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Analysis of Revenues and Expenses of Local Budgets

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In this paper the current mechanism of local finance regulation is analyzed, and certain ways of its reforming are proposed. The main distinction of this research from other ones in the framework of this problem area is the use of significant data file on budget execution in specific municipalities. Thereby the results of this research and its practical applications reflect not only theoretical views but also solid calculations based on real budget data.

On the basis of this data certain scenarios were created to forecast financial consequences of implementation of certain measures including changes in local authorities competence as well as an assignment of various revenue sources and mechanisms of inter-budget equalization for municipalities. In this paper a certain procedure is proposed to estimate the possible outcome of existing projects on local government reform.

In one of the chapters international experience of municipal functioning and local finance regulation is analyzed.

Team leader - Starodubrovskaya I.

Authors:

Chapters 1,2, 4, 8, 9 (with annexes), introduction and conclusion – Starodubrovskaya I.

Chapter 3 (with annex) - Starodubrovskaya I., Javoronkov S., Milenteva K.

Chapter 5 (with annexes) - Starodubrovskaya I., Slavgorodskaya M., Yudin A., Korovin E.

Chapters 6,7 (with annexes) - Starodubrovskaya I., Slavgorodskaya M., Yudin A.

Chapter 10 – A. Sancton, Department of Political Science, the University of Western Ontario, London, Ontario

Chapter 11 – H. Kitchen, Department of Economics, Trent University, Peterborough, Ontario, Canada

Chapter 12 – I. Gauthier and F. Vaillancourt, the Institute for Intergovernmental Affairs, Queen's University, Canada

Chapter 13 – M. McMillan, Department of Economics, the University of Alberta, Edmonton, Canada

Chapter 14 – Dr. Douglas M. Brown, Institute of Intergovernmental Relations, Queen's University, Canada

Trunin I. – scientific consultant

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5, Gazetny per., Moscow, 103918 Russia

Tel. (095) 229-6736, FAX (095) 203-8816

E-MAIL – **info @iet.ru**, WEB Site – **http://www.iet.ru**

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Part I. Municipal Finances: a Qualitative Analysis

Chapter 1. Municipal Entities in Russia – Basic Characteristics

Legal basis for local self-governance

The constitution of the Russian Federation prescribes that in towns and rural communities, as well as in other territories there is established local self-governance, which ensures that the population solves issues of local importance independently and has municipal property in its ownership and at its disposal. Local self-governance belongs to the basics of the constitutional order in the Russian Federation, its normative regulation is described in a separate chapter of the Russia's constitution. By this the municipal level is actually acknowledged by constitutional norms, though not as a part of the government, but as a special form of sovereignty of the people – local self-governance. The constitution stresses not only the fact that local self-governance is independent within the framework of its powers, but also that local governments are not a part of the state government system.

This provision on separation of local self-governance from the state government system is rather controversial and did not enjoy everyone's support neither at the time when the Constitution was being worked out, nor after it was adopted. There were actually formed three different concepts about the nature of local self-governance, they give different interpretations of the state government's role in functioning of this institution, also in the part of regulation of its financial foundations.

According to one of the existing positions local self-governance is viewed first of all as a form of citizens' self-organization, as an institution of a civil society¹. This interpretation treats a maximal participation of citizens in taking decisions and an active control of their execution as a key issue for a successful functioning of local self-governance. In such conditions the local self-governance shall be as close to the population as possible and exist at the level of even the smallest settlements, where conditions for a direct democracy are most favourable. Such an understanding of local self-governance is most consistent in pursuing the idea of its separation from the government and to a certain degree even puts it in opposition to the state government. At the same time the issues of professionalism and effectiveness of local governments are placed in the background here, as far as democratic values become self-sufficient and it is acknowledged that the society will have to pay for their realisation.

Another position treats municipal governments as being actually a third level of the state government², where the population's control of government bodies uses same mechanisms as at the level of a RF subject and the Russian Federation as a whole. For example, direct election in Russia is a feature typical not only of local, but also of regional and federal levels. Local self-governance exists in the framework of Russian laws and legislations of RF subjects and is not entitled to contravene the existing laws by its decisions. Thereby the constitutional provisions about the non-government nature of local self-governance are actually viewed as a juridical case being in contradiction with the general logic of Russian laws. The role of these provisions is boiled down to a purely ideological one aimed at disintegration of the government vertical of the Soviet time and a transition to democratic governance mechanisms. Additional argumentations to support this kind of interpretation are provided by the Budget Code that describes the budgetary system of the Russian Federation as comprised of three levels: the federal budget, budgets of the RF subjects and local budgets.

And finally there is an intermediary position that views local self-governance as a level of public, but not state power that contains a strong social component. The nature of local self-governance in this case is of a mixed character, a socio-government one³. The government prescribes general juridical and financial frameworks, pro-

¹ Among advocates of this interpretation are, for example, the authors of the paper "The Constitution of the Russian Federation: comments to problems", who explain local government as "an institution of civil society (a form of the citizens' self-organisation), which is empowered by the government to take decisions of general effect on issues of local importance and thus turned into a corporation of public law" (Konstitutziya Rossiyskoy Federatzii: Problemny Kommentariy, 1997, p. 98). At the same time they stress that local government "is developed from the population's initiative, from the natural historic foundations for citizens' self-organisation in places where they live, and is not determined by government forms of power" (Ibid.).

² For example, O. Salov points out that "separation of local government, which in the whole world is **one of the forms** (namely a local form) **of public authority**, from the government administration is not possible in principle. The sphere of government interests and challenges includes (and must include) all kinds of problems of local public importance. Splitting them, separating them, tearing them from each other is extremely difficult (Salov, 2001, p. 19).

³ "Municipal authority is a special form of power. By its nature it is both a public power, its decisions in this case are ensured by the government's enforcement, and a social one, in this quality it stands as a form of coordination, self-organisation of

vides local authorities with incentives for their effective effort and gives them the responsibility for the results of their own decisions, it also builds mechanisms that guarantee citizens' rights to have local self-governance. The local level of power, though, remains to a certain degree autonomous and is not included into the executive power vertical of the government. This kind of autonomy's basic goal provides local communities with a possibility to find their own effective ways of using local resources to satisfy their own needs and pursue their interests. At the same time the local power level also possesses real authorities to execute power, which presupposes that the decisions are obligatory, they can be enforced, etc.

In the situation when constitutional norms are rather vague, rulings of the Constitutional Court have become an important source of municipal law, they give their interpretation to certain provisions in the Constitution. In the context of the discussion about the nature of local self-governance the position of the Constitutional Court on interpretation of local self-governance as a right or an obligation of each citizen plays a very important role. In this situation the Constitutional Court is more inclined to interpretations from the standpoint of "government" ideology, treating local self-governance as a certain form of public life obligatory for all citizens. In a most concentrated form this position was revealed in the dissenting opinion of judge N.V. Vitruk on the so-called "Udmurtiya case" that gained a wide public response; the judge stated that "the source of establishing and reorganisation of local self-governance is the Constitution and the law, not agreements and citizens' will, who only have the right to **participate** in application of local self-governance" (Vestnik..., 1997, volume 1).

At the same time the position of the Constitutional Court is not that indisputable and is shared by no means by all specialists. Pointing out to the fact that the Constitution does not oblige citizens to participate in local self-governance and referring to the European Local Government Charter that defines local self-governance as the right and a real ability of local communities within the framework of the law and at their own responsibility and for the welfare of the people to control and to govern a considerable part of public affairs, advocates of an alternative concept say that citizens are entitled to participate in local self-governance and the government is obliged to guarantee that right and to provide conditions for realisation of this right (Belkin, Burmistrov, 1999). This position is actually used in the current version of the Law "On General Principles of Organisation of Local Government in the Russian Federation" (see below), where article 4 in the law is called "The right of citizens of the Russian Federation to apply local self-governance" and article 9 is named "State government support to local self-governance".

In addition to the Constitution and rulings by the Constitutional Court legal regulation of local self-governance at the federal level is also provided by federal laws, the most important of which are the Law "On Basic Principles of Local Self-governance Organisation in the Russian Federation" number 154-FZ of August 28, 1995 (further on referred to as the Law "On general principles...") and the Law "On Financial Foundation of Local Self-governance in the Russian Federation" number 126-FZ of September 25, 1997 (further on – the Law "On financial foundation..."). Besides, municipal issues are regulated by the Law "On Foundation of Municipal Service in the Russian Federation" number 8-FZ of January 8, 1998, the Law "On Basic Guarantees of Electoral Rights of Citizens of the Russian Federation and Their Right to Participate in Referendums" number 67-FZ of June 12, 2002 and a number of other legislative documents.

The Law "On general principles" directly links the notions of municipal entities and local self-governance, it gives definition of municipal entity as a town or rural settlement, several settlements united by a common territory, part of a settlement, other populated areas under the present Federal Law that have local self-governance in that areas and possess municipal property, have local budgets and elected bodies of local government. This Law provides legal framework for functioning of municipal entities including issues of municipalities' powers, territorial structure, the system of municipal entity's government, economic basis for municipal activities, etc. Following the Constitution the Law uses the notion of "local self-governance" as the basic one, refraining from usage of "municipal entity" as the basic definition. The Law also regulates such forms of local self-governance execution as local referendum, municipal elections, meetings (gatherings) of citizens, etc. Different aspects of normative regulation contained in this Law will be treated in more detail later in this survey, when we will view concrete issues of formation and organisation of municipal entities' activities.

In the Law "On financial foundations..." there was taken a partially failed attempt to regulate basic issues of municipal finances, to restrict uncontrolled redistribution of financial resources among municipalities on the part of regional authorities, to strengthen guarantees of financial independence of municipal entities and to form legal grounds for inter-budgetary relations between regions and municipalities. We will give a more detailed analysis of this law in next chapter, when we will view the evolution of financial basis of local self-governance in Russia.

citizens, who voluntarily bind themselves by some kind of institutions inherent in this kind of power. Thus, municipal authority is a special public and social institution that provides citizens with the power to decide local issues and solve government ones at local level by themselves" (Peshin, 2002, p. 48-49).

At present it is commonly accepted that the legislation on issues of local self-governance has become outdated in many respects and needs a considerable revision.

As far as Russia's Constitution refers establishing general principles of local self-governance organisation to subjects of joint competence of both the Federation and RF subjects, regional lawmaking in this sphere also has a considerable influence on normative and legal environment in which municipal entities function. By the present moment there is accumulated a rather large corpus of normative and legal documents in the subjects of the Russian Federation, for the most part of legislative acts. Among them there are first of all the following laws:

- on election of bodies and officials of local self-governance in subjects of the Russian Federation; on local referendums in subjects of the Russian Federation;
- on municipal services in subjects of the Russian Federation;
- on budgets and the budget process in subjects of the Russian Federation;
- on procedure of registration of municipal entities' statutes.

Regional normative documents are far from being always in complete compliance with the federal legislation. Among most typical deviations one can name the following:

- imposing restrictions on independence of local self-governance in locally important issues;
- transfer of certain state government's powers to local governments without providing an adequate material and financial support;
- withdrawal of some of territories from the effective sphere of local self-governance legislation (see in Munitzipalnoye Pravo 2002, p. 37-38).

The territorial structure of municipal entities

The question of municipal entities' territorial structure or in terms of the Law "On general principles..." of territorial foundation of local self-governance is one of the most complicated ones among municipal problems. It says in the Constitution that local self-governance is performed in city, town, rural settlements and other territories. It is also fixed in the law that establishing and changing borders of municipal entities, as well as the procedure of forming, merger, transformation and abolishing of municipal entities shall be established by the RF subjects. When such questions are being decided upon one is obliged to take the population's opinion into consideration and the legislation of the RF subject shall contain guarantees of this. Legal interpretation and practical application of these provisions are ambiguous, a considerable uncertainty in approaches to formation of municipal entities' territorial structures persists until present.

According to one of positions on this issue the Constitution does not provide a clear territorial foundation for local self-governance: municipalities can be formed both in separate settlements and on territories belonging to several settlements, parts of settlements, etc. This kind of interpretation has found its way into the Law "On general principles...", where local entity is defined as "a town, rural settlement, several settlements united by a common territory, part of a settlement, other kind of populated territory under the present Federal Law that are under self-governance within their limits, possess municipal property, have local budgets and elected bodies of local self-governance".

According to another position the provisions of the Constitution are interpreted as a predominance of the settlement principle – municipalities shall be formed at the level of settlements (in town and rural settlements), but can also be formed on other types of territories. This position is reflected, for example, in the dissenting opinion of judge of the Constitutional Court Gadjiyev G.A. on "Udmurtiya Case": "The Constitution of the Russian Federation in solving the question of on what kind of territories citizens enjoy the constitutional right of local self-governance proceeds from the concept of natural settlements. ... Thus, it is not the subjective opinion of legislative bodies of the RF subjects (including that of constitutional lawmakers), but objectively formed settlements that ... shall be the constitutionally significant criterion for defining a local self-governance territory..." (Vestnik..., 1997, vol. 1).

The official position of the Constitutional Court on this issue is more eclectic than the previous ones. On the one side, on a number of cases the Court formulated its position in a rather cautious way, according to it "defining territorial foundation for local self-governance shall as far as possible promote that local governments are drawn closer to the population and allow solving the whole complex of issues of local importance" (Vestnik..., 1997, vol. 1). In addition to that it is especially stressed that "defining territorial levels, at which establishing municipal entities is possible, is referred to the competence of subjects of the Russian Federation and can differ depending on historical and other local traditions of various subjects of the Russian Federation" (Ibid.). On the other hand, in its ruling on "Udmurtiya case" the Constitutional Court directly opposed giving rights of municipal entities to administrative districts (rayons) when town and rural settlements that they consist of are deprived of

that right on the basis that this “would not have brought local governments closer to the population, but on the contrary would have estranged them from each other” (Vestnik..., 1997, vol. 1).

In practice there is built up lots of concrete models of local self-governance organisation in different regions of Russia, and it is not always that they comply with constitutional provisions even if these are interpreted in a most general and liberal way. Among the most used models one can name the following ones.

1. The “rayon” model. Municipalities are established at the level of administrative districts, no local government is planned at lower levels. Representative bodies are elected and local budget is formed at the district level. In certain settlements there are representatives of the regional administration or its territorial subdivisions, which can make expenditures within their estimated limits. Also according to this model the town or the large village that historically played the part of the “rayon” centre can either become part of the “rayon” or be singled out as a separate municipal entity.
2. The settlements’ model. Municipalities are established at the level of inhabited areas (which usually do not coincide with settlements and consist of several closely located villages or a settlement with surrounding villages). Each of such municipalities has elected bodies and its own budget. In these cases it is common that there exist several hundred municipalities within one region. At the level of administrative districts (with a few exceptions) there are established territorial state government bodies that solve inter-municipality problems.
3. The two-level model. Municipalities are established both at the level of separate settlements and that of administrative districts. Elected administrative bodies and local budgets shall be formed at each of the levels. It is not always that it happens in practice, though. There can be cases when local budgets in settlement municipalities are not always established or not formed at all, though the two-level municipal entities’ structure is formalised in the regional legislation. As far as a local budget according to the Constitution of the Russian Federation is one of the obligatory attributes of a municipal entity, one can state that in cases when local budgets at the level of settlements in a certain region are lacking it means that the “rayon” model was applied.
4. Local self-governance functions only in certain towns and settlements on the territory of a given subject of the Federation, in the rest of cases it is the territorial bodies of regional government that actually take upon themselves solving local problems. At the same time municipalities can formally exist, but they are not given the right to form independent local budgets. That kind of approach to local government organisation contradicts the Constitution of the Russian Federation, which has several times been confirmed by the Constitutional Court⁴. Nevertheless, this kind of practise is rather widely represented also today.

According to the information of the Centre for fiscal policies municipal entities at the level of “rayons” and towns singled out as regional centres exist today in 48 subjects of the Russian Federation, at the level of settlements in 17 subjects (in 10 of those the number of local budgets is much smaller than that of municipal entities at that), in 22 of the regions municipal entities exist at both levels (but only in 5 of these the number of municipal entities and municipal budgets is the same, and in 11 subjects municipal entities of the lowest level are completely devoid of municipal budgets). Based upon this information one can draw the conclusion that in the overwhelming majority of regions the “rayon” model prevails completely or transition to this model is at its final stage (there are approximately 60 of those regions). Cases when the settlements’ model and the two-level model are preserved in their complete form are actually isolated instances (in 5 to 7 regions with respect to each of the models). One can also assume that there is a high probability that at least in 10 regions there are serious breaches of the Constitution in the part of the citizens’ right to have local self-governance.

In recent years regional authorities were very active in spreading the “rayon” model of municipalities’ organisation. An example of it is Tyumen oblast, where in the course of 2001 the number of municipal entities decreased approximately tenfold.

The existing tendencies in changes of municipal entities’ territorial structures, advantages and disadvantages of different models receive unequal assessments in researchers’ communities, in political circles and administra-

⁴ In the course of “Udmurtiya case”, which was quoted previously and got the largest public response in this context, the Constitutional Court analysed in particular compliance of the provision of the Law of the Republic of Udmurtiya “On the system of government bodies in the Republic of Udmurtiya” that prescribes that local governments are only possible at the level below that of town and region, at the town and regional level there can only function government bodies, and ruled the provision to be in contradiction with the Constitution (Vestnik..., 1997, vol. 1). The Constitutional Court expressed this very idea in an even more direct way in its ruling in a case of Kursk oblast, which said that “issues of local importance can and shall be solely decided upon by bodies of local government or by the citizens directly, and not by government authorities” (Vestnik..., 2001, vol. 1).

tive government bodies. This reflects to a certain extent the objective fact that “when borders of municipal entities are being drawn, there always appears a certain contradiction in an attempt to achieve two goals: to ensure that the power gets closer to citizens and more accessible for them and to get an ideal economically and financially all-sufficient territorial unit” (Patokina, 2001, p. 192). But the excessive politicisation of this process to the prejudice of an effective functioning of municipal entities is by no means less evident. These real-life problems are closely connected with a thesis that has been gaining popularity lately and which says that it is necessary to make a transition throughout the country to a unified two-level municipal entities’ structure, which according to its advocates will allow solving in a most adequate way the whole set of locally important issues and ensuring a most profound realisation of the local self-governance principles. With the aim to realize this approach in practice it is suggested to start full-scale reforms in the nearest future. At the same time other viewpoints are also expressed; one of these, for example, is that the functions of a municipal entity can most effectively be performed by bodies that will have an intermediate position between the level of the settlements and that of the “rayon”.

Municipal entities’ powers

According to the current legislation municipal entities shall deal with issues of local importance. Besides, they can be given certain government responsibilities. The Law “On general principles...” provides a municipality with 30 issues of local importance, among them are

- adoption and changes in statutes of the municipal entity and control of their observance;
- possession, usage and disposal of municipal property;
- local finances, formation, approval and performance of the local budget, imposing local taxes and duties, solving other financial issues of local importance;
- social and economic development of the municipal entity as a complex;
- maintenance and usage of municipal housing and non-residential property;
- organisation, upkeep and development of municipal health institutions, ensuring sanitary order for the population’s benefit;
- maintenance of public order, organisation and upkeep of municipal public order institutions, control over their activities;
- regulation of planning and building up at the territory of the municipal entity;
- control over land use at the territory of the municipal entity;
- regulation of usage of locally important water bodies, deposits of generally found mineral resources, as well as of land under the surface for building underground constructions of local importance;
- organisation, upkeep and development of municipal power, gas, heat and water supply and sewage systems;
- organisation of fuel deliveries to the citizens and municipal institutions;
- municipal roads construction and maintenance of locally important roads;
- improvements and planting of greenery at the territory of the municipal entity;
- organisation of recycling of domestic waste;
- organisation of undertaker services and maintenance of burial places;
- organisation and maintenance of municipal archives;
- organisation of transport services for the citizens and municipal institutions, ensuring communication services to the population;
- creation of conditions to provide the population with trade, public catering and consumer services;
- creation of conditions for the activities of cultural institutions in the municipal entity;
- preservation of historical and cultural monuments in municipal property;
- organisation and maintenance of municipal information service;
- creation of conditions for the activities of mass media of the municipal entity;
- creation of conditions for organisation of public performances;
- creation of conditions for development of physical culture and sports in the municipal entity;
- ensuring social support and promotion of citizens’ employment;
- participation in nature protection at the territory of the municipal entity;
- ensuring fire safety measures in the municipal entity, organisation of municipal fire fighting service.

But the list of municipalities’ powers is kept open. Municipal entities can deal with other questions that are referred to the issues of local importance by the laws of RF subjects, as well as with questions that are not excluded from their competence and not referred to the competence of other municipal entities and government

bodies. Thus one can say that the following principle is applied to local self-governance: everything that is not prohibited by the law is allowed.

Basic drawbacks of this list of powers can be described as follows.

First of all, the list is too vast and lacks concreteness. It contains a mixture of both real functions and responsibilities of local self-governance and instruments for their execution (adoption of statutes, disposal of municipal property, local finances). The Law uses such indefinite notions as creation of conditions, participation, etc., without elaborating on concrete meanings of those. It is still unclear how a municipality's competence in education, health care, culture and social protection are correlated with that of the Russian Federation and its subjects in these spheres and guarantees provided to those in the Constitution. This does not help to divide the locally important issues into questions directly referred to the competence of local self-governance and those under the authority of the state government, the ones that state government have the final responsibility for. Neither it is defined which of the responsibilities – in normative and legislative regulation, finances and administration – shall be executed by municipalities with respect to this or another locally important issue.

