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## The Challenge of Fiscal Decentralization in Transition Countries

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**The Challenge of Fiscal Decentralization in Transition Countries**

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**Abstract**

The views expressed in this Working Paper are those of the author(s) and do not necessarily represent those of the IMF or IMF policy. Working Papers describe research in progress by the author(s) and are published to elicit comments and to further debate.

This paper examines key aspects of the ongoing decentralization process in transition economies and identifies areas where the present systems can have potentially adverse impacts on both service delivery and macroeconomic performance. We discuss three critical principles of a sound and efficient decentralized fiscal system—and then show the contrasts between these and actual trends and policies in transition countries.

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## I. INTRODUCTION

A number of developed and developing countries have undertaken comprehensive reforms of their intergovernmental fiscal systems over the past two decades, and this trend has extended to the transition countries in Eastern Europe and The Baltic countries, Russia, and other countries of the Former Soviet Union (BRO) as well. Several countries in the region are already in the process of considering or implementing far-reaching “second-generation” reforms in this area.<sup>2</sup> However, persistent macroeconomic instability in some, and the entrenched legacy of socialism and central planning in others, have generated additional challenges which are complicating the design of an effective decentralized system.

The virtually global trend towards devolving service implementation to lower levels of government is based on the wide acceptance of the subsidiarity principle and on the view that it results in improved efficiency in the delivery of public services and, hence, a more efficient allocation of resources in the economy.<sup>3</sup> The current movement towards democratic forms of governance is also closely associated with the demand for decentralized government.<sup>4</sup> At the same time, increased fiscal decentralization, in itself, is seen as an important means of increasing democratic participation in the decision-making process, thereby, enhancing accountability and transparency of government actions. In yet other countries, the trend towards greater autonomy for subnational levels of government is driven by the need for national coherence in the face of ethnic or regional centrifugal forces or conflicts. In many transition economies, the political and economic failure of autocratic, highly centralized socialist regimes may have provided an impetus to the subsequent decentralization initiatives.

Whatever the precise background and the motivation in different countries, it is generally acknowledged that the manner in which decentralization is carried out can have a significant impact on macroeconomic management and performance. A common view in the literature is that decentralization may aggravate fiscal imbalances, thereby, endangering overall macroeconomic stability, unless sub-national governments are committed to fiscal discipline and the decentralization package includes incentives for prudence in debt and expenditure

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<sup>2</sup> See Bird et al (1995), Wallich (1994), and Ter-Minassian (1997) for a discussion of fiscal decentralization experiences during the early years of transition.

<sup>3</sup> The traditional public finance literature maintains that while allocative functions of the public budget are best carried out by lower levels of government, redistribution and stabilization functions should be in the domain of central governments (Musgrave (1959)).

<sup>4</sup> The 1999 World Development Report notes that the proportion of countries with some form of democratic government rose from 28 percent in 1974 to 61 percent in 1988 (World Bank 2000) partly as a response to the ongoing globalization and integration of national economies with increasing circumscription of the powers of nation-states that it entails.

management.<sup>5</sup> Empirical evidence on the relationship between decentralization and macroeconomic instability is mixed. Stein (1999) finds that decentralization, as measured by subnational share of total public spending, is not associated with higher deficits of the public sector in Latin America. However, Fornasari, Webb, and Zou (2000) and DeMelo (2000) find that increases of subnational spending and deficits lead to an increase in spending and deficits at the central level.

Recent studies suggest that the design and implementation of a multi-tier system of government can significantly affect overall resource allocation in the economy and, hence, economic efficiency, growth, and welfare. A central argument for fiscal decentralization leading to improved resource allocation rests on the assumption that fiscal decentralization increases local influence over the public sector. However, in theory, there is an equal possibility that fiscal decentralization simply transfers power from national to local elites and that improved access of local elites to public resources increases opportunities for corruption.<sup>6</sup> In general, the impact of fiscal decentralization on corruption depends to a large extent on the quality of the supporting institutional framework and in particular, the degree that subnational governments and/or officials can be held accountable.

In light of the possible effects—that depend on the institutional design—of fiscal decentralization on economic growth, macro-fiscal balances and corruption, a key challenge for many transition economies has been to reap the economic benefits of decentralization while maintaining control over public expenditures and borrowing, restoring growth and improving accountability of local governments and officials to limit corruption.

In retrospect, for many former socialist countries, the combination of efforts aimed at consolidating macroeconomic stabilization during the early years of the transition, together with the fundamental structural changes in the economy, in some cases strong centrifugal forces, and political and ethnic conflicts, created an extremely complex setting for fiscal decentralization. This goes a long way in explaining why the fiscal decentralization process in many transition countries has been rapid, haphazard and largely non-transparent, with the emerging system of intergovernmental relations having important implications for budgetary developments.

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<sup>5</sup> See Prud'homme (1995), Tanzi (1995), and Ter-Minassian (1997). McLure (1995) and Sewell (1996), among other, however, have questioned the validity of the adverse link between decentralization and macroeconomic stability. Qian and Weingast (1997) stress the need for market-preserving federalism—a system of intergovernmental relations that is conducive to private sector development—as key to the relationship between decentralization and sound macroeconomic performance.

<sup>6</sup> Fisman and Gatti (2000) report a strong negative relationship between expenditure decentralization and corruption. However, Treisman (2000) does not find any significant relationship between fiscal decentralization and corruption.

In recent years, there has been progress in efforts to reform intergovernmental relations in many of the transition economies and decentralization issues have been on the policy agenda of even those countries that had previously not addressed such issues (such as Georgia and Ukraine). However, this progress has been uneven across countries and across various components of intergovernmental fiscal relations. It is widely agreed that the Czech Republic, Hungary, Poland and the Baltics have been the more active reformers in many of the key aspects of intergovernmental fiscal relations. They have made considerable progress in carrying out fiscal decentralization and have promoted institutional settings and processes that allow for the articulation of interests and policymaking based on consensus building. However even in these countries, there remain challenges and areas for needed progress. Many other countries, including Russia, Ukraine and the Central Asian States still need substantial reforms of the incentive structures that govern intergovernmental fiscal relations in order to obtain an efficient and well-functioning multi-tier system of government.

A recent and comprehensive assessment of the uneven progress on fiscal decentralization and key challenges to effective decentralization in the transition economies of Europe and Central Asia was made by Wetzel and Dunn (2001). Our paper differs from theirs in that we provide an analytical framework to identify and assess key adverse incentive mechanisms inherent in the design of the system of intergovernmental fiscal relations in these countries. In particular, we examine areas where key principles of sound fiscal decentralization have been breached with their potentially negative impact on the effectiveness of service delivery as well as macroeconomic performance. This includes an assessment of the strength of institutions pertinent to the intergovernmental financial relations, relevant laws, regulatory frameworks and other incentive structures that may facilitate or undermine effective fiscal decentralization.

The paper proceeds as follows: Section II examines the context for and experiences of decentralization in transition economies. In Section III, we identify three critical principles of sound decentralization which are then contrasted with actual policies and practices in select transition countries. Section IV discusses the reform agenda for the future. Section V concludes.

## **II. OVERVIEW OF FISCAL DECENTRALIZATION**

### **A. Initial Conditions**

To set the stage for the discussion that follows, some of the essential characteristics of the fiscal adjustment that occurred during the early years of transition are presented. In the pre-transition period, government finances in all BRO and Eastern European countries were interconnected with the administration of a heavily state-controlled economy, a relatively distorted price regime, extensive regulation, ill-defined property rights and incomplete or non-existing markets (Wildasin (1998)). The fiscal consequences of central elements of reform: privatization, price liberalization, and the establishment of property rights and contracts and deregulation were, therefore, quite significant.

During the initial years of transition, fiscal imbalances quickly emerged as output collapsed due to structural dislocations with concomitant loss of revenues, particularly for the transfer-dependent states of the former Soviet Union. The negative impact on growth from structural dislocations was further aggravated by high inflation resulting from price liberalization and the monetization of large fiscal deficits to sustain output and employment (Tanzi and Tsibouris (2000), Alam and Sundberg (2001), and Valdivieso (1998)).

Significant progress has been made towards achieving fiscal and macroeconomic stabilization since the transition in most countries—progress which has importantly changed the environment in which the decentralization process is taking place. There has, however, been substantial variation in the nature and pace of reforms across countries. In general, the Eastern European and Baltic countries, the most advanced reformers, have made rapid progress, while the intermediate and slow reformers have been less successful in establishing fiscal institutions, controlling fiscal imbalances, and redefining the role of the state.<sup>7</sup>

All transition countries underwent a dramatic fiscal adjustment in aggregate terms, but the advanced reformers maintained moderate overall public sector deficits after the first few years of rapid transition (Figure 1). The fiscal adjustment in many of the intermediate and slow reformers was necessitated by a sharp contraction in revenues during the early years of transition, reflecting shrinking and porous tax bases and dismal collection enforcement. The transition also brought about an overhaul of the tax system in many countries, with the introduction of new and more efficient instruments of taxation, which has resulted in the stabilization of revenues in recent years.<sup>8</sup> Countries that have lagged in terms of market reforms or have experienced civil unrest, have been able to minimize or delay the decline in revenues, primarily by resorting to their traditional tax bases (Figure 2). At the same time, the more advanced reformers have seen their revenue shares in GDP maintained.

In the face of a revenue collapse in many countries, fiscal adjustment was accomplished primarily through expenditure cuts. As can be seen in Figure 3, however, there has been a significant differentiation in country experiences. The advanced reformers experienced more modest expenditure cuts, in part as a result of the availability of financing due to less unfavorable revenue developments. Those countries that experienced the largest contraction

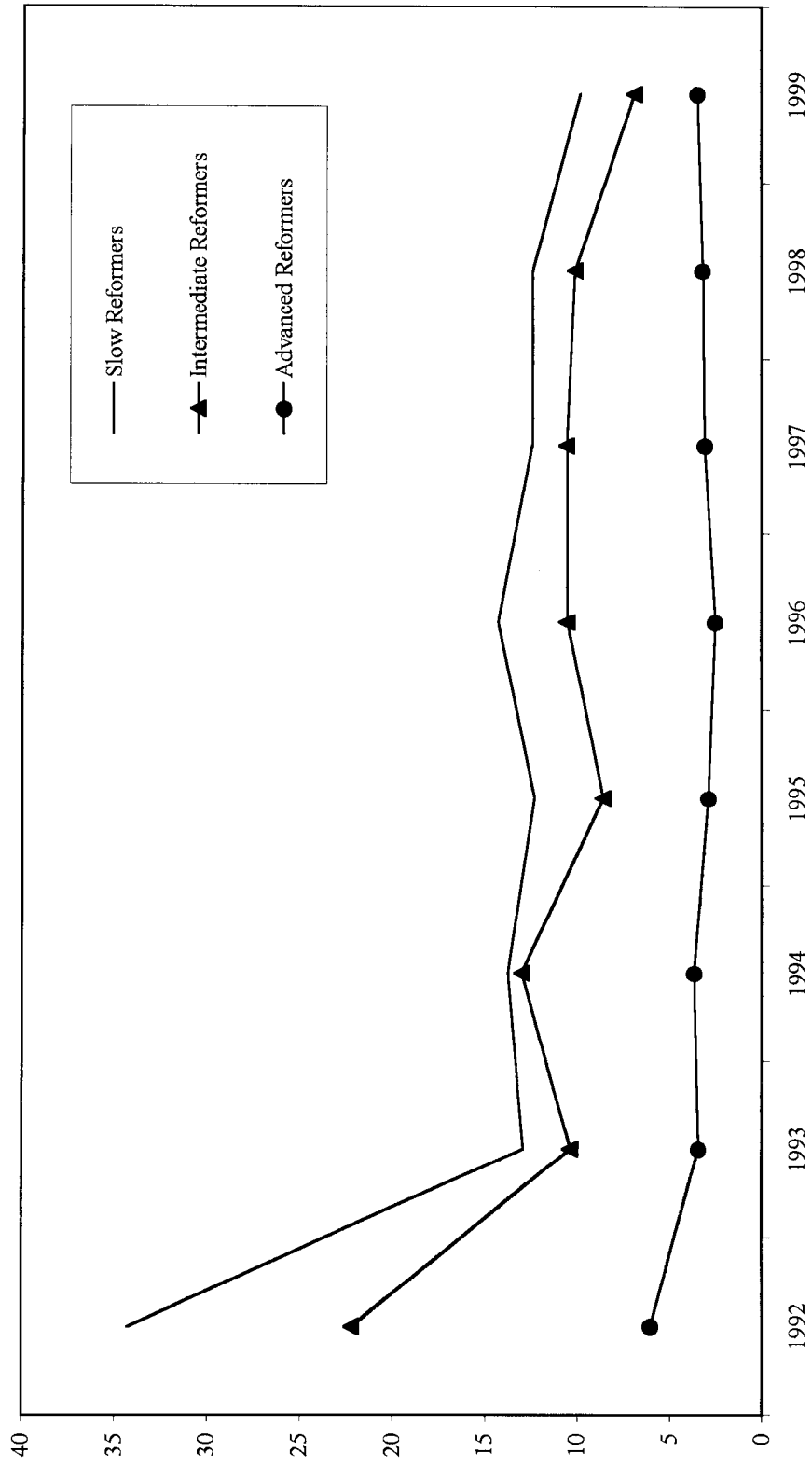
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<sup>7</sup> The South-Eastern European countries of Albania, Bulgaria, and Romania, and the BRO countries of Russia, Ukraine, Moldova, Kazakhstan, and the Kyrgyz Republic are widely regarded as the intermediate reformers. The slow reformers are the BRO countries of the Caucas and Central Asia: Armenia, Azerbaijan, Belarus, Georgia, Tajikistan, Turkmenistan, Uzbekistan (See EBRD (1998), and Valdivieso (1998)).

