shown in Figure 1. Local governments in Russia include all administrative bodies subordinate to federal subjects. Local governments were treated as single-tier organizations in the Law of local self-government, which was enacted in 1995 under the Yeltsin administration, though the new legislation on local self-government introduced in October 2003 (Law 131)⁴ divided them into two layers. Now there are three kinds of municipalities. First are the city- and village-type settlements. Second is the municipal *raion*, which is established above settlements. Third is the city district, which has the combined functions of settlements and the

¹ The expression *statization* (огосударствление) appears in ИЭГ(2003), Гельман и др.(2008), etc.

² According to Гельман и др.(2008), after about 15 years since the transition began, reform of local self-government in Russia has reached a new equilibrium, similar to the one in the Soviet age, with minimum self-governance and local democracy.

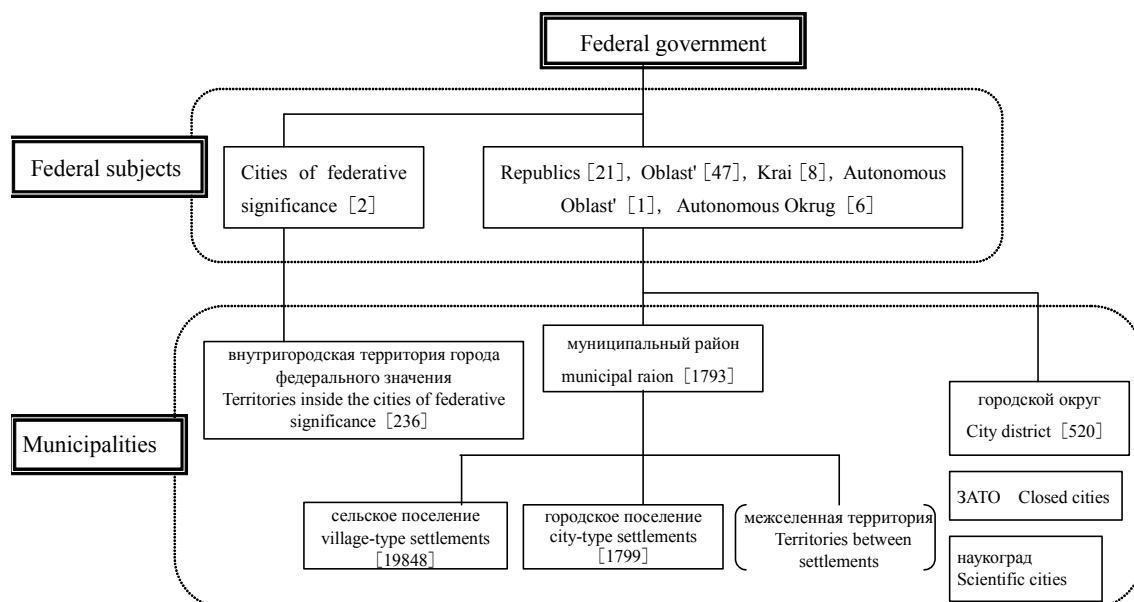
³ Зубаревич (2005) tried to analyze the regional transformation of Russia based on the social dimension approach.

⁴ Federal Law from 6 Oct. 2003, No.131-ФЗ “Об общих принципах организации местного самоуправления в Российской Федерации.”

municipal *raion*. Moscow City and St. Petersburg are acknowledged as federal cities and had the status of both federal subjects and local municipalities previously. However, the territories inside both cities are proposed to given the status of municipalities by Law 131⁵.

So far, research on local finance in Russia tended to pay attention to the relationship between the center and regions⁶. This paper focuses on municipalities because local governments are involved in social service delivery as mentioned earlier, although federal subjects in Russia are positioned as “state power organizations,” and therefore have central government functions, partly. Therefore, it seemed to be more desirable that research attention should be directed at the municipality level, in the area of local public finance. In the following paragraphs, the author refers mainly to sub-national governments as federal subjects and lower layers as municipalities, although the former and the latter are sometimes described as regional and local governments, respectively.

Figure 1. Administrative structure of Russian Federation



Note: Numbers in parenthesis indicate the number of administrative groups, which existed at the beginning of 2006.

Although research on local government finance of Russia is much less than studies on fiscal federalism, some previous works in this field do exist: Zhuravskaia (1998) focused on the fiscal relationship between regional and local government in the 1990s, Mitchneck (1994, 1997) examined the finances of city governments, ИЭГ (2003) and Martinez-Vazquez, Timofeev, and Boex (2006)

⁵ According to the Law 131, the system of local self-government in the municipalities inside the Moscow and St. Petersburg, including its boundary, properties, and fiscal resources, are determined by the legislation of these cities, not by federal laws.

⁶ The major research works are by Hanson and Gibson (1996), Treisman (1999), Московский центр Института Восток-Запад (1999), Kouznetsova et.al. (1999), Shleifer and Treisman (2000), OECD (2000; 2002), Lavrov et.al. (2001), Martinez-Vazquez and Boex (2001), and Thiessen (2006).

studied the whole reform process of the municipal fiscal system since the 1990s, and Гельман Рыженков, Белокурова, and Борисова (2008) analyzed the local reforms from an institutional approach.

These works evaluated as either positive or negative the recent trends toward a centralized system of local finance in the reform process. The advantages of decentralization are emphasized in the theory of public finance, for example, in Oates's decentralization theorem and Tiebout's hypothesis of voting with the feet, as it encourages inter-regional competition and improves the efficiency of local fiscal management. The United States is supposed to embody these principles, and Weingast's (1995) idea of market-preserving federalism also reflects this theory. Besides, there is the principle of subsidiarity, which is the fundamental idea of European-type decentralization, based on a bottom-up administration. It can be said that the advanced countries in Europe and America tend to aim at decentralization as a whole, although there is a difference of directionality between them. Some researchers criticize the reforms in Russia on the ground that they seem to recede from the European or American decentralized model and return to the Soviet-type administrative command system (Швецов, 2005). Specialists of public finance, such as Martinez-Vazquez et al. (2006) and Bird (2003), also suggest on the bases of these conventional theories that insufficient fiscal autonomy in Russia would affect local governments' accountability to residents and that Russia, too, should try to decentralize its fiscal system.