The second drawback is that in the majority of cases when this or another responsibility was referred to municipal competence the criteria that were used was not the function (for example, organisation of heat supply in the municipal entity) or the sphere of activities (for example, infant education, social housing), but the form of property (municipal housing, municipal infant schools, municipal heat supply). This leads to a situation when a municipality's scope of powers is defined by a rather arbitrary distribution of property among federal, regional and local levels. To give an example, according to the Decree of The Supreme Soviet of the Russian Federation of December 27, 1991, number 3020-1 municipal property was enlarged with housing and parts of engineering infrastructure, the overwhelming majority of public health establishments (with the exception of oblast hospitals and specialized health centres), public education establishments (except specialized schools for children with chronic diseases), and those of culture and sports. Later a similar transition of property that had previously belonged to different departments, institutions and organisations to municipal ownership took place. Municipal entities in many case turned out to be unprepared to administer such large scale and varied households. At the same time in a number of spheres powers of municipalities were groundlessly cut. For example, a municipality cannot regulate the local heat market on the whole, as far as its responsibilities cover only municipal boiler-houses, while departmental and private sources of heat that work at the same local market are regulated at the regional level. The approach to distribution of powers in question also created conditions for unjustified interferences of regional bodies of power into purely local problems. For example, the transfer of water-supply systems into regional property that is happening in a number of regions under pressure of subjects of the Federation automatically excludes the question of water-supply to the citizens from issues of local importance, though it does not change anything in the real mechanism of providing this service.

In addition to issues of local importance local governments can also execute certain government powers, which are delegated to them by government bodies. This possibility is provided for in the Constitution of the Russian Federation, but this delegation of certain government powers to local authorities shall be drawn up as a legislative act and accompanied by a transfer of required material and financial resources. This provisions with different inessential variations is reproduced practically in all legislative acts related to general problems of local self-governance and its financial foundation. But in the situation when division of functions and responsibilities between different levels of power is rather vague, the "government responsibility" notion is not clearly formulated, and a mechanism to define the scope of material and financial resources required to execute it is not established in any document, these legislative provisions actually don't work in practice. Local governments have no possibility to reject execution of non-financed government powers and decisions of state government bodies and are forced to bear the whole responsibility for realisation of those.

Structure of local governments

According to the Constitution of the Russian Federation the structure of local governments shall be decided upon by the citizens independently. In addition it is generally accepted that local self-governance being of a non-governmental nature, a division of powers into a representative and an executive one is not obligatory⁵.

In practice the local government organisational pattern is often defined at the regional level and is basically uniform throughout the subject the Federation. It was only in a few regions, for example in Leningrad oblast, that municipalities were given the possibility to choose from several variant.

⁵ This conclusion can be drawn in particular from the ruling of the Constitutional Court on Chita oblast, that declared the binding instructions to local governments to form executive bodies as unconstitutional (Vestnik..., 1996, vol. 1).

The predominant government organisation form is the pattern that got the name “strong mayor – weak council”. According to this pattern the head of a municipal entity, just like the representative body, is directly elected by the citizens. In many cases he is the head of the elected body and of the local administration simultaneously. An alternative to this is election of the head of the municipal entity by the elected body of local self-governance. In practice this variant allows regional authorities to execute a greater control over how local bodies of power are being formed and in the majority of cases actually means that mayors are appointed by the governor. In some municipal entities it is usual to hire administrators, but this pattern gained no wide popularity.

The roles of the elected body and the head of a municipal entity are in many respects determined by the distribution of powers fixed in the statutes of the municipal entity. The federal legislation defines the issues that are referred to the exclusive competence of the elected body of a municipal entity. But in practice interpretation of these issues is not that simple, especially with respect to such an issue as “adoption of rules of general effect on issues that fall under competence of municipal entities”. The question of giving additional powers to elected bodies is also solved in different ways. For example, the tempo of the housing reform at the municipal level is in many ways dependent on which of the power branches – the representative or the executive – is given the power to regulate tariffs for enterprises and citizens.

A summary of different variants of local authorities, officials of local self-governance and their interrelations are given in *Table 1.1.* (Voblenko, 2002, p. 35-36).

Table 1.1.

Local governments – structure and interrelations

1. The way the elected bodies and local administrations of a local self-governance are formed			
11.1	Local self-governance’s elected body is elected on the basis of	11.3	Local administration is formed:
•	majority system;	•	by the head of the municipal entity independently;
•	proportional system;		
•	mixed system	•	by the head of the municipal entity and shall be approved by the representative body of the local government
1.2	The head of the municipal entity is elected:	1.4	Officials are appointed:
•	by the citizens;	•	leading ones -at consent of the representative body of the local government, others – by the head of the municipal entity independently;
•	by the elected body:		
•	a) among elected representatives		
•	b) among professional managers.	•	leading ones – by the head of the municipal entity, those dealing with current economic issues – shall be recommended by the head of local administration (or the town administrator).
2. Place of the head of the administration in the system of local governments			
2.1	The head of municipal entity leads:	2.3	Interrelations between the head of the municipal entity and the representative body:
•	the local administration;	•	he organises the work of the representative body of local government, but has no right of decisive vote;
•	the representative body of the local self-governance;	•	he participates in the work of the representative body of local administration and possesses the right of decisive vote.
•	the local administration and the representative body of local self-governance.		
2.2	Interrelations between the head of a municipal entity and the administration:	•	he possesses the right of suspension veto (complete veto) on decisions made by the representative body of local government;
•	he personally leads the work of local administration;	•	he has no veto right on decisions taken by the representative body of local administration.
•	he performs general management, operational management is performed by an appointed (hired) head of administration;		
•	he does not participate in the work of local administration, local administration is headed by an appointed (hired) head of administration.		
3. The head of the elected body			
• organises and leads the work of the council,			
• organises the council’s work and performs functions of the town secretary.			
• performs functions of the head of municipal entity.			

Local self-governance reform

Drawbacks of the current normative regulation system of local self-governance and the mass breach of the existing legislation in this sphere call for an urgent reform. This problem was raised by the Presidential Commission for division of powers. As part of its activities the Commission worked out a new variant of the Law “On general principles for local self-governance in the Russian Federation”, which suggests considerable changes in legal foundation in this sphere. The basic novelties suggested by the Commission can be boiled down to the following:

In the first place it is suggested to establish a unified territorial pattern for municipal entities on the whole of country’s territory. Municipal entities shall be formed at the level of town and rural settlements, municipal regions and city districts. As a basic pattern a two-level “settlement – region” structure is suggested. At the level of settlements there is planned performance of a limited list of municipal powers; within regions there will be solved problems of inter-settlement character (for example, organisation of transport between settlements), powers in the sphere of education and public health that are kept by the municipal level will also be executed in regions. Regions shall also be responsible for execution of state government powers delegated to them. The level of city district shall combine functions of settlements and administrative districts. A new territorial pattern shall be established by the government of the RF subject.

Secondly, the scope of municipal responsibilities is given a more precise shape; at the same time powers of municipal entities get rather considerably reduced. For example, the regional level gets the responsibility for organisation of educational process in the sphere of education, the functions of municipal entities get completely devoid of social issues. At the same time such drawbacks as form of property orientation when defining responsibilities and prescription of concrete forms to solve this or another issue of local importance inherent also in the previous law are kept by the suggested variant.

Thirdly, the new draft of the law prescribes in detail (in certain instances in too much detail) forms and mechanisms for citizens’ participation in local self-governance. For example, it says that when local budget is being adopted and report on its executions is being approved public hearings are obligatory.

The fourth innovation is a more strict regulation for the local government’s pattern. Representative and executive powers in a municipal entity are clearly separated from each other. At the level of municipal region there are prescribed two possible patterns to organise the powers: the elected body is either formed of representatives of settlements and hires a paid manager, or is elected by direct vote. In settlements all variants to form power bodies existing today can be realised in principle: the head of municipal entity can be elected by direct vote or by the elected body, he can lead the elected body or the local administration. But for the head of municipal entity it is forbidden to simultaneously hold offices of the chairman of the representative body in local government and the head of local administration. It is suggested to legally fix the number of deputies in the local representative body depending on the population number in municipal entity. In case the head of municipal entity does not lead local administration, it shall be headed by a hired manager. Election by the citizens of other bodies and officials for local self-governance is also possible.

The fifth novelty is wider rights of local governments to finance issues of local importance, simultaneously the responsibility of the government to finance delegated government powers is toughened. It is suggested that local governments are delegated the right to independently fix wages and conditions of remuneration of labour of municipal employees, of those employed by budget organisation (which actually means cancellation of The Uniform Tariffs System), and to establish other standards, as well as norms for planning and financing local budget expenditures to solve issues of local importance. At the same time financing of government powers receives a more strict regulation, it can only be performed as subventions and at a level at least equal to the one marginally guaranteed by the law. But alongside with these no doubt progressive elements the new law also envisages a complicated multistage system to level out budget sufficiency, which can in many instances outweigh the incentives to an effective municipal management. It is also planned to establish negative transfers for municipalities with the highest fiscal capacity.

The sixth novelty is a toughened financial and administrative responsibility of bodies and officials in local self-governance. It is envisaged that government bodies of a RF subject can temporarily execute powers of local governments in particular in cases when the budget of a municipal entity is insolvent or budget funds allocated for execution of state government powers are used for other purposes. In cases of overdue debts that exceed the limits defined by the law a provisional financial administration of up to one year can be imposed.

At the same time the suggested approach to local self-governance reform is not shared by everyone. Its critics point out to considerable organisational expenses and a possibility of embezzlements when the whole structure of municipal power in the Russian Federation will be reformed simultaneously, to excessiveness of the sug-

gested mechanisms for fiscal equalization and insufficiently developed issues for cases of municipal entities' insolvency. What is alarming here is the "governmental" bias of the suggestions; their practical realisation will lead in many instances to a situation when local self-governance will be turned into the third level of the government (at least with respect to municipal regions). Experts question conformity of the suggested draft law to the Constitution of the Russian Federation⁶.

Alternative suggestions to reform the local self-governance system are boiled down to the following. As far as local self-governance is not an institution of the government, the latter shall in the first place ensure conditions for its effective functioning. These conditions are divided into organisational and financial ones.

Creation of organisational conditions presupposes restricting arbitrariness on the part of the government bodies in the RF subjects in changing the territorial structure of municipal entities, as well as the possibility for any settlement or a group of settlements that satisfy conditions provided by the federal law to form an independent municipal entity regardless of the regional authorities' will. With this end there shall be adopted a separate federal law on creation, reorganisation and liquidation of municipal entities or corresponding provisions shall be included into the Law "On general principles...". As prerequisites for any settlement or a group of settlements to form an independent municipal entity shall be used the following:

- citizens' wish vocalised in a referendum (the law in question shall provide for financial sources to arrange such referendums, as well the nature of questions that can be put at referendums, so that they are not formulated like "Do you wish to have a good life and to establish an independent municipal entity?");
- obligation to perform all obligatory functions that are attached to local governments in the law shall be stated in the Statutes of the new municipal entity in question (which shall be confirmed by legal experts' examination of the draft Statutes);
- the new municipal entity shall not originally be of a highly subsidised type (definition for a highly subsidised entity shall be provided for in the law), which shall be confirmed by a contract with the government of the subject of the Federation about conditions of financial support.

To perform some of the powers (including the compulsory ones) municipal entities can create associations and unions, in the frames of which they can consolidate their financial and organisational resources and jointly perform their tasks. Creation of such associations can be done both within the limits of administrative districts and with no account to these borders. To perform various powers there can be created associations and unions of different shapes. It is feasible that such unions can be created both to solve locally important questions and to execute powers delegated by the state government. This kind of role of associations and unions created by municipal entities differ to a considerable degree from the one, which at present is stated in the Law "On general principles...". The provision of this law that says that associations and unions of municipal entities cannot be given powers of local governments (art. 10) should be reviewed.

As for delegated government powers is concerned, this issue should be solved by bodies of the state government and state administration. It can have various solutions both in different subjects of the Federation and within a single subject. For example, government powers can be delegated to large municipal entities that possess sufficient organisational and administrative resources to execute them, or to associations of municipal entities (or if this is more correct from the legal viewpoint, to municipal entities that association is comprised of). In case of lack of both one can establish territorial government bodies that can take upon themselves execution of government powers (but will be devoid of the right to interfere in solving issues of local importance).

Creation of financial conditions presupposes securing financial guarantees to local self-governance. Here one does not question such suggestions by The Commission for division of powers as reinforced financial independence of municipalities on issues of local importance, tougher responsibility of state government bodies for financing of state government powers and mandates. The importance of a more precise definition of the scope of municipal powers is also acknowledged here. But the fact that the provisions about fixing own revenue sources for municipal entities are vague and the suggested system of fiscal equalization is too complicated causes a serious anxiety. Besides, two radical reforms of such a scope such as changes in the territorial structure of municipal entities suggested by the Commission and transformation of principles and mechanisms to regulate municipal finances performed concurrently are viewed as being practically unfeasible. As far as according to those who represent the alternative approach the basic reasons of an ineffective local self-governance lie not in the drawback of the territorial structure of municipal entities but in the flaws of the municipal finances' regulation system, the priority here should be given to solving financial problems, while the evolution of the territorial structure

⁶ The suggestions by the Commission for distribution of powers were criticised by a number of experts, see in "Mer budet...", 2002, p. 24, "Yescho Odno Ogosudarstvleniye...", 2002, "Munitzpalnaya Reforma...", 2002.

should take a step-by-step course, being in many respects determined by the new regulatory milieu, which should be shaped in the sphere of municipal financing.

Thus, the question of securing financial guarantees for local self-governance according to the logic of the alternative approach should be brought to the foreground and become the key issue for the reform of local self-governance.

Chapter 2. Evolution of Municipal Finance

General Description of Municipal Finance

It is certain that in the course of more than ten years that have passed since the beginning of the reforms an integral concept of municipal finance reforms has never been realised. This field remains one of the least reformed in the institutional aspect and the mechanisms applied here basically are the same as in the times of the Soviet Union. While a certain progress has been achieved in the field of regulating financial relationship between the centre and the regions, this is not the case in relation to the RF subject or municipal entities.

The data in *Table 2.1* demonstrating the overall dynamics of the sources of income from 1994 till 2001 fully corroborate this conclusion. Obviously, although certain fluctuations in the debt structure can be observed during the period under review, no substantial changes have occurred. The share of sources directly controlled by regional authorities (shared taxes and financial aid) fluctuated approximately from 2/3 to 3/4 of all municipal revenues, even exceeding this level in certain years. This considerable part of municipal entities' revenues may be revised annually (and sometimes even in the course of a financial year); local authorities have no guarantees of stability or predictability of changes of sources of income in respect to this part. The main portion of revenues was formed by the income tax, profit tax, VAT (up to 2001) and excise taxes, i.e. the same sources that form the basis of the federal and regional budgets.

Table 2.1

Structure of Revenue Sources of Municipal Entities in 1994 - 2001 (in %)

	1994	1995	1996	1997	1998	1999	2000	2001
Total revenues, including:	100	100	100	100	100	100	100	100
Tax revenues, including	62.2	61.8	59.9	60.6	63.7	70.6	66.9	60.5
Local	9.3	7.1	7.7	8.7	11.3	12.8	14.4	5.4
<i>Assigned</i>	5.7	7.6	11.3	10.9	13.1	13.3	12.8	12.9
<i>Shared</i>	44.7	43.1	37.3	37.4	36.7	43.9	39.3	41.2
Non-tax	4.8	2.6	2.4	2.2	3.7	3.6	3.5	3.8
Financial Aid	32.9	35.6	37.6	37.0	32.3	25.1	28.5	34.6

However, while the system of municipal finance regulation has remained practically unchanged, the municipalities' range of responsibilities, institutional environment and mechanisms of operations have undergone fundamental changes. The evolution of municipal entities' financial status may be divided into three stages determined by the various financial tasks facing the municipalities: from 1991 till 1994, from 1995 till 1999 and from 2000 till 2001.

At stage one, from 1991 till 1994, the financial crisis has for the most part affected the federal authorities, while no serious financial disparities could be observed at the regional and local levels. As the data in *Table 2.2* (Bogacheva, Amirov, 1997, page 18) demonstrate, territorial budgets were performed with a surplus. However, starting from 1993 this occurred mainly due to transfers from the federal level, and to a lesser extent, owing to revenues from privatisation, reflecting, above all the lobbyist potential of the regions in their struggle for financial resources against the weakened central authorities.

Starting from 1995 regional budgets have been performed with a deficit; according to experts' observations, the main amount of the deficit, up to 80 percent, has occurred at the local level (Bogacheva, Amirov, 1997, page 18). The period of an acute crisis of municipal finance lasted from 1995 till 1999. The worsening of local budgets' financial problems was related to a number of reasons.

A considerable range of functions was transferred to the municipal level, partly legally, partly spontaneously. The scope of competence of municipal authorities expanded substantially. According to the data for 1997, out of total budgetary expenses at all levels, local budgets accounted for 42 percent of total expenses on social policies, 57 percent of expenses on health care and physical culture, 42 percent of total expenses on culture and the arts, 66 percent of total expenses on housing and utility services, 67 percent of total expenses on education (and in respect of secondary education, 95 percent were funded at the local level) (Local Self-Governance Finance, 1997, page 11).

Table 2.2

**Total Revenues, Expenses and Balances of Consolidated Budgets of the Subjects
of the Russian Federation (RUR billion)**

		1992	1993	1994	1995	1996
Revenues less transfers from target budgetary funds and other authority levels, earnings from privatisation		2300.0	2321.3	86237.8	201948.9	264284.7
Expenses, less expenses of target budgetary funds and on aid to other levels of authority		2253.4	26879.5	108062.4	238536.3	338389.2
Balance	RUR billion	46.6	-2667.2	-21824.6	-36587.4	-74104.5
	% of GDP	0.3	-1.6	-3.5	-2.2	-3.3
Earnings from privatisation		43.4	252.5	634.0	1308.4	1872.8
Interbudgetary transfers		261.9	4282.7	25404.6	30282.7	51704.5
Balance	RUR billion	351.9	1868.0	4214.0	-4996.3	-20527.2
	% of GDP	1.9	1.2	0.7	-0.3	-0.9

The transfer of federal commitments to fund the expenses related to social decisions did the greatest harm to local finance. E.g., while before 1992 only nine categories of the population were entitled to reduced rent and communal charges, from 1992 till 1999 six additional laws were passed that extended these benefits to 18 more categories of the population. 38 categories received benefits in respect to urban transportation fare and 21 categories received benefits in respect of medicines (Belovodova, page 17). According to the estimates by the Ministry of Finance, the total amount of the largest federal mandates was 60 percent of the expenses of the regional consolidated budgets in 1999, and the amount of the mandates on the whole was 170 percent (Lavrov, Litvak, Sutherland, 2001, page 37). Acceptance of enterprise houses and social purpose facilities also caused substantial additional expenses. From 1993 till 1997, in Russia on the whole cca. 80 percent of enterprise houses, 76 percent of nurseries and kindergartens, 82 percent of medical establishments were transferred to the municipal property. As a result, according to the available estimates, the municipal stock of social purpose facilities increased 65 percent, and in some cities, dozens of times (Pronina, 1998, page 22).

But the growth of expense commitments was not accompanied by an adequate increase of sources of income. This was related both to objective reasons (a setback in production, expansion of the economic crisis) and to the financial policy of the federal centre and the subjects of the RF. The transfer of additional powers to the local levels was accompanied by centralisation of financial resources. While in the period from 1993 till 1998 the share of local budgets on the expense side of the consolidated budget of the Russian Federation grew 10 percent, the corresponding share on the revenue side grew only four percent (Boreskova, Kitova, 2000). Expenses on benefits that had been introduced at the federal and regional levels often without specifying the source of funds were not reimbursed. Additional expenses related to the acceptance of enterprise facilities were reimbursed after years of delays, and regions and municipalities suffered inflation losses. Therefore, it became quite popular to accept budgets with a large deficit without specifying the sources of its coverage and to considerably understate the necessary budget expenses on acquisition of goods and services at the stage of budgetary planning. As a result, enormous budgetary debt accumulated for actually received goods and services, which the municipal authorities were formally not obliged to repay.

The crisis of municipal finance has had a destructive impact on all aspects of local authorities' operations. In fact, only salary expenses were funded (with considerable delays) and some current expense items (catering, medicines). Practically no funds were allocated to pay for the utility services; as a result, heating debts of many municipalities grew to amounts comparable to the annual budget. The enormous debts to utility services were related to non-funded federal mandates. The practice of non-monetary settlements, netting and barter gained wide acceptance. Municipal entities were seeking to form the monetary part of local budgets in amounts that were sufficient to pay the salaries; all other funding was carried out in non-monetary form. Capital expenditure funding was brought down to the minimum; directions of the capital expenditure were determined by the resources received from barter operations. To cover the barest necessities, municipalities had to make borrowings on unfavourable terms and conditions, which complicated the situation even more.

The policies pursued by regional authorities quite often were far from abating the crisis. Deduction ratios for shared taxes changed every year and were established on the basis of subjective, often political, criteria. Although, starting from 1995 some regions began to apply the mechanism of transfer allocation by a fixed formula, in fact there prevailed the practice of distributing financial aid on the basis of actual costs, at best, or, if the worst came to the worst, by means of 'political accords'. The deficit of local budgets (as a rule, it was evenly distributed between all municipal entities) was planned at the stage of budgetary planning. The practice of centralised procurement was widespread (under such practice, regional authorities centralised the funds of municipal budgets for purposes of purchasing medicines, preparing for the coming winter etc. Such centralisation limited local authori-

ties' ability to manage their resources flexibly, and economies of scale often failed to compensate the drawbacks. Moreover, centralised procurement was often carried out at higher prices than decentralised purchases. In a number of cases municipal functions have been transferred to the subjects of the Russian Federation (primarily, by municipal entities that to a large extent depended on subsidies).

The situation somewhat improved in 2000 - 2001: these years may be regarded as a period of temporary financial stabilisation. The main reason for it was the beginning economic growth and the corresponding increase in tax revenues. Non-monetary forms of budget implementation were to a considerable extent overcome. A certain order introduced into the funding of federal benefits also played a role. In addition, the reforms were accelerated at the local level, especially in the sector of housing and utility services. The share of individual payments for the services increased considerably. The completion of acceptance of enterprise houses and social facilities to the municipal property had positive effect in most of the municipal entities.