<sup>8</sup> For instance, transition saw a shift from direct taxes towards indirect taxes and, within direct taxes towards personal income taxes. At the same time, the efficiency of the tax system was enhanced with the introduction of the VAT, although problems with design and implementation have persisted in many countries. See Ebril and Havrylyshyn (1999) and Martinez-Vazquez and McNabb (2000) for more information on tax reforms in transition countries.



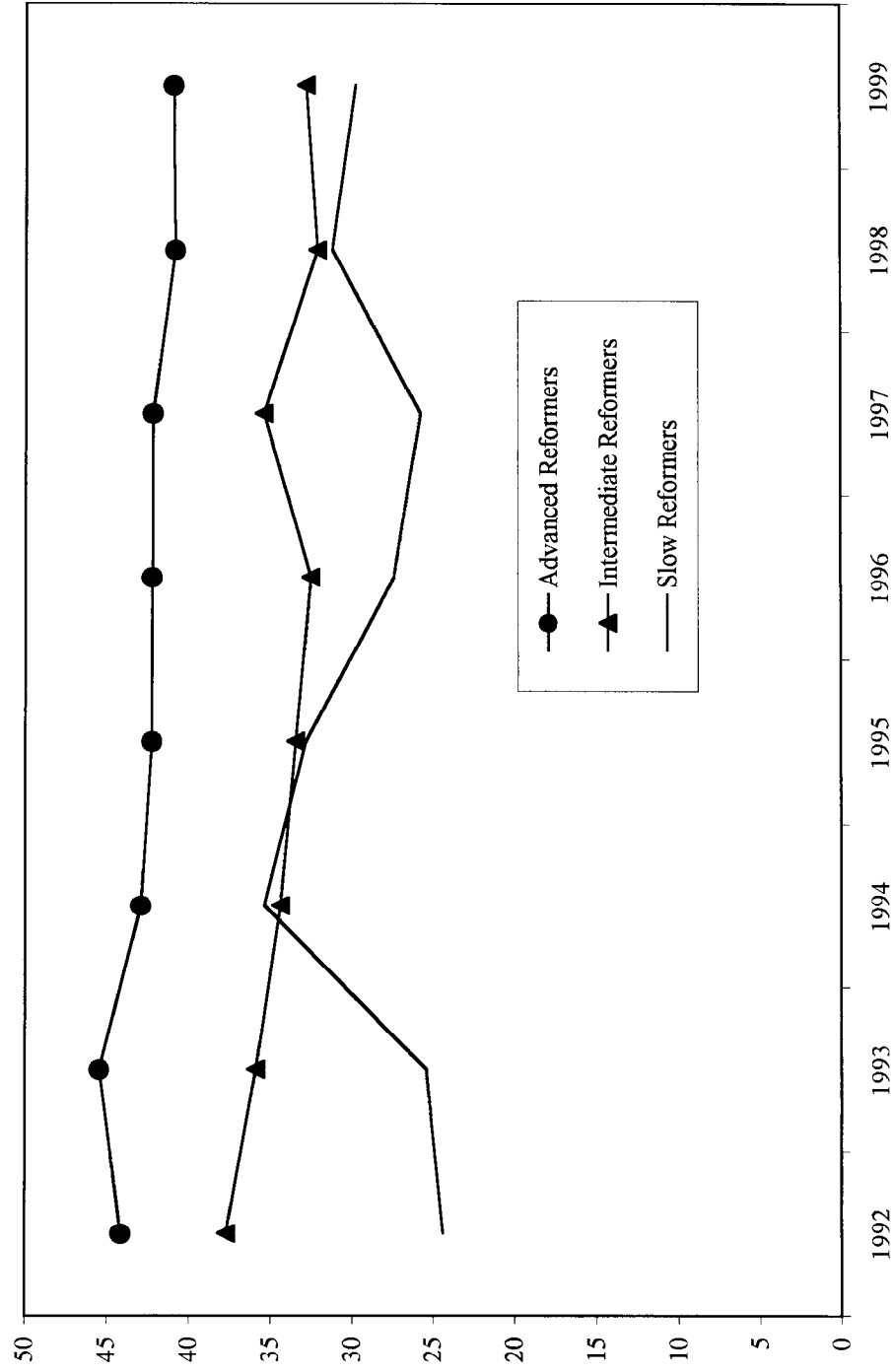
Figure 1. General Government Fiscal Deficit, 1992-99  
(In percent of GDP)



Note: Group averages are weighted by GDP.

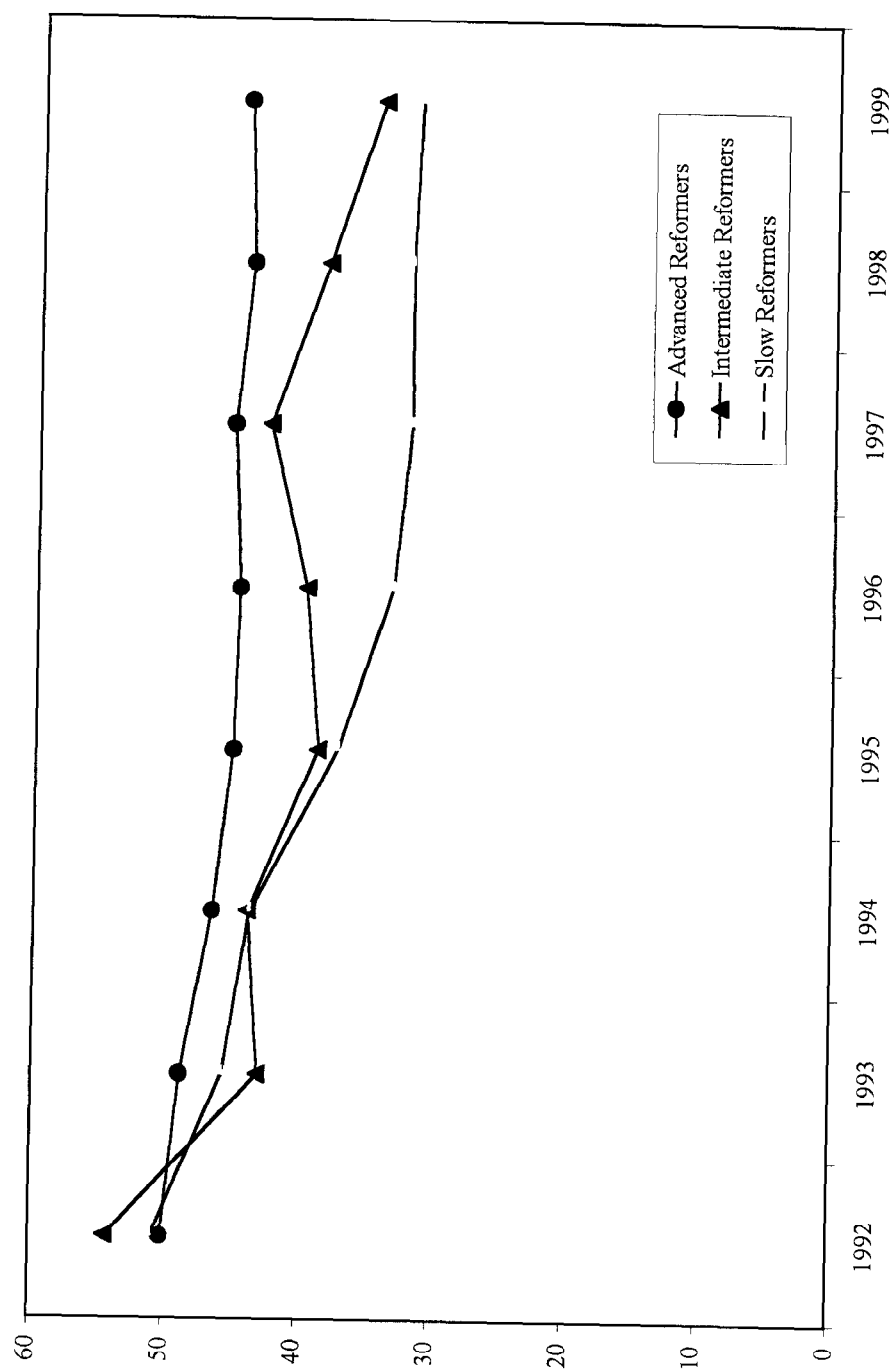
Figure 2. General Government Revenue, 1992-99

(In percent of GDP)



Note: Group averages are weighted by GDP.

Figure 3. General Government Expenditures, 1992-99  
(in percent of GDP)



Note: Group averages are weighted by GDP.

in revenues also faced the largest expenditure cuts. In many instances, these expenditure cuts did not come about from a systematic reassessment of government priorities (Tanzi and Tsibouris (2000)). Instead, there was heavy reliance on sequestration of expenditures and stop-gap revenue measures, and frequently insufficient attention was paid to the accumulation of payments arrears by governments and state enterprises.

The adjustments that took place in the context of economic stabilization, therefore, represented, only the first phase of a more substantial fiscal reform process. With the initial task of fiscal and macroeconomic stabilization complete or nearly so in most countries, a similarly formidable challenge for the medium term is to ensure enduring fiscal consolidation and to put in place measures to enhance economic growth and efficiency. A key challenge for these countries, therefore, is to implement reforms aimed at improving the quality and efficiency of government, including improvements in institutional arrangements that underpin fiscal policy, and to enhance transparency and accountability at all levels of government. The reform of the structure of intergovernmental relations remains an important element of this reform agenda.

## **B. Decentralization Experiences**

A common feature of almost all transition economies is that they began from a legacy of a highly centralized system of public finances with subnational governments acting mainly as administrative units with little independent fiscal responsibility. While originating from the similar economic structures and political systems, these countries have chosen very different routes and approaches to decentralization, with some countries being considerably more centralized than others.<sup>9</sup> In addition, progress with implementing intergovernmental fiscal reform has varied across the region.

One difficulty in comparing the degree of decentralization to date across the various countries is that fiscal decentralization is a multidimensional phenomenon, involving not only the assignment of expenditure and revenue responsibilities among different levels of government but also the extent of subnational policymaking autonomy. For instance, the share of subnational spending in total government spending, which is a common measure of decentralization, on average about 25 percent among the transition countries, varies from 15 percent in Albania and Macedonia to over 50 percent in Russia and Kazakhstan (Figure 4). This standard, however, fails to take into account the effective decision-making authority of subnational governments. It also does not take into account whether subnational governments have the financial resources required to meet their assigned expenditures.

The uneven nature of the degree of decentralization as well as the extent and scope of intergovernmental fiscal reform among the former socialist states largely reflects, among other things historical, political, ethnic, geographic, and demographic differences (see Table 1). For instance, countries with larger populations or geographic areas (such as Russia,

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<sup>9</sup> With the exception of Russia and Bosnia, which are federal states, all countries have a unitary system with about three levels of government on average.

Figure 4. Subnational Government Spending as Percentage of General Government Spending



Table 1. Structural Aspects of Fiscal Decentralization, 2001

Country	Number of subnational tiers	Number of top tier (regions/ province/oblast)	Average population	Number of lowest tier (town/municipality)	Average population
<b>Armenia</b>	2	11	336,000	930	3,970
<b>Azerbaijan</b>	2	71	107,000	...	...
<b>Belarus</b>	3	7	1,454,000	133	58,000
<b>Estonia</b>	2	15	96,000	247	6,000
<b>Georgia</b>	2	12	450,000	~1000	5,400
<b>Kazakhstan</b>	3	14	978,000	258 1/	60,000
<b>Kyrgyz Republic</b>	3	7 2/	645,000	549 3/	--
<b>Latvia</b>	3	33 4/	71,527	541	2,219
<b>Lithuania</b>	2	10	371,000	56	66,000
<b>Moldova</b>	2	11	390,000	911	4,300
<b>Russia</b>	3	89	1,652,000	2337	63,000
<b>Tajikistan</b>	2	3	1,967,000	70	84,000
<b>Ukraine</b>	3	27	2,058,000	937 5/	59,000
<b>Uzbekistan</b>	3	14	1,721,000	1749	14,000
<b>Albania</b>	3	12	275,000	374 6/	9,000
<b>Bulgaria</b>	2	9	921,000	255	33,000
<b>Croatia</b>	3	20	230,000	423	10,900
<b>Czech Republic</b>	3 7/	14	740,000	6292	1,700
<b>Macedonia, FYR of</b>	2			123 8/	16,500
<b>Hungary</b>	1	3177	3,200	3177	3,200
<b>Poland</b>	3	16	2,419,000	2483	16,000
<b>Romania</b>	2	41	548,780	2948 9/	7,632
<b>Yugoslavia</b>	2			187	55,500

Source: IMF country economists.