On the other hand, the unconditional application of this Western concept to Russia is also criticized. For instance, Ильяба (2004) insists that advocates of inter-regional competition do not consider the peculiarity of the behavior of regional and local governments in Russia, where the central government was so weak. Hanson (2006) also suggests that Russia does not fulfill the preconditions of the conventional theory. Inadequate local administration capabilities in present-day Russia, the weak competitive election system, and huge economic disparities between regions can justify stronger central government control than what is usually supposed to be the preferred norm in economic theory. He assumes that the re-centralization started under the Putin administration can offer some advantages, at least in the short term, even though it will pose problems in the long term.

Apart from Martinez-Vazquez et al. (2006), very few researchers have analyzed Russian local finance based on the theory of public finance after the reform of 2003. Therefore, this paper attempts to evaluate the local fiscal system after the reforms introduced by Law 131 of 2003 based on the conventional theory of intergovernmental function and tax distribution. Then, the characteristics of the Russian institutional arrangement will be clarified by comparison with advanced countries.

Our analysis in this article targeted at the period starting with the introduction of Law 131 to 2007. Therefore, the effects of the financial crisis from autumn 2008 on local finance are excluded from consideration.

1. Analytical framework: intergovernmental allocation of functions and tax sources

According to the conventional theory of fiscal federalism by Musgrave and Oates, there exist standard norms of assignment of government functions and tax resources between two or more levels of government, which is shown in Table 1 (Oates, 1972; Musgrave, 1980). There are three functions for public finance: allocation function (i.e., provision of public goods and services), redistribution function (redistribution of income), and stabilization function (economic stabilization). Redistribution and stabilization functions are preferably assigned to the central government, and the allocation function is shared between different levels of government in proportion to the benefits derived from public goods and services supplied. That is, the central government should provide public goods and services that benefit the whole state, while local governments should provide local public goods and services to its residents.

Table 1. Assignment of functions and taxes by the conventional theory of fiscal federalism

	Government functions	Tax resources
Federal government	provision of national public goods and services, income redistribution, stabilization of national economy	progressive personal income tax, corporate income tax, natural resource tax
State government	provision of regional public goods and services	retail sales tax, specific consumption tax
Local government	provision of local public goods and services	property tax

Tax resources should also be distributed corresponding to the assignment of functions. Taxes, appropriate for income redistribution and economic stabilization, are preferable for the central government. These are the progressive income tax and corporation income tax which easily fluctuate with business cycles, and the natural resource tax which is unevenly distributed between regions. On the other hand, taxes which correspond to the benefit from services and those with an immobile tax base are suitable as local taxes. Property tax is considered as a typical local tax. Also, taxes such as retail sales tax on final consumption and specific consumption taxes are considered to be suitable for the middle level of government.

However, this conventional norm consequentially leads to a biased tax revenue distribution in the favor of the center, allocating the major taxes to the center while giving a few taxes with low elasticity to the regions. Therefore, this causes a gap between expenditure and the own tax revenues at the provinces, which in turn leads to a need for fiscal transfers from the central government to regional and local budgets to fill the gap. Such a mechanism has worked effectively in the centralized welfare state built in Western Europe after the Second World War. However, in recent years such a vertical imbalances (i.e., huge gaps between annual revenue and expenditure, which must be filled by the fiscal transfers from center) tend to be criticized as they make local

governments heavily dependent on transfers and thus weaken their fiscal accountability to local taxpayers, causing the fiscal illusion and the soft budget constraint (Mochida, 2004, pp. 68-70). The worldwide trend toward decentralization, which is observable today, results in a gap between the conventional theory of tax allocation and actual economic policy. Therefore, a theoretical reexamination to expand the function and tax base of the local governments has been attempted in recent years.

The new theory of tax allocation, proposed by the Canadian specialist of public finance R. Bird, suggests the expansion of the local tax base to correct the vertical fiscal imbalance and secure the sufficient own revenue sources for local governments⁷. Concretely, it suggests, as a principle strategy, that local governments should be given a larger tax base, corresponding to the benefit of local public services — a part of the revenues from personal income tax, which is based on a flat tax rate, regional consumption tax, and corporate income tax collected under pro forma standard taxation, for example, in addition to the property tax. Moreover, it is also important that the new theory favors tax rates being set by the local government. It is believed that the right to decide tax rates in order to raise its main tax revenues helps the local government to strengthen its local fiscal accountability toward residents.

Now, how do we evaluate the reforms in Russia in the context of the above theory? The next section presents an overview of the Russian reform process of intergovernmental fiscal relationships and clarifies the position of local governments in it. Then, an evaluation of the present system will be attempted in sections 3 and 4.

2. Centralization and reform of local finance in Russia

The position of local governments in the Russian fiscal system has been changing greatly since the beginning of the transition. The former local soviet system had been abolished in the first half of the 1990s and the municipality has taken over its place. Since then, many laws on local self-government have been made, including the European charter of local self-government, which was ratified in 1998, and Russia seemed to be proceeding to the realization of local autonomy. However, the responsibility and the fiscal base of the municipality were prescribed by federal laws only vaguely, and the realities of home rule were different in each region. The fiscal resources of the municipalities were given a legal sanction for the first time in 1997 by the federal law “On the financial bases of the local self-government in the Russian Federation.” Actually, however, there was no substantial change in the sense of that tax revenue distribution was based on ad hoc negotiations between regional and local governments held annually or biyearly (Zhuravskaia, 1998), and the municipalities could not help depending on unstable fiscal resources. However, this kept local

⁷ See Mochida (2004) for details.

governments under a certain kind of soft budget constraints, and therefore “big local government” persisted in the 1990s.