The period of a temporary financial stabilisation is marked by an abatement of the public sector worker salary problem, lower rates of debt growth, including the debt for utility services (and, in some cases, the debts were even repaid) and a certain increase in capital expenditure. We do not have systematic information on municipal entities' budgets, but, judging by the data on the consolidated budgets of the subjects of the Russian Federation in Table 2.3 (Christen, 2002(2), page 11), in 2000 to 2001 overall budget surplus replaced budget deficit, the amount of accounts payable was considerably reduced, and repayments were actively going on. However, Table 2.3 demonstrates that these processes were very irregular.

Table 2.3

Some Indicators of the Consolidated Budgets of RF Subjects in the Period from 1998 till 2001.

	1998	1999	2000	2001 (11 months)
<i>Deficit/Surplus, % of Expenses</i>				
On average by RF subjects	-2.4	-0.2	3.4	4.7
including:				
non-subsidised	-2.1	1.5	6.7	7.0
subsidised	-2.2	-0.9	1.4	1.7
highly subsidised	-3.3	-3.3	-4.4	2.7
<i>Change in budgetary accounts payables over the year, % of the beginning of the year</i>				
On average by RF subjects	67.6	6.8	-25.0	-14.9
including:				
non-subsidised	76.5	-23.6	-28.2	-11.6
subsidised	67.4	28.5	-36.8	-10.1
highly subsidised	62.2	5.9	-8.6	-20.4
<i>Change in budgetary accounts payables over the year, % of the expenses during the year</i>				
On average by RF subjects	21.4	14.6	6.9	4.8
including:				
non-subsidised	11.0	5.2	2.1	1.7
subsidised	27.4	23.6	11.1	7.5
highly subsidised	37.8	26.3	16.7	9.3
<i>For Information:</i>				
<i>The share of consolidated budgets of RF subjects in budgetary revenues (financial aid not included) of the consolidated budget of the RF, %</i>	54	49	46	41
<i>The share of financial aid from the federal budget in the revenues of the consolidated budgets of RF subjects</i>	11	10	9	18

The 2002 situation demonstrated that financial stabilisation of municipal finance is not long-lasting. The decision to increase the salaries of public sector employees (which, in fact, was just another non-funded federal mandate) in many cases destabilised the position of local budgets, again demonstrating that, without resolving the basic problems of municipal finance it would be impossible to achieve stable positive changes in that field. The main drawbacks of mid-90s again began to occur (albeit not at such a catastrophic scale): delays in salary payments and growing debts for the heating. The need for serious reforms became obvious.

Evolution of Approaches to Municipal Finance Regulation

The drawbacks of the existing system of local budget regulation (e.g., the assignment of sources of income 'from above' and an annual revision thereof, which lead to subjective attitudes on the part of regional authorities and parasitic attitudes on the part of local authorities) were obvious even in the first years of economic reforms⁷ However, the approaches to solving these problems differed over the reform period. One can distinguish three stages in the development of municipal finance reform ideology. These may be termed as follows: experimenting with local taxation; integrating into the state finance system; searching for a model of financial autonomy.

At stage one, the main attention was paid to developing a system of local taxes that was regarded as a guarantee of local budgets' independence. As early as in 1992 to 1993 local authorities were allowed to introduce 23 local taxes. Three of the taxes, namely, personal asset tax, land tax and registration fee charged from individuals conducting business operations, were mandatory, others could be introduced on decision of local self-governance bodies. The list of local taxes was not disclosed and the establishment of tax rates was in an overwhelming majority of cases strictly regulated in the federal law.

In 1994 serious changes occurred in this field. The Presidential Decree "On Forming the Republican Budget of the Russian Federation and on Relationship with the Budgets of the Subjects of the Russian Federation in 1994" of 22 December, 1993 determined that additional taxes and fees collected in the RF subjects and additional local taxes and fees not envisaged in the law may be introduced on the basis of decisions of RF subject authorities and local authorities. In addition, regional and local authorities were granted free hand in imposing new tax rates, in particular the rate of profit tax. In the end of 1993, a local tax on the maintenance of the housing resources and social and cultural facilities was introduced with a special aim of covering the financial consequences of the transfer of enterprise houses and social and cultural facilities to the municipal property.

Regional and local authorities actively used the right to impose taxes independently. In the period from April to June of 1994 alone over 70 regional and local taxes and fees were introduced in addition to those envisaged in the federal law (Pankov, 1994, page 17). However, these taxes on many an occasion proved ineffective. Regional and local authorities often introduced a lot of small and difficult to administer taxes; moreover, in doing so they tried to adjust the revenue system to their numerous functions and the corresponding expenses. As a result, the practice of introducing target fees aimed at solving certain tasks became widespread, but the fees only brought a small portion of the funds needed to solve the task. E.g., the fee for the needs of educational institutions in the Chelyabinsk oblast covered only five percent of the funds needed to finance education. Besides, the authorities attempted to regulate economic activities at the regional and municipal levels – naturally, to the extent of their understanding of the desirable lines of development. In the widely discussed case of the Kursk oblast, its authorities imposed such taxes as, e.g., a tax on products sold outside the oblast, a tax on production slowdown and a tax on uninstalled equipment. A tax on using foreign words was introduced at the regional level (Gorski, 1995).

While noting the negative consequences of an open list of regional and local taxes, experts at that time had no doubts as to the importance of granting large powers to municipal authorities in the field of local taxation. In their opinion, the decision lay in adopting a law on local taxes aimed at regulating the problems arising in that field. This draft law never passed the discussion stage, though.

The experience gained in applying local taxes brought to light another problem that mostly the representatives of municipalities paid attention to: in the event that sources of income of local budgets were regulated 'from above', additional revenues from local taxes were simply taken into account in calculating the norms of the shared taxes that were decreased by the corresponding value. Moreover, regional authorities made unrealistic forecast of revenues from local taxes, which complicated the status of municipalities even more. It was becoming more and more apparent that it was not possible to form an efficient financial system at the local level using only local taxes, without resolving more general issues of municipal finance regulation.

The Law "On Financial Foundations..." marks a turn towards a broader and more comprehensive consideration of the municipal finance issue. This is related primarily to the fact that the aim of the Law is to regulate the processes that to an overwhelming extent determined the finances of municipal entities, namely the mechanisms of assigning shared taxes and granting financial aid. Previously an attempt to regulate these issues somehow was

⁷ "As for local budgets, that most widespread element of the budgetary system, practically nothing has changed in this field during the years of radical economic reforms... The hopelessly outdated mechanism of centralised regulation used by higher authorities to regulate the income of local budgets is being used and will be used for an indefinite term. This deprives local authorities of financial independence and binds the development of local economy and social sphere to the higher bodies' capabilities and wishes to resolve the problems of the administrative districts, towns, settlements and villages for years to come. In addition, the many years of practice have demonstrated that the budgetary regulation system gives rise to parasitic attitudes because there is no urgent need to earn money if it can be obtained on demand or by persistent asking." (Pankov, 1994, page 15).

made in the Law "On General Principles...". This Law established that government agencies had to provide municipal entities with minimum local budgets; the minimum required expenses of local budgets had to be determined in the laws of the subjects of the Russian Federation on the basis of the norms of the minimum fiscal capacity. Quite obviously, declaring general principles that have not been formulated with sufficient detail was far from enough to be able to resolve such a complicated problem. The Law "On Financial Foundations..." makes a clear step forward in this direction. However, the compromise nature of this law prevented it from ensuring considerable changes in the existing practice of interbudgetary relationship between the subjects of the RF and municipalities. The most significant provisions of the law were as follows:

Firstly, the minimum proportions of federal taxes assigned to municipal entities were established, including⁸:

- at least 50 percent of the income tax;
- at least 5 percent of the profit tax;
- at least 10 percent of the VAT;
- at least 5 percent of excise taxes on alcohol, vodka and alcoholic beverages, and at least 10 percent of excise taxes on a number of other products liable to excise taxes.

However, these shares have been assigned to all subjects of the RF on average, and not to each municipality in particular, i.e. regional authorities have retained the possibility to apply a subjective approach in assigning taxes to a municipality. Moreover, in some cases this law has been used to reduce the ratios assigned to the municipal entities (that were previously assigned higher ratios of deduction from shared taxes), and municipalities have suffered considerable financial losses (Boreskova, Kitova, 200, page 15). This was typical, e.g., of Orenburg. At the same time, according to interpretations by some courts, the provisions of the Law related to individual municipal entities, hence municipalities won the claims for bringing ratios of deductions from shared taxes in accordance with the Law (e.g., the cases in the Lipetsk oblast (Pudrov, 2002, page 16) and Irkutsk oblast (in Bratsk).

Secondly, the Law regulated in sufficient detail the principles and mechanisms of establishing interbudgetary relationships between regions and municipalities, in particular, granting financial aid to municipal entities. An order for the forming and functioning of the fund for financial support to municipal entities was established and criteria for the distribution of the fund's aid determined.

Thirdly, the Law has attempted to ensure certain independence guarantees for local authorities, but this attempt has been rather modest. It has been established that the shares of federal taxes calculated for each municipal entity should be assigned on a permanent basis; additional deductions for at least three years may be assigned besides these deductions. It has been declared that the actual increase in local budgets' revenues resulting from their own efforts cannot be regarded as grounds for lowering the ratios of deduction from shared taxes or the next year's financial aid. In reality these provisions of the Law have been in the majority of cases ignored.

On the whole, the Law "On Financial Foundations..." has failed to justify the hopes pinned on it⁹. Examples in *Table 2.4* demonstrate that the practice of unjustified revision of deductions from shared taxes has remained basically unchanged in comparison with the period before the adoption of the Law; this has kept the budgetary conditions at the municipal level unstable and unpredictable and has often lead to considerable financial losses for local budgets. Distribution of financial aid has also remained subjective.

Table 2.4

**Ratios of Deductions from Shared Taxes to Local Budgets,
by Individual Towns (%)**

	<i>Volkhov</i>			<i>Petrozavodsk</i>			<i>Syktyvkar</i>		
	<i>1995</i>	<i>1996</i>	<i>1997</i>	<i>1997</i>	<i>1997</i>	<i>1999</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>
Profit Tax	6.1	2	0	9	10	8.5	7	2.9	0
VAT	15	5	0	20	7	8.25	1.7	1.7	0.03
Income tax	58.4	10	90/100*	90	70	45.6	41	14.5	0

* The norm was established at the level of 90 percent in the first six months and at the level of 100 percent in the second six months.

⁸ The first attempt to resolve the problem was made in Presidential Decree "On the Main Lines of the Tax Reform and Measures Aimed at Strengthening Tax and Payment Discipline" of 18 May, 1996. This Decree introduced minimum deductions from sharing taxes to the budgets of various levels, including local budgets, starting from 1 January, 1997.

⁹ "The Federal Law "On Financial Foundations for Local Self-Governance in the Russian Federation" adopted in 1997 has failed to justify the hopes pinned on it. Relationships between regional and local budgets remain unregulated and 'opaque', and the degree of real financial independence and responsibility of local self-governance agencies very low" (Christenko, 2000, page 6).

Moreover, the Law that was aimed at protecting financial autonomy of municipal entities in fact marked the beginning of a new stage, in which the issues of local budgets' independence receded into the background and a course was taken aimed at integrating municipal finance into the federal budgetary system. In our opinion, this has occurred because the task of the Law was to regulate the present day practice by introducing certain modifications into it, and not to carry out fundamental reforms. In fact, the Law established that shared taxes were the main source of municipal income, and not independent local sources. Thus, it is quite logical that this law has failed to provide a foundation for changing the trends existing in the interbudgetary relationships at the subfederal level. As for the elements of local budgets' independence that have been declared in the Law, practice has rejected them because they do not correspond to the system's overall logic.

The introduction of the Law "On Financial Foundations..." was accompanied by limitations of municipal entities' rights in the area of local taxation. Starting from 1 January, 1997, regions and municipalities were deprived of the right to introduce taxes not envisaged in the federal legislation. The list of local taxes authorised by the law was also gradually reduced. E.g., it was fixed in the law that introducing the regional sales tax would abolish 16 local taxes provided for in the Law "On the Foundations of the Tax System in the Russian Federation". The Tax Code of 1998 is also extremely austere in this respect. Article 15 places only five types of tax payments among local taxes and fees:

- land tax;
- personal asset tax
- tax on advertising;
- death and gift tax;
- local license fees.

And, since it has been declared that the property tax is a regional tax, upon its introduction only three latter taxes remain (i.e., the land tax and personal asset tax are excluded).

At the same time, the authorities started to increase the degree of financial resource centralisation in the federal budget. E.g., it was proposed to resolve the issue of financing the social commitments stated in federal laws. Indeed, this could be a way towards a considerable recovery of the local budgets' financial status if a considerable part of these commitments were abolished and the remaining commitments would be fully funded from the federal budget. However, in practice the centralisation of funds was not accompanied by a considerable decrease in the state's social commitments, and a simple redistribution of sources of income could not cover the expenses that nobody had previously funded. The problem of funding the government's decisions remained as acute as before.

In 2001 the revenue base of local budget underwent the most serious changes: the local housing maintenance and social and cultural facilities maintenance tax was abolished and the VAT fully centralised in the federal budget at the same time. As a result, municipalities lost more than 25 percent of their sources of income. The only local tax that constituted a sizeable share of municipal revenues was abolished. On average, this share was cca. 18 percent in municipal entities, sometimes reaching one half of all tax receipts. Estimated consequences of such decisions were far from comforting.¹⁰ According to the estimates, introducing the five-percent profit tax would not offset the lost revenues, as the regions would reduce their transfers of shared taxes in the corresponding amount. In 2001, however, the situation did not deteriorate; instead, perceptible positive changes were observed. As it has been mentioned above, this may be primarily explained by favourable economic dynamics leading towards considerable growth of tax receipts. Nevertheless, objections to the position of the Tax Code aimed at excessive centralisation have been growing ever more active. The government started looking for new approaches to municipal finance regulation.

The "Programme of Development of the Budget Federalism in the Russian Federation for the Period up to 2005" adopted in 2001 is a large step forward in forming a new ideology of regulating regional and local finance. Although this document postulates the necessity to centralise budgetary resources in the short and medium terms, its main aim is to ensure independence of regional and local budgets and regulate interbudgetary relationship. The most important Programme provisions with respect to the financial basis of local self-governance are as follows:

- regional and local authorities should be granted clear and real powers to incur expenses balanced with the financial resources;

¹⁰ "Thus, as a result of the reforms, the declared situation: "One tax, one budget", will be implemented for the federal budget (100 percent VAT) and for the regional budget (99 percent income tax). The local budget will also keep one local tax, the tax on advertising, but it will be not enough to form the budget" (Eremeeva, 2001, page 17).

- it is necessary to reduce the number of 'non-funded federal mandates' and in future to liquidate them, providing for full financial support of the legally fixed budgetary commitments.

The Programme pays considerable attention to the issue of regional and local budgets' own sources of income. Based on the methodological approaches stated in the Programme, local budgets should be assigned the most stable, evenly distributed tax sources with immobile taxation basis. In addition, it should be the taxes that municipal authorities can influence to the greatest extent, thus creating the conditions for and increase or decrease of the taxation basis, stimulating or dissimulating the development of objects of taxation¹¹.

The Programme proposed to use this basis for assigning to local budgets the guaranteed share of the income tax, profit tax, sales tax and the tax on utilisation of generally used natural resources. It was proposed to make the property tax local; in respect of the taxes on total revenues, it was proposed to transfer them in full amount to local budgets and to expand local authorities' powers relating to the regulation of tax regimes.

Further discussion of this issue focused primarily on three types of taxes, namely: the income tax, property tax and small business tax. At present it is widely acknowledged that precisely these three types of taxes, in various combinations, should create the financial basis of local budgets. This has been on many occasions said in the course of parliamentary hearings dedicated to legislative issues in the field of local self-governance in January 2001 (Problemy Zakonodatelstva, 2001, page 14, 24); this position has been supported in researches on local self-governance (Salov, 2001). Even in the events that it is planned to assign to local budgets a wider ranges of sources of income, these three taxes take the central position (Pronina, 2001, page 30 - 33). In doing so, it is proposed to make the property tax and small business tax local (Salov, 2001, pages 125 0 134; Pronina, 2001, pages 30 - 33).

Focusing mainly on financial equalization, the Commission for Division of Powers has not introduced any fundamentally new aspects in this issue. Consequently, at the present time the main approaches to the reform of the municipal finance regulation system have been laid down, but so far they do not have any influence on the practical activities in this field.

The Main Drawbacks of the Existing Municipal Finance Regulation System

Before analysing in detail the changes in financial legislation necessary to provide the financial guarantees of local self-governance, let us briefly formulate the main problems with respect to the functioning of the existing municipal finance regulation system.

The most serious problem is municipal authorities' lack of interest in efficient independent activities. It should be borne in mind in this respect that, due to the decisions made in early 1990-s and to the transfer of enterprise social facilities to municipal ownership, municipalities concentrated a considerable amount of property under their control. In the first place, these were the housing resources, educational and health care institutions, clubs, stadiums and other social sphere facilities. In addition, these were municipal unitary enterprises and organisations in the field of housing maintenance, heat and water supplies, other utility services, transportation etc. Effectively managing this property, increasing its economic efficiency and implementing a competent privatisation policy belong to the most important factors determining the quality of municipal governance and, at the end of the day, the efficiency of municipal entities' financial operations. These factors play an especially importance role at present since they are directly connected with implementation of the reforms that affect not only the municipal level (namely, the reform of housing and utility services, social sphere, federal and municipal unitary enterprises). To improve the quality of financial operations it is just as important to efficiently manage budgetary resources, namely: distribute the municipal orders on a bidding basis, attract private companies to its implementation, liquidate unnecessary expenses etc.

Meanwhile, in the current conditions municipal entities are not interested in managing property or financial resources efficiently. Improving the quality of municipal activities, implementing reforms aimed at saving budgetary assets and deriving additional financial means does not have positive influence on the status of the municipal budget or municipal economy. It is highly probable that already next financial year the means in question will be centralised at the regional level and redistributed in favour of other, less efficient municipal entities, while the

¹¹ The approach formulated in the Programme reflects traditional views at the distribution of taxation authorities set forth in the budget federalism theories. At the same time, some researchers do not support such viewpoints. E.g., according to the public choice theory, subnational bodies should be authorised to tax the most mobile factors, and tax competition is considered an important condition for ensuring the tax system's efficiency. In this theory, the general approach is based on the assumption that it is necessary to decentralise the production of most of public goods (at least, of those that have no externalia or spillover effect) and assign tax authorities that ensure a correspondence between the income capabilities and expense commitments. For a review of budget federalism theories, in particular, various view at the distribution of expense commitment and tax authorities between the budgetary system's different levels, see: Budget federalism, 2001, p.p. 122 - 157.

rate of reduction in expenses can well be introduced as the basis for future operations, which will deteriorate the municipality's status in medium term. At the same time, due to a large amount of and unpredictable changes in non-funded mandates, an increase in efficiency will in no way influence real financial results. Instead, it will only result in a slight decrease of the debt, the amount of which mainly depends on other, much more important factors. Moreover, a competent municipal policy may aggravate the problem of non-funded mandates. As the experience of the town of Cherepovets shows, transition to full payment of housing and utility services by the population caused an unplanned increase in the amount of benefits with respect to the services, which resulted in reallocating the town's funds in order to cover the additional expenses. On the whole, it is obvious that municipalities find it more convenient to live on subsidies than to be donors, prefer to increase expenses instead of reducing them. As long as the current system of municipal finance regulation exists, hopes for the acceleration of institutional reforms at the local level will remain groundless.

The existing system of sources of income, in which shared taxes play a leading role, does not stimulate municipalities to manage property efficiently or implement competent municipal policy either. From the point of view of revenue growth, it is much more important for a municipality to have good relationship with the management of large corporations located in its territory than either to worry about improving the quality or increasing the value of the property or to create favourable conditions for small business development. Thus, municipal entities' interest in operation efficiency is the least precisely in those fields where it could produce the most significant positive effect.

Without adequate economic incentives municipalities use totally different criteria in their policy. E.g., populist, economically unjustified decisions, monopolisation of municipal service market, support of affiliated municipal organisations irrespective of the real degree of their operational efficiency are common practice. Quite often decisions are made based on the personal interests of a municipality's management. It is evident that the reform of municipal finance is unlikely to extirpate these problems. However, it is of fundamental importance that at the present time the financial capacity of and, therefore, the quality of life in a municipal entity practically do not depend on the degree of honesty or competence of the management (or is even inversely proportional to that degree!). Thus, even rational motivations of the population at the elections to local governance bodies are very far from optimal.

Changes in financial conditions that take place every year, instability and unpredictability of the financial situation prevent municipalities from planning future lines of their operations and raise considerable difficulties to attracting long-term investments. The contradictions related to it could be clearly seen in cases when municipalities acted as borrowers or sub-borrowers under loans by international financial organisations to projects related to the development of infrastructure. A change in political or economic conditions in the region brought about sharp shifts in the structure and amount of sources of income assigned to the municipalities, which on many occasions resulted in their inability to service and repay long-term debts. Similar problems arise in other cases of attracting investments into the communal infrastructure. Taking into account that, due to a high degree of wear and to considerable breakdown rate of communal facilities such investments are instrumental to creating normal living conditions for the population, the need to solve this is really pressing.

Finally, the existing mechanisms of municipal finance regulation inevitably make interbudgetary relationship highly dependent on politics. Under soft budgetary limitations, political factors may have much greater influence on municipal entities' financial capacity than real management efficiency. At the same time, regional authorities are always capable of punishing a disobedient municipality. This factor plays an especially negative role in the events of a serious conflict between the mayor of the capital city and the governor. The relationships are 'sorted out' by means of financial pressure and maximum reduction of sources of income for large cities, and as a result the inhabitants of municipal entities suffer. Revenues are also centralised in the periods of preparation for governor elections; in such cases the funds are used to win over the population to the governor's side, and on many occasions the methods of achieving this end are economically unjustified.