1/ 173 rural rayons and 85 towns of rayon status.

2/ One independent city (Bishkek) functions as an oblast.

3/ 72 rayons, 19 towns and 458 village centers.

4/ 26 districts and 7 republican cities.

5/ 490 rayons and 447 municipalities

6/ 65 communes and 309 municipalities.

7/ District offices have been phased out from January 2001. This phase out will be completed by the end of 2002.

8/ The number of municipalities may be reduced during 2002 to about 85.

9/ 2948 municipal councils (2686 communes, 182 towns and 80 municipalities).

Kazakhstan and Poland) require a greater decentralization of public service provision to subnational governments as compared to smaller countries like Moldova and the Kyrgyz Republic. Similarly, ethnically diverse countries such as Russia also would have fairly high need for fiscal decentralization compared to other, smaller and ethnically more homogeneous transition economies (such as Slovenia). At the same time, political factors such as the accession to the EU can be seen as providing an impetus for reform in countries like the Baltics, the Czech Republic, Poland and Hungary. In countries such as Croatia and Bosnia and Herzegovina, ethnic conflict may have played a significant role in shaping the nature of fiscal decentralization that has evolved. Differences in institutional, economic and political development can also be expected to influence the extent of decentralization across these countries.<sup>10</sup>

These factors not only have influenced the observed degree of decentralization across the region, but also whether decentralization policies are effective and have had their desired impact. At the same time, macroeconomic and fiscal policies adopted at the outset of transition have had an impact on the system of intergovernmental relations that has evolved in many countries.<sup>11</sup> Many of the more advanced reformers, with more stable macroeconomic conditions, including low overall public sector deficits, have made considerable progress in carrying out fiscal decentralization and, in particular, have promoted institutional settings that are supportive of effective decentralization. However, even in these countries, weaknesses in existing systems have prevented them from fully exploiting the potential public finance and service delivery benefits from decentralization. In countries that are regarded as intermediate reformers in the broad fiscal arena, the current design and structure of the intergovernmental systems contains many inappropriate incentive structures that are adverse to the sound working of the fiscal system and, hence, to overall macroeconomic performance. Among the slow reformers, both in terms of the timing and actual implementation of fiscal reforms, intergovernmental fiscal relations preserves many features, patterns and structures of the Soviet system.

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<sup>10</sup> Bird and Yilmaz (2001) note that high income OECD countries tend to be more decentralized than others, as measured by indicators of subnational share of revenues and expenditures.

<sup>11</sup> For instance, in several countries, the process of fiscal decentralization occurred at a time when central governments faced intense pressures to curb their fiscal deficits. As a result, expenditure responsibilities, in particular on capital and social outlays, were devolved to subnational governments. However, in the absence of an adequate assignment of revenues, this resulted in intergovernmental fiscal imbalances (Bird et al. (1995)).

### III. PRINCIPLES FOR SOUND AND EFFICIENT DECENTRALIZATION

There is broad agreement that unsuccessful fiscal decentralization can undermine effective service delivery and impede macroeconomic stability.<sup>12</sup> At the same, the structure of intergovernmental relations is closely related to the tax system, and the institutions that carry out revenue and budgetary management at both federal and subnational levels. Therefore, weaknesses in the design of the system of intergovernmental relations and its institutional underpinnings can compromise the workings of the entire fiscal system.

The importance of the relationships between decentralization and macroeconomic performance underscore the need of identifying the factors that would ensure a sound and efficient decentralized fiscal system. We outline three basic principles that capture some key aspects of the incentive mechanisms needed for sound and effective decentralization.<sup>13</sup> The overarching objective of the underlying analysis is to ensure *accountability and transparency* at all levels of government.

In the ensuing discussion, it is important to note that there is no unique optimum degree of fiscal decentralization or prescribed set of rules governing the decentralization process that apply to all transition countries. Country-specific factors, such as the level of economic and institutional development, political factors, geographical size of the country, size of its population and degree of ethnic heterogeneity, etc., have an important bearing on the appropriate degree of fiscal decentralization for a country. What is key is that the design of the system foster sound incentives and the devolution of fiscal powers is commensurate with the institutional strengths and capacities of the various levels of government. The latter imposes a ceiling on the appropriate extent of fiscal decentralization at any point in time and, hence, provides guidance for the sequencing of reforms in this area.

- **The need for clarity of roles and responsibilities** between different levels of government. Clarity, transparency, stability and well-defined rules of the game are paramount for achieving accountability that efficient and sound decentralization requires. Given the interdependence among the various components of the system of intergovernmental relation, this requires a clear and effective delegation of functions by central government, with revenue assignments that are transparent, unambiguous, and commensurate with subnational governments' expenditure responsibilities. It also requires transfers that are based on stable principles and specified by legal formulas that support hard budget constraints.

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<sup>12</sup> Throughout the paper we use the term sound fiscal decentralization with regard to the extent it is conducive to macroeconomic stability. The term efficient fiscal decentralization refers to the extent it enhances microeconomic efficiency in the input and output mix of public service delivery.

<sup>13</sup> See Dabla-Norris, Martinez-Vazquez, and Norregaard (2002).



- **A measure of autonomy** for subnational governments on the expenditure and revenue side is crucial for realizing the efficiency gains of decentralized government and supporting macroeconomic stability.
  - On the expenditure side, this requires subnational budget flexibility to decide—within limits—expenditure priorities and the choice of both the output mix and techniques of production.
  - On the revenue side, this requires that subnational governments have the authority to own-finance locally provided services at the margin. More complete revenue autonomy requires a minimum of authority to set tax rates and an assignment of at least one significant tax source.
  - Sustainable autonomy and economic efficiency, however, also requires a reduction of vertical imbalances and some equalization of opportunity to allow subnational governments to perform their assigned functions.<sup>14</sup> This points to the crucial importance of intergovernmental transfers in fiscal decentralization design.
  - While autonomy should be explicit and well-defined, it must also be circumscribed with respect to the access to borrowing by subnational governments in order to support hard budget constraints and reduce moral hazard.
- **Institution building** is the last of the three pillars. A prerequisite for successful decentralization is that subnational governments possess the administrative and technical capacity required to effectively carry out their assigned responsibilities. Supporting institutions, including democratic representation, sound budget processes, local government revenue collection capacity, and mechanisms to ensure coordination and cooperation between different levels of government—both at the political and the technical level—are crucial for the functioning of a multi-tier system of government.

In the remainder of this section we provide an overview from a broad range of transition economies to illustrate instances where these principles are lacking, with potentially adverse impacts on economic efficiency, macroeconomic stabilization, and growth.

## **A. Clarity of Roles**

### **Legal and institutional structure**

In many transition countries, the evolution of the legal and institutional framework has been subject to a fairly continuous series of revisions, reversals, and shifts in focus and has reflected political compromises rather than consistently applied rules and principles. The degree to which the legal and institutional framework supports a well-defined system of intergovernmental fiscal relations, however, varies (see Table 2). Countries like Hungary, the Czech Republic and Poland have pioneered reforms in the legal and institutional

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<sup>14</sup> A vertical imbalance occurs when the expenditure responsibilities of subnational governments do not match with their ability to raise revenues.

Table 2. Legal and Institutional Basis for Decentralization, 2002

Country	Legal Basis of Subnational Government
<b>Armenia</b>	Law on Budgetary System (1997), Law on Financial Equalization (1998), Law on Local Self-governance (1996) and Law on Territorial Administration.
<b>Azerbaijan</b>	Budget Law. Assignments vary. Local executive power lies with regional governors appointed by President.
<b>Belarus</b>	Annual Budget Law.
<b>Estonia</b>	Constitution, Local Government Organization Act, and other laws.
<b>Georgia</b>	Constitution and Budget Law. No formal assignment of responsibilities.
<b>Kazakhstan</b>	Constitution (Article 87, part1), Budget System Law on Local Government (2001).
<b>Kyrgyz Republic</b>	Constitution, Law on Local Self-Governance, Law on Budget Principles.
<b>Latvia</b>	Law On Local Governments (1994); Law On Local Government Budgets (1995); Law On Budgetary and Financial Management (1994).
<b>Lithuania</b>	Law of Administrative Units and Boundaries of 1994.
<b>Moldova</b>	Law of Local Public Finances and the 1999 Administrative Teritorial Reform. Annual budget determines sharing arrangements.
<b>Russia</b>	Constitution, Budget Law.
<b>Tajikistan</b>	Constitution.
<b>Ukraine</b>	Constitution and the General Budget Law.
<b>Uzbekistan</b>	The Constitution and the 'Law on Budget System'.
<b>Albania</b>	New law on organization and functioning of local government (2000) created 12 regions and disbanded districts as administrative units.
<b>Bulgaria</b>	Constitution; Law on State Budget; Law on Municipal Budgets.
<b>Czech Republic</b>	Constitution, Act on municipalities, Act on regions, Budgetary Rules, etc.
<b>Macedonia, FYR of</b>	A new Law on Local Self-Governments was passed on January 24, 2002.
<b>Hungary</b>	The constitution, and a series of legislative acts.
<b>Poland</b>	Law on self-government finance; public debt law; law on public finance.
<b>Romania</b>	Constitution of Romania, Law of Local Public Finance (no.189/1998), passed in August 1996, with subsequent modifications; Law of Local Public Administration (no.215/2001) with subsequent modifications.
<b>Yugoslavia 1/</b>	Law on Self-Governance passed in February 2002.

Source: IMF country economists.

1/ Excluding Kosovo.

framework required for decentralization, and have had considerable success in defining the role of intermediate levels of government. However, current legislation in these countries has set the stage for the fragmentation of municipalities into entities of inefficient sizes.<sup>15</sup> Some countries in Central Asia (for example, Kyrgyz Republic and Tajikistan) still lack a well-specified legal and institutional basis for decentralization.

Other countries (Russia, Ukraine, and Kazakhstan) have made significant progress in recent years to clarify the legal and institutional framework for decentralization between the center and regional (oblast) governments, but the distribution of functions to local governments remains ambiguous, with important gaps in the legislation arising from the lack of well-defined criteria to determine the assignment of functions and powers across regional and local governments. In some countries (Belarus and Azerbaijan), the practice of resolving contradictions between the various legislation in an ad hoc manner, with crucial provisions often decided in the annual budget laws, has imparted a measure of unpredictability and instability to the system of intergovernmental relations. In addition, overlapping and poorly defined roles, and unclear divisions of power between different levels of government has created confusion about the functions and modes of interaction of different parts of government.

### **Expenditure assignment**

The presence of a clear, stable and well-defined assignment of expenditure responsibilities is commonly identified as an essential starting point for the system of intergovernmental fiscal relations. This requires establishing primary responsibility or paramountcy in the case of concurrent responsibilities and an explicit assignment of responsibilities for regulation, financing, and implementation of service delivery.

In recent years, but to varying degrees, progress has been made in clarifying expenditure assignments. While actual assignments often broadly correspond to the principle of subsidiarity (Table 3), further progress is needed in a number of countries.<sup>16</sup> The ambiguity stemming from shared responsibilities between the center and subnational government needs to be reduced. There is also a wide variation across countries with respect to the distribution of specific expenditure responsibilities. In most countries, regional and local governments bear a substantial portion of expenditures on education and social insurance and health services. This figure is higher for the Baltics and the Central Asian countries, reflecting, in part, differences in physical and demographic characteristics, institutional capacities, political

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<sup>15</sup> The average size of Hungary's municipalities is 3,200 people and over half of the municipalities have a population below 1,000 (Wetzel and Papp (2001)). In the Czech Republic, 86 percent of the municipalities have fewer than 1,500 inhabitants, and 42 percent have fewer than 300 inhabitants (Oliveira and Martinez-Vazquez (2001)).

<sup>16</sup> This principle suggests that provision of any given public service should be assigned to the lowest level of government that allows for the full internalization of the costs and benefits associated with that service.