It was only after 2000 that the establishment of rules concerning local public finance started in full swing in Russia. The government’s “Program for the development of fiscal federalism in the Russian Federation until 2005,” established in 2001, was the first comprehensive federal program on intergovernmental fiscal relations in this country, which involves three levels of government: central, regional, and local. The “program” points out the problems of fiscal federalism, especially the unclear fiscal status of local governments, suggesting it has made the local fiscal accountability ambiguous and brought about inefficient fiscal management. Therefore, the program emphasized that local fiscal independence should be improved within the limits of law and a more decentralized fiscal system should be built as a long-term goal⁸. At the same time, however, it also states that Russia needs a big federal budget in the short term because some social expenditures seems to be more appropriate for federal-level management and a long time is needed to create local fiscal accountability and the hard budget constraint at local level and to train staff. Thus, the “program” had an ambivalent characteristic.

The reform policy of the Russian government clearly turned to centralization by Law 131 of 2003. Law 131 was one of the accomplishments of the presidential committee for the division of power between federal, regional, and local governments — the Kozak Committee, set up in 2001⁹. The Kozak Committee itself was of a liberal character, and it aimed to divide the authority of federal subjects between federal and the local governments by Law 131 to create a power balance based on a triangular relationship between three levels of government. However, the federal government could not help favoring the federal subjects in order to win support for the law at the Upper House of Parliament, which consists of the representatives of each region. Therefore, the law has resulted in very severe constraints for the municipality¹⁰. In a word, the federal subjects demanded that their power over the local government should be strengthened as a compensation for the reduction of their own authority in the entire reform toward centralization.

At the time Law 131 was adopted, about 27,000 local settlements existed in Russia, and only

⁸ Lavrov et.al. (2001), reflecting on the idea of government at that time, drew attention to a concept called market-preserving federalism as an orientation at which Russia should aim. This idea, advocated by Weingast (1995), states that competition between local governments under specific conditions contributes to the economic development of a country.

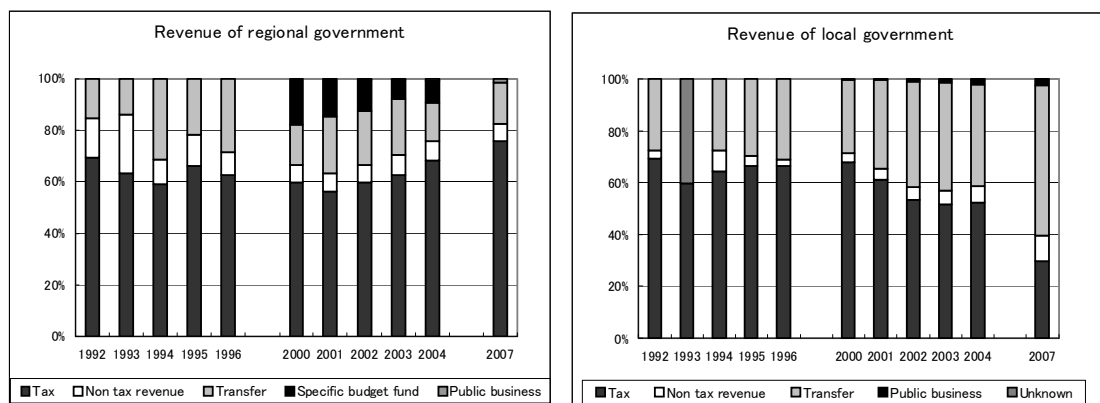
⁹ Complete enforcement of Law 131 was scheduled for January 1, 2006, though it was postponed, in the autumn of 2005, to January 1, 2009. The reason was that the Russian Parliament aimed to avoid the risk of social and political instability that might be caused by the local reform at a time when the Parliament elections of 2007 and the presidential election of 2008 were expected. Also, it is possible that many regions were just not prepared to start the reform, which required a great number of law revisions (Young and Wilson, 2007, p.1081).

¹⁰ See Campbell (2009, p.279). Campbell also pointed out that the municipal congress, the representative lobby group for local governments, has no power to demonstrate their influence at a federal level, while regional governments are able to reflect their interests through the Upper House. It is said that the number of corrections to Law 131 exceeded 6,500 (Гельман и др., 2008, С.91).

11,500 of them enjoyed the status of municipalities. Further, of the 11,500 local governments only 52% had their own budgets, and about 1/3 did not own any property such as medical, educational, and cultural facilities¹¹. After the introduction of Law 131, more than 24,000 municipalities were set up in the whole of Russia by summer 2005, and more than 40% of them formed assemblies. About 30% had local elections for mayor and nominated the head of the administration. Moreover, in regions where local elections were held, legislation for the budgetary process proceeded smoothly¹².

Law 131 can be seen as a valuable legislation in the sense that it tries to achieve rule-based local governance, bring government closer to residents by establishing municipalities, and clarify the division of authority and fiscal resources between municipalities such as districts and settlements. However, there is much criticism against the law because of its extremely centralizing character. For instance, Ross (2008) describes the law as follows: “It is obvious that the law tries not only to reduce local autonomy but to make local governments directly subordinate to the federal subjects and the federal government, though citing the Russian Constitution, which lays down that the local government is not a part of the national power structure.” It is stated that local autonomy has been sacrificed by the struggle for power between the federal center and the federal subjects (Ross, 2008, pp.113-114). The provisions that enable dismissal of the local head and dissolution of the assembly by the federal subjects (articles 73, 74) were criticized as they emasculate the home rule principle, and the revised Budget Code which followed Law 131 has greatly reduced local fiscal autonomy, too.