It is evident that, while the existing practice affects the majority of municipal entities negatively, its consequences for large and medium cities are especially destructive. It is precisely in these cities that the main amount of municipal property and the largest budgetary resources are concentrated; thus, the losses from ineffective management are especially serious. At the same time, it is precisely in such cities, with valuable property, good prospects for competition growth, small business development potential and investment opportunities that the idle reserves related to inadequate motivation of municipal management are especially large. Such municipal entities are usually donors; thus they suffer most from subjective approaches to the regulation of sources of income. And it is precisely in the relations with such municipalities that political reasons and conflicts with the regional authorities play the greatest role. Thus, although the issue of making local budgets independent and es-

Establishing clear rules of the game in interbudgetary relationships is on the agenda of all municipalities, it is especially pressing for large and medium cities.

Chapter 3. Municipal Revenues in the Context of the Tax Reform

Small Business Taxation Reform

There are two special systems of small business taxation in Russia: a single tax on imputed revenues and a simplified taxation system. Although both these systems have certain features in common (e.g., in both cases the single tax takes the place of a similar list of taxes applied within the general taxation system; both systems may be introduced for legal entities and for private persons), their introduction aims and application mechanisms differ considerably.

The single tax on imputed revenues was introduced on the basis of Law No. 148-FZ of 31 July 1998. Initially, this tax was regional. The decision to introduce the tax, the detailed list of types of activities covered by the tax (within the framework of the list introduced by the federal law), the introduction of correction factors used to calculate the imputed revenues, tax benefits and other parameters were regulated at the level of the subject of the Russian Federation. In the event that the imputed revenue tax were introduced in the territory of a subject of the Russian Federation the tax became mandatory; i.e. an entrepreneur had no choice whether to pay this tax or the taxes envisaged in the general taxation system. The tax rate was 20 percent of the imputed revenues. Taking into account that the tax was regional, it would be distributed to the budgets of all levels, including the federal level, and the distribution ratios varied depending on whether the single tax was applied to a legal entity or to an entrepreneur.

It was envisaged that the tax would be introduced first of all for the types of operations that were related to considerable turnover of cash and were difficult to control. It was assumed that the scale of tax evasion in these fields was especially large and many economic agents were paying no taxes at all. The list of such operations included repair and construction services, consumer services to private persons, public catering (for public catering points with no more than 50 employees), retail trade (for shops with up to 30 employees, other stationary and non-stationary points of sale), short-term dwelling services, consultancy, bookkeeping, audit and legal services, teaching and tutoring services etc. At the same time it was assumed that conscientious entrepreneurs would find such a system beneficial since it would considerably decrease the number of taxes paid.

Table 3.1 shows that the imputed revenue tax failed to become a really important item of regional budgets. At the same time, the introduction of the tax entailed significant negative consequences. E.g., due to unclear criteria for the calculation of imputed revenues and a wide range of possibilities for the regional authorities to manipulate those criteria, entire sectors of economic activities became unprofitable in certain regions. This tax was also used to suppress competition. Moreover, introduction of the tax on the regional level resulted in objective limitations on its adequate application since, at the level of a subject of the RF, it is impossible to take into account the specifics of the economic situation in each particular municipality. As a result, in 1998 - 1999 entrepreneurs went on strike in a number of regions, protesting against the new tax.

The practice of regulating the imputed revenue tax differed greatly in various subjects of the RF. This tax was introduced at different points in time: i.e., in late 1998 in the Rostov oblast, and only in mid-2000 in the Tver oblast. This tax covered different kinds of activities; and, while, e.g., in the Sverdlovsk and Tver oblasts the list of such operations was much shorter than the federal list, in the Amur oblast, Kabardino-Balkar Autonomous Republic and the Krasnoyarsk Krai the tax applied even to the kinds of operations that were not included in the federal legislation. In certain regions the situation changed over time. E.g., in the Novosibirsk oblast the list of operations covered by the imputed revenue tax was initially rather limited, then it began to grow and finally it exceeded the limits provided for in the federal law. The methods used to calculate the imputed revenue were also different. E.g., in the Krasnoyarsk Krai 17 correction factors were used and two of them were introduced by local governance bodies. In some regions the distribution of funds between the regional and local budgets and contributions to the road fund were established on a long-term basis, while in other regions they were determined on an annual basis by the law on the budget. Moreover, these contributions could be uniform for all municipalities or be differentiated between them. The tax on imputed revenues of legal entities and entrepreneurs usually was distributed in different ways. E.g., in the Leningrad oblast the distribution of the tax on imputed revenues of legal entities was on the whole regulated by the legislation of the oblast, and the revenues from the tax on entrepreneurs were distributed in accordance with the law on the budget adopted on an annual basis. On top of that, in 2000 the ratio of deductions from the imputed revenue tax was established at the level that was uniform for all municipalities, 60 percent; in 2001, for three municipalities, deductions from this tax were not envisaged at all, and for the all the rest the ratio was 90 percent, i.e. the tax was received almost in full.

The situation with the simplified taxation system existing since 1995 was slightly different. This taxation regime was regulated at the federal level in more detail, and transition to this tax was voluntary. Regional authori-

ties were able to influence the single tax rate: it could be established either within the limit of 10 percent of the receipts, or 30 percent of the income. A certain patent value was introduced for entrepreneurs. This taxation regime was envisaged for the smallest businesses; its main aim, alongside with the reduction of tax burden, was to simplify the accounting and reporting in such way that this would not require special accounting skills.

This system failed to gain large-scale acceptance. It was mainly applied by entrepreneurs, and, according to the available data, not more than one percent of them¹². Transition to this system was limited by rather high tax rates (at least, for legal entities) and impossibility to deduct capital expenditure in any form. According to the data shown in *Table 3.1*, budgetary revenues are extremely low and in many cases have only symbolic meaning due to application of this system.

Federal Law "On Introduction of Changes and Additions to Part Two of the Tax Code of the Russian Federation and Certain other Legislative Acts of the Russian Federation, and on Declaring Certain Legislative Acts of the Russian Federation on Taxes and Fees Invalid" No. 104-FZ adopted in July, 2002, introduced significant corrections to the mechanisms of functioning of small business taxation systems.

As far as the single tax on imputed revenues is concerned, most of the changes in this area can be assessed quite positively. The list of operations, to which this system could apply, was somewhat shortened (e.g., construction was taken out), and the application criteria were specified (e.g., in the field of trade and public catering the criterion of the number of employees was replaced by that of area of the premises). A certain limitation was imposed on the arbitrary introduction by regional authorities of correction factors used to calculate imputed revenues. The number of such factors was brought down to three (and it should be noted that the rules applied to calculation of two of them are quite clear: factor K1 is calculated on the basis of the cadastre value of land¹³, and factor K3, on the basis of consumer price index. Factor K2 includes all the remaining conditions that are difficult to formalise (such as location, the range of goods and services, seasonality, time of work etc.). This factor may be fixed within the range from 0.1 to 1 in relation to the basic revenue level established in the Tax Code. The rate of tax has been established on the level of 15 percent of the imputed revenue¹⁴. The distribution of revenues from the tax on legal entities and entrepreneurs has been unified, and now 20 percent of the revenues are transferred to the federal budget, 70 percent are transferred to the budgets of the subjects of the RF and local budgets and 10 percent to the non-budgetary funds.

The simplified taxation system has undergone even greater changes. Transition to this system has remained voluntary; now the taxpayer is entitled to choose the taxation base: either the revenues or the revenues less incurred expenses.¹⁵ In the former case the rate is six percent, in the latter case it is 15 percent, which is considerably less than the previously established rates. The terms and conditions for the transition to the simplified system have been somewhat modified. The revenues from the single tax collected under the simplified system are distributed as follows: 30 percent go to the federal budget, 15 percent go to the budgets of the subjects of the Russian Federation, 45 percent go to local budgets and 10 percent go to non-budgetary funds.

Experts differ about the reform of the simplified taxation system¹⁶. It is noted that, while this reform reduces the tax burden in a number of cases, it fails to achieve the main goal, i.e. simplification of accounting and reporting. At the same time, there is a risk that large corporations would use this system to evade taxes. The law provides for certain limitations on application of the simplified system that are aimed at preventing such abuse of simplified taxation, but the limitations are not effective enough and their realisation mechanism has not been worked out in detail. Taking into account the aforesaid, the market conditions for small businesses may even deteriorate because big business will get competitive advantages by giving itself away as small business and availing itself of the beneficial taxation.

Throughout the term of their application, all special systems of small business taxation have had one feature in common, namely: taxation has been regulated at the federal and regional levels, while local budgets, at best, only received a fraction of such revenues. In the meantime, it is obvious that local authorities, on the one hand, have a much better understanding of the specific conditions of local markets, in which small businesses and entrepreneurs primarily operate, and on the other hand, can exert very significant influence on the formation of the

¹² According to the Head of the State Duma Budgetary Committee AD Zhukov, only 1 percent of businessmen are using the simplified system at present, and the state receives only RUR 5 billion (*Vremya Novostei*, 31 May, 2002).

¹³ However, according to the available information, due to lack of the land cadastre, in a number of regions this factor is established at the level of one for all businessmen, which increases the level of imputed revenues significantly.

¹⁴ The rate was reduced from 20 percent to 15 percent of the imputed tax in accordance with the amendments to the federal law of 31 December, 2001.

¹⁵ Starting from 01 January, 2003, only the amount of revenue less expenses is regarded as the object of taxation.

¹⁶ See Sapov, 2002; Shkrebel, 2002, 2003.

entrepreneurial climate for the small business. Consequently, it would be quite logical that the conditions of small business taxation were to a great extent determined at the local level.

Potential risks in this respect are that the local authorities have greater possibilities than the regional authorities to introduce benefits for affiliated by applying the differentiation criteria that would practically allow individual regulation. However, experience shows that even when local authorities cannot influence tax regulation, they still have numerous non-tax tools that help regulate the access to the local market quite effectively. This problem may be solved only by means of toughening budgetary limitations and awaking real interest of the local authorities in expanding their tax basis. Fixing at least a part of small business taxes as local taxes would help to solve this task. However, due to possible abuse of the simplified taxation system and probable modification of the mechanisms used to regulate small business taxation in the medium term, a compromise settlement is proposed at this stage.

It is advisable to make the imputed revenue tax local already now. I.e., the tax rate within its maximum limit and the correction factors used in calculating the imputed revenue should be established at the municipal level, and the entire amount of tax should be transferred to the local budget. As far as the simplified taxation system is concerned, taking into account the possibility to increase the revenues from this tax not owing to the real development of small business, but owing to large corporations using this scheme to evade taxes, it would be expedient to distribute the related benefits and risks equally between the budgets of various levels. Thus, retaining the ten-percent deductions to the non-budgetary funds, it would be possible to transfer the remaining 90 percent to the federal, regional and local budgets in equal portions (30 percent each). The following calculations of assigning revenue sources to local budgets have been based precisely on this prerequisite. However, if, in accordance with the existing law, the deduction ratio remains at the level of 45 percent, this is not going to affect the results of calculation in any way, since at present the revenues from the simplified taxation system are extremely low.

Table 3.1

Possibilities of Financing the Expenses of Consolidated Regional Budgets out of Proceeds from the Single Tax on Imputed Revenues, Simplified Taxation System and Sales Tax

	1998	1999	2000	2001	2002 (10 months)
Amount of sales tax transferred to the consolidated regional budget (RUR billion)	1.5	19.3	34.7	45.1	40.8
Amount of single tax on imputed revenues for certain types of operations transferred to the consolidated regional budget (RUR billion).	1.7	4.1	9.5	16.5	19.9
Amount of single tax collected due to application of the simplified taxation, accounting and reporting system transferred to the consolidated regional budget (RUR billion)	1.9	1.6	2.7	3.8	4.4
Expenses of the consolidated regional budget (RUR billion)	994.8	738.4	1164.1	1520.6	1482.3
<i>Proportion of the single imputed revenue tax for certain types of operations in the financing of the expenses of the consolidated regional budget (percent).</i>	0.0	0.6	0.8	1.1	1.3
<i>Proportion of the single tax collected due to application of the simplified taxation, accounting and reporting system in the financing of expenses of the consolidated regional budget (percent).</i>	0.2	0.2	0.2	0.3	0.3
<i>Proportion of the sales tax in financing expenses of the consolidated regional budget (percent).</i>	0.2	2.6	3.0	3.0	2.8

The Prospects of Transition to the Property Tax

The property tax has been traditionally regarded as a local tax and has been used appropriately in many countries. E.g., in Canada it is the only local tax, in the USA it is one of the main local taxes, in European countries it is also quite widely used. The prevailing interpretation of this tax as a local tax results from a number of reasons. Firstly, this tax has the features that under the traditional approach are regarded as especially suitable for local taxation, namely: it is relatively evenly distributed over the territory of the country; it has an immobile tax basis and is capable of bringing relatively stable tax receipts. Secondly, since a significant part of local authorities' activities results in increasing property prices (and surveys show that not only dwelling but also commercial property grows in price), the property tax is regarded as a kind of payment of the services of local authorities in this respect. Therefore, it has been traditionally assumed that receipts from this tax should be directed to the funding of the so called 'hard services', i.e., infrastructural operations, first of all. Thirdly, this tax is rather difficult to administer and requires large-scale collection, processing and actualisation of data at the local level.

Property taxation in Russia is represented by three property taxes: personal asset tax, corporate asset tax and land tax. The taxation basis used to collect those taxes is not related to the market value of the property. The drawbacks of such an approach are obvious:

- taxation is unfair because tax differentiation is not related to real differentiation of income or wealth;
- taxation fails to raise local authorities' interest in increasing the value of property, which is directly related to improvement of the quality of life of the population.

Additional negative effects are a consequence of the peculiarities of applying property taxes in Russia. In particular this manifests itself in the following:

- the corporate asset tax is imposed not only on immovable property but also on movables, which discourages investments;
- the rate of personal asset tax is so low that the receipts are comparable with the expenses on administering this tax;
- payments for the land are unstable, the rates of tax and rent are revised practically every year; this complicates calculations of economic efficiency of investment projects and negatively affects the competitiveness;
- a considerable part of newly erected facilities are not taxed since they continue to be carried as construction in progress.

At the same time, transition to property taxation requires that certain preconditions are established, and it is far from obvious that the necessary preconditions are present in the current situation in Russia. At the minimum, this requires developing a property market, in particular, the land market. This, in turn, implies clear delineation of the rights to the land, establishment of full-fledged institute of private ownership of land, liberalisation of the land market etc. All these issues are still waiting to be resolved. The market of property objects is developed unevenly over the country: while in oblast capitals it is more or less stable, in smaller localities sales are occasional, which prevents from establishing real market prices. Many other problems are also related to the transition to this tax.

Is the transition to property tax possible considering that the property market is underdeveloped and affected by various aberrations? In July 1997 it was resolved to carry out experimental introduction of property tax in Novgorod and Tver¹⁷; this experiment was aimed at answering the question. In accordance with the established terms and conditions, the property tax was introduced as a local tax and the receipts were fully transferred to the local budget. Taxable objects included plots of land, buildings, constructions and other property. Taxpayers were released from property taxes (with the exception of the tax on the means of transportation as part of the personal asset tax) and the land tax¹⁸. Local administrations were granted the right to establish the rates of property tax within the following limits:

- for individual dwelling houses, flats and dachas: no more than 0.5 percent of the assessed market value;
- for garages for one or two cars: no more than one percent of the assessed market value;
- for property facilities used for the purposes of industrial production: no more than two percent of their assessed market value.
- for other objects: no more than five percent of their assessed market value.

It was supposed to conduct the experiment in the period from 1997 till 2003.

The experimental results received produce a mixed impression. The property tax in Novgorod has been applied since 2000 only to the enterprises that own both land and property facilities. The rate of property tax has been established on the following level:

- for individual dwelling houses, flats, living quarters and dachas owned by legal entities: 0.5 percent;
- for property facilities used for industrial production: two percent.

Other tax payer categories are free from the tax. In Tver the tax has not been introduced up to the present moment.

Naturally, such delays in the performance of the experiment need an explanation. Therefore it is expedient to study the practice and problems of the participating cities and to find out the main achievements and drawbacks.

¹⁷ Federal Law "On Conducting an Experiment on Property taxation in the cities of Novgorod and Tver" # 110-FZ was adopted in July 1997; in November 1999 amendments to the Law were adopted.

¹⁸ This collides with the imputed revenue tax. Since, among other taxes, this tax replaces the property tax but does not replace the land tax, it is difficult to establish the property tax.

The most important lesson that one can learn from the experiment is that it was not the insufficient development of the property market that caused the critical problems, which the participating cities encountered and which, in particular, impeded the experiment in Tver. The reason of the problems was the necessity to overcome the lack of contacts between government agencies carrying out the cadastre and technical accounting of the property, registering the right of ownership and the corporations and taxpayers holding the corresponding information. E.g., in Tver the normative base of the register was not developed; as a result, the register of property facilities contained lacunas and was not updated. The parties engaged in the experiment failed to establish cooperation between local and regional agencies, which, particularly, negatively affected the inclusion of legal information in the register. In Novgorod these issues have been solved: a property register for taxation purposes has been established and put into operation that contained data on the facilities, rights and right owners, which created the grounds for transition to the property tax. This was not particularly easy to accomplish either: e.g., conflicts with the tax services used to occur. However, a viable scheme of property tax administration has been created in the course of experiment; a short description of the scheme follows in *Table 3.2*.¹⁹

Table 3.2

Distribution of Property Tax Administration Functions in Novgorod

Property Tax Administration Functions	Agency in Charge
Determination of the order of tax collection	City Duma
Keeping the property register for taxation purposes	City Administration, Department of Economic Regulation*
Property assessment, issuance of assessment reports, appeals on accounting and reporting	Department of Economic Regulation, outside valuers
Issuance of tax bills	Department of Economic Regulation
Tax collection	State Tax Service
Tax collection monitoring	State Tax Service
Enforcement of tax payment	State Tax Service
Administrative consideration of appeals	Complaint Consideration Commission

* The Department of Economic Regulation organises and co-ordinates the keeping of the register, and the Committee for Land Resources and Organisation of Use of Land, the Municipal Technical Inventory Bureau and the Committee for the Management of Municipal Property are responsible for including the data in the register.

As far as the determination of property market value is concerned (which, on the face of, presents the biggest problem), in Novgorod this issue has been resolved as follows. The property assessment model based on comparative sales method has shown quite good results in the course of operations with residential property and commercial objects. This method allows assessing the value of an object by analysing prices of deals with and offers of other objects. To carry out a deal, a number of methodologies of mathematical-statistical analysis are used: multiple regression analysis, feedback method etc. However, practically no data on market sales have been available for the residential property, and especially industrial property. Hence, the so-called cost-based method has proved more adequate; this approach is based on establishing the cost of construction of a similar object less physical, economic and functional depreciation²⁰. The mass assessment method is used for taxation purposes, and it is proposed to call in independent valuers in case of disputes over or complaints against the amount of tax assigned. All objects included in the register undergo market assessment.

Other conditions for large-scale transition to collecting property tax have also been created: the issues of taxation of construction in progress have been studied²¹ and the objects whose owners do not present the necessary data on their property have been assessed²². At the same time with creating the register, an overall stocktaking of property objects was carried out. Upon the taking of stock and revaluation, the number of registered ob-

¹⁹ The table demonstrates that a considerable part of the functions relating to tax administration rests on the shoulders of the city administration. In our opinion, this is an argument for the permission to establish local tax authorities that would administer local taxes, in particular such taxes that are too difficult for the State Tax Service to administer.

²⁰ The cost-based method has allowed to obtain more adequate results in assessing such complicated specialised objects of real estate as, e.g., refrigerated warehouses. Application of the sales comparison method produced an understated assessment for such objects since they were usually not offered in the real market; instead, simple design warehouses were sold.

²¹ An object of construction in progress can be regarded as real estate for construction purposes if, upon expiration of the initial construction period stated in the design and estimate documentation the object has not been either commissioned or temporarily closed down in accordance with the established procedure.

²² In case the officials representing the agency in charge of accounting and tax appraisal are not allowed to survey the facility or denied access to the documentation necessary for tax calculation purposes, the taxable value of an object of property is established on the basis of the assessed value according to the available data or to similar objects. In this case the taxpayer loses its right to lodge complaints against the decision on the object's assessment for the current accounting period.

jects in Novgorod increased considerably; the number of garages more than doubled and of other non-residential objects, grew more than 25 percent. The legal status of the newly discovered objects was also determined. In particular, it was established that the ownership rights of individuals had been registered for only half of the 14,000 thousand garages registered in the city's books.

However, in reality all this preparatory work has entailed quite modest results. At present only 19 enterprises participate in the experiment. Throughout year 2002 numerous variants of personal asset tax were considered, including owners of garages, residential property, individual dwelling houses etc., but no practical steps were made. The financial results also failed to justify the hopes pinned on that tax. E.g., in 2000 the city budget's revenues from property tax were RUR 386.8 thousand or RUR 497 thousand less than plan revenues from the replaced taxes. Thus, the tax burden on the enterprises participating in the experiment was significantly lowered. The losses have been partially offset by a growth of the income tax, although, obviously, various factors contributed to this growth and it is rather difficult to single out the result of abandoning the tax on movable property. In 2001 the situation somewhat improved, but one of the experiment's aims, namely keeping the income at a level not lower than under the old system, has never been achieved.

The rent for the land that logically follows from the transition to the property tax has not been reformed. The rates of rent for one and the same plot of land differ greatly by tenant category (commercial tenants, industrial tenants, and budgetary and subsidised tenants). E.g., the rates of rent for the former category are approximately one half of the rate of land tax; at the same time, a kiosk pays up to 250 percent of the market value of the land that it rents.

At the same time it is obvious that the real potential of the property tax differs from the picture created in the course of experiment realisation. In the beginning experts made a forecast of the impact that the transition to the property tax and associated reforms would have on the city's enterprises. Two percent were taken as the base rate for the property tax and 20 percent, as the base rate for land tax. Reduced taxation factors were introduced for industrial objects (50 percent) and for social, cultural and consumer facilities (15 percent).

Calculations have produced the following results. For more than 60 percent of enterprises the transition to property tax entailed losses, including 13 percent of enterprises, for which the tax burden grew more than tenfold. For approximately 40 percent the transition proved profitable, including 20 percent whose profits were considerable (more than twofold). The main factors contributing to tax burden growth included an increase in the rent for the land and, in certain sectors of economy, cancellation of benefits envisaged in the property tax. The main factors of tax burden decrease included transition from the book value to the market value of the property, reduction of the tax basis under the property tax and, in certain cases, reduction of rent for the land.