Table 3. Structure of Expenditures for Each Level of Government, Most Recent Year

(Percent of total within each level of government)

	Level	General Public Services	Defense and Public Order	Social Insurance and health services 1/	Education	Culture and Recreation	Other 2/	Total
Azerbaijan (1998)	C	6.3	21.1	31.9	3.5	1.5	35.7	100.0
	R&L	4.3	0.0	22.7	60.2	4.4	8.4	100.0
Belarus (2000)	C	4.6	8.5	41.7	3.9	1.6	39.8	100.0
	R&L	2.8	1.3	20.8	26.5	3.1	45.5	100.0
Estonia (2000)	C	7.2	12.2	47.9	10.2	4.0	18.4	100.0
	R&L	11.2	0.3	12.1	38.9	11.4	26.0	100.0
Georgia (2000)	C	7.4	12.6	35.4	3.6	2.9	38.1	100.0
	R&L	9.8	3.7	11.2	31.8	7.7	35.7	100.0
Kazakhstan (2000)	C	6.6	14.2	42.6	3.6	1.2	31.7	100.0
	R&L	3.5	5.1	22.2	23.6	4.3	41.3	100.0
Kyrgyz Republic (2000)	C	14.9	16.0	20.5	19.5	2.9	26.2	100.0
	R&L	9.4	1.5	28.4	45.0	3.4	12.3	100.0
Latvia (2000)	C	5.4	9.5	52.8	5.6	2.1	24.5	100.0
	R&L	10.5	1.3	9.2	45.5	6.4	27.1	100.0
Lithuania (2000)	C	4.2	11.4	52.5	5.8	1.9	24.3	100.0
	R&L	4.8	0.8	15.1	58.9	4.6	15.8	100.0
Moldova (2000)	C	3.7	5.7	43.6	4.0	1.0	42.0	100.0
	R&L	9.4	3.5	26.0	38.2	2.7	20.2	100.0
Russia (2000) 3/	C	7.6	17.8	32.5	2.3	0.7	39.1	100.0
	R&L	25.6	2.8	19.2	17.8	3.5	31.1	100.0
Tajikistan (2000)	C	20.5	20.0	20.9	3.2	3.3	32.2	100.0
	R&L	10.2	3.0	18.2	39.8	2.5	26.1	100.0
Ukraine (2000)	C	11.1	14.0	22.8	7.7	0.7	43.6	100.0
	R&L	4.0	1.4	34.7	23.3	3.5	33.1	100.0
Albania (1998)	C	5.8	9.4	23.9	1.9	0.9	58.1	100.0
	R&L	10.4	0.0	33.5	41.6	2.6	11.9	100.0
Bulgaria (2000) 4/ 5/	C	7.5	14.0	40.6	4.3	1.6	32.0	100.0
	R&L	7.4	0.7	36.0	31.0	2.8	22.2	100.0
Croatia (2000)	C	3.7	12.9	55.0	7.9	1.2	19.3	100.0
	R&L	22.4	0.8	3.9	11.9	14.3	46.7	100.0
Czech Republic (2000)	C	2.9	9.8	54.3	9.4	1.1	22.5	100.0
	R&L	15.4	3.9	16.6	7.5	7.0	49.5	100.0
Hungary (1999)	C	4.9	5.5	32.3	7.7	1.6	48.0	100.0
	R&L	12.6	0.9	27.1	23.1	4.3	32.0	100.0
Poland (2000)	C	4.0	7.5	51.9	4.7	0.5	31.2	100.0
	R&L	7.2	4.1	32.0	27.5	3.7	25.5	100.0
Romania (1999)	C	4.1	9.1	43.4	9.8	1.0	32.6	100.0
	R&L	13.2	1.8	8.1	8.4	4.3	64.3	100.0

Sources: IMF country economists; *Government Finance Statistics* (IMF).

1/ GFS categories "Health" and "Social Security and Welfare."

2/ GFS categories "Housing and Community Amenities," "Agriculture, Forestry, Fishing and Hunting," "Mining, Manufacturing and Construction," "Transportation and Communication," "Other Economic Affairs and Services" and "Other Expenditures."

3/ Central government transfers to extrabudgetary funds are included. General government includes wages and salaries.

4/ Some small contributions to Defense and Education by both governments are included in the 'other' category.

5/ General government services comprises "Wages and Salaries" and "Maintenance and Operations."

preferences and the degree of centralization. In other countries, local governments are routinely mandated to fund and provide redistributive social services, funding for which could be more effectively provided by the central government.

The advanced reformers (Czech Republic, Hungary, Poland, Estonia, and Lithuania) have developed clear assignments of expenditure responsibilities. However, the efficiency of service delivery is often compromised due to the excessive fragmentation of municipalities in countries such as Hungary and the Czech Republic, as many small local governments are required to provide a broad range of services. In addition, local governments are frequently given greater flexibility in providing certain voluntary services with the option of passing this responsibility to a higher level of government.<sup>17</sup>

In a number of countries, such as Albania, Moldova, Georgia, Romania, and Azerbaijan, the distribution of spending responsibilities remains ambiguous. Similarly, in many Central Asian countries, Ukraine, and to a lesser extent in Russia, the presence of many different and often conflicting laws, decrees, regulations, and departmental orders has affected the clarity of expenditure assignments, especially in the areas where there are concurrent or overlapping responsibilities among different levels of governments (Dabla-Norris et al (2002)). In Russia, for instance, ambiguity in the assignment of the authority to regulate and issue declarative norms and the resultant proliferation of unfunded mandates, until recently, compromised subnational budgetary positions. In general, the lack of clarity and stability in expenditure assignments have detracted from accountability at all levels of government and undermined the efficiency of public expenditures. Moreover, in many countries, it has reduced incentives to prioritize budgets, lower costs of service delivery, eliminate excess physical capacity, and properly maintain capital infrastructure at the subnational level.

One important source of ambiguity has resulted from the divestiture of social expenditure responsibilities by state enterprises (housing, transportation, health clinics, and other facilities), many of which were subsequently assumed by subnational government budgets. Subnational governments in Russia, Ukraine and other countries have also been slow to rid their budgets of private market interventions, with subsidies for housing and communal services, including public utilities, accounting for a large proportion of their expenditures. For instance, subnational governments in Russia spend close to one-third of their total resources on subsidies to consumers and in Kazakhstan the relevant figure was 10 percent (Dabla-Norris et al (2002)). Among the more advanced reformers, such as Hungary, Poland, and the Baltics, subnational governments have been more successful with privatization and contracting out of service provision. For other countries with limited private sector capacity and a weak legal and institutional environment for private providers, the private sector response has been marginal.

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<sup>17</sup> For instance, the Law on Local Government in Hungary specifies certain potential responsibilities for local governments (urban development, housing, and waste management) that leave a degree of ambiguity in the system as local governments can “pass up” a voluntary responsibility to a higher level if unable to meet the costs of providing that service (Wetzel and Papp (2001)).

In many cases, the problem of unclear expenditure assignments has been especially acute at the regional-local level, with regional governments enjoying a high degree of discretion, with the result that they exert a certain arbitrariness over expenditure assignments to their subordinate local governments. For instance, local governments in Georgia and Kazakhstan lack a formal assignment of expenditure responsibilities which may negatively affect the accountability of both regional and local governments to taxpayers and subject local governments to added budget uncertainty.

In a number of countries, the assignment of capital expenditure responsibilities at different levels of government has been a particularly murky issue (Dabla-Norris et al (2002)). The ambiguity in capital expenditure contributed to the failure to maintain existing infrastructure by subnational governments in these countries. It also appears that subnational expenditures on capital infrastructure, in addition to that on maintenance, have been low, in part resulting from budgetary expediency under severe financing constraints.<sup>18</sup>

### **Tax assignment**

While progress to varying degrees has been made in recent years in many countries in the region (for example, Hungary, Poland, the Czech Republic and the Baltics, and, to a lesser extent, in Russia, Kazakhstan, Kyrgyz Republic, and—more recently—Ukraine) to make revenue assignment more transparent and predictable by formalizing revenue sharing arrangements and adopting stable and uniform sharing rates at the central-regional level, in other countries, revenue assignments continue to rely on the “regulating approach.” Under this approach, the formal basis for setting tax sharing rates is the central government estimates of each region’s “minimum” expenditures needs. This practice has resulted in customized and yearly changing sharing rates and compensations through non-transparent transfers to fill the subnational budget gaps as well as assignments being ad hoc and negotiated with individual regions through bilateral bargaining. However, even in countries like Russia and Kazakhstan, revenue sharing arrangements between regional and local governments continue in large measure to be based on the regulating approach.

The lack of clearly defined, stable and uniform revenue assignments between the center and subnational governments inherent in this approach has weakened budgetary management at the subnational level and created perverse incentives for subnational governments to either hide locally mobilized revenue sources in extrabudgetary funds (for example at the municipal levels in Russia and Ukraine, and at the regional level in many Central Asian countries), or to simply reduce their efforts to mobilize revenues locally. Evidence from Bulgaria, Georgia and other countries suggests that central governments routinely revise tax sharing rates on an

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<sup>18</sup> Subnational governments have found it easier to cut capital and maintenance expenditures than to cut other items of current expenditures, such as wages and salaries. In addition, institutional failures, negative incentives for subnational governments stemming from the non-transparency of central government expenditures, and the lack of access to long-term credit have also played important roles.

annual basis in face of political and economic pressures.<sup>19</sup> Punitive “extractions” by higher level governments in the form of clawing back any additional revenues raised by lower level governments through reduced sharing rates have also created perverse incentives for revenue mobilization, at the local levels in many countries.<sup>20</sup> In Albania, while there has been improvement in recent years, local governments’ efforts to improve revenue collection in the past were discouraged since they were not free to determine the spending allocation of funds collected under the local (independent) budget. This led to surplus funds being trapped in the treasury system and captured by the central government by the end of the year. The resultant non-uniformity in revenue sharing and the absence of stability undermined sound fiscal management at the local level (Banks and Pigey (1998)).

As seen in Table 4, subnational governments in most transition economies are assigned income taxes as the most important type of shared revenue with consumption taxes trailing far behind and generally being more important at the central government level. Property taxes, which are widely recognized as an important source of finance for local governments, are still a small and underutilized revenue source locally, often reflecting lags in regularizing the property market as a basis for taxation.

### **Transfers**

In most transition economies—the Slovak Republic, Poland, Hungary and the Baltics are among the exceptions—transfers among the various levels of government remain discretionary, and negotiated, with transfers largely unconditional and determined ad hoc by the central government, often changing with each annual budget. Other countries, including Bulgaria, Croatia, Romania, Georgia, Russia, Kazakhstan, and more recently, Ukraine have moved towards more transparent formula-based systems, although weaknesses remain. In addition, there appears to be wide variation in the nature of formulas used.<sup>21</sup> While most formulas include indicators of expenditure needs and tax capacity, in Bulgaria and Estonia for instance, formulas continue to incorporate a fiscal gap component, creating negative incentives for revenue mobilization (Table 5). In many countries, transfer formulas are undermined through end-year negotiated transfers that serve to soften budget constraints.

The gap-filling nature of the transfers between central and regional governments in many transition countries and between regional and local governments in most countries, however, provides negative incentives for revenue mobilization by subnational authorities and the efficient provision of public services as any increase in regional own revenues or budgetary savings in the provision of public services triggers, often commensurate reductions in the level of transfers. This practice is seen in Albania, Bulgaria, Belarus, Moldova, Ukraine, Russia and all Central Asian countries.

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<sup>19</sup> Dabla-Norris, Martinez-Vazquez and Norregaard (2002) and Wetzel and Dunn (2001).

<sup>20</sup> See Martinez-Vazquez and Boex (2000) and Zhuravskaia (1999) for the case of Russia.

<sup>21</sup> See Wetzel and Dunn (2001).