Figure 2. Change of regional and local revenue structures



Note: Official date was not published until 1999. Data from 1992 to 96 are extracted from a working paper of World Bank, which used the closed statistical source of Russian Ministry of Finance. Data for 2005 and 2006 are omitted because the total data for all regions is absent.

¹¹ Климанов (2005, С.9).

¹² Информация о результатах мониторинга органов государственной власти субъектов Российской Федерации и органов местного самоуправления по обеспечению составления местных бюджетов на 2006 год (downloaded from the site of the Russian Ministry of Finance http://www1.minfin.ru/common/img/uploaded/library/2007/09/monitoring_na_15_aug.pdf).

Source: Freinkman and Yossifov (1999) pp.46-47, Министерство Финансов РФ (2001, 2002, 2003, 2004, 2005), Федеральное Казначейство России (2008).

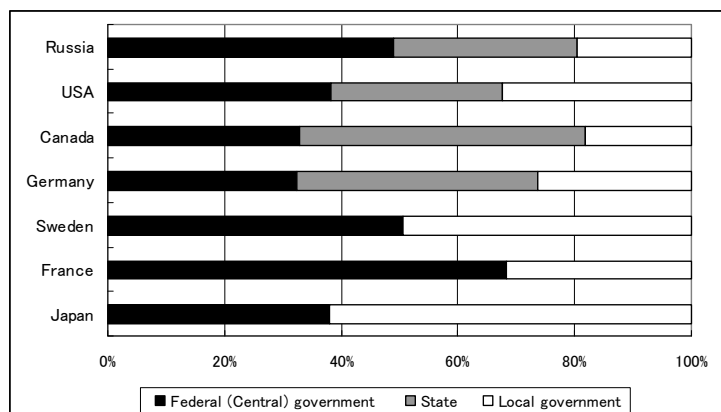
According to Figure 2, which shows the revenue composition of regional and local governments, the ratio of tax revenue to total annual revenue rises in the 2000s, at the federal subject level, recently exceeding the level of the 1990s. On the contrary, at the local level the ratio tended to decrease after 2000, sharply falling to almost 30% in 2007, thus strengthening the dependency of local governments on fiscal transfers from the upper government. Thus, we can observe a contrasting tendency in the Russia of recent years: federal subjects show improvement, while municipalities show deterioration in fiscal independence. In the next section, the functions and revenue resources of local governments in Russia after the introduction of Law 131 are considered against the background of the general theory of local public finance.

3. Functions and tax resources of local governments after reform

3.1 Intergovernmental assignment of functions and the role of local governments in Russia

The annual expenditure of federal, regional, and local governments for 2007 amounted to 13.9% of the GDP for the federal, 8.9% for regional, and 5.6% for the local governments. Compared to the weight of each levels of budget of other advanced countries, in Figure 3, it is observable that Russia, as a federal state, has a relatively large federal government.

Figure 3. International comparison of expenditure ratio of different levels of government



Note: Data of Russia is for 2007, Japan for 2003, and data of other countries are for 2001. Expenditure in this figure means a general government expenditure, excluding spending for social insurance fund. Fiscal transfers for other levels of governments are excluded from the total amount of each government, so that figure shows net expenditure. As for unitary states, Sweden, France, and Japan, all governments below the prefecture are put together as local government.

Source: Федеральное Казначейство России (2008), Japanese Ministry of Internal Affairs and Communications (2005), IMF (2006).

Before Law 131 was introduced, the range of duties of the municipality was not clarified in the federal law. Therefore, municipal services in various regions were provided on the basis of informal historical practices, rather than formal legislation. The relationship between regional and local governments and the range of services covered by private companies and non-budget funds such as the medical insurance fund have determined service delivery in each region¹³. This vagueness caused serious problems of so-called unfunded federal mandates, especially in the welfare field.

Law 131 has clearly divided the range of responsibilities of the municipality to solve such problems. The main change was the transfer of several responsibilities from the municipality to federal subjects— including social welfare such as the veteran allowance, special allowances for disabled people, child-support allowance, teacher's salary, housing subsidy for the lower income group, and support for agricultural producer. As the result, the annual expenditure of municipalities has decreased greatly¹⁴: thus, municipalities were released from excessive burden.

How do we evaluate the reform in Russia to reduce the functions of municipalities in accordance with the theory of intergovernmental assignment of functions? Judging from the conventional theory of function assignment, which assumes that the central government should undertake the responsibility for income redistribution, we find a huge divergence from the principle in pre-reform Russia, where municipalities were charged with social welfare responsibilities to a considerable extent¹⁵. Therefore, it can be said that the reform, which reduced the income redistribution function of the municipality, limiting it to the supply of local public services, has brought the assignment of government functions in Russia closer to the conventional theory.

However, in contrast to the municipality's role, the income redistribution function of federal subjects has been strengthened by the reform in recent years¹⁶. In the area of social welfare, some of the tasks which were moved to the regional level are actually carried out at the municipal level as

¹³ See Martinez-Vazquez et al. (2006, pp.63-64). Bird (2003) also pointed out a specific problem of the transitional economy— unclear division of functions not only between different levels of government but also between government and private activities (p.423).

¹⁴ See Климанов (2005, С.18-19). Teacher's salaries were about 40% of educational expenses. As for social welfare, the total of veteran allowance, allowance for handicapped persons, and child-support allowance amounted to about 3.44% of the GDP (this is based on 1998 calculations [OECD, 2000, p.132]). Housing subsidies accounted for about 80% of the expenditure on housing and utility services in 2001.

¹⁵ Specialist on public finance Bird also described the Russian situation, in which a considerable amount of social welfare expenditure was incurred at the regional and local level, as problematic from a viewpoint of the theory of fiscal federalism, which assumes that normally the local government should only provide these services and the central government should guarantee its financial resource (Bird, 2003, p.422).