Hotels were the greatest losers upon transition to the new taxation systems as the change from book value to the market value affected the increase in tax burden. In this case the share of losers was 100 percent, including 30 of those percent whose tax burden grew tenfold or more. In social spheres (sports, culture, education, medicine) the number of losers was six times greater than the number of winners, mainly due to cancellation of tax benefits. In the sector of retail trade, credit and finance, insurance, audit and mediator companies the amount of winners and losers was approximately the same. In the industrial and construction sector this correlation was formed at the average level for whole sector, 60 to 40 percent.

Thus, the analysis demonstrates that, in respect of legal entities, property assessed at market value on the whole constitutes approximately one half of the basis of enterprise property tax and that the revenues from the tax, when regarded in isolation, are bound to sink (unless the rate of tax is significantly increased). However, in case of package reforms that include cancellation of most of tax benefits and restructuring of land rent, budgetary losses could be minimised. In doing so, it should be kept in mind that such reforms are rather painful for a considerable number of enterprises and in certain cases may result in material financial problems.

As for individuals, the situation is quite the opposite: according to projections, the transition to assessment at market value, even if the rate of tax remains at the level of 0.1 percent, would result in an increase in tax revenues of, on average, more than 2.7 times (2.75 times for residential objects, 1.45 times for non-residential objects and 2.68 times for garages). E.g., according to available assessments, the introduction of property tax on garage owners would result in an increase of budgetary revenues from RUR 1.067 thousand to RUR 4.774 thousand (depending on the rate and basis of taxation), which would offset the year 2000²³ losses from tax on property of enterprises many times.

The slow rate of conducted reforms is usually explained by drawbacks of the federal law, primarily in the field of land tenure, registration of rights of ownership etc. There is no doubt that these factors play a considerable role. However, they are not enough to explain the existing situation. It is obvious that the city administration

²³ 10 enterprises participated in the experiment at that time.

has been trying to avoid unpopular or painful steps throughout the experiment. The property tax was introduced only in case it was favourable for the taxpayer; therefore the achieved results are practically not representational. The wish to avoid social conflicts considerably outweighed the commitment to replenish the local budget.

It should be noted in this connection that such policies of local authorities were totally rational. Considering the lack of financial guarantees at the municipal level, full disclosure of the tax basis and utilisation of all the reserves of income growth would inevitably result in reductions of other sources of income, and so it was far from obvious that the city would have any financial gains. Thus, upon paying a social price for unpopular reforms, the city's leaders would most probably not be able to reap any positive results (such as an increase in budgetary revenues and improved municipal services to the population). In that way, aberrations in the course of the experiment and a tendency towards populist measures are explained mainly by the inherent drawbacks of the financial system existing at the municipal level (these drawbacks have been described in the previous chapter). As a matter of fact, the course of the experiment in Novgorod totally confirms the conclusions made. So, it was not accidental that the city administration put the lack of long-term policy of interbudgetary relationship before all the factors impeding the experiment's acceleration.

Thus, up till now the experiment has failed to reveal the true potential of the property tax and, at the same time, has disclosed that there are serious factors preventing its large-scale introduction. Taking into account the aforesaid, the alternative of immediately introducing the property tax is improving taxation mechanisms used to collect three property taxes that have so far remained separate. In respect of these mechanisms, the following directions of tax reform are now under discussion:

- in relation to the personal asset tax: transition to assessing the property owned by individuals at market value (on the basis of the methodology prepared with the account of the Novgorod experience);
- in relation to corporate asset tax: partial removal of the active assets (above all, turnover funds) from the taxable basis;
- in relation to the land tax: transition to establishing the taxable basis using the cadastre value of land.

It is also assumed to expand the taxable basis of these taxes by including the objects that previously did not come within this tax.

It is assumed that personal asset taxes and on land will remain local and the corporate asset tax will remain regional. It is also planned to reduce sharply the amount of benefits granted under these taxes. On the whole, this approach seems quite promising; however, the details of regulation of each tax require further discussion.

E.g., as far as the personal asset tax is concerned, the transition to assessing it at market value is rather difficult and requires a lot of effort. According to the Novgorod experience, the main difficulties lie not only in the mechanism of property assessment (it is proposed to assess the property in accordance with the single governmental methodology), but also in the forming of a register of objects of property, which requires collection, processing and constant updating of large amounts of data and close co-operation between municipal and regional administrative agencies. Therefore, in the beginning, the maximum rate of tax could be significantly increased without changing the mechanisms of tax basis assessment. This measure would make this tax a more important source of income for local budgets and would create incentives for better clarification of the tax basis and collection of the necessary data. According to the available estimates, at the present time local administrations have data on no more than 50 to 75 percent of objects of property located in their territories. The options of regulating the rate of personal asset tax assessed both at the book value and the market value, together with the consequences of the selection of these options, are analysed in Annex 3.1.

Besides, taking into account the local nature of the personal asset tax and the land tax, it would be expedient not to go beyond general regulation of the tax basis and the maximum rate leaving the differentiation of taxation, introduction of tax benefits and other specific issues at the option of local authorities.

While focusing on improving taxation under the three property taxes, it is nevertheless necessary to keep in view the prospect of transition to the property tax and to create the best conditions for such transition. Moreover, in accordance with the international practice and taking into account that (as the Novgorod experience has shown) a lot of work and considerable investments are required at the local level, it is expedient to make this tax local. To this end, it is advisable to stick to the following approaches:

Firstly, assign all property taxes and rents to the local level. There is no sense in keeping the corporate asset tax regional under such conditions²⁴. This tax should either become local (however, relatively strict regulation of the tax at the federal level should remain so that it would not be possible to shift the tax burden from the popula-

²⁴ If, nevertheless, it is decided not to transfer this tax to local budgets in full, it can remain regional.

tion to the business at a large scale), or it can be made federal for a certain period of time, but the revenues would be transferred to the local level in full. Usually, the chief argument against such a proposal is that excessive differentiation in revenues of municipal agencies is possible owing to factors that do not depend on efforts of the local authorities or the local community. Calculations will show the extent to which this menace is real. However, it should be noted that if active assets are partially excluded from taxation, this would reduce the taxation basis for the tax in question, and transition to assessment at the market value would decrease the existing differences even more.

Secondly, draw the existing property tax rates (here: maximum rates) together. The authors believe that at present it is possible to establish the maximum rate of all these taxes at the two-percent level and to allow municipalities to carry out independent policy in respect of local taxation. However, under these circumstances we encounter the issue of tax potential assessment in the course of calculating financial aid at the regional level. Apparently, in the case in question it would not be correct to use the maximum rate of tax determined in the law as the benchmark. Taking into account the international practice, it would be preferable to determine the average actual rate for this tax for all municipalities of the corresponding region in the preceding period and to use this rate in calculations of the tax potential.

Thirdly, establish a period of transition in the course of which municipalities may carry out the transition to the property tax as the necessary conditions are formed. Upon completion of this period, the introduction of property tax should become mandatory. This period can be rather long but the prospects should be clearly set. Otherwise, there is no reason in hoping that municipalities would invest considerable funds in forming conditions for the introduction of property tax. The period of transition can include two stages: at stage one, assessment of tax basis for the personal asset tax and land tax at the market value and cadastre value, correspondingly, is introduced; as stage two, full-scale transition to the property tax takes place.

Abolition of the Sales Tax

Introduction of the sales tax in the Russian Federation began in 1998. It was introduced at the local level, at the option of local authorities; in doing so, local authorities abolished 16 local taxes. According to the federal law, the sales tax was distributed between the regional and local level at a ratio of 40 to 60. At the present time, the sales tax has been introduced in most of the regions, although not all of them. Experience demonstrates that the revenues under this tax usually failed to make up for the taxes abolished upon its introduction. E.g., in the Leningrad oblast (in which the sales tax has not been introduced) the revenues from local taxes are more than two times as great as the revenues from the sales tax in the Sverdlovsk oblast, which is comparable in respect of its economic situation. In the Krasnoyarsk Krai, where the sales tax has not been introduced either, the situation is similar.

The sales tax is regarded as an interim measure. In accordance with the existing legislation, this tax is going to be abolished starting from 1 January, 2004. This is explained by the fact that the simultaneous application of the VAT at the federal level and a sales tax at the regional level is regarded economically unjustified.

Indeed, in accordance with traditional approaches, simultaneous collection of two consumption taxes regulated under different rules is regarded unjustified since it complicates tax reporting for economic entities, increases their expenses and impedes tax administration. Out of two main consumption taxes, the VAT and sales tax, the former is more preferred since it is difficult to evade and allows avoiding the cascade effect of product price growth, which is practically impossible in the case of the sales tax.

At the same time, decentralisation processes that lead to the growing importance of regional and local authorities make researchers look for new sources of subfederal revenues; hence, their attention is again drawn to consumption taxes. R. Bird in the 1999 publication, upon considering the possibilities of harmonising the regional VAT and the federal VAT, proposed the regional VAT as the new subfederal tax. At present, consumption taxes are collected both at the federal and regional levels in Brazil and Canada; introduction of such a scheme is being discussed in Argentina and India. In Canada, there is quite positive experience of applying the provincial VAT in some provinces and the provincial sales tax together with federal VAT in other provinces.

As for Russia, international experts do not see any material aberrations in relation to the application of a regional sales tax at the same time with the federal VAT in case the rates are not excessive (within the existing five percent boundaries) and the rules of collecting the two consumption taxes are as unified as possible (The VAT, ... 2002). At the same time, it is necessary to take into account that fulfilment of the decision previously made in respect of the sales tax would confirm the consistency and predictability of the Russian government's tax policy, which is of crucial importance for the establishment of a favourable investment climate and is not directly related to the issue of positive or negative features of a certain tax. It should also be taken into consideration that the sales tax has not gained critical importance as a source of income for regional and local budgets (although, the

revenues from this tax are appreciably higher than, e.g., from the imputed income tax). According to the data in *Table 3.1*, revenues from this tax have been quite stable over the past years; approximately, three percent of the consolidated regional budget's expenses have been covered out of these revenues²⁵. Under such circumstance, abolition of the tax would probably be justified.

At the present time, the issue of sales tax is open to discussion; arguments both for and against its abolition on 1 January, 2004 are produced. In this connection, this survey analyses various options of assigning sources of income both including the sales tax and without it. In addition, it is analysed if the sales tax is efficient in covering municipal expenses in the event that this tax were fully transferred to the local budgets or were made a local tax.

Annex 3.1. Analysis of the Personal Property Tax

At present the personal asset tax is practically immaterial; sometimes it even fails to cover the expenses on its administration. E.g., in 2001 in large cities the average amount of this tax was cca. RUR 11 (the range was from RUR 1 to RUR 40 per capita). A significant growth may be observed in comparison with 1999, when the average amount of that tax was only slightly more than RUR 4, and it is obvious that there is a quite considerable potential of further growth.

The following approach was used to assess the growth potential of the personal asset tax. It may be assumed with a high degree of probability that local authorities will not establish this tax at a level exceeding the one that allows receiving, on average, one percent of revenues from each inhabitant of the municipal entity. Most probably, the tax will be progressive. The level of the rent that the persons living in municipal housing pay is established in correlation with the level of the property tax imposed on objects of private property. Thus, it would be expedient to regard these two payments together, without dividing the population of municipal entities into persons living in municipal and in privatised dwellings.

Since the data on the revenues of the population is not available, the approach described in Chapter 5 has been used. All municipalities have been divided into three groups, depending on the full amount of the income tax and small business taxes collected in their territory in respect of individuals; this value was taken as an indirect indicator of the revenue level of the population. Then the data on the revenues of the population on average for the region were used, and then the coefficient of 1 was applied in case of municipalities with low revenues of the population, the coefficient of 1.25 in case of municipalities with medium revenues and the coefficient of 1.5 in case of municipalities with high revenues. In an overwhelming majority of cases this approach produced quite adequate results; in a small number of municipal entities this data required modification, though²⁶. The assessment results are shown in *Fig. 3.1.1* and *3.1.2, Chart 2*.

Obviously, the existing system of regulating the personal asset tax prevents from collecting this tax in an amount that seems optimal to municipalities and affordable to the population. To create conditions for transition to property tax it would be expedient to establish the tax rate at a level that similar to the rate of corporate asset tax. At the same time, considering the local nature of this tax, it is necessary to confine oneself to regulating only its highest rate, leaving the issues of differentiation at the option of local governments. Taking into account that due to the existing progressive scale of property tax and lack of data on the book value of housing by municipal entities it would be difficult to assess the real rate of this tax, let us assume that upon transition to the two-percent rate the overall amount of tax payments may increase 20 times at the maximum. In this case we are interested in calculating two indicators: the maximum possible tax potential for this tax (with the account of the rent) and the tax potential with the account of differentiation of the tax rate, possible tax benefits etc.

The maximum tax potential is calculated based on the premise that all benefits under this tax are abolished, its rates are not differentiated and the rent level introduced is similar to the property tax. Hence, the calculation proceeds as follows:

- 1) the existing personal asset tax grows 20 times;
- 2) the value derived in Par. 1 increases 20 percent since, according to expert opinion, this is the amount of benefits granted under this tax;

²⁵ Quite appreciable differences between regions hide behind average figures. E.g., as we have already noted, in the Leningrad oblast and the Krasnoyarsk Krai this tax has not been introduced at all. At the same time, e.g., in the Saratov oblast five percent of the consolidated regional budget's expenses are covered due to the revenues from this tax; in the Chuvash Republic: 4.5 percent.

²⁶ E.g., the modification was required in case the average data for the region included extremely high revenues in the territories with very rich treasures of the soil to which the municipality in question has no right. Another option: the average data for region include the revenues of the northern territories, and the municipality itself is located in the Southern part of the region. In both cases the data has been adjusted towards a lower value.

- 3) then the value derived in Par. 2 increases by another 40 percent that should be received due to introduction of the rent, taking into account at present that the average proportion of privatised dwellings is cca. 60 percent (the data on the proportion of privatised housing by municipal entities is not available).

Thus, the maximum tax potential is calculated according to the formula:

$$T_{ij}^{(pat,bv)}(\max) = 1,4 \cdot 1,2 \cdot 20T_{ij}^{(pat,2001)} = 33,6T_{ij}^{(pat,2001)},$$

where $T_{ij}^{(pat,bv)}(\max)$ is the maximum potential of the personal asset tax assessed at book value in the i municipality of the j region; $T_{ij}^{(pat,2001)}$ is the personal asset tax in the i municipality of the j region in 2001.

The results of the calculation are shown in *Fig. 3.1.1, Chart 1*.

The forecast of the tax potential with the account of tax differentiation and the benefits is carried out as follows:

- 1) the existing amount of personal asset tax is increased 20 times; in doing so it is assumed that the differentiation of rates under this tax would result in losing an amount comparable to the existing amount of benefits;
- 2) the amount derived in Par. 1 is increased by another 30 percent since the rent will most probably be established at a level slightly below the property tax.

Hence, the tax potential forecast is carried out by the following formula:

$$T_{ij}^{(pat,bv)} = 1,3 \cdot 20T_{ij}^{(pat,2001)} = 26T_{ij}^{(pat,2001)},$$

where $T_{ij}^{(pat,bv)}$ is the potential of the personal asset tax in i municipality of the j region; $T_{ij}^{(pat,2001)}$ is the personal asset tax in the i municipality of the j region in 2001.

The results of the assessment are shown in *Fig. 3.1.2, Chart 1*.

To assess the tax basis of the personal asset tax upon transition to market prices for such property the information on the housing market by cities is necessary. Such information in systematic form is non-existent. There is data on market prices of the housing by regions; this information can be found in two sources, namely the data of the RF State Committee for Statistics and the assessments by the RF State Committee for Construction used in the course of realisation of the State Housing Certificates Programme. For purposes of this analysis it would be preferable to use the data provided by the State Committee for Statistics that mainly reflect the situation in large cities. However, this data is available only by federal superregions for 2001, which is obviously not enough. Therefore, the annualised quarterly data provided by the State Committee for Construction have been used for the calculation, and this data is slightly lower since it is to a considerable extent related to average regional values. The per capita taxation basis and the rent have been determined based on the average availability of housing in each of the regions.

This calculation basis has been used to find the same indicators as for the personal asset tax assess at book value, namely the maximum tax potential and the tax potential with the account of differentiated rate and introduced benefits. To calculate the maximum tax potential, the taxation basis was multiplied by the rate of tax. As for the tax potential with the account of differentiated rates and introduced benefits, the values derived in the course of calculating the maximum tax potential were lowered 30 percent (divided as follows: losses from differentiation (benefits) common for the property tax and the rent, 20 percent; losses from additional rent benefits, 10 percent).

The personal asset tax assessed at market value has been calculated in three versions. Version one implied introduction of tax rate of 0.5 percent of the half market value of the property. This version reflects the approach taken in one of the draft articles on property tax in the Tax Code. Version two is based on introduction of a maximum rate of two percent of the full market value of the housing. Version three, provisional, implied introducing a rate of one percent of the full market value of the housing. In other words, the calculation was carried out in accordance with the formula:

$$T_{lij}^{(pat,mv)}(\max) = t_l \lambda_l O_{ij}^{(h)} p_{ij}^{(h)} N_{ij}^{(2001)},$$

where $T_{lij}^{(pat,mv)}(\max)$ is the maximum potential of the personal asset tax assessed at market value under

version l in the i municipality of the j region; $t_l = \begin{cases} 0,005, & l = 1, \\ 0,02, & l = 2, \\ 0,01, & l = 3 \end{cases}$ is the tax rate under version l ;

$\lambda_l = \begin{cases} 0,5, & l=1 \\ 1, & l=2;3 \end{cases}$ is the tax basis adjustment coefficient²⁷ under version l ; $O_{ij}^{(h)}$ is the indicator of average availability of housing in (m² of total space per one person) in the i municipality of the j region; $p_{ij}^{(h)}$ is the market value of one square meter of housing in the i municipality of the j region; $N_{ij}^{(2001)}$ is the amount of population in the i municipality of the j region in 2001.

The tax potential with the account of differentiated rates and introduced benefits has been calculated by the following formula:

$$T_{lij}^{(pat.,mv)} = 0,7 \cdot T_{lij}^{(pat.,mv)}(\max) .$$

The results of calculation of the maximum tax potential under these versions are presented in *Charts 3, 4, 5, Fig. 3.1.1*; the results of calculation of the tax potential with the account of differentiated rates and introduced benefits, in *Charts 3, 4, 5, Fig. 3.1.2*.

In performing comparative assessment of these versions, a number of factors should be taken into consideration. Firstly, the selected version of personal asset tax regulation should not only permit to establish a rate that would on average allow collecting in the form of the tax cca. one percent of the individuals' average yearly income, but also permit to introduce differentiated rates; thus, it should substantially exceed the line of *Chart 2* in *Fig. 3.1.1* and slightly exceed the line of *Chart 2* in *Fig. 3.1.2*. Secondly, if the situation is considered on the whole, by municipal entities, and not by large cities, then real estate prices would be considerably lower in many of the entities, and revenue estimates would change only to a small extend since they are based on average regional indicators.

It becomes obvious at once that the draft versions of the Tax Code not only fail to take account of the above-stated factors, but also prevent from establishing the tax at a level corresponding to one percent of the average yearly revenues of the population. This version clearly underestimates the potential of the personal asset tax in a sizeable number of municipal entities. As for the comparison between versions two and three, taking into account the above-stated considerations, version two (two percent of the full market value of the real estate) seems preferable as it gives more freedom of manoeuvre than version three, which, just like the Tax Code version, prevents from fully using the potential of the property tax in cities with high revenues of the population.

Establishing the maximum rate of personal asset tax at a considerably higher level than the estimated rates in the majority of municipal entities poses at least two issues of material importance for the regulation of municipal finances.

Firstly, there arises the issue of assessing the potential of this tax in calculating the amounts of financial aid at the regional level. In this case it would be obviously incorrect to use the legally determined maximum rate as the benchmark. Taking into account the international practice, it seems advisable to determine the average actual rate of this tax for all municipal entities of the corresponding region and use it for calculations of the tax potential.

Secondly, it is necessary to determine the extent to which municipal entities may have free hand in differentiating tax rates, introducing benefits etc. In countries where local taxes are not strictly regulated by the state, limitations on the differentiation of property tax rates are sometimes introduced. This measure is aimed primarily at protecting entrepreneurs from municipal entities' attempts to shift to them a disproportionately large share of municipal expenses. Maybe in future such mechanisms will be used in our country, too. However, to do this we need to acquire real experience of municipal regulation of large local taxes, assess the positive and negative aspects of such activities and understand, in what direction such measures should be applied. It seems inexpedient to introduce these measures at the present time.