Table 4. Structure of Tax Revenues at Each Level of Government, Most Recent Year

Country	Central / Regional & Local	Total Subnational Tax Revenue		Income Taxes	Payroll Taxes and Social Security Contributions	Consumption Taxes	Property Taxes	Other Tax Revenue	Total
		Percent of GDP	Percent of total SNG revenues						
Azerbaijan (1998) 1/	C			22	25	40	3	10	100
	R&L	4	95	43	0	40	6	11	100
Belarus (2000) 2/	C			12	41	42	0.0	6	100
	R&L	15	91	31	0	57	7	5	100
Estonia (2000)	C			16	38	46	0.0	0	100
	R&L	5	83	89	0	1	10	0	100
Georgia (2000)	C			9	22	62	0.0	7	100
	R&L	4	93	52	0	11	26	11	100
Kazakhstan (2000)	C			31	8	53	0.3	8	100
	R&L	10	96	51	31	8	10	0	100
Kyrgyz Republic (2000)	C			18	0	78	0.0	4	100
	R&L	2	75	38	0	62	0.0	0	100
Latvia (2000)	C			13	39	46	0.0	1	100
	R&L	5	72	80	0	2	19	0	100
Lithuania (2000)	C 6/			13	35	51	0.0	1	100
	R&L	6	95	91	0	0	9	0	100
Moldova (2000)	C			4	30	59	0.0	7	100
	R&L	4	77	55	0	19	26	0	100
Russia (2000) 3/	C			14	34	37	0.3	15	100
	R&L	11	80	49	0	30	10	11	100
Tajikistan (2000)	C			3	22	59	1	15	100
	R&L	4	94	40	0	40	14	6	100
Ukraine (2000) 4/	C			24	9	60	0.0	7	100
	R&L	7	86	71	0	13	11	5	100
Albania (1998)	C			9	18	52	0.4	20	100
	R&L	0	40	0	0	92	0.2	8	100
Bulgaria (2000)	C			16	33	48	0.0	3	100
	R&L	3	77	90	0	0	10	0	100
Croatia (2000)	C			10	34	49	0.4	7	100
	R&L	3	59	85	0	4	11	0	100
Czech Republic (2000)	C			14	46	36	1	2	100
	R&L	5	71	91	0	5	5	0	100
Hungary (1999)	C			22	35	38	1	5	100
	R&L	4	57	45	0	44	11	0	100
Poland (2000)	C			21	35	42	0.0	3	100
	R&L	6	64	24	55	2	18	0	100
Romania (1999) 5/	C			18	39	37	0.0	6	100
	R&L	3	84	77	0	2	18	2	100

Sources: IMF country economists; *Government Finance Statistics*.

1/ Assumes that unaccounted-for local revenue is split up evenly between 'other tax revenue' and transfers.

2/ Other revenue of central government includes property taxes and other tax revenue.

3/ 'Other tax revenue' includes fees and other revenues.

4/ VAT and excises are no longer allocated to local budgets.

5/ Property taxes of subnational government includes land tax.



Table 5. Transfers (Grants) from Central to Subnational Governments, Most Recent Year

	SIZE		TYPE OF GRANT		PROPERTIES OF GENERAL GRANTS
	Percent of GDP	Percent of total revenue	General	Specific	Determinants of Total Amount
Azerbaijan (1998)	2.8	42	100	0	Gap-filling.
Belarus (2000)	3.0	15	100	0	Gap-filling.
Estonia (2000)	2.0	26	Yes	Yes	Revenue equalization.
Georgia (2000)	0.5	10	0	0	"Rich" regions make transfers to poor regions. Not transparent transfer system, based on negotiations between central and local government.
Kazakhstan (2000)	1.7	14	100	0	Gap-filling after revenue sharing. "Fraternal" system introduced in 1999 budget formulations which determines subventions to poorest regions and withdrawals from richest regions.
Kyrgyz Republic (2000)	2.6	49	100	0	Gap-filling. Since 1998, categorical grants which fund wage spending for health and education at subnational level. Poor regions without sufficient tax revenues receive equalization grant. Amount negotiated with Ministry of Finance.
Latvia (2000)	2.5	26	100	0	Revenue equalization; process initiated by the local governments.
Lithuania (2000)	0.7	10	100	0	Expenditure needs based on inflation-adjusted previous year expenditures: 1. Allocated based on claims at the end of the year; 2. Allocated in order to bring forecast tax revenues below national average and close to national average; and 3. Allocated on "fraternal system" based relative measure of need adjusted with demographic coefficient.
Moldova (2000)	2.7	34	100	0	Gap-filling, based on expenditure norms and revenue mobilization capacity.
Russia (2000)	1.4	9	Most	Some	Equalization and gap filling.
Tajikistan (2000)	1.2	24	90	10	Gap-filling. Not transparent transfer system; based on negotiations between central and local government.
Ukraine (2000)	2.5	23	60	40	Expenditure needs and population; Conditional grant.
Albania (1998)	5.4	96	100	0	Gap filling.
Bulgaria (2000)	3.3	43	80	20	Transparent transfer system.
Croatia (2000)	0.2	5	Small	Most	Equalization grant for specific purposes. Not transparent transfer system.
Czech Republic (2000)	2.3	25	0.0	100.0	Grants are calculated each year when preparing the central government budget or distributed according to a specific legal frame work. The precise use of grants is defined by the central government. Typical criterion is per pupil, per bed etc.
Hungary (1999)	6.3	49	69	31	Certain degree of equalization. Dependency of municipal sector from grants is high.
Poland (2000)	6.0	39	60	40	Equalization block grant, capital expenditures. Equalization grants bring localities up to 85% of national average per capita revenues. Transparent formula using objective criteria.
Romania (1999)	0.7	17	Yes	Yes	Equalization grant. Transparent transfer system.

Sources: *Government Finance Statistics* (IMF), IMF country economists; Wetzel and Dunn (2001).

Apart from equalization transfers, other types of grants and transfers are used across the region. Matching grants for funding centrally mandated services in the areas of education, health or social spending are used widely in Croatia, the Kyrgyz Republic and Poland, and for investment purposes, in the Czech Republic and Hungary. In Russia and Ukraine, however, the use of other ad hoc and non-transparent transfers, such as mutual settlements, which accounted for over 75 percent of all non-equalization transfers in Russia in 1998, provided a soft budget constraint environment at the subnational level.<sup>22</sup>

The use of specific or conditional grants (i.e., earmarked for specific purposes) is also common. For example, in the Czech Republic all grants are specific, covering a number of delegated responsibilities (state administration and environmental protection) and own responsibilities (education, social care and cultural activities). In Poland, the widespread use of specific grants has been criticized on the grounds that it provides negative incentives for local governments to exert tax-effort (OECD (2001f)). Other countries (Russia and Kyrgyz Republic) provide conditional grants on a per capita basis, while Armenia, Hungary, Kazakhstan, and the Baltics do not provide conditional grants for current expenditures.<sup>23</sup>

## **B. A Measure of Autonomy**

### **Expenditure autonomy**

Sound and efficient decentralization requires a close correspondence between responsibility and decision-making authority. However, effective expenditure autonomy at the subnational level has been limited in most transition economies (Table 6). Norms and regulations (for instance with regard to quality and scope of service provision) emanating from central government agencies have interacted with explicit spending priorities set by the central governments, including spending mandates to severely constrain the authority of subnational governments to adjust current expenditures. For instance, in Bulgaria about 90 percent of actual local expenditure in 1999 were not under the control of local authorities (McCullough et al. (2000)) and in Albania this figure was 90-95 percent (Banks and Pigey (1998)). Hence, the outcome in most transition economies has been considerable burdens imposed on subnational budgets.

This is in contrast to the situation in Hungary, Poland, Estonia, Latvia and the Czech Republic, where subnational governments are granted greater flexibility in service delivery, backed by law. In Hungary, local governments are entitled to determine the ways and modes

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<sup>22</sup> Mutual settlements, which consist largely of unbudgeted transfers to compensate regional governments for mandates or the delivery of federal programs, emergency transfers, as well as other negotiated and discretionary funds, are typically allocated during the process of budget execution. In Ukraine, this practice was eliminated in 2000.

<sup>23</sup> In Lithuania, the Law on the Methodology of Establishment of Revenues of Municipal Budgets, which was passed in October 2001, provides conditional transfers for state delegated functions and educational expenditures calculated on a per capita basis.

Table 6. Level of Autonomy with Respect to Spending by Subnational Governments

Armenia	Local governments can levy fees and rents for their own expenditure decisions. Wages of civil servants set by center.
Azerbaijan	Local governments operate autonomously in allocating their budgetary resources. In practice assignments are ad-hoc.
Belarus	Practically no autonomy over expenditures. Certain extrabudgetary funds (i.e. Road Fund, Social Production Fund, Employment Fund and the Fund for Support of agricultural producers) have considerable financial autonomy.
Estonia	Local governments have independent budgets, which have to be presented to, but are not formally approved by, the Ministry of Finance. Employment and salaries of civil servants are regulated by central government.
Georgia	There is no formal assignment of expenditure responsibilities between the different levels of government in Georgia. Local governments have a limited degree of independence.
Kazakhstan	Some autonomy. After central government approval of the volumes of subsidies and withdrawals for each local government, the local governments prepare their own budget that needs to be adopted by the local parliaments.
Kyrgyz Republic	Some autonomy. Extrabudgetary funds have considerable independence.
Latvia	Municipal councils have considerable spending autonomy. They independently prepare, approve and manage their budgets, and decide about expenditures. Municipalities' budget expenditures shall not exceed the total amount of estimated revenue for the respective budget year plus the balance of previous year funds. In general, no output controls of local government service provision. Local governments are free to provide services according to law and norms in certain sectors (education, welfare and environment), to structure the provision of services and, in general, to decide the service level. There is a tendency for the central government to reduce the share of state functions by delegating part of these to local governments and the private sector.
Lithuania	Municipal councils have considerable spending autonomy to prepare and manage their budgets and decide about expenditures. 55 percent of municipal revenues are earmarked (through transfers) to finance functions delegated by the state.
Moldova	Overlapping assignments in spending. Fairly limited autonomy.
Russia	De jure, there is local autonomy on expenditures.
Tajikistan	Local governments are responsible for selecting people eligible to receive welfare payments.
Ukraine	No constitutional mandate on expenditure levels, but expenditure levels to a large degree negotiated with central government.
Uzbekistan	Local governments are required to have balanced budgets. Limited discretion for reallocation of local funds.
Albania	Local governments do not have freedom to determine spending priorities and act mostly as agents for the central government implementing its policies. Local governments have discretion in the selection of welfare recipients.
Bulgaria	Very limited. 90 percent of actual local government expenditure is not under the control of the local authorities.
Czech Republic	Local discretion over municipal expenditures is relatively high. Central mandates on local governments as regards to employment and salaries of civil servants.
Croatia	Fairly limited autonomy; autonomy only in the area of local utilities and cultural services. Central and local government functions are clearly separated.
Macedonia, FYR of	Local governments operate autonomously in spending their budgeted revenues but their spending responsibilities are not clearly defined. Types of revenues and other financing is to be determined with the law on financing local self governments.
Hungary	Local governments have considerable autonomy. They are entitled to determine the ways and modes for service provision depending on the requirements of the local population and their financial resources. Mandatory duties of service provision can only be imposed by law approved in Parliament and with the required funding provided by Parliament.
Poland	Since 1999, a high degree of autonomy and responsibility has been legally granted.
Romania	Limited autonomy. Law of Local Public Finance of 1996 gave them more responsibilities. Local councils and county councils, respectively, approve local budgets. The approved budgets have to be balanced and observe the regulations regarding the allocation of amounts with special destinations.
Yugoslavia	Local governments pass their own budgets, they select people eligible to receive welfare payments and pay welfare payments (such as one-off social assistance in cash and commodities, material expenditures regarding preschools, schools and social institutions) and pay subsidies to local public enterprises.

Sources: IMF country economists; Bird and Yilmaz (2001).

for service provision, depending on the requirements of the local population and their financial resources. Mandatory duties of service provision can only be imposed by law approved in Parliament and with the required funding provided by Parliament (OECD (2001c)). In Latvia, local governments face no output controls on their service provision. They are free to provide services according to law and norms in certain sectors (education, welfare and environment), to structure the provision of services and, in general, and to decide the service level (OECD (2001d)). In the Czech Republic, local governments decide on the structure of local expenditures and the quality and quantity of the services to be provided (with exception of some earmarked activities financed by specific grants). However, in some areas such as education a considerable share of the local costs is determined by the central government while in other areas the local governments have considerable discretion (Oliveira and Martinez-Vazquez (2001)).

While many of the expenditure norms developed by central government agencies in countries like Russia and Ukraine, are merely indicative in nature, other regulations directly affect the expenditure positions of subnational governments. For instance, local governments in Russia, Armenia and Kazakhstan have little flexibility in setting wages, or the wage fund of public employees.<sup>24</sup> The lack of effective autonomy over expenditures combined with weak capacity for budgetary management has encouraged the accumulation of payments arrears by subnational governments as a means of deficit financing, and eroded fiscal discipline and accountability. Even among the more advanced reformers, central government mandates on local governments with respect to employment and salaries often constrain budgetary autonomy of local governments (Bird and Yilmaz (2001)). However, unlike in the intermediate and slow reformers, local government associations in these countries typically play an important role in negotiating mandates with the central government.

In a number of transition economies, local autonomy has also been constrained by the shifting down of subsidies and social services to local governments since the beginning of the transition. Minimum expenditure requirements for social services imposed by the central governments impinge upon the budgetary autonomy of local governments. In Bulgaria, municipalities have to fund 50 percent of social welfare payments from their own revenue which results in significant disparities among municipalities in residual spending on other services (McCullough et al (2000)). In Russia, this problem has been compounded by the existence of regional norms and regulations in conjunction with federal norms and mandates, and the failure of local governments to distinguish between funding for each. While existing laws in Ukraine and Russia grant local governments the right to limit the execution of decisions made by higher-level governments to the amount of funding transferred to them, in practice, expenditure requirements associated with mandates exceed their financing.