¹⁶ The reform of "monetization of privileges" in the welfare field also enlarged the functions of federal subjects (Wengle and Rasell, 2008).

delegated jobs¹⁷, although the fiscal resource for them is supposed to be guaranteed by federal subjects. Russia has a very specific socio-geographical structure, which was a result of its historical city formation: the population and economic activities concentrate so heavily in the regional capital, unlike in other advanced countries, and the economic difference between the core city and other peripheral municipalities is extremely large (Лексин, 2006). Therefore, for the achievement of a certain level of administrative services in all municipalities, strengthening income redistribution and public service delivery by federal subjects would possibly be more effective than decentralizing them to the local level. Thus, it can be said the allocation of government functions in Russia is characterized by the important role of its federal subjects in the income redistribution function.

3.2 Distribution of tax resources to the local government in Russia

As for tax distribution to the municipality, the 2001 program referred to earlier was aimed to enlarge the tax base of the municipality and strengthen its right of taxation — which was not realized, though. However, as a result of the introduction of Law 131, the tax revenue of the municipality was greatly reduced, in proportion to the reduction of its function.

The concrete provision of the legislation on local tax revenues were included in the amendment to the Budget Code of 2004¹⁸, which followed Law 131, and the taxes shown in Table 2 were assigned to each levels of government: federal, regional, and local governments (including districts, settlements of rural and urban type, and cities). According to this, settlements must be given 100% of the land tax and personal property tax as their own tax revenue and 10% of personal income tax and 30% of the unified agricultural tax under a tax-sharing scheme with federal and regional governments. On the other hand, districts, which stand above the settlements, must be given the land tax and personal property tax collected in the “territory between settlements”¹⁹ as their own resource and 20% of the personal income tax, 30% of the unified agricultural tax, and 90% of the unified tax on incomes from specified activities under the scheme of tax sharing. In this case, attention should be paid to the fact that there is little land tax and personal property tax revenue in the “territory between settlements”. Therefore, the districts actually do not have any specific tax base. The city districts will be given both the tax revenues supposed to be distributed to the settlements and districts.

¹⁷ Информация о результатах мониторинга местных бюджетов Российской Федерации за 2006-2008 годы (downloaded from the homepage of the Russian Ministry of Finance, http://www1.minfin.ru/ru/reforms/local_government/monitoring/index.php?pg4=1).

¹⁸ Federal law from August 20, 2004, No.120-ФЗ “О внесении изменений в Бюджетный кодекс Российской Федерации в части регулирования межбюджетных отношений”.

¹⁹ Law 131 prescribes the village- and city-type settlements as residences of more than 1000 people, including unions of several small residences. Also, the territory of each settlement must be kept in a width, in which residents can shuttle to its administrative center on foot within a single day. Therefore, the “territory between settlements” means scarcely populated territory, distant from any other settlements.

Table 2. Allocation of tax revenue to local government after the reform

Tax	Ratio of revenue distribution			
	Federal	Federal Subjects	Municipal Raion	Settlements
			City District	
Federal taxes				
Personal income tax		70%*	20%	10%
State duty		100%**	100%***	
United agricultural tax		30%	30%	30%
United tax on incomes from specific activities			90%	
Regional taxes				
Local taxes				
Land tax			100% (levied on the territory between settlements)	100%
Individual property tax			100% (levied on the territory between settlements)	100%

Note: City districts receive revenues of both Municipal Raion and Settlements. Remaining 10% revenue of United agricultural tax and United tax on incomes from specific activities are missing in this federal law.

*Federal subjects can allocate the tax additionally to local governments by its annual budget law. Also, representative organs of raions can be given a right to allocate the tax additionally to settlements by the regional laws.

**it follows the provision 56 of amended budget code.

*** it follows the provision 61 of amended budget code.

Source: №120-ФЗ от 20 августа 2004г. "О внесении изменений в Бюджетный Кодекс Российской Федерации в части регулирования межбюджетных отношений."

The main changes introduced by the revision of the Budget Code are, first, the abolition of the surtax on the corporate income tax given to the municipality till then, and second, the stopping of the distribution of corporate property tax to the municipality. The surtax on corporate income tax was introduced as an alternative source, when the tax for the maintenance of social and cultural facilities²⁰ were abolished in 2001, and levied at a rate of 5% at first and at 2% since 2002. Other changes include a reduction of the distribution rate of personal income tax to the municipality from 50% to 30% and, oppositely, an increase of the distribution rate of land tax from 50% to 100%.

Table 3, the revenue composition of local government from 2000 to 2007, shows how the above-mentioned reform was reflected in actual local revenue. We can see a sharp decline in the ratio of taxes to the total revenue from 52.4% in 2004 to 29.7% in 2007, while fiscal transfers from the upper levels of government have risen from 43.4% to 57.2%. Besides, such a sharp decline of tax revenue can be regarded as a result of, first, the rapid decrease of the corporate income tax, which was the second biggest tax source for the municipality after personal income tax, and, second, the decrease of corporate property tax, which accounted for most of the property tax revenue.

²⁰ The tax was imposed on the sales of the enterprise, excluding VAT and commodity tax, at a rate of 1.5% or less.