²⁷ коэффициент учета налоговой базы

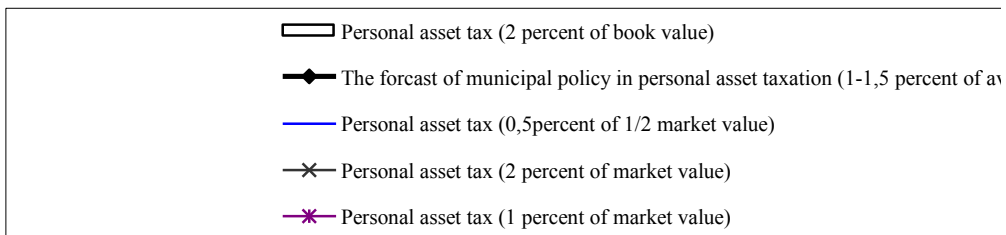
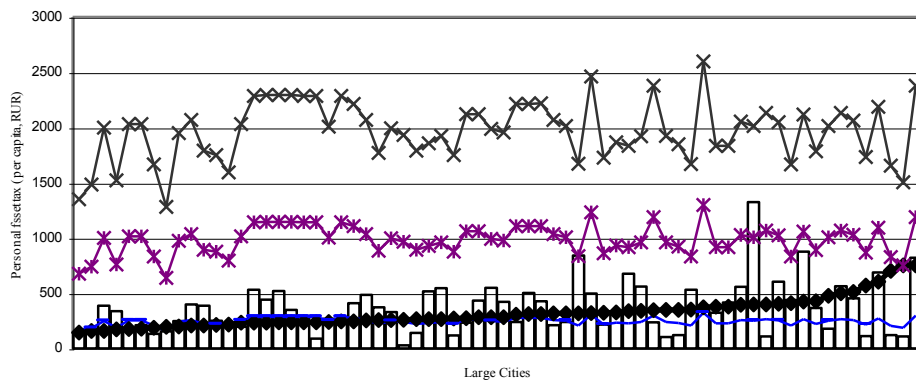


Fig. 3.1.1. Assessment of the maximum potential of the personal asset tax (including the rent)

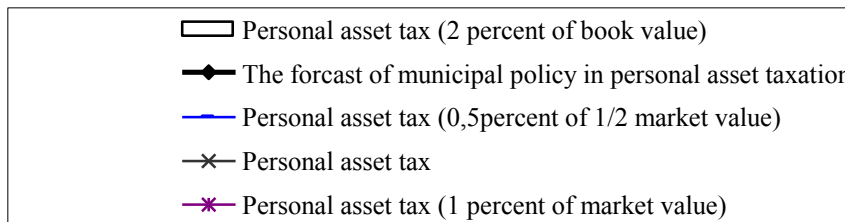
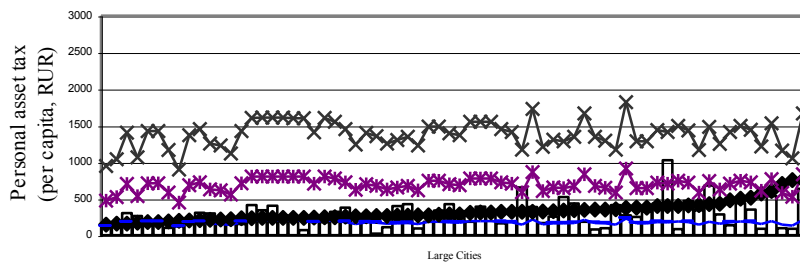


Fig. 3.1.2. Assessment of the maximum potential of the personal asset tax with the account of differentiated rates and introduction of benefits (including the rent)

Chapter 4. Municipal Expenses: Current Status and Future Prospects

Budgetary Expenses of Municipal Entities

The structure of municipal entity expenses includes more than 15 lines; over 50 percent of local budgetary expenses are related to the development of the human capital, cca. 25 percent to the services affecting property value and less than 10 percent, to business support.

Only four expense items account for approximately three fourths of all municipal expenses: housing and utility services, education, health care and social policy. The structure of municipal budgetary expenditure in Russia is shown in *Table 4.1*.

Table 4.1

Structure of Municipal Budgetary Expenditure in the Russian Federation as a Whole (%)

<i>Code</i>	<i>Items of Expenditure</i>	<i>1995</i>	<i>1998</i>	<i>2000</i>	<i>2001</i>
0100	STATE ADMINISTRATION AND LOCAL SELF-GOVERNANCE	3.2	5.0	5.8	6.3
0700	INDUSTRY, ENERGY AND CONSTRUCTION	1.7	0.0	1.2	9.0
1000	TRANSPORTATION, ROAD-BUILDING AND ROAD MAINTENANCE, TELECOMMUNICATIONS AND INFORMATICS	3.9	3.2	3.0	2.1
1200	HOUSING AND UTILITIES SECTOR	26.4	27.8	28.2	23.4
1400	EDUCATION	24.1	26.0	27.4	27.3
1700	HEALTH CARE AND PHYSICAL CULTURE	14.9	13.8	15.7	14.4
1800	SOCIAL POLICY	6.9	5.3	4.6	6.9
	OTHERS	18.9	18.9	14.1	10.6
	TOTAL	100	100	100	100

The data in *Table 4.1*. allows to suppose that in 2001 considerable structural changes occurred as compared with 2000. However, to make a conclusion in this area a more detailed analysis is required. The matter is that in 2001 (unlike in 2000) all capital expenditure was posted to the item "Industry, power engineering and construction", hence the data is not fully comparable. This factor will be taken into account in the course of further analysis.

It is evident that at present the expenses of municipal entities, instead of corresponding to the powers, which have been assigned to them, reflect the general lack of regulation in the distribution of functions and responsibilities between various levels of power as well as the constant shortage of funds that results in insufficient financing of a number of budget items and accumulation of budget debt. And what is more, regional differences in these issues are quite substantial. It is necessary to analyse in detail the contents of various items of expenditure, find out the inevitable factors of expenditure growth and the possibilities of abating them, and understand how a change in the scope of municipal entities can affect various lines of municipal expenditure. The main aim of the analysis carried out in this Section is to estimate the effect that all these factors have on the expense side of local budgets.

Potential and future expenditure of local budgets

Continuos underfunding of a number of items in local budgets in the course of the past six to eight years has lead to permanent accumulation of accounts payable that have not been formally reflected in the budgetary classification. E.g., according to the data available for year 2000, accounts payable and debt were: in Lipetsk, 41 percent; in Kaliningrad, 44 percent; in Krasnoyarsk, 45 percent; in Novosibirsk, 64.7 percent; in Voronezh, 92.8 percent; in Perm, 100 percent; in Saratov, 147 percent of budgetary expenses (Mateyuk, 2000, page 18). As the data in *Table 4.2*. demonstrate, the amount, structure and dynamics of this debt differ considerably in different municipalities even of comparable sizes.

Generalised data on the total debt of municipal entities is not available. However, there are indirect assessments that may be used in this context. E.g., according to the available information, the main debts of municipalities results from partial payments for housing and utility services relating both to subsidies for the services to the population and to covering the corresponding expenses of municipal institutions in the field of education, health care, social policies etc. According to the official data provided by the Russian State Committee for Construction, as at the beginning of 2001 in Russia on the whole this debt was RUR 247 billion, or more than 40 percent of

total expenses of municipal entities. As at the end of 2001 it grew to RUR 253 billion. Since other data is not available, we will use only this type of budgetary debt in the analysis.

Table 4.2

Accounts payable (% budgetary expenses)

<i>City*</i>	<i>1996</i>	<i>1997</i>	<i>1998</i>	<i>1999</i>	<i>2000</i>	<i>2001</i>
1	N/A.	1	49	13	4	0
2	33	32	46	48	9	11
3	36	51	120	79	77	84
4	N/A.	N/A.	104	75	15	7
5	38	58	87	65	47	21
6	N/A.	N/A.	N/A.	N/A.	14	8
7	N/A.	N/A.	N/A.	N/A.	117	77

* The table contains data on the cities included in the sampling. However, since municipal administrations sometimes consider this data confidential, the names of the cities are not given.

The data on budgetary debt not accounted for in the budgetary reporting is necessary for two directions of analysis.

Firstly, lack of formal recognition of the debt fails to solve the problem in essence and does not prevent creditors from exercising pressure on municipalities so that the latter would repay their debts (especially if a creditor is a natural monopoly and it is impossible to refuse its services). RAO United Energy Systems has taken an extremely austere stance in this respect. As a result, in 2001 current payments to that 'Big Energy Company' were made almost in full. Anyway, accumulated debts also have to be repaid. This is why, although accounts payable for housing and utility services are not included in budgetary classification, almost all regions informally account for it.

Secondly, debt accumulation reflects the fact that some items of the municipal budget are undervalued since the allocated funds prove insufficient for covering real expenses. However, it is year-on-year dynamics of the accumulated debt, not its total amount, that play the key role in this respect. E.g., in 2001 the debt grew RUR 6 billion, or 2.4 percent, and the situation differed considerably from municipality to municipality: some of them continued to accumulate debts and others not only were making current payments but also repaying the debt.

Another item of expenditure that is bound to grow in importance in the near future is the servicing of municipal debt. It is evident that constant underfunding of municipalities' capital expenditure cannot go on indefinitely; therefore municipal entities will start to look actively for the sources of capital expenditure funding. The most natural and tested mechanism in the international practice is related to borrowing. Hence, expenses on the servicing and repayment of debt should be carried as contingent liabilities of local budgets.

An increase in expenses will also be related to an increase in the salary of municipal personnel and public sector workers. Starting from December, 2001, quite radical decisions have been made in this connection, and this has already caused serious problems with the funding of regional and municipal expenses in 2002. As at 1 August, 2002, in 32 regions there have occurred problems with paying salaries to public sector employees. However, it is obvious that the salary growth of public sector employees is a natural and long-term trend that should be accounted for in projecting future municipal expenses.

Housing and utility services

Since housing and utility services are one of the main items of expenditure in municipal budgets, the dynamics of this item affect the change of total expenses. On average in the country, the share of this item was 28.2 percent in 2000 (the largest item of expenditure) and 23.4 percent in 2001 (second largest item of expenditure). However, taking into account the expenses on capital construction (in case we suppose that they are at the level of 2000), one can assume that the reduction is not that great and in reality the average share of the housing and utility services was cca. 27 percent. On the whole in Russia, the main part of the expenses of the housing and utility services is funded precisely from municipal budgets; regional expenses under this item are small, although a trend towards their growth has been observed in the past years. As one can see in Annex 4.1., in 2001 in 22 percent of subjects of the Russian Federation regional budgets were used to fund over ten percent of the costs of housing and utility services; in other regions this share was smaller.

The item "Expenses on housing and utility services" is in most cases used to finance the following costs:

- budgetary subsidies for housing and utility services related to partial payment for these services by the population (usually, they are reflected in two sub-items: "Losses of the institutions of housing and utility services" and "Compensation for the price difference for heating "");
- benefits;
- housing allowances to low-income households²⁸;
- housing improvements;
- capital expenditure (capital repair; capital construction).

However, this classification is not clearly reflected in the Ministry of Finance' reporting on municipal budgets, therefore it is rather difficult to estimate the amounts of each direction of financing on the basis of the available data. The expenses on housing and utility services presented according to the existing classification are shown in *Table 4.3*.

Table 4.3

Structure of local budgets' expenses on housing and utility services (%)

<i>Items of expenditure</i>	<i>2000</i>	<i>2001</i>
SUBSIDIES, SUBVENTIONS AND CURRENT TRANSFERTS, including:	78.0	88.3
Subsidies and subventions	98.1	97.1
Transfers to individuals	1.9	2.9
CAPITAL INVESTMENTS IN FIXED ASSETS, including	21.4	11.7
Acquisition of equipment and durable items	5.0	0.0
Capital construction	55.0	0.0
Capital repair	40.1	100
TOTAL	100	100

It is evident that to present day the main expenses under this items have been directed at subsidising current operations of housing and communal enterprises, while transfers to individuals are small.

Before 2000 this item of expenditure was greatly distorted by offsets, but by 2001 it has practically ceased; payments were carried out mainly in monetary form.

The increase in the share of the population in covering the costs of housing and utility services should result in reduction of expenses funded from the budget. This process does take place, albeit it is not as quick as normative documents stipulate. For the first time it could be observed in 2001, when the share of expenses on housing and utility services in municipal budgets somewhat decreased. It is rather difficult to forecast the exact dynamics of these expenses for the next 2-3 years. It will to a great extent depend on how consistent the federal centre will be in the transition to full payment for housing and utility services.

At the same time, the experience of municipalities that are introducing full payment for the services by the population ahead of schedule allows to make certain conclusions. E.g., in 2001 the city of Cherepovets introduced 100-percent payments for the housing and utility services by the population. As a result, the share of expenses on the services in the local budget fell to 19.5 percent in the second half-year of 2001 (in Quarter IV: to 14.5 percent), and the share of expenses on housing allowances in that amount was less than two percent. The plan share of expenses on housing and utility services for 2001 is 21.5 percent; the actual figure in the first half-year is 19.8 percent, including 2.7 percent of housing subsidies. In other cities approaching the transition to 100-percent payments for the services by the population, the share of expenses on housing and utility services is comparable. E.g., in the town of Kovrov, the Vladimir Oblast, where, starting from the beginning of 2002, the inhabitants have been paying for 80 percent of expenses on heating and 100 percent of expenses on all other housing and utility services, the plan share of these services in the town's budgetary expenses is 20 percent, including 5 percent that should be directed to payments for housing allowances. In Tyumen, where the population paid for 90 percent of expenses on the housing and utility services, the plan share of the corresponding budgetary expenses for 2002 is 18.6 percent.

Calculations directly excluding housing allowances and heating services, water supply and sewage services produce lower results. E.g., in this case the aggregate share of the housing and utility services in budgetary expenses has averaged 9.3 percent without taking into consideration housing allowances. Several factors account for this. On the one hand, while an overwhelming part of funds were directed to current subsidies, other components of the housing and utility services, above all the capital repair and improvements were to a great extent un-

²⁸ A trend has been observed recently to transfer these expenses to the social protection system; in this case they are sometimes found in the item "Social policy".

derfunded, hence it is quite natural that expenditure along these lines would grow. On the other hand, this item is used to fund benefits and to partially repay debts. It is evident that these expenses are temporary and will disappear upon normalisation of the mechanisms of local budget financing. Thus, it may be assumed that upon transition to full payment for the housing and utility services out of the money of the population, the share of the corresponding expenses in municipal budgets will be 10-12 percent, at least with respect to cities.

However, the dynamics of expenses on the housing and utility services are also affected by opposite factors. E.g., the strengthening of discipline of payments for electric power resources imposes limitations on possible underfunding of this item and accumulation of accounts payable (which was widely used in the past). According to the available data, in 2001 the majority of municipalities paid to fully cover the difference in heating prices. It is obvious that in the period of transition to full-scale payment for the housing and utility services by the population, the strengthening of payment discipline under the conditions of growing prices for fuel and energy resources will contribute to the increase of this item's share and role.

At the same time, the increasing share of payment for the housing and utility services by the population is accompanied by an increase in expenses on the funding of benefits and housing subsidies. Forecast with respect to the consequences of this trend may be founded only on expert estimates²⁹. These estimates demonstrate that in case the system of benefits is not restructured, the increase in benefits will to a large extent neutralise the budgetary economy achieved owing to transition to full-scale payment for the housing and utility services by the population. With respect to housing allowances, it is planned that upon transition to full-scale payment for the housing and utility services by the population the subsidies would amount to RUR 40 billion, or 6.6 percent of local budgets' expenditure in 2001.

The proposed reform of municipal entities will have a considerable impact on the expenses on the housing and utility services. In a few words, the changes will be as follows.

Firstly, the main authorities in the field of the housing and utility services will remain at the municipal level. Municipalities are responsible for the organisation of electric, heating, gas and water supply to the population, for sewage, fuel supplies, maintenance of the social housing stock, collection, removal, utilisation and processing of household and industrial garbage, for the development of the territory and planting trees and gardens etc. However, at present it is difficult to estimate the potential expenses related to these functions since, as noted above, neither the rates nor the mechanisms of completing the reforms of the housing and utility services are clear. E.g., it remains unclear what additional expenses may arise in connection with the maintenance of social housing since the issue of social housing has not been legally determined so far.

Secondly, benefits with respect to payment for the housing and utility services are either cancelled or fully financed from higher-level budgets. Non-funded benefits are at present the main source of financial problems in the field of the housing and utility services. Thus, in case this provision of the reforms is realised, it is bound to have considerable effect on the financial status of the housing and utility services. However, it is precisely due to widespread substantial underfunding of these benefits that their effect on decreasing municipal budget expenses will be much lower. According to the available estimates, in 2001 only approximately one third of the benefits granted were financed; RUR 17 billion were allocated on it from budgets of all levels.

It would be realistic to suppose that municipalities carried out approximately half of this funding.³⁰ Correspondingly, in case benefits are either cancelled or fully funded from higher-level budgets, the possible reduction under current conditions will on average be cca. 6 percent of expenses on the housing and utility services in local budgets or 1.6 percent of total municipal expenses in 2001.

Thirdly, the reform provides for transition of the housing allowances funding to the regional level. In our opinion, this decision has been a mistake. Municipal entities were responsible for most of the parameters determining the amount of expenses on housing allowances (establishment of tariffs on the services of municipal companies, determination of the level of payment for expenses on the housing and utility services by the population). It is inexpedient to transfer these functions to the level of the subjects of the Russian Federation since the functions are realised based on the correlation between demand for and offer of the housing and utility services, social structure and paying capacity of the population, possibilities of introducing mechanisms of competition and other similar factors of purely local nature. In case a subject of the RF starts to carry out these functions, this will, all other conditions being equal, result in unjustified unification and deterioration in the regulation efficiency of local natural monopolies. For the same reasons it would be expedient to keep the detailed management of the housing allowances mechanism within municipality competence. However, under these circumstances regional bud-

²⁹ The Institute of Urban Economy foundation has carried out large amount of work in this area; the calculations that follow are based on the foundation's estimates.

³⁰ In 2001, municipal budgets received from higher-level budgets RUR 8.3 billion for compensating the expenses on benefits to the disabled and war veterans, i.e. approximately one half of the amount funded in reality.

ets will incur additional (sometimes, unjustified) expenses relating to the decisions made at the local level. Housing allowances may become a kind of a local mandate the funding of which would be shifted to the shoulders of federal entities. This will inevitably reduce the responsibility of municipalities for the decisions with respect to the reforms of the housing and utility services. It would be more expedient to leave these expenses to local budgets; in doing so it is necessary to provide for co-funding out of higher-level budgets in case certain limits are exceeded (e.g., expenses on housing allowances exceed 10 percent of a local budget's expenditure or the share of households receiving housing allowances exceeds 20 or 25 percent, etc.). Naturally, in order to receive these funds it is necessary to comply with the conditions of housing allowance provision established at the federal and, possibly, at the regional level.

Education

Education was the second most important item of the municipal budget in 2000 and took the top position in 2001. This item is the main source of financing pre-school education (cca. 20 percent) and general education (almost 70 percent). Expenses in this respect in Russia on the whole were 27.4 percent of municipal expenditure in 2000 and remained practically unchanged in 2001 (27.3 percent); however, taking into account capital construction, a growth of approximately 0.6 percent may be assumed. Thus, we can observe a continuation of the trend that started in previous characterised by quite significant increase in the share of expenses on education: from 24.4 percent in 1994 up to 27.4 percent in 2000, or 3 percentage points over six years. The main part of expenses on education comes from municipal budgets, but the differentiation of the regional policy is more obvious in this case than in the case of the housing and utility services. E.g., in 27 percent of RF subjects at least 10 percent of educational expenses are funded from regional budgets, in 56 percent of cases this share lies in the range from 10 to 20 percent, and in 7 percent of regions it exceeds 40 percent.

Table 4.4. shows the structure of municipal expenses on education.

Table 4.4

Structure of local budgetary expenses on education (%)

<i>Item of expenditure</i>	<i>2000</i>	<i>2001</i>
REMUNERATION OF LABOUR OF STATE EMPLOYEES AND DEDUCTIONS FROM SALARIES	55.8	58.3
ACQUISITION OF SUPPLIES AND DISPOSABLE MATERIALS	8.8	8.7
PAYMENTS FOR THE HOUSING AND UTILITY SERVICES	15.7	16.4
OTHER CURRENT EXPENSES ON PURCHASING OF GOODS AND SERVICES*	4.5	4.5
TRANSFERS TO INDIVIDUALS	6.1	5.6
CAPITAL INVESTMENTS IN FIXED ASSETS, including:	8.0	5.7
Procurement of equipment and durable items	21.6	29.1
Capital construction	32.1	0.0
Capital repair	46.3	70.9
TOTAL	100	100

* Funds in this item are used mainly to pay for current repairs.

It is obvious that, considering the economy's strategic tasks and the necessity to increase its competitiveness, education expenses in most of the items should be increased in future. Increasing teachers' salary and improving the equipment of the education process is necessary to ensure that the education corresponds the modern requirements. However, it is hardly possible that these tasks could be resolved mechanically; to this end, a purposeful governmental policy is required. The matter is that the Russian education is positioned at a disproportionately high level in relation to the country's economic development measured by the per capita GDP. Thus, in the event that this process is allowed to develop on its own, education would gradually be reduced to the 'natural' level determined by the current economic circumstances. On the other hand, in the event that education would really become a priority of the governmental policy, the corresponding expenses would have to be funded (at least partially) not only from municipal budgets but also from higher-level budgets, above all from the federal budget. Otherwise, one could predict that the trends existing in this field would remain.

An opposite trend towards reducing education expenses could be related to the restructuring of educational institutions, growing efficiency of the educational system, increasing student numbers per one lecturer etc. The utilisation of budgetary funds has been growing ever less effective over a long period of time, so there is considerable room for improvement in this field. E.g., from 1985 till 1999 attendance of kindergartens almost halved; the number of pupils per one teacher was 18.2 in 1985/85 academic year, then fell to 14.5 in 1992 and to 13.2 in 1999; while the total number of pupils was falling, the number of teachers even increased, let alone decreased (Tipenko, 2001, page 8). However, it is obvious that it will take quite a long time and organisational efforts to

change the prevailing trends in this field; we believe it is impossible to make realistic forecasts with respect to the impact this change would have on municipal expenses in the next three to five years.

As for utility expenses, if reforms in this field accelerate one may expect that in the medium term they would somewhat diminish due to optimisation of the budgetary network, regulation of accounting, implementation of resource-saving technologies etc. However, it is practically impossible to estimate the probability of quick implementation of these measures. Moreover, the resource-saving measures require considerable additional expenses from the municipal budget.

In the proposed reform, municipal entities retain the organisation of pre-school, primary general, basic general and secondary (full) general education and additional education, with the exception of the educational process funding (which includes expenses on teacher salaries, school-books, technical teaching aids etc.). Hence, subjects of the Russian Federation must grant subventions out of own funds for the support of the educational process to local budgets. Thus, it is proposed that cca. 60 percent of education expenses covered by municipalities in 2001 should be funded out of regional budgets³¹.