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<sup>24</sup> For instance, in Russia the wage fund of public employees accounts for nearly a quarter of budgeted expenditures of local governments (Ministry of Finance of the Russian Federation (1999)).

Overall, there is considerable spending autonomy in the Central and East European countries, such as the Czech Republic, Hungary, Poland and the Baltics, whereas in Ukraine, Albania, Bulgaria, the Kyrgyz Republic and Moldova, the local spending level and priorities are mainly determined by the central government.

### **Revenue autonomy**

Granting effective subnational revenue autonomy—the authority for subnational governments to determine tax rates and/or bases—remains a critical challenge for most transition countries. As seen in Table 7, only the advanced reformers have devolved limited revenue autonomy to subnational governments, although they still rely on the central government for the bulk of their revenues. In the Czech Republic, the Slovak Republic, Hungary, and Poland, the share of “own” revenue (over which they have policy control and collect themselves) ranges from 33 to 40 percent. In the Czech and Slovak Republics most of this revenue is non-tax revenue; in the former local governments have very limited tax authority. In Lithuania, legislation giving municipalities greater discretion in setting tax rates and fees accruing to local budgets—including a real estate tax of up to 1.5 percent of assessed property values—is under consideration for 2002.

A few countries among the intermediate reformers also appear to have fairly high shares of “own” revenue (Romania (33 percent), Ukraine (31 percent) and Russia (43 percent)).<sup>26</sup> In the remaining transition countries, subnational revenue autonomy remains virtually nonexistent. Even among the Baltics, that have made significant progress in other areas of intergovernmental finance, only a very small share of subnational revenue is controlled by subnational governments, which depend almost entirely on transfers from the central government.

The generally low level of revenue autonomy, particularly among the intermediate and slow reformers, reflects, in part, weak subnational administrative capacity, political constraints, preemption of the local tax base by central governments, and central limits on subnational tax rates. Taxes typically assigned to subnational governments include property taxes, user charges and a number of “nuisance” taxes with little revenue potential. These raise only a small proportion of the total revenue of local governments even among the more advanced reformers—around 9 percent in Estonia, and 6 percent in Hungary, for instance.<sup>27</sup> In Poland and Romania, however, local taxes account for 26 and 17 percent of local tax revenues, respectively.

Closely related to the issue of subnational tax autonomy is the widespread use of tax sharing arrangements, with revenues from taxes shared on a derivation basis, whose structures can

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<sup>26</sup> These data should be treated with caution. The reported share of own revenue in Romania seems somewhat high compared with information about the extent of discretion local authorities have over tax rates and/or bases.

<sup>27</sup> IMF (1998).

Table 7. Degree of Tax Sharing vs. Own Financing of Subnational Governments, Most Recent Year

	Own taxes as % of total SNG revenue	Own nontax revenue as % of total SNG revenue	Total own revenue as % of total SNG revenue (ex grants)	Total subnational tax revenue in percent of total subnational revenues	Distribution of total subnational tax revenues		Degree of Autonomy	
					Tax sharing	Own-financing (percent)	To set tax base	To set tax rate
Armenia	0.0		0.0	52.0	100.0	0.0	none	none
Azerbaijan 1/	...	8.0	...	...	55.0	45.0	none	none
Belarus 2/	6.0	4.1	10.1	96.0	93.8	6.2	none	some discretion over local taxes
Estonia	6.3	9.1	15.4	62.0	89.2	10.8	none	some discretion over local taxes
Georgia	...	6.2	...	n.a.	95.0	5.0	none 3/	none 3/
Kazakhstan	0.0	3.2	3.2	82.0	100.0	0.0	none	none
Kyrgyz Rep.	...	12.7	...	n.a.	64.6	35.4	none	none
Latvia	0.0	16.1	16.1	55.2	100.0	0.0	none	none
Lithuania	0.0	4.8	4.8	...	...	...	none	on land tax, up to 4% ceiling.
Moldova	15.4	12.4	27.8	80.4	80.9	19.1	none	none
Russia	34.4	9.1	43.5	86.0	60.0	40.0	none	none
Tajikistan	...	...	...	39.4	95.0	5.0	none	can set local tax rates
Ukraine	30.9	...	30.9	87.0	64.4	35.6	none	very limited
Uzbekistan 7/	...	...	...	88.4	n.a.	n.a.	very limited	very limited
Albania	0.0	1.6	1.6	35.7	100.0	0.0	none	none
Bulgaria	...	11.9	...	72.9	90.0	10.0	none	none
Croatia	...	...	...	55.8	85.0	15.0	very limited	very limited
Czech Republic	3.9	36.3	40.2	47.7	91.7	8.3	limited	limited
Macedonia, FYR of	...	...	...	86.4	...	...	none	local govt financing is currently under discussion.
Hungary	16.3	17.0	33.3	18.0	67.4	32.6	some 4/	rate autonomy on substantial share of revenue
Poland 6/	10.6	24.6	35.2	40.0	57.7	42.3	none	rate autonomy on substantial share of revenue
Romania	...	12.6	...	73.7	75.0	25.0	some 7/	some 8/
Yugoslavia	...	...	...	71.5	8.0	92.0	none	none
Average					82.4			
Standard deviation					16.1			

Source: IMF country economists.

1/ Percent of local tax revenue from tax-sharing includes personal income tax in which local governments' share is 100 percent.

2/ Revenue as a percent of GDP excludes Extrabudgetary Funds.

3/ Over shared taxes. Local governments impose a few minor taxes and fees, and there is evidence of local governments creating tax bases outside of the official mandate.

4/ Building tax, land tax, communal tax on private individuals and businesses, tourism tax, and local business tax.

5/ Can set rate on local business tax within ceiling.

6/ No autonomy with respect to share of income tax, and little or none on real estate tax.

7/ Local authorities have discretion only with regard to granting tax exemptions, delays and spacing out of tax payments.

8/ Local councils can increase or decrease proposed tax and fee rates within a range of 50 percent.

only be changed at the central level, accounting for the largest share of regional revenue receipts. As seen in Table 7, in all transition countries tax sharing constitutes more than 50 percent of total subnational tax revenue. Some of the advanced reformers in Central and Eastern Europe (Poland and Hungary) have the lowest tax sharing rates, whereas in Russia, Ukraine, and most Central Asian countries, revenues from taxes shared on a derivation basis continue to account for well over 60 percent of regional revenue receipts. The minimal subnational autonomy to raise revenues and decide tax policies at the margin and the resultant mismatch between expenditure responsibilities and the real tax base, has important implications for accountability and responsibility at the subnational level. In many countries, limited formal revenue autonomy has encouraged the widespread use of informal revenue generating mechanisms, such as tax offsets and extrabudgetary funds.

It is important to note that cross-country comparisons of subnational revenue autonomy as seen in a number of reports can in general be misleading. This is because such comparisons are based on GFS data for the share of subnational revenue in total general government revenue across countries. GFS data only measures the quantity of revenue that eventually ends up as being used by local governments and does not capture the extent of discretion or control by local governments associated with each type of revenue collected (Ebel, R. and S. Yilmaz (2001)). As an example we show these ratios for a wide selection of transition economies in Table 8. Note that all countries that score high on the criterion using GFS data (for instance higher than 30 percent) are the BRO countries in Central Asia or Caucasus. These countries all score low on a more detailed institutional analysis of revenue autonomy. Similarly, the fact that some of the advanced reformers in Central and Eastern Europe have a substantially higher degree of revenue autonomy is not captured.

## **Transfers**

Achieving meaningful and sustainable autonomy at the subnational level and avoiding an inequitable geographical reallocation of resources requires a “level playing field” such that local and regional councils can provide relatively uniform service levels at reasonable levels of tax effort. Such equalization of fiscal disparities is possible only when effective sizeable and well-designed equalization transfers are put in place.<sup>28</sup>

Countries in Eastern Europe and Baltics generally have relatively sound equalization transfer systems (Table 5). While the Czech Republic does not use equalization transfers, it does however have formula based features in its tax-sharing system. However, the existing system has been criticized for being unwieldy, unstable, and nontransparent (World Bank (2001)). In a number of countries the equalization transfer system, however, suffers from weaknesses that prevent it from achieving its goal of reducing the gap in fiscal revenue per capita across municipalities and intermediate level governments. For instance, in Romania the equalization transfer system suffers from relying on an unpredictable pool of transfer funds, a formula that does not target funds to local councils with inadequate revenues to provide basic services;

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<sup>28</sup> See Wetzel and Dunn (2001) for a comprehensive assessment of the characteristics of transfers in transition countries.

Table 8. Revenue Responsibilities  
(Revenues as percentage of GDP)

	Total Revenue of General Government				Subnational Government *					
	1996	1998	1999	2000	1996		1998		1999	
					Total	Tax revenue	Total	Tax revenue	Total	Tax revenue
Armenia 1/	17.6	20.7	22.7	20.7	1.0	0.5	1.3	0.7	1.1	0.7
Azerbaijan 2/	17.6	16.0	16.7	20.1		4.3	6.1	4.3	3.9	6.1
Belarus	30.0	44.5	45.7	42.3	10.3	9.1	10.3	9.1	14.0	13.0
Estonia	39.0	39.4	38.6	38.5	7.7	5.5	8.6	5.9	8.8	5.4
Georgia	13.7	15.5	15.3	14.8			4.0	3.9	4.4	4.1
Latvia	37.4	42.7	42.2	40.5	8.4	6.9	10.5	5.6	10.2	5.6
Lithuania 4/ 5/	29.6	30.7	31.9	31.1	8.7	6.3	8.3	6.4	7.3	6.8
Kazakhstan	13.3	18.2	17.2	21.8			8.7	5.6	10.8	8.6
Kyrgyz Republic 6/	15.9	18.0	17.7	15.9			...	...	2.8	2.1
Moldova 7/	31.7	33.1	27.1	25.8			6.9	5.5	8.3	4.6
Russia 8/	33.5	33.4	35.6	29.9	12.4	10.6	12.3	10.6		
Tajikistan	12.1	12.0	13.5	13.6	6.7	2.6	6.7	2.6		
Ukraine 9/	36.7	34.6	33.9	32.7	14.0	11.9	13.8	12.0	10.8	9.4
Uzbekistan	34.2	31.1	29.3	31.1					19.7	16.0
Albania	18.4	20.3	21.3	22.4	0.5		0.2		0.2	
Bulgaria 10/	36.8	39.0	41.3	41.6	4.2	3.4	4.8	4.2	5.4	3.8
Croatia 11/	47.9	50.8	47.7	44.5	5.1	3.2	5.2	3.5	4.9	3.2
Czech Republic 12/	39.4	38.4	40.3		7.1	3.9	7.1	3.9	8.4	4.0
Macedonia, FYR of	33.9	33.3	35.4	36.7	0.2	...	0.5	...	0.3	0.3
Hungary	44.4				13.6	2.7				
Poland 13/	43.0	41.0	41.1	39.6	8.0	4.8	8.3	5.3	10.5	4.7
Romania	29.2	30.1	33.3	31.5	4.6	2.6	3.6	2.0	3.9	3.0
Yugoslavia 14/				41.4						

Sources: IMF country economists; *Government Finance Statistics* (IMF).

\* Extrabudgetary funds' revenues, if they exist, are excluded from the subnational governments' revenues but included in the general government's revenues.

1/ Including grants. Revenues of subnational governments in 1996 column refer to 1997.

2/ Includes revenue from Social Security Contributions, but excludes revenue from the Forex reserve and the Employment Fund Reserve.

3/ Transfers and own-tax revenues of regional government also includes that of local governments. Includes Extrabudgetary Funds.

4/ The figures on subnational governments refer to municipalities.

5/ Estimated figures for 1998.

6/ Figure in 1996 column refers to last semester of 1994 and first semester of 1995.

7/ Includes revenues from social security contributions, equivalent to about 25 percent of general government revenues.

8/ Includes budgetary funds (Road fund, Ecological Funds).

9/ Tax revenues of local governments includes Pension Fund.

10/ The general government encompasses the Central government, the social security system, the local governments and 28 extrabudgetary funds. Data in 1996 column for subnational government's revenue refers to 1997.

11/ Transfers and own-tax revenues of regional government also includes that of local governments. Includes Extrabudgetary Funds.

12/ Numbers in 1996 columns refer to 1997. In 1997-1999, there was only one level of subnational government - municipalities.

13/ Numbers in 1996 column refer to 1997. Tax revenue of subnational governments includes all revenue other than state budget subsidies.

14/ Data for Yugoslavia is consolidated revenue and is for 2001.



and lack of accountability at the county level for distributing funds according to published criteria (World Bank (2002)). In Russia and Armenia, equalization transfers are supplemented by gap-filling transfers with associated drawbacks.