Table 3. Revenue of local government (thousand rubles)

	2000	2001	2002	2003	2004	2007
Tax revenue total	308,381,816 67.9%	343,615,661 61.2%	379,039,763 53.6%	431,322,446 51.6%	549,524,844 52.4%	579,491,411 29.7%
Corporate income tax	61,770,749 13.6%	94,121,501 16.8%	77,484,456 10.9%	80,226,804 9.6%	180,413,386 17.2%	32,895,760 1.7%
Personal income tax	76,450,955 16.8%	118,630,999 21.1%	164,970,603 23.3%	198,674,734 23.8%	219,222,298 20.9%	388,728,007 19.9%
VAT	24,432,940 5.4%	45,872 0.0%	351 0.0%	269 0.0%	25 0.0%	0 0.0%
Excise tax	7,200,420 1.6%	9,181,754 1.6%	10,901,061 1.5%	10,488,029 1.3%	11,922,596 1.1%	508,004 0.0%
Sales tax	13,368,155 2.9%	16,050,336 2.9%	17,467,839 2.5%	19,834,253 2.4%	2,049,178 0.2%	
United income tax	8,559,987 1.9%	13,948,777 2.5%	17,679,446 2.5%	13,748,804 1.6%	28,089,909 2.7%	61,652,942 3.2%
Property tax	28,099,739 6.2%	37,829,378 6.7%	49,874,823 7.0%	57,273,437 6.9%	56,855,786 5.4%	82,410,717 4.2%
Individual property tax			1,819,148 0.3%	2,518,451 0.3%	3,061,306 0.3%	6,797,498 0.3%
Corporate property tax			47,807,993 6.8%	53,984,594 6.5%	52,890,186 5.0%	5,718,608 0.3%
Land tax						63,885,403 3.3%
Natural resource tax	26,005,889 5.7%	28,873,753 5.1%	28,326,576 4.0%	37,276,391 4.5%	34,097,812 3.3%	1,229,304 0.1%
Other taxes	71,052,969 15.6%	38,882,068 6.9%	30,014,054 4.2%	27,548,529 3.3%	16,873,854 1.6%	
Non-tax revenue	15,867,307 3.5%	24,240,029 4.3%	34,870,459 4.9%	45,222,560 5.4%	65,651,619 6.3%	196,701,957 10.1%
Fiscal transfers	128,573,619 28.3%	191,927,495 34.2%	286,740,894 40.5%	348,228,598 41.7%	413,751,396 39.5%	1,129,745,855 57.9%
transfers from other levels of government	125,516,964 27.6%	186,852,371 33.3%	283,806,858 40.1%	344,905,154 41.3%	455,158,423 43.4%	1,116,916,280 57.2%
Specific budgetary funds	1,313,413 0.3%	1,598,751 0.3%	1,140,498 0.2%	1,644,302 0.2%	2,153,126 0.2%	
Revenue from public business			5,989,729 0.8%	9,017,057 1.1%	16,992,608 1.6%	45,528,101 2.3%
Revenue total	454,136,155 100.0%	561,381,936 100.0%	707,781,343 100.0%	835,434,963 100.0%	1,048,073,593 100.0%	1,951,467,324 100.0%

Note: Data for 2005 and 2006 are omitted because of the lack of data. Land tax was included in natural resource tax until 2004. United agricultural tax and united tax on incomes from specific activities are included in the united income tax.

Source: Министерство Финансов РФ (2001, 2002, 2003, 2004, 2005), Федеральное Казначейство России (2008).

Now, how can such a tax revenue distribution to the municipality be evaluated against the backdrop of the conventional theory of tax allocation? It can be regarded as a rational arrangement to assign personal property tax and land tax exclusively to municipalities in Russia, according to the theoretical assumption that the property tax is suitable for the municipality level. However, the corporate property tax, which accounts for most of the property tax in Russia, is no longer distributed among local governments. Therefore, there is a problem from the viewpoint of sufficiency of tax revenue. As for the sharing of personal income tax, it can be said that it is suitable for local tax revenue because the Russian government applies a flat tax rate of 13% for personal income tax, which corresponds to the benefit of services provided. Also, the abolition of the distribution of corporate income tax can be regarded as a measure that is in agreement with the principle of tax allocation. Revenue differences between municipalities can be effectively corrected by taking away company-related taxes such as corporate income tax and corporate property tax from the municipality, because in Russia these taxes tend to concentrate in the capital cities of federal

subjects in view of their geographical structure mentioned above. Thus, the direction of changes in Russian tax assignment system seems to differ from the one in other advanced countries, where the framework of the conventional model no longer applies because of the progress of decentralization, and Russian system have approached a more traditional model by recent reforms. As a result, the fiscal base of the municipality became more dependent on transfers from the upper levels of government than on local taxes. In the next section, I will compare the intergovernmental tax distribution and local taxation system of Russia with the corresponding systems of other countries and clarify the characteristics of the Russian system.

4 The characteristics of intergovernmental tax allocation in Russia: an international comparison

4.1 Intergovernmental tax revenue allocation

In spite of the previously mentioned principle of intergovernmental tax revenue allocation, the actual state differs among countries. Here, I will extract the institutional characteristics of Russia through comparison with other countries, especially advanced countries with a federal structure. Federal countries featured here possess various forms of local government under a federal center and the states. I refer to all the administrative groups positioned below the state government as local governments²¹. The federal subjects and municipalities in Russia correspond to the states and local governments, respectively, of other federal countries.

First of all, the international comparison of the proportion of tax revenue distribution between federal, state, and local governments is shown in Table 4. According to the table, the concentration of tax revenue in the federal government has increased from 1996 to 2007 in Russia. The increase in tax revenues of the federal government is attributed to the effects of reforms in Russia on energy taxation since 2000. The reform has established a mechanism to concentrate natural resource-related revenue in the federal budget, and the federal government enjoyed an abundant income from the rise of world oil prices, which continued till 2008 (Tabata, 2008). Russia seems to have a relatively centralized system of tax distribution, compared to other federal countries except Australia. In Russia, tax distribution to the municipality in Russia has decreased remarkably from 26.5% in 1996 to 5.4% in 2007. Municipalities with such limited revenue sources of their own can also be regarded

²¹ The United States and Canada adopt the multi-tiered structure which differs in each state. In the United States, there are about 87,500 local governments, including county, municipality, township, and so on, under 50 states. In Canada also there are almost 5,000 local governments such as county, city, town, village, township, etc., under 10 states and 3 sub-states. Germany adopts the three-tiered system of state (land), county (landkreis), and municipality (gemeinde). There are 323 counties and 116 independent cities (kreisfreie stadt) under 16 states and about 12,300 municipalities under counties. Australia has a two-tiered system, and there are about 720 local governments under 6 states and 2 sub-states (source: the Japanese Ministry of Finance, Policy Research Institute, 2006).

as a Russian peculiarity.