On the face of it, this redistribution of powers seems to comply with the overall strategy of education reform the necessity of which we have mentioned. However, in point of fact this is not so. The transfer of powers of funding the educational process to the regional level has not been accompanied with a real shift in governmental priorities towards education support; hence, it is not going to introduce any fundamental improvements in this field. Under such circumstances it would be expedient to keep the expenses in question at the local level (because this would allow the local community to influence the quality of child education) instead of transferring the expenses to the regions, which do not seem to be particularly interested in funding them.

In the event that the task of funding the educational process is nevertheless transferred to subjects of the Russian Federation, it seems necessary at least to charge them explicitly with granting subventions to municipal entities on the per capita basis and not on the basis of the requirements of the existing budgetary network with its rigid distribution between individual items. Otherwise the proposed measures would have not positive effect on the budgetary network and would contradict the changes aimed at increasing the independence of educational institutions.

Health Care

Health care and physical culture form the third largest item of municipal expenses; in 2000 its share in Russia was on average 15.7 percent, in 2001 it was 14.4 percent (in the event that capital construction is taken into account practically no decrease can be observed). The share of health care expenses in this item was on average more than 95 percent in 2001, and the expenses on sanitary measure and epidemic control, physical culture and sports also included in that item are mainly connected with grants to the population and with capital expenditure. The structure of municipal expenses in this item is shown in *Table 4.5*.

Table 4.5

Structure of local budgetary expenses on health care and physical culture (%)

<i>Expense items</i>	<i>2000</i>	<i>2001</i>
EXPENDITURES FOR REMUNERATION OF LABOR WITH PAYROLL TAX	33.0	35.4
PROCUREMENT OF SUPPLIES AND EXPANDABLE MATERIALS, including	17.2	16.3
Medical expenses	53.8	50.6
Linen and uniform	2.4	2.3
Foodstuffs (food supplies)	25.1	24.4
PAYMENTS FOR UTILITY SERVICES	10.0	11.8
OTHER CURRENT EXPENSES ON PURCHASING OF GOODS AND SERVICES*	7.2	8.8
SUBSIDIES, SUBVENTIONS AND CURRENT TRANSFERS	2.5	16.9
CAPITAL INVESTMENTS IN FIXED ASSETS, including:	14.0	8.8
Procurement of equipment and durable assets	31.9	49.6
Capital construction	40.9	0.0
Capital repair	27.2	50.4
OTHER EXPENSES	16.2	2.0
TOTAL	100	100

* Funds in this item are mainly used to pay for current repair.

Looking from the viewpoint of municipal expenses, health care is the most complicated item since its size is affected by a number of important factors.

³¹ In 2002 this share should be even greater due to the increase in the salary level in the public sector.

Firstly, unlike the aforementioned expenses, health care expenses are funded from three sources and not from two, namely: regional budgets, municipal budgets and the Compulsory Medical Insurance Funds (CMIF). The share of expenses covered out of the CMIF can vary significantly from region to region. E.g., while in the Samara Oblast (where, according to expert opinion, the model of budgetary and insurance health care funding combination envisaged in the federal law (Shishkin 2000, page 206) has been realised to the greatest extent) two thirds of funds used to finance the state guarantee programme came from compulsory medical insurance assets, in the Smolensk and Chita Oblasts the ratio was inverse, and in the Kirov and Omsk Oblasts the share of compulsory medical insurance did not exceed 20 percent. On average, 35 percent of health care expenses in Russia were funded out of compulsory medical insurance.³²

Secondly, regional and local budgets both finance health care institutions directly and make contributions to the CMIF for nonworkers. There are no definite instructions either on the amount of contributions or on their direct source (the regional or the local budget); there are considerable differences from region to region. Payments for compulsory medical insurance for nonworkers may be made either only from local budgets, or both from local and regional budgets, or only from the budgets of subjects of the Russian Federation (Shishkin 2000, page 198 - 199). Hence, the correlation between regional and municipal expenses for these purposes differs a lot from region to region.

The 2001 Tyumen budget can serve as an example of the transitional health care expenses structure that reflects the unaccomplished change processes in that area. While health care expenses in the city budget were 1.8 the size of the corresponding expenses of the CMIF, insurance payments for nonworkers were only 16 percent of budgetary expenses. In practice, compulsory medical insurance covered less than 60 percent of expense items it had to cover; the remaining part was funded out of the local budget.

In future, municipal expenses on health care should decrease due to the transfer of a considerable portion of expenses to the CMIF. In accordance with the existing methodologies, the following items should be funded out of the CMIF:

- expenditures for remuneration of labor with payroll;
- the greater part of the item " Procurement of supplies and expandable materials " (foodstuffs, medicines and dressing materials, linen).

A definite decision about what government agency should be the insurer for nonworkers and, therefore, make contributions to the CMIF, should affect this item's dynamics considerably.

The municipal reform concept proposed by the Committee for Division of Powers offers the following solutions. Municipalities continue to organise urgent medical care (except for aviation medicine), stationary and outpatient primary medical care, and medical care for pregnant women and childbearing care. Subjects of the Russian Federation should finance out of their budgets expenses on the organisation of medical care in specialised medical institutions and specialised (sanitary and aviation) urgent medical care; in addition, they should envisage expenses on compulsory medical insurance of non-workers.

However, it remains unclear whether the costs of organising medical care include the items that should be funded from the CMIF or the reform of local self-governance should be carried out at the same time with the completion of health care reform in accordance with the previously adopted concept. The funding of primary care and urgent medical care poses the greatest problems. Probably, it would be expedient to fund these services entirely out of municipal budgets, at least in the near future. The reason for this is that, on the one hand, the issue of selecting the doctor and the medical institution is not as pressing here, and, on the other hand, the risks of transition to multichannel financing of these services that could lead to lack of co-ordination, instability and irregular allocation of funds are too high.

Hence, based on the concrete distribution of obligations to finance the existing budgetary network between the regional and municipal level, forecast of the reform ratio in this field and possible adjustments in the reform directions, it is possible to obtain only a rough estimate of the future dynamics of municipal expenses on medical care.

Social policy

The share of expenses on social policy in local budgets is less than the share of other items under review. In 2000 it was 4.6 percent, in 2001 it demonstrated considerable growth, up to 6.9 percent. Income distribution between regional and municipal levels differs considerably from one RF subject to another, and, while the cases in which the region finances less than 20 percent are quite seldom (only eight subjects of the RF did so in 2001), in

³² The data on the share of regional budgets are provided without taking into account insurance payments for nonworkers.

the 20 to 100 percent range RF subjects are distributed quite evenly. In most cases the share of municipal expenses lies in the 60 to 80 percent range.

It is not possible to explain the dynamics of this item at the municipal level without considering the nature of the expenses financed out of it. The fact is that this item combines two polytypic components: the expenses on municipal social policy and on funding municipal social institutions, on the one hand, and expenses on financing the government's powers delegated to the municipal level, on the other hand. *Table 4.6.* demonstrates both lines of expenses; the financing of the government's powers is reflected in the items "Other measures in the field of social policy" and "State allowances to citizens with children". While in 2000 in Russia on the whole the share of these items was cca. 56 percent, in 2001 it neared 70 percent. This trend demonstrates positive shifts in the decrease of non-funded federal mandates. E.g., in 2001 the benefits under the Law on Disabled and, partially, under the Law on Veterans were financed at the same time with child allowances. Still, the funding of the benefits established in federal laws is far from full.

Table 4.6

The Structure of Local Budget Expenses on Social Policy (%)

<i>Expense Items</i>	<i>2000</i>	<i>2001</i>
SOCIAL SECURITY AND EMPLOYMENT SERVICE INSTITUTIONS	23.2	17.2
SOCIAL SUPPORT	16.0	10.3
YOUTH POLICY	3.8	2.7
OTHER MEASURES IN THE FIELD OF SOCIAL POLICY	14.1	47.1
STATE ALLOWANCES TO CITIZENS WITH CHILDREN	42.1	22.7
OTHERS	56.2	69.8
TOTAL	<i>100</i>	<i>100</i>

The proposed changes in the distribution of powers imply radical solutions with respect to this field. While the existing Law "On General Principles..." stipulates that social support for the population is in the competence of municipal entities, in the propositions on the new edition of the law it is transferred to the national level entirely. In our opinion, such an approach is too radical. Along with the federal and regional aspects of social support, there are many other issues that should be preferably solved at the local level, where it is possible to provide quick and less formalised aid to those in a difficult situation. The advantages of a full-scale transfer of social institutions and youth policy to the regional level are also not clear. It is precisely in the field of social activities that the familiarity with local conditions and support from informal mutual aid systems (including charity) established in the local community play a key role in making effective solutions. Centralisation in this field may result in unjustified unification, loss of flexibility and lesser catering for direct needs of the population.

Other Expense Items

Other most important expense items are "State administration and local self-governance", "Industry, energy and construction" and "Transportation, road building, telecommunications and informatics"

The share of the item " State administration and local self-governance " has been steadily growing throughout the past ten years, reaching 6.3 percent on average in the country in 2001. The maximum share of this item is approximately ten percent. The weaknesses of executive power organisation at the local level, above all an unclear organisational structure, excessive numbers of government employees and their low skills, are well known. However, it is not obvious that their liquidation would result in considerable savings on costs under that item. Part of the functions currently carried out by municipal employees would be transferred to the market basis and, in many respects, would be handed over to the private sector. Budgetary expenses could fall to the extent, in which this transition would result in their shifting to the population. However, as far as the part financed from the budget is concerned, the need for funding may even grow. In addition, in order to improve municipal governance, a decrease in the number of municipal employees should be accompanied with a considerable increase in their fees, and the final balance is not clear in this case either.

Expenses in the item "Transportation, road construction, telecommunication and informatics" have been cut considerably over the past several years, and on many occasions a decrease of their share has been accompanied by a decrease in their amount. Most likely, this results from the growing amounts of funding allocated for these expenses from the regional budget.

As for the dynamics of the item "Industry, energy and construction", in 2001 its share grew on average in Russia from 1.2 to 9 percent. The existing dispersion is also quite large: e.g., in cities this item ranges from under one percent to almost 40 percent of local budgets. An overwhelming majority of expenses in that item are related to capital construction; it is noteworthy that, above all, this reflects the above-mentioned accounting peculiarities

in 2001 and not a real increase in expenses in this field. On considering the dynamics in the item "Capital construction" in the economic classification of expenses, the progress is far more moderate, from 6.9 percent in 2001 up to 7.7 percent in 2001. Direct support to enterprises granted under this item is immaterial. E.g., even in Tyumen noted for its financial well-being it is less than 0.1 percent.

Federal Mandates

The real structure and the sources of federal mandate funding, especially of the benefits stipulated in the federal law for various categories of the population, constitute a rather complicated issue that is interpreted by various researchers in different ways. One thing is certain: expenses on these commitments allocated from municipal budgets are made in the amounts of subventions transferred for these purposes from higher level budgets; on the whole this amounts to cca. five percent of municipal expenses.

It is rather difficult to establish the extent, to which federal commitments are covered for the account of other local budgetary items. We have attempted to make such assessments with respect to the allowances for housing and utility services earlier in the text in the course of analysing the expenses on housing and utility services.

The funding of the state's commitments out of local budgets puts two questions before municipal authorities. Firstly, if local budgets are used to fund a considerable part of expenses on federal benefits, the corresponding amounts of funds are taken out of other items representing local expenses proper. Secondly, if such funding is immaterial, the arrears of benefits both before the population (in the event that benefits are granted in the monetary form) and before associations of housing property owners and enterprises selling goods and services to which benefits apply. The situation differs in various municipal entities, but the second option seems to be more widespread. While federal commitments (child allowances, in particular) are funded in the monetary form owing to subventions, debts before enterprises and associations of housing property owners still remain the issue of the day. Our estimate of the amount of municipal budgetary expenses on federal commitments (with the exception of subventions allocated for these purposes) is rather low, ranging from three to four percent of the total municipal expenses.

Although the issue of sources of financing benefits and other federal commitments has become one of the most pressing problems at the level of municipal finance, it is obviously not a local level problem. Such issues as the extent to which the existing benefits should be cancelled, the scope of financing that the government is able to provide for the corresponding expenses, fixing a list of remaining benefits and determining the source of their financing require an individual, in-depth research and cannot be resolved within the framework of this survey. Therefore, it is proposed that in the course of the subsequent analysis the corresponding federal commitments are either cancelled or reimbursed in some forms not related to local budgets or fully funded out of subventions from higher level budgets. As a matter of fact, this viewpoint has been set forth in the draft new edition of the law "On General Principles of the Organisation of Local Self-governance in the RF". Hence, it is possible to forecast that this factor would bring about a decrease in municipal expenses of approximately 3-4 percent.

Annex 4.1

Item to Item Correlation between the Expenses of Regional and Local Budgets, Year 2001 (%)

№	Regions	<i>Housing and Utility Services</i>		<i>Education</i>		<i>Health Care</i>		<i>Social Policies</i>	
		<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>
1	Republic of Bashkiriya	2.7	97.3	10.9	89.1	26.5	73.5	31.5	68.5
2	Republic of Buryatia	1.4	98.6	9.9	90.1	35.9	64.1	19.3	80.7
3	Republic of Daghestan	0.4	99.6	17.0	83.0	80.5	19.5	84.3	15.7
4	Kabardin-Balkar Republic	22.4	77.6	22.3	77.7	39.1	60.9	77.4	22.6
5	Republic of Kalmykia	21.1	78.9	14.9	85.1	52.0	48.0	11.0	89.0
6	Republic of Karelia	0.0	100.0	14.1	85.9	46.3	53.7	61.4	38.6
7	Komi Republic	0.0	100.0	8.3	91.7	47.8	52.2	23.5	76.5
8	Republic of Mari El	0.6	99.4	17.1	82.9	31.2	68.8	42.1	57.9
9	Republic of Mordovia	4.2	95.8	13.6	86.4	33.7	66.3	63.5	36.5
10	Republic of North Ossetia (Alania)	3.1	96.9	20.5	79.5	53.5	46.5	95.9	4.1
11	Republic of Tataria	5.6	94.4	8.5	91.5	27.5	72.5	53.9	46.1
12	Republic of Tyva	14.3	85.7	17.3	82.7	56.2	43.8	23.6	76.4

№	Regions	<i>Housing and Utility Services</i>		<i>Education</i>		<i>Health Care</i>		<i>Social Policies</i>	
		<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>
13	Udmurt Republic	4.5	95.5	7.1	92.9	27.9	72.1	90.9	9.1
14	Republic of Ingushetia	50.6	49.4	26.7	73.3	52.6	47.4	99.2	0.8
15	Chuvash Republic	0.1	99.9	12.7	87.3	29.8	70.2	30.1	69.9
16	Republic of Sakha (Yakutia)	99.3	0.7	99.6	0.4	100.0	0.0	100.0	0.0
17	Altai Krai	0.8	99.2	7.0	93.0	26.2	73.8	73.9	26.1
18	Krasnodar Krai	2.9	97.1	5.7	94.3	25.6	74.4	5.7	94.3
19	Krasnoyarsk Krai	0.0	100.0	10.9	89.1	30.6	69.4	21.2	78.8
20	Primorski Krai	0.1	99.9	11.0	89.0	43.0	57.0	40.4	59.6
21	Stavropol Krai	34.6	65.4	45.4	54.6	55.5	44.5	66.7	33.3
22	Khabarovsk Krai	25.7	74.3	9.8	90.2	41.0	59.0	90.1	9.9
23	Amur Oblast	2.8	97.2	14.8	85.2	42.6	57.4	72.5	27.5
24	Archangelsk Oblast	0.2	99.8	8.0	92.0	33.9	66.1	57.7	42.3
25	Astrakhan Oblast	2.2	97.8	22.5	77.5	36.6	63.4	66.2	33.8
26	Belgorod Oblast	0.7	99.3	14.1	85.9	40.5	59.5	22.7	77.3
27	Bryansk Oblast	5.3	94.7	16.2	83.8	62.4	37.6	62.5	37.5
28	Vladimir Oblast	0.8	99.2	5.5	94.5	30.6	69.4	12.2	87.8
29	Volgograd Oblast	1.8	98.2	13.0	87.0	21.8	78.2	70.7	29.3
30	Vologda Oblast	0.3	99.7	25.4	74.6	30.8	69.2	64.5	35.5
31	Voronezh Oblast	1.9	98.1	12.2	87.8	34.8	65.2	56.1	43.9
32	Nizhny Novgorod Oblast	0.1	99.9	15.5	84.5	15.4	84.6	84.4	15.6
33	Ivanovo Oblast	0.9	99.1	9.0	91.0	31.9	68.1	45.9	54.1
34	Irkutsk Oblast	1.3	98.7	10.9	89.1	25.2	74.8	44.2	55.8
35	Kaliningrad Oblast	0.8	99.2	7.3	92.7	38.7	61.3	63.4	36.6
36	Tver Oblast	0.2	99.8	7.7	92.3	44.0	56.0	87.4	12.6
37	Kaluga Oblast	2.5	97.5	16.5	83.5	41.1	58.9	77.4	22.6
38	Kamchatka Oblast	0.0	100.0	14.9	85.1	33.8	66.2	72.2	27.8
39	Kemerovo Oblast	0.1	99.9	12.7	87.3	20.5	79.5	27.0	73.0
40	Kirov Oblast	4.6	95.4	5.7	94.3	27.4	72.6	20.7	79.3
41	Kostroma Oblast	22.9	77.1	10.7	89.3	28.2	71.8	34.0	66.0
42	Samara Oblast	0.9	99.1	41.0	59.0	77.9	22.1	67.7	32.3
43	Kurgan Oblast	0.5	99.5	17.6	82.4	39.6	60.4	15.2	84.8
44	Kursk Oblast	10.1	89.9	11.5	88.5	36.2	63.8	41.3	58.7
45	Leningrad Oblast	0.3	99.7	44.1	55.9	58.9	41.1	64.7	35.3
46	Lipetsk Oblast	2.6	97.4	12.6	87.4	37.7	62.3	71.0	29.0
47	Magadan Oblast	6.7	93.3	10.2	89.8	44.8	55.2	27.4	72.6
48	Moscow Oblast	0.6	99.4	17.2	82.8	33.0	67.0	22.1	77.9
49	Murmansk Oblast	0.0	100.0	9.3	90.7	37.6	62.4	55.0	45.0
50	Novgorod Oblast	29.2	70.8	7.9	92.1	38.7	61.3	13.0	87.0
51	Novosibirsk Oblast	0.9	99.1	10.1	89.9	37.2	62.8	61.8	38.2
52	Omsk Oblast	15.7	84.3	42.4	57.6	44.8	55.2	95.4	4.6
53	Orenburg Oblast	1.1	98.9	7.9	92.1	53.8	46.2	82.0	18.0
54	Oryol Oblast	0.9	99.1	11.7	88.3	30.3	69.7	54.9	45.1
55	Penza Oblast	9.4	90.6	45.6	54.4	67.5	32.5	64.5	35.5
56	Perm Oblast	0.1	99.9	7.5	92.5	27.4	72.6	41.5	58.5
57	Pskov Oblast	32.5	67.5	15.7	84.3	38.0	62.0	89.8	10.2
58	Rostov Oblast	0.2	99.8	13.6	86.4	34.6	65.4	16.0	84.0
59	Ryasan Oblast	0.2	99.8	11.7	88.3	41.1	58.9	59.7	40.3

№	Regions	<i>Housing and Utility Services</i>		<i>Education</i>		<i>Health Care</i>		<i>Social Policies</i>	
		<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>	<i>RB</i>	<i>LB</i>
60	Saratov Oblast	1.6	98.4	10.6	89.4	30.1	69.9	80.3	19.7
61	Sakhalin Oblast	1.6	98.4	7.6	92.4	27.0	73.0	22.8	77.2
62	Sverdlovsk Oblast	5.3	94.7	17.2	82.8	43.8	56.2	87.8	12.2
63	Smolensk Oblast	0.9	99.1	13.7	86.3	26.9	73.1	66.8	33.2
64	Tambov Oblast	0.0	100.0	9.5	90.5	40.5	59.5	84.8	15.2
65	Tomsk Oblast	0.1	99.9	8.6	91.4	29.5	70.5	50.6	49.4
66	Tula Oblast	4.8	95.2	9.1	90.9	27.1	72.9	78.4	21.6
67	Tyumen Oblast	3.2	96.8	13.2	86.8	50.8	49.2	58.2	41.8
68	Ulyanovsk Oblast	21.5	78.5	19.6	80.4	44.7	55.3	45.9	54.1
69	Chelyabinsk Oblast	2.4	97.6	14.3	85.7	21.6	78.4	58.9	41.1
70	Chita Oblast	1.7	98.3	16.6	83.4	44.9	55.1	22.9	77.1
71	Yaroslavl Oblast	0.6	99.4	10.1	89.9	30.0	70.0	51.3	48.7
72	Republic of Adygeya	5.7	94.3	16.8	83.2	43.9	56.1	83.5	16.5
73	Altai Republic	5.5	94.5	17.8	82.2	46.0	54.0	31.3	68.7
74	Jewish Autonomous Okrug	7.9	92.1	14.9	85.1	75.8	24.2	20.7	79.3
75	Karachai-Cherkes Republic	31.2	68.8	10.9	89.1	38.6	61.4	36.8	63.2
76	Republic of Khakassia	12.7	87.3	10.2	89.8	25.6	74.4	66.9	33.1
77	Aginsk Buryat Autonomous Okrug	7.1	92.9	15.1	84.9	90.9	9.1	98.9	1.1
78	Komi-Permyak Autonomous Okrug	0.0	100.0	13.1	86.9	53.7	46.3	72.4	27.6
79	Koryak Autonomous Okrug	0.0	100.0	21.0	79.0	21.5	78.5	65.8	34.2
80	Nentsi Autonomous Okrug	23.2	76.8	39.7	60.3	85.1	14.9	95.9	4.1
81	Taimyr (Dolgan Nentsi) Autonomous Okrug	80.8	19.2	15.9	84.1	75.4	24.6	83.0	17.0
82	Ust-Orda Buryat Autonomous Okrug	59.1	40.9	9.9	90.1	41.8	58.2	4.6	95.4
83	Khanty-Mansi Autonomous Okrug	1.0	99.0	8.5	91.5	15.3	84.7	34.2	65.8
84	Chukotka Autonomous Okrug	0.0	100.0	39.6	60.4	34.7	65.3	32.9	67.1
85	Evenki Autonomous Okrug	36.3	63.7	23.0	77.0	57.8	42.2	50.4	49.6
86	Yamalo-Nentsi Autonomous Okrug	18.0	82.0	10.4	89.6	26.3	73.7	12.8	87.2

Section II. Municipal Finances: Quantitative Analysis

Chapter 5. The Assignment of Revenue Sources to Municipal Entities: the Program of Calculations

Formulating the problem

In order to work out approaches to the mechanism ensuring financial guarantees of local government, it is necessary to settle two problems. The first problem is to elaborate the substantive aspects of the problem of formation of a regulatory environment, which would permit to guarantee independence of local budgets and form incentives for effective municipal management. The second problem at the first glance seems to be a purely technical one and is to determine concrete revenue sources assigned to municipal entities to defray their expenditures at varying distribution of functions and powers between the municipal and regional levels. However, both these problems are closely interrelated and the results of calculations may have significant consequences for substantive conceptual conclusions.