While a significant number of countries in the region have moved towards the increasing use of equalization transfers, the actual volume of funds involved is either small or equalization transfers only account for a small share of total transfers. For instance, given the relatively large fiscal disparities existent in Russia, the on-going level of funding for equalization transfers in Russia (1.1 percent of GDP in 1998) appears to be insufficient to bring about a significant level of equalization. Although the overall funding for equalization transfers is also quite limited in other countries such as Ukraine, Estonia, and Croatia, they have less pronounced fiscal disparities at the subnational level.<sup>29</sup> In Hungary and Poland, where transfers account for half of local revenues, the overwhelming reliance on transfers is viewed as circumscribing local autonomy.

Gap-filling transfers, however, remain the norm in most BRO countries. This provides disincentives to local revenue mobilization and cost savings through increased efficiency in delivery of services. In a number of countries (Bulgaria and most Central Asian countries), the allocation of transfers, in practice, has remained uneven and subjective, with a tendency for transfers to not get implemented entirely as budgeted or, if they do, the actual flows have been unpredictable and subject to long delays. The instability in transfer allocation impacts the ability of subnational governments to budget and plan expenditures, thereby undermining subnational investment and growth.

### **Subnational borrowing**

Allowing subnational borrowing from financial markets can contribute to improvements in resource allocation and in accountability of public service provision. However, to the extent that prerequisites such as hard budget constraints and a stringent regulatory and supervisory framework are lacking, such access to financing can increase the risk of macroeconomic instability. In particular, subnational borrowing in the absence of both market discipline and a sound, effective and strictly enforced regulatory framework (as seen in some transition economies) can undermine achieving fiscal targets for the general government and hence pose a risk to macro-fiscal stability.<sup>30</sup> For instance, if central governments lack credibility with regard to not bailing out subnational governments with debt servicing problems, given the implicit moral hazard, it cannot solely rely on the market to enforce sufficient fiscal discipline on subnational governments (Ter-Minassian (1997)). As a result, the framework

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<sup>29</sup> In Ukraine, net equalization transfers to local budgets accounted for 1 percent of GDP in 2001.

<sup>30</sup> The experiences of Argentina, Brazil and India with extensive borrowing by subnational governments illustrate clearly this problem. In these cases the absence of effective limits on borrowing by subnational governments greatly complicated achieving overall fiscal tightening.

for subnational borrowing requires an appropriate balance of market discipline, rules-based controls, and administrative oversight and supervision.

In recent years, subnational governments in a number of transition countries have been borrowing from a variety of sources, including, (i) the central government, (ii) subnational or national financial institutions (often regional institutions), and (iii) tapping domestic or international financial markets, by issuing domestic bonds or Eurobonds.<sup>31</sup> However, there appears to be a wide variation in the subnational borrowing practices of countries and in the strictness of administrative controls over borrowing, largely reflecting the extent of development of financial markets and progress in other areas of intergovernmental fiscal relations (see Table 9).<sup>32</sup> In many countries, while the overall level of subnational borrowing remains low, there has been an increasing trend towards greater subnational deficits, accumulation of debt, and loan guarantees.

In countries with relatively undeveloped financial markets (Belarus, Bulgaria, Moldova and all Central Asian countries), subnational borrowing generally takes the form of central government loans. In many of these countries (such as Bulgaria and Albania), the market for municipal debt is underdeveloped because of the failure of municipalities to establish creditworthiness, which is a precondition for access to private credit. The limited revenue and spending autonomy in these countries and associated problems is reflected in the overwhelming reliance on the central government for financing subnational deficits. As a result, on the margin there is little difference between central government loans and transfers.<sup>33</sup> One important threat to subnational budgetary discipline in all these countries is the moral hazard or impression of a soft budget constraint created by the practice of the central government granting loans that are eventually forgiven.

Subnational borrowing from subnational or national state-controlled financial institutions, on the other hand, also poses significant macroeconomic risks. For instance, in Russia, commercial bank debt has become an important source of deficit finance, particularly since promissory notes (veksels) were disallowed since 1997. Subnational governments in Ukraine have also used veksels or bills of exchange as important means of financing.<sup>34</sup> However,

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<sup>31</sup> In other transition countries—Armenia and Kazakhstan, for example—borrowing by subnational governments is not allowed.

<sup>32</sup> See Wetzels and Dunn (2001) for a discussion of subnational borrowing in transition countries.

<sup>33</sup> When subnational revenue and expenditure autonomy is basically nonexistent, servicing debt to the central government would imply less resources available for the other mandated expenditures and hence the need for a correspondingly larger transfer from the central government.

<sup>34</sup> In 1998, over 16 percent of all subnational tax collections in Ukraine were in the form of veksels and 17 percent were collected in the form of tax offsets.

Table 9. Borrowing by Subnational Governments

	Borrowing Allowed?		Actual amount % of GDP	Regulations		Is there regulation for municipal bankruptcy?	Sources of financing	
	At home	Abroad		Yes	No		Yes	No
Armenia	Yes	.....	0	1. The annual interest payment for earlier borrowing should not exceed 20 percent of local budget's reserve fund. 2. Reserve fund itself should be limited by 30 percent of the noted administrative budget. 3. These limitations apply to all types of expenditure and there are no limitations on the purpose for which the money is borrowed.		No	Only from home sources, not from abroad	
Belarus	Yes	...		Repayable within a year		No	In practice, build up of arrears.	
Estonia	Yes	Yes	2.6 1/	Financing of current costs only with short-term loans to be repaid by the end of the budget year. Three controls on borrowing in excess of 12 months: (i) only for investment; (ii) stock of debt must not exceed 75 percent of projected last year's revenues; (iii) debt service payments not exceed 20% of projected revenues. Law allows borrowing from private and state sources but in practice local borrowing is constrained to loans from the state or international organizations with central government guarantee.		No	Financial markets.	
Georgia	Yes						Can borrow from the central budget to meet temporary deficits.	
Kazakhstan	Yes	No	n.a.	1. Borrowing in any year cannot exceed 10% of local revenue in that year. 2. Total debt cannot exceed 25% of local revenue in that year 3. Expenditure on debt service must not exceed 10% of local revenues in any year. 4. Total local borrowing is limited annually in the Republican budget. 5. Local borrowing is limited to financing capital investment programs only. Ceiling: 20% of their revenue. MOF authorization is necessary.		No	SNGs can borrow 1) from the Central Government to repay local debts; 2) from securities market for financing local investment programs	
Kyrgyz Republic	Yes					No		
Latvia	Yes	Yes	0.4	Regulation of The Cabinet of Ministers No 64 "On Municipalities Loans and Guarantees" of 1997. Yearly cap on borrowings and guarantees to be determined by Cabinet of Ministers in process of Budget Negotiations.		No	From central government; Minister of Finance is authorized to approve of another party to the loan agreement.	
Lithuania	Yes			Regulation of The Cabinet of Ministers No. 10 "On the Order of Borrowing by Local Authorities" of 2001. Yearly cap on borrowings and guarantees to be determined by Cabinet of Ministers.		No	Credits guaranteed by the government; other creditors.	
Moldova	Yes		n.a.	1999 Law of Local Public Finance.			Arrears to Social Funds and wage arrears.	
Russia	Yes	No		Limits to the overall level of debt for regional and local governments imposed by the budget code: 1. Budget deficits of local government limited to 3% of budget revenues (before transfers and loans). 2. Debt service expenditure limited to no more than 15% of annual expenditure (in any year). Recently, Law on the financial Foundations of Local government in the Russian Federation of Sept 1997 restricted the amount that local governments may borrow to 15% of budget expenditure (applying only to local not regional government). 3. Purpose of subnational borrowing and bond issuing restricted to capital investment. Municipally-owned banks are banned. No law that regulates local borrowing but in practice local governments are subject to law on bankruptcy.		No	Bonds, bank loans and vexels.	
Tajikistan	No					Yes	Arrears	
Ukraine	Yes	Yes	0.9	1. Since January 2000 interbudgetary loans are forbidden. Prior to that, the process of intergovernmental loans was non-transparent, no clear government guidelines to decide when or how to allocate intergovt. loans, loose accounting methods for reporting intergovt. loans, and unpaid loans were de facto subsidies. Officially, there were low requirements and national accessibility for loans from higher levels of government. MoF has direct relationship with the oblast financial offices, therefore greater control on their repayment rates and lower percent of unpaid balances for oblasts. 2. Borrowing from commercial banks is used, only for liquidity purposes (only short-term bank debt), paying wages, smoothing out local expenditure in the face of unstable payments from the State.		No	In practice, build up of arrears Most widespread: 1. loans from central government. 2. Short-term loans from government.	

Table 9. Borrowing by Subnational Governments (*concluded*)

	Borrowing Allowed? Actual amount		Regulations	Is there regulation for municipal bankruptcy?	Sources of financing
	At home	Abroad			
Uzbekistan	No				
Albania	Yes	(apparently local governments have not taken on any loans)	Implementing regulations have never been issued.		
Bulgaria	Yes	Yes 2/	1. Can't exceed 10 % of local revenue. 2. Loans can be raised to cover only "insufficiencies" in the municipal budget. 3. Loans cannot be used for general purposes (salaries etc).	No	
Croatia	Yes, but very limited		The central government has to approve the local government deficit and loans by local governments, and gives its approval only to finance investment. In practice, the local governments have built up arrears.		
Czech Republic	Yes	Yes	There is no control on local borrowing.	No	Local government may borrow from any institution (even abroad) at any terms of
Macedonia, FYR of	Yes	No	New financing law under discussion.		
Hungary 3/	Yes	Yes	0.1%	Yes	Bonds and bank loans
Poland	Yes		Ceiling on bank borrowing: Sums for paying back loans and loan interest in all financial years must not exceed 20% of the revenues of the last accepted budget, loans excluded. Overall ceiling on national debt, percent of local expend. limit on interest cost 1. A gmina's annual debt service could not exceed 15% of planned revenues, minus the debt service on loans secured by real property. 2. A provision also allows the central govt. to guarantee gmina loans, although procedures for issuing these guarantees and the method of their repayment in case of default has never been specified. Only a handful of gminas has actually applied to MoF for guarantees. 3. Act on Local Government gave gminas the right to borrow for both cash flow and investment purposes.	No	They can borrow from local market. Not clear if they can borrow from abroad.
Romania	Yes	Yes	Borrowing by local councils, which according to the law, may borrow up to a limit of annual debt service of 20% of their current income. Law no.189/1998 of Local Public Finance 3/.	No	Bonds and bank loans. External credits guaranteed by the central government.
Slovakia	Yes	Yes	No limitations. Municipalities have the right to borrow without special approval of the state administration body. Towns and municipalities have established their own bank. Law states that the central government will not bail out local governments.	No	Bonds and bank loans - both from local banks and domestic branches of foreign banks.
Slovenia	Yes		Debt levels have to be kept within limits determined by the Central Government. Local communities are allowed to borrow short-term to cover current expenditure while long-term debt can be raised only for infrastructure financing.	No	
Yugoslavia	Yes		Presently Law on public revenues and expenditures. But Organic Budget Law and local authorities are obliged to start acting in accordance with this law in maximum 2 years.	No	Commercial banks
Bosnia	No				

Source: IMF country economists.

1/ Estimate is for 1998. This equivalent to about 16 percent of local government revenue.

2/ Localities have not borrowed in the past, except Sofia municipality.

3/ Refers to 2000.

these transactions are often non-transparent, subject to abuses and in many cases the loans are procured from commercial banks owned by regional governments.<sup>35</sup>

A number of countries have gained access to private domestic and international sources of finance (such as the Czech Republic, Hungary, Poland, Russia, Ukraine and Estonia). While liberalization of subnational borrowing in Hungary, the Czech Republic and Poland has been accompanied by relatively effective institutional and regulatory frameworks and increasing reliance on market-based discipline, in many countries such frameworks are virtually nonexistent. Other countries (such as Russia, Kazakhstan and Estonia) have enacted legislation limits on overall debt as well as limits of the budget deficits of regions and require control and supervision of all subnational bond issues.<sup>36</sup> However, the lack of effective monitoring and enforcement and the general absence of adequate municipal bankruptcy procedures (with the sole exception of Hungary) and financial emergency controls for defaulting governments pose important risks. For instance, while the regulatory framework in Estonia for municipal borrowings is sound, borrowing regulations are often ignored, there are no effective sanctions of violators and lenders may still perceive that there is an implicit sovereign guarantee. This has led to rapidly growing indebtedness of many municipalities with the potential need for future bailouts. In the Czech Republic there is no ex-ante control on local borrowing in place but the existing legislation states that the central government is not responsible for local debt. At the same time, determining the actual level of local indebtedness is often difficult due to the existence of contingent liabilities and other forms of off-budget operations (Oliveira and Martinez-Vazquez (2001)).