Table 4. International comparison of intergovernmental tax revenue distribution (%)

	Federal	State	Local
Australia	81.8	15.3	3.0
Canada	48.1	41.9	10.0
Germany	50.4	36.6	11.8
USA	54.1	26.3	19.3
Russia 1996	49.8	23.7	26.5
Russia 2004	64.1	24.8	11.2
Russia 2007	66.0	28.6	5.4

Note: Data for countries except Russia are for 2002. Revenues of social insurance funds are excluded, although Russian federal revenue for 2004 and 2007 include united social tax.

Source: OECD (2004), Freinkman and Yossifov (1999), Министерство Финансов РФ (2005), Федеральное Казначейство России (2008).

Next, tax revenue structures are compared across countries with a consideration of the kind of tax base in each country. Table 5 shows the composition of tax revenue of federal, state, and local governments in federal countries according to the tax base. As for the revenue structure of the federal government, we can see the difference between the Anglo-Saxon countries, which depend mainly on income tax, and European countries, which depend rather on the consumption tax and the payroll tax. Russia, unlike either of them, has a peculiar structure in which the major revenue comes from the general consumption tax (VAT) and others. The “others” in this case mean charges for the use of natural resources and revenue from international economic activities such as export duty. Therefore, this shows that Russian federal finance depends on the abundant revenue from taxes related to the natural resources. Considering the principle of tax allocation, it can be said that moving natural resource taxes from the regional to the federal government was an advantageous measure for Russia, because these taxes tend to be unstable, changing according to fluctuations in the global market price of resources, and very unevenly distributed, regionally.

As the revenue for state-level government, taxes such as the consumption tax imposed on final consumption are supposed to be suitable theoretically. In Russia, however, all VAT revenue goes to the federal budget, and the sales tax was also abolished in 2004: therefore, the regional government does not have any general consumption tax. It has a 5.9% specific consumption tax (excise tax), though the small proportion of consumption taxes stands out in Russia in comparison with the United States, Canada, and Germany. On the contrary, the ratio of income tax is 80%, and remarkably higher in Russia than in other countries. Of the income tax, 2/3 is corporate income tax. Therefore, it can be said that the composition of regional tax revenue in Russia is contrary to the theory, with a small consumption tax and a large corporate income tax. Further, such a tax structure is vulnerable to business recession and liable to cause the revenue gap among rich and poor regions

to expand.

Table 5. International comparison of tax revenue structure of different levels of government

Federal government							
	Personal income tax	Corporate income tax	Payroll tax	Property tax	General consumption tax	Specific consumption tax	Others
Australia	47.1	20.5	1.6	0	16.5	13.9	0.4
Canada	53.8	16			19.4	8.1	0
Germany	37	2.2			28.7	32.1	0
USA	75.8	14		2.3		7.9	
Russia 2007		9.2	5.8		32.3	1.9	50.9
Japan	32.3	20.8		6.1	21.4	16.9	2.5
Sweden	-3.1	8.7	41.5	5.7	32.4	13.2	1.5
State government							
	Income tax	Payroll tax	Property tax	General consumption tax	Specific consumption tax	Use tax	Others
Australia		28.0	39.0		19.2	13.8	
Canada	46.9	5.6	5.7	20.8	17.4	3.6	
Germany	50.2		4.9	38.6	1.8	4.6	
USA	39.5		3.1	33.6	15.5	8.4	
Russia 2007	80.2		10.8	5.9			3.1
Local government							
	Income tax	Payroll tax	Property tax	General consumption tax	Specific consumption tax	Use tax	Others
Australia			100				
Canada			91.5	0.2		1.8	6.5
Germany	75.8		17.7	5.4	0.5	0.5	0.3
USA	5.2		72.6	11.4	5.0	5.8	
Russia 2007	83.4		14.2		0.1		2.3
Japan	44.6		33.0	7.3	8.3	5.7	1.0
Sweden	100						

Note: Data for countries except Russia are for 2002.

Source: OECD (2004), Министерство Финансов РФ (2008), Федеральное Казначейство России (2008).

Finally, as for the local level, a clear difference exists between the Anglo-Saxon countries and Europe: local governments in Anglo-Saxon countries heavily rely on the property tax, while the main resource in European countries is the income tax. According to Table 5, for the Russian local government the biggest tax is the income tax of 83.4%, 70% of which is the personal income tax. Therefore, it can be said that Russia has a structure close to the European type, especially the German²². In addition to these taxes, Russian municipalities have a 14% property tax. However, property tax is still not a sufficient tax source in transitional countries such as Russia, because they have a specific problem resulting from the vague assessment of property values, which must be the base for imposing the property tax (Bird, 2003, p.431). Therefore, although the land tax and personal property tax are given to the municipality as its own tax base, personal income tax sharing

²² The local government in Sweden can independently set a rate for the local income tax. In Germany the revenue of the municipality consists of a peculiar tax that includes the property tax and the business tax and revenue sharing from joint taxes (personal income tax, corporate income tax, sales tax, etc.).

has become its fundamental source of revenue.

The above international comparison has featured the Russian model of intergovernmental tax allocation. The federal and regional governments in Russia have a peculiar tax composition: the federal government heavily depends on the resource-related tax revenue, and the regional government has a small consumption tax and a large corporate income tax. On the other hand, the local government has a theoretically compatible tax composition, comparatively, with the personal income tax at a flat rate and the property tax. However, the personal income tax in Russia is supposed to apply to the workplace, and not to the taxpayer's place of residence, although it is conventionally taxed at the place of residence because many of the local public services that the municipality supplies are for the households. In the Russian case, tax revenue is concentrated in the core city, where business enterprises are located. This might cause an inconsistency between those who receive the benefit from services provided and those who bear its cost. Thus, the principle that local residents directly bear the cost of social services by paying taxes is still not institutionalized in Russia, where enterprises have supplied such services and paid most taxes for a long time since the Soviet era.