### **C. Building Institutions for Fiscal Decentralization**

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

#### **Representative institutions**

While local governments in a number of transition economies (for example, Hungary, Poland, the Czech Republic, the Baltics, and Russia) are led by democratically elected councils and governors/mayors, the heads of regional governments continue to be appointed by the central governments (for example, in Ukraine, Georgia, and all Central Asian states) (Table 10). Belarus, Azerbaijan, and Turkmenistan have no elections for subnational governments. The lack of democratic representation at lower levels of government may importantly affect the responsiveness of these governments, since conflicts between policies

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<sup>35</sup> Despite the prohibition on veksel, subnational governments have continued to issue promissory notes or switched to alternative instruments, such as veksel issued by commercial entities including public companies under control of subnational governments.

<sup>36</sup> In Estonia, before the introduction of control regulation for subnational borrowing, local governments had the potential to derail fiscal policy. The main problem related to the control of local government borrowing.

Table 10. Political Accountability in Selected Transition Economies

Country	Elections at regional level?	Elections at local level?	Comments on political accountability and elections:
<b>Armenia</b>			
Executive No	Yes	Yes	Central government appoints and dismisses heads of regional governments.
Council Yes	Yes	Yes	
<b>Azerbaijan</b>	No (district)	Yes	Representatives of central government in lower levels.
<b>Belarus</b>	No	No	President appoints regional governors, who then appoint subordinates.
<b>Estonia</b>			
Executive No (district)	Yes	Yes	County governor appointed by central government on proposal of Prime minister.
Council Yes	Yes	Yes	Local councils elected, local councils appoint mayor.
<b>Georgia</b>			Top tier in general governed by central government appointed commissioners.
Executive No	Yes	Yes	Two lowest tiers (municipal and district) have elected councils and executives.
Council No	Yes	Yes	
<b>Kazakhstan</b>			Oblast akims appointed by president. Local level akims appointed and removed by oblast-level. Regional and local councils elected.
Executive No	No (district)	No	
Council Yes	Yes	Yes	
<b>Kyrgyz Republic</b>			President appoints oblast and rayon governors. Heads of village councils are elected locally.
Executive No	No	No	
Council Yes	Yes	Yes	
<b>Latvia</b>			Local governments are elected and form the district councils. District councils consist of lower chairs of municipal councils. Local councils are elected, local councils appoint mayor. No representatives of central government in local councils.
Executive No (district)	Yes	Yes	
Council Yes	Yes	Yes	
<b>Lithuania</b>	No (district)	Yes	Central government appoints and dismisses governors of regional administrations. Local councils elected, local councils appoint mayor.
<b>Moldova</b>	No	Yes	Local councils are elected. Executive selected locally but approved by the President.
<b>Russia</b>	Yes	Yes	Representatives of central government in lower levels (super-districts).
<b>Tajikistan</b>			Executive at regional and local level appointed by the president. President can remove local officials, including locally elected mayors.
Executive No	Yes	Yes	
Council Yes	Yes	Yes	
<b>Ukraine</b>	No	Yes	Regional governors are appointed. Rayon and local level elected (but have in past been removed by the President).
<b>Uzbekistan</b>			Regional executives are appointed. Local leaders selected from "village elders". Regional and local councils are elected but elections influenced by higher level.
Executive No	Yes	Yes	
Council Yes	Yes	Yes	
<b>Albania</b>			Representatives of central government in 12 regions replacing districts as administrative units by law in 2000.
Executive No	Yes	Yes	
Council	Yes	Yes	
<b>Bulgaria</b>	No	Yes	Central government appoints governors of regional administrations. Local councils and local leaders (mayors) are directly elected for 4-year terms.
<b>Czech Republic</b>	Yes	Yes	
<b>Macedonia, FYR of</b>		Yes	Local elections at the municipal level for mayors and local council members.
<b>Hungary</b>	Yes (district)	Yes	Representatives of central government in lower levels.
<b>Poland</b>			
Executive No	Yes	Yes	Vovoidship (regional council) elected, but head appointed by prime minister.
Council Yes	Yes	Yes	
<b>Romania</b>	Yes (district)	Yes	Representatives of central government in lower levels.

Source: IMF country economists.

implemented and the preferences of local taxpayers are politically inconsequential. In cases of weak local influence on local officials decentralization could simply lead to a transfer of power from national to local elites. With improved access of local elites to public resources this could increase opportunities for corruption. Furthermore, a system of appointed officials may imply that central political or other interests dominate local policy making, again adversely affecting the responsiveness of subnational governments to the interests of local citizens. Ultimately, the objective of enhanced accountability of regional and local governments is negatively affected.

### **Cooperative institutions**

International experiences have shown that a basic requirement for efficient multi-tier governments is the presence of intensive cooperation between the main stakeholders—the different levels of government. Countries have chosen very different ways of securing the required cooperation, but common experiences seem to indicate that an efficient system is characterized by transparent, regular, and comprehensive exchanges of information and discussions, and that cooperation must take place at the political as well as the technical level. Very few BRO countries have established such consultation mechanisms or cooperative bodies, with Estonia and Latvia being important exceptions. Other Eastern European economies, such as Hungary, Poland and the Czech Republic also have such coordinating institutions in place.

At present, there is a clear lack of interaction and coordination between central government agencies (ministries of finance and line ministries) and regional government agencies (finance departments and sectoral departments) in many BRO countries. This lack of dialogue has occasionally led to unrealistic regulations, the proliferation of unfunded mandates, ineffective supervision and weak support and absence of performance evaluation of subnational programs. More generally, it has encouraged conflicts and frictions in intergovernmental relations.

### **Tax administration**

The lack of a modern tax administration has hampered both the day-to-day implementation of revenue assignments, and adversely affected general government revenue collections in many transition countries (for example, in Russia). In most BRO countries, the tax administration is a central government agency exclusively responsible for collecting taxes at all levels of government. Regional and local governments do not have their own tax administrations. However, the lack of effective control over the regional and local offices of the central tax administration and the *de facto* dual subordination of tax administrators to the central tax authorities and to subnational government officials has had an important impact

on tax collections at all levels of government.<sup>37</sup> Even among the more advanced reformers, local capacity in tax collection is generally low, which reduces the effectiveness of tax collections (Bird and Yilmaz (2001)).

### **Budget process**

With the exception of the more advanced reformers, budget process at the subnational level remain deficient in most transition economies and strengthening institutions for fiscal management remains a key challenge. Formulating budget objectives in a clear, transparent and realistic manner, strengthening budget execution, monitoring, and cash management at all levels of government, to varying degrees, are on the policy agenda of many of the intermediate reformers. However, progress in many of these areas has been slow.

## **IV. THE REFORM AGENDA**

In this section we focus on issues that must be addressed by the transition countries to ensure orderly and successful reform of their systems of intergovernmental fiscal relations. Policy advice about the appropriateness and sequencing of reform measures in these countries would need to take into account an assessment of the potential risks posed to the macroeconomy if essential prerequisites are not met.

The advanced reformers have not only largely attained aggregate fiscal discipline, with moderate and sustainable deficits, but have also been the more active reformers in many of the key aspects of intergovernmental fiscal relations. As such, they face a relatively low macro-fiscal risk from continued devolution of revenue and spending autonomy. However, there are several steps that could contribute to improving intergovernmental fiscal relations in order to exploit more fully the benefits of fiscal decentralization. Improvements in service provision and cost savings can be realized through rationalization of the size of municipalities, particularly in the Czech Republic and Hungary. In all countries, there is a need to increase subnational revenue autonomy by further developing own source revenues (user fees, property taxes, etc.) and strengthening local government tax administration capacity. This is particularly important in light of the considerable expenditure autonomy that already exists at the local level. Decentralization efforts must ensure that the existing tax sharing and transfer systems create incentives to exert tax effort and impose hard budget constraints on subnational governments. Reforms would also have to focus on improving oversight and monitoring of local government borrowing, setting up of adequate municipal bankruptcy procedures, and building subnational capacity in public expenditure and debt management.

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<sup>37</sup> Regional and local officials may be more interested in preserving the economic viability of local enterprises which provide employment and a tax base for subnational taxes than ensuring that federal taxes get paid. They may, therefore, pressure tax officials to be selective in their collection efforts. Furthermore, subnational officials may press tax administrators to employ more resources to the collection of subnational taxes than the low yield of these taxes may warrant.



In the case of the intermediate reformers, a number of essential prerequisites for sound and efficient decentralization have not yet been met. As a result, further devolution of revenue authority and granting spending or borrowing autonomy to subnational governments in the absence of reforms in the administrative, legal and regulatory frameworks and systems for accountability could pose a risk to macroeconomic stability. Furthermore, in cases where accountability by local governments to the local electorate is weak, fiscal decentralization could simply result in a transfer of power from national to local elites and could increase opportunities for corruption since local elites would have improved access to public resources. Strengthening the stability and transparency of intergovernmental fiscal relations would require initiatives in several areas of intergovernmental finance, including building capacity at local levels and improvements to the system of fiscal management and in some cases, strengthening the influence of the local electorate on local officials through changes in the formal electoral process.

Greater clarity in the assignment of expenditure responsibilities between different levels of government is required in order to increase accountability and the overall efficiency of decentralized spending. This would require streamlining and harmonizing the various conflicting laws, decrees and regulations especially in the areas of concurrent and overlapping responsibilities, reassigning the funding responsibility for redistributive social assistance to central governments, and clarifying capital expenditure responsibilities.

Expenditure autonomy could be enhanced by rationalizing the various expenditure mandates and the provision of adequate funding from central governments to finance the remaining mandates. While granting effective revenue autonomy remains a critical challenge for these countries, there is a greater need to strengthen local revenue mobilization capacity and increase incentives for subnational governments to exert tax effort. In a number of countries, reforms should focus on clearly defining revenue assignments and making them more stable, and predictable. In addition, strict implementation of transparent, formula-based transfers and tax sharing rules and strengthening of the legal and regulatory framework for subnational borrowing is required to reduce moral hazard and support hard budget constraints. In some countries this would include explicit legislation (for instance with limits on the size of overall debt as well as subnational government deficits). In countries that have already established such legislation (Russia and Ukraine), efforts will have to focus on strengthening enforcement and monitoring.

The slow reformers have done very little in the area of fiscal decentralization, and a considerable share of elements that are conducive to sound and efficient decentralization are weak or lacking. However, if the current lack of subnational spending and revenue raising autonomy remains unchanged, the origin of potential macro-fiscal problems is not likely to be subnational finances, but rather central government policies with regard to subnational revenues, transfers and spending, including specific spending mandates. On the other hand, devolving spending or borrowing authority to subnational governments before institutional prerequisites for decentralization are met could pose a substantial risk of increasing overall public sector deficits and macroeconomic instability. For these countries, major reforms should be undertaken to strengthen institutions and incentive structures and improve

administrative capacity over and above what is required for the intermediate reformers before further decentralization initiatives are undertaken.

## V. CONCLUSION

Progress in reforming intergovernmental relations in the last decade has been uneven across the group of transition economies and across various components of intergovernmental fiscal relations. The nature and extent of decentralization to date has been shaped in large measure by political, historical, and ethnic realities, and its effectiveness influenced by the institutional design and capacities of the various levels of government. In many countries, much has been accomplished in putting sound foundations in place, while, in others decentralization reforms have been carried out without institutional and legal support mechanisms and appropriate intergovernmental fiscal arrangements to support a decentralized system.

In this paper we have provided an overview of key aspects of the ongoing decentralization process in transition economies to illustrate instances where certain broad principles for sound and effective decentralization are breached. To this end, it is important to note that there is no unique design or optimal degree of decentralization that is “appropriate” for all countries. The institutional context for decentralization, including the overall level of economic development, ongoing economic and political reforms, existing technical and administrative capacity of subnational governments, geographic, demographic and other factors determines the design of intergovernmental fiscal system and ultimately affects the outcome of the fiscal decentralization reform process. As a result, within the broad set of principles outlined in this paper, there would be a need to assess, on a country-by-country basis, the priority and feasibility of specific actions and approaches that are needed in the future.

In general, institutional reforms that minimize adverse incentives and promote transparency, predictability, and accountability are key to an effective decentralized system. However, in the absence of strong institutional capacity and firm and transparent rules that regulate intergovernmental relations, forcing subnational governments to provide an adequate level of services and maintaining a sustainable decentralized system can pose a formidable challenge. Hence, further transfer of fiscal powers to subnational governments must be carefully calibrated to the financial resources assigned to these governments in the form of taxes, transfers, and borrowing, and to their technical and administrative capacities. Transfer of budgetary autonomy should be supplemented by arrangements that monitor the system, enforce hard budget constraints, promote political accountability and economic efficiency, and reduce the possibility of macroeconomic instability. This would require that the reform agenda in each country attempt to balance the objectives of granting greater budgetary autonomy with that of improving capacities for regional and local budgetary management and control.

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