4.2 Local government and power to tax

From the above discussion, it is clear that the assignment of functions and tax bases to the local government is approaching the more traditional model in Russia — a centralized structure in which local governments are fiscally dependent on the upper-level government.

In the theory of public finance, the power of the municipality to tax is regarded as an important element for local fiscal autonomy. As discussed in section 1, the new theory of intergovernmental tax allocation assumes it is important that the municipality has the power to decide the tax rate and control its own revenue. However, the taxation right of the municipality in Russia is much less in Russia than it is in advanced nations²³. Nevertheless, municipalities in Russia have a de facto authority that cannot be measured by a formal institutional analysis. Municipalities were able to provide corporations some kind of privileges in the form of tax reduction and tax exemption. They often took measures to relieve the deficits of big enterprises in the region by providing corporate income tax and corporate property tax exemptions, which would otherwise have become their revenues²⁴. A questionnaire survey also confirms this: many companies responded that they have

²³ OECD (2000). Also, Martinez-Vazquez et al. (2006) measured the size of the taxation right of local governments in Russia from 1996 to 2001, based on the OECD index.

²⁴ According to Жихаревич, Жунда, and Русецкая (2006), who conducted the questionnaire survey among 70 municipalities in 32 federal subjects in the latter half of the 1990s, it was possible for the local authority to adopt regional economic policy in the form of tax exemption and tax reduction, although the reforms since the end of the 1990s took off such authority and little room has been left for a regional independent economic policy. In the questionnaire more than 90% of respondents answered that the biggest obstacle for the implementation of the regional economic policy was the insufficient own local revenue.

received financial support from regional and local governments in the form of taxation benefits, while companies have granted various kinds of support to these governments in return (Яковлев, 2007). Moreover, tax sharing with the municipality was not based on a constant rule but on discretionary negotiations with federal subjects held in Russia every year or every other year in the 1990s. Therefore, even if the tax revenue of local governments decreased by the tax exemption for enterprises, they could receive additional revenue from it. Thus, a soft budget constraint existed.

However, the taxation right of the municipality was sharply reduced by Law 131. The power to decide the rate of personal income tax, which is a fundamental revenue base for municipalities, vests the federal government because it is a federal tax. Thus, the municipality has almost no taxation authority now. According to the present legislation, the municipality can only lower the rate of land tax and personal property tax within a limited range, although they cannot afford to reduce the tax rate because of their scarce resources. Besides, these two taxes accounted for only 3.6% of the annual revenue of municipalities in 2007. Abolition of the distribution of corporate income tax and corporate property tax to local governments has deprived them of a roll in original economic policy making regarding enterprises. In sum, it can be said that the reform greatly narrowed the role of local authorities in taxation and increased their dependency on federal subjects for the acquisition of fiscal resources. At the same time, the reform eliminated the soft budget constraint of municipalities through the taxation system and, thus, cut off the relationship between the local administration and enterprises. Martinez-Vazquez et al. (2006) emphasized the importance of local accountability, which can be realized by local fiscal autonomy (revenue autonomy). On the contrary, the reform in Russia tries to limit the soft budget constraint between municipalities and local enterprises and improve financial discipline and transparency by decreasing local fiscal autonomy²⁵.

Conclusion

The reforms in Russia based on Law 131 have brought about a large reduction of fiscal resources and functions for municipalities, in contrast to the worldwide trend of decentralization. Behind the reform process are the dynamics of political power, as mentioned in this article, and the Russian government might not have intended such drastic reforms for the municipalities initially. Keeping in mind that the reforms in Russia are still an ongoing process, I can point out the following tentative conclusions.

First, the reforms are valuable in the sense that they have established clear rules for local public

²⁵ Hanson (2006) mentions the possibilities of reform in decreasing corruption and micro interference of local government in the regional economy. Also, Жихаревич, Жунда, and Русецкая (2006) state that reforms might, on the one hand, reduce the risk of abuse of authority by municipalities as well as their inefficient expenditure while, on the other, diminish their incentives to implement economic policy for regional development.

finance in Russia and made the system of intergovernmental distribution of functions and the tax base closer to the theoretical framework.

Second, the reform of tax distribution to municipalities can be expected to diminish the soft budget constraint between local governments and enterprises through the tax system. However, the relationship between companies and other levels of government must also be considered for a conclusive statement on the soft budget constraint. This remains as a future task.

Third, the reform has not only made municipalities more dependent on federal subjects fiscally, but has strengthened political centralization and reduced the idea of local self-government declared in the constitution to empty rhetoric. As a result, this has caused a democratic impasse in that local residents have lost a channel of communication. The policies of local governments, such as the reduction of public services and increase in their charges, should directly hit the life of local residents. Therefore, a channel should be left open to absorb their claims as well as secure their fiscal resource by transfers from the upper levels of government.

As mentioned above, two sides are observed in the local reform process in Russia: the strengthening of centralization and the establishment of a theoretically more normal rule. It could be considered as the present feature of institution building in Russia that these two processes are going parallel. From a long-term perspective, the Russian local finance system is still on the path of development. In the future, enterprises and residents might raise the demand for local autonomy in the course of the economic development, or reforms might be imposed “from above” to reduce the inefficiency of a highly centralized system. However, in the short term, Russia needs to set up an organizational structure for local self-government all over the country and construct a rule-based management of local finance and administration before thinking about decentralization and delegation of revenue sources and functions to provinces. Therefore, Russia cannot but implement institution building more or less within a centralized system.

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