The problem of assignment of revenue sources is complicated by an enormous dispersion of the economic base, tax generating capacities, and fiscal capacity of municipal entities. However, an attempt to assign revenue sources adequate to needs of all municipal entities will render the problem insoluble. Therefore, it is necessary to find out how revenue sources are assigned to different groups of municipalities for exercise of different sets of municipal powers.

It appears that the system of assignment of revenue sources may consist of three tiers:

- permanent revenue sources for all municipal entities shall be assigned at the federal level;
- additional revenue sources (same for each municipal entity in the framework of the region) may be assigned on the permanent basis at the regional level;
- revenue sources determined on the basis of individual standards may be assigned to municipal entities at the expense of financial aid for short or medium term periods via agreements made between a municipality and RF subject.

It is necessary to ensure the settlement of the first of these three problems at the federal level, as well as to set the legislative framework and limits for the settlement of two other problems at the regional level. At the federal level, the problem may be resolved by two major methods.

First, revenue sources may be assigned proceeding from the economic conditions characteristic of the majority of municipal entities. At the same time, the municipalities where fiscal capacity is significantly above the average shall pay a part of their revenues in the form of negative transfers³³.

Second, the system may be built in a way allowing to avoid negative transfers. However, in this case revenue sources should be assigned at the level covering only the expenditures borne by the most financially secure municipalities. As concerns other municipal entities, their financial problems should be settled in the framework of respective regions, either basing on the assignment of revenue sources at the regional level, or via transfers at the expense of financial aid.

At the first glance, it appears that the first variant is more preferable than the second one since it reflects interests of a much more considerable part of municipal entities (more municipalities become self-sufficient and do not need financial support). However, this conclusion appears to be not sufficiently correct due to the following reasons:

- the mechanism of negative transfers is rather complicated for introduction and administering, besides, it provokes conflicts and will inevitable entail statistical games with indicators of budgetary security both at the regional and municipal levels thus making municipal budgetary relations less transparent;
- introduction of the mechanism of negative transfers limits incentives for effective budget policy and effective management of municipal property exactly in the municipal entities where this motivation could have produced the maximal economic effect, and in fact sets the limit on the striving of other municipal entities for development at the level, at which there start negative transfers;

³³ The international practice of negative transfers at the municipal level is rather limited, and even where existing is nicknamed the "Robin Hood principle."

- high level of fiscal capacity does not always means an actual excess of revenues over expenditures, therefore this mechanism may sharply aggravate the financial situation in the municipalities where objective factors increase expenditures (Northern, not easily accessible, etc. municipalities);
- the system of assignment of only minimal revenue sources at the federal level is more flexible and allows to adjust the amounts of allocated financial resources at the regional level proceeding from the differentiation of actual functions performed by different municipalities, what does not require the transition to the uniform territorial structure of municipal entities.

Taking into account the aforesaid considerations, this study is based on the second approach. Accordingly, the objective is to calculate variants of assignment of revenue sources adequate for financing of municipal expenditures at different sets of municipal responsibilities and powers for most financially secure municipal entities. At the same time the proposed approach to the assignment of revenue sources shall not cause significant negative consequences for different groups of municipalities not belonging to the financially secure municipal entities (for instance, lead to a significant deteriorating of their financial standing resulting from the limitation of financial aid provided to them from budgets of RF subjects).

This formulation of the problem predetermines the necessity to do two groups of calculations basing on different samples of municipalities. The first group of calculations is based on the budgetary data on municipal entities, which may potentially be donors of the regional budget. On this basis, there are formulated hypotheses about possible variants of assignment of revenue sources to the municipal level. The second group of calculations embraces a considerable part (in theory - all) municipal entities in individual regions, on this basis, there are tested the results of the formulated hypotheses for a wider circle of municipalities not being potential donors.

Characterizing the database

The structure and volume of the database of municipal finances were determined by the aforesaid formulation of the problem as well as the available sources of information. At the preliminary stage of the study, there was conducted the analysis of potential sources of information about municipal finances, including the data provided by the RF Finance Ministry, the RF Goskomstat, and the available regional data. The analysis revealed that the data pertaining for a wide circle of municipal entities are not numerous. As a result, the calculations were done on the basis of the following information:

- the data about the size of the population in municipal entities (RF Goskomstat);
- the data about the execution of the federal budget, budgets of RF subjects, and municipal entities (Finance Ministry);
- federal and regional legislative acts regulating the distribution of different revenues sources across the levels of the budgetary system, including concrete years.

At the same time, the database included information pertaining to 1999 through 2001, the calculations used also the available budgetary information for 10 months of 2002. It is unfeasible to include the data pertaining to the earlier periods, first, because they are fragmented and unordered, and, second, due to objective constraints on the analysis of financial flows in the situation of non-cash execution of a considerable part of local budgets and, therefore, conditionality of the indicators included in the budgetary reporting.

The fact that the available information was limited did not allow doing calculations and making forecasts based only on the available data and in many cases the study had to proceed from hypotheses and estimates. Whenever possible, such estimates took into account the practice observed in concrete towns where there was conducted more thorough analysis of financial situation. These case studies were not reflected in the database, however, they were a considerable aid in the course of calculations³⁴.

Taking into account the objective of this study, the database was formed of two large blocks. The first block included cities where populations exceed 200 thousand persons, which were reviewed as potential donors. At present, there are 92 such municipalities in the Russian Federation, however, the data on the execution of budgets is not available for all these municipal entities. Information provided by the Finance Ministry pertains to 63 cities with populations exceeding 200 thousand residents (1999), 48 cities (2000), and 78 cities (2001). However, the data pertaining to one city for 2000 and seven cities for 2001 had to be excluded due to their apparent unreliability.

Besides, the analysis of the data revealed the fact that the cities included in the database could be clearly classified in two subgroups. The first subgroup included the overwhelming majority of the cities. The second subgroup consisted of several Northern cities being in the sphere of interests of large raw material corporations

³⁴ In the process of the study, the information relating to cities of Tyumen and Cherepovets was used most intensively, there were also used the data from cities of Ryazan, Vladimir, Kovrov, Petrozavodsk, and Orenburg.

and significantly different from the rest by both the amount and structure of their revenue sources, and expenditure items. The second subgroup included Norilsk, Surgut, and Nizhnevartovsk. An illustrative example of the anomalous nature of financial indicators of these urban localities are the data on per capita expenditures of local budgets in 2001 presented in Figure 5.1. The analysis of this subgroup of municipal entities is further complicated by the fact that a considerable part of services to households has been still provided by the largest raw material corporations based in these municipalities, therefore the structure of respective municipal expenditures is incompatible with the data on other municipal entities. For instance, in the city of Norilsk all residential housing has been in fact listed in the fixed assets of the Norilsk Mining and Metallurgical Company and therefore the municipality has borne practically no expenditures in this sphere. Taking into account the aforesaid factors, this subgroup of cities was excluded from the calculations used to formulate hypotheses about the assignment of revenue sources to municipal entities.

The second block included municipal entities situated in concrete regions, which were selected in accordance with the following method. There was conducted cluster analysis of all RF subjects based on two criteria: fiscal capacity and the share of financial aid in the revenues of the regional budget. For the result of the analysis see Annex 5.1. This analysis permitted to classify regions in five major groups. Three regions from each group except the first (the least fiscal capacity, the highest share of financial aid) were selected for the further analysis. The selection was based, first, on the necessity to present the geographical diversity (there were presented all federal okrugs), second, the availability of the data on the execution of respective budgets, and, third, on the accessibility and fullness of the regional budget legislation. Only two regions could be included in the first cluster due to unreliable information and the lack of regional legislation. Therefore, the regional block of the database was formed of 14 regions. However, the further testing revealed a high probability that the information pertaining to two regions included in the sample could be unreliable. Therefore, the analysis was conducted basing on the data from 12 RF subjects.

The adequacy of the formed database pertaining to the cross regional sample of finances of municipal entities was also influenced by two other factors. First, the data provided by the RF Finance Ministry include only the information pertaining to the level of administrative districts and do not allow to reflect the situation in the regions, where municipalities are formed on the settlement principle. Therefore, the Tyumen oblast, for instance, was excluded from the calculations. Second, it has proved impossible to discern real municipal entities from the state authorities functioning at the town and district level (often in defiance of the RF Constitution and the federal legislation) basing only on the budgetary information. Accordingly, some of the analyzed budgets could in practice not belong to municipal finances. Most probably, this situation existed, for instance, in the Novosibirsk oblast and the Kabardian - Balkarian Republic. For a more detailed characteristic of the database, see Table 5.1. The description of the database is presented in Annex 5.2.

Table 5.1

Characterizing the database: municipalities and regions included in the database

	1999	2000	2001
Cities	63 (60/3)*	47 (46/1)	71(68/3)
Regions, including	397	360	400
<i>Central okrug</i>			
1. Tver oblast	40	36	41
<i>North West okrug</i>			
3. Leningrad oblast	28	28	26
<i>Privolzhski okrug</i>			
5. Komi - Permyak AO	7	7	6
6. Chuvash Republic	26	26	26
7. Saratov oblast	38	40	39
<i>Ural okrug</i>			
8. Sverdlovsk oblast	67	67	68
<i>Southern okrug</i>			
9. Rostov oblast	55	55	54
10. Kabardian - Balkarian Republic	11	11	11
<i>Siberian okrug</i>			
11. Novosibirsk oblast	42	n / a	40
12. Krasnoyarsk krai	56	57	56
<i>Far East okrug</i>			
13. Amur oblast	27	27	27
14. Yevreyskaya AO	n / a	6	6

* The number of cities belonging to the first and second subgroups is indicated in brackets.

Preparing to do the calculations

In order to determine the revenue sources assigned to municipal entities it is necessary to evaluate both amounts of potential revenues and the scale of expenditures to be defrayed at the expense of these sources. For these purposes, contingents of taxes and adapted municipal expenditures were calculated for all municipal entities included in the database.

Tax contingents are full amounts of taxes collected in the territory of the municipal entity, which may later be distributed among the budgets of all levels of the budgetary system³⁵. The contingents were calculated across all taxes due to the budgets of municipal entities. In the cases where the rate of allocation to the local budget was at zero, the contingent was determined to be at zero, and the municipality was excluded from the analysis of contingents of the respective tax. Since the structures of revenue sources of municipal entities are different, the contingents of different taxes could be calculated across different number of municipalities.

For the calculation of tax contingents, there were used the data about the amount of tax revenues flowing in local budgets and allocations of the regulating taxes set forth by regional laws on annual budgets or other legislative acts determining the distribution of taxes among the different levels of the budgetary system of the Russian Federation (regional laws concerning the single tax on imputed income for certain types of activities, the application of the simplified system of taxation, etc.). Since in many regions the rates of allocations of regulating taxes are determined not as shares of the respective contingents, but as the percentage of regional revenues, the rates of allocations to the federal budget set forth in the laws on the federal budget for the respective year, the federal law “On land payments,” etc. were used for the calculation of contingents. In the process of determination of contingents relating to local and assigned to municipal budgets tax sources there were also used normative acts issued at the federal level.

The contingents were calculated according to the following method:

$$K_{ij}^{(kt)} = \frac{100T_{ij}^{(kt)}}{n_{ij}^{(kt)}}, \forall i, j, k, t;$$

where $K_{ij}^{(kt)}$ is the contingent of the k -th tax in the i -th municipality of the j -th region in the t -th year; $n_{ij}^{(kt)}$ is the rate of allocation of the k -th tax in the budget of the i -th municipality of the j -th region in the t -th year; $T_{ij}^{(kt)}$ is the amount of the k -th tax retained at the disposal of the i -th municipality of the j -th region in the t -th year.

In the course of the calculations, there were made certain assumptions. For instance, the fact that a number of regions determined lists of enterprises with rates of allocations of the profit tax, income tax, VAT, and the corporate asset tax to the regional and local budgets significantly differing from the rates applicable to the municipal entities on the whole was not taken into account. In the course of determination of the contingent of the tax levied in relation to the application of the simplified taxation system, the fact that certain regions introduced preferential rates for prioritized types of activities was not taken into account. As concerns regional and local taxes, it was assumed that the respective rates were set at the maximal possible level. Calculations concerning certain years also encountered certain problems, which required to use hypotheses and estimates³⁶.

As concerns the regions, for which the information about all municipal entities was included in the database, the amounts of contingents were determined more precisely basing on the comparison with revenues generated by respective taxes in the consolidated regional budgets. Primarily, this control concerned regional taxes (the corporate asset tax, sales tax), as well as the income tax, the overwhelming portion of which (99 per cent in 2001) was transferred to regional budgets. This adjustment was made for four regions (in the rest of the cases not all municipal entities could be included in the database).

³⁵ In principle, in contradistinction to all other taxes, aggregate profits are usually viewed as the contingent of the profit tax. However, since only the information about the general amount of the profit tax distributed among budgets of different levels, but not the total amount of profits, is available, in this case there will be used the definition of the contingent similar to other taxes.

³⁶ For instance, in accordance with federal law No. 62 FZ of March 31, 1999, “On amendments to the law of the Russian Federation ‘On the tax on profits of enterprises and organizations,’” the rates of the tax on profits of enterprises and organizations were changed on April 1, 1999. As a result, a part of RF subjects changed the regional rates of the profit tax on April 1, 1999, while the rest set regional rates at levels of 19 per cent and 27 per cent since January 1, 1999, or prolonged the terms of validity of regional rates applied in 1998 (22 per cent for enterprises and organizations, 30 per cent for exchanges, brokerage offices, etc.) until the end of 1999. For the purposes of this analysis, the rates of allocation of the profit tax in 1999 were calculated as the simple average of the allocation rates applied in the 1st and subsequent quarters of 1999. The rates of VAT allocations in 1999 were calculated in the similar way for the 1st and subsequent quarters of 1999 (since federal law No. 36 FZ of February 22, 1999, “On the federal budget for year 1999” set forth different proportions of distribution of tax revenues between the federal budget and budgets of RF subjects).

Adapted expenditures are the expenditures which should be defrayed at the expense of assigned tax and additional non-tax revenue sources. They differ from actual municipal expenditures because of two factors. First, they do not include subventions for financing powers and federal mandates assigned to municipalities, since these expenditures should not be defrayed at the expense of own revenues. These subventions are reflected in the expenditure item “Social policy.” Second, they were reduced by the amount of expenditures defrayed at the expense of non-tax sources, since the calculations do not presuppose the exclusion or reduction of the amount of any existing non-tax sources. Therefore, this value is assumed to be a constant, which would not affect the results of the calculations.

Accordingly, the adapted expenditures ($R_{ij}^{(\Sigma,t)}(a)$) of municipal budgets were calculated as

$$R_{ij}^{(\Sigma,t)}(a) = R_{ij}^{(\Sigma,t)} - R_{ij}^{(nontax,\Sigma,t)} - R_{ij}^{(fms,t)},$$

where $R_{ij}^{(\Sigma,t)}$ are actual municipal expenditures; $R_{ij}^{(fms,t)}$ are the expenditures for financing of federal mandates at the expense of subventions; $R_{ij}^{(nontax,\Sigma)}$ are non-tax revenues of the i -th municipality of the j -th region in the year t .

In order to make the data comparable across municipal entities of different sizes, per capita or relative indicators were used in all calculations.

Besides, in the course of calculation it was taken into account that the capacity of municipal financial and budgetary policies to a certain extent depend on the level of residential household incomes. The data pertaining to the household incomes as broken down by municipal entities are not available at the federal level. Therefore, indirect evaluations had to be used in order to take this factor into account. The first variant of evaluation was based on the average household incomes in a RF subject. The second variant envisaged a somewhat more complex algorithm. The aggregate per capita contingent of the income tax and the tax on aggregate personal incomes was determined for each municipal entity. This indicator was assumed to be an indirect indicator of the level of household incomes. Depending on its value, all municipal entities were classified in groups, conventionally defined as municipalities with low, medium, and high levels of household incomes. For instance, as concerns the data for year 2001 pertaining to cities where populations exceed 200 thousand persons, the municipalities where the amount of the contingent was below Rub. 1500 were included in the first group, the municipalities with the amount of the contingent above Rub. 2500 were included in the third group, and those with amounts of the contingent falling between these indicators – to the second group. For the distribution of cities across these groups, see Figure 5.2. Accordingly, the fact that municipalities belonged to one of these groups was taken into account in the course of evaluation of potential revenues and expenditures of municipal entities.

At the next stage of preparations for the calculation, the annual data were evaluated aiming at the determination of periods, in which the calculations could produce most adequate results. The analysis revealed that year 2001 was most suitable from this point of view, because of the following:

- there are available the data pertaining to the largest number of municipal entities;
- increase in creditor indebtedness has the least deforming impact on the amount of expenditures;
- influence of non-cash forms of execution of the budget is insignificant;
- financing of federal mandates from budgets of higher levels may be evaluated most thoroughly;
- there exists a lower probability of an error in the course of calculation of contingents of the taxes recommended for the assignment to the municipal level (in any case, in comparison with 1999);
- there exist more adequate conditions for forecasts, since both the economic situation, and the regulatory mechanisms have significantly changed in comparison with 1999 and even 2000.

Therefore, the data for year 2001 were determined as the basis for the calculation of variants of assignment of revenue sources to municipal entities. Wherever possible, the data were adjusted taking into account the trends characteristic of 2002. Therefore, there were used the data collected over 10 months of 2002, which were compared with the indicators registered in the respective period of 2001. This approach was applied for adjustment of both revenue sources and individual expenditure items.

Approaches to the formation of revenue sources of municipal entities

The discussion about preferable revenue sources at the local level has already been reviewed in Chapter 2, and the conclusion was that the income tax, property taxes (in perspective, the property tax), and taxes on aggregate income were most suitable for this purpose. There is also possible a variant where the sales tax is turned into a local tax. Basing on the available data, the study will attempt to test these conclusions by reviewing the degree of evenness of the distribution of different taxes and their adequacy to the amount of municipal expenditures.

Table 5.2 presents the capacity to defray adapted municipal expenditures at the expense of contingents of different taxes assigned at present to municipal budgets as concerns the sample of large cities. For each contingent, there was calculated the respective coefficient of variation. The obtained results reveal that the income tax to the greatest extent corresponds to municipal expenditures, at the same time, for three years there was observed a favorable tendency of its changes – the capacity to defray municipal expenditures at the expense of this tax has increased from about 40 per cent to more than 50 per cent, while the coefficient of variation decreased from 29.5 per cent to 25.5 per cent. Property taxes may be considered the second best option, as 18 to 19 per cent of expenditures may be defrayed at their expense, however, in this case the coefficient of variation makes about 40 per cent. As concerns the taxes on aggregate income, their share in funding of municipal expenditures demonstrates an upward trend (it has increased more than two times over 3 years), while the coefficient of variation (initially rather high) displays a downward trend (from 85 per cent to 51 per cent). The sales tax demonstrates less favorable dynamics – the share of funding of municipal expenditures at the expense of this tax has decreased from 11 per cent to 9 per cent, while the coefficient of variation fluctuated between 45 per cent and 50 per cent. At last, the land tax defrays a rather small and decreasing share of municipal expenditures and demonstrates the highest values of the coefficient of variation out of the revenue sources under observation. Proceeding from the assumed prerequisites of the analysis, it should not be assigned to municipal entities. However, since this tax is a local tax and in perspective will become a component of the property tax and the mechanisms of its imposition will radically transform, at present it would be illogical to separate it from other property taxes.

As concerns three large regulating taxes making a considerable portion of municipal budgets over the last three years, i.e. the profit tax, excises, and, until 2001, VAT, it is apparent that they are least suitable for the assignment to municipal budgets. The coefficient of variation pertaining to these taxes was at or above 66 per cent and in certain cases exceeded 106 per cent. At the same time, it is necessary to take into account the fact that the distribution of these taxes across smaller localities will be even less even.

Therefore, the conducted analysis indicates that the present notion about the taxes most suitable for the assignment to the local level is correct and the further calculations will be done basing on these conclusions.

The calculations also took into account the potential mechanisms of assignment of taxes to municipal entities relating to the enhancement of their equalizing effect. The program of development of fiscal federalism till 2005 envisaged the division of the majority of assigned revenue sources in the guaranteed and equalizing parts. The guaranteed part of a tax is assigned in proportion to its contingent, while the equalizing part is assigned basing on the results of the redistribution of the tax at the regional level in proportion to the size of the population. In this study, this mechanism is analyzed in relation to the income tax, since it is supposed to form other tax revenues either at the expense of local taxes, or taxes insufficiently large for such redistribution.

The calculation of the size of the equalizing part is done in the following way. Basing on the data pertaining to the consolidated regional budget and the size of the population, there were determined average regional per capita indicators relating to the income tax in 2001 for each region included in the analysis, or that where there was situated at least one of the cities from the sample. Further, this indicator was multiplied by the share of the income tax planned to be assigned as the equalizing part.

Therefore, the mechanisms of assignment of the income tax were calculated in the following way:

$$T_{ij}^{(it,t)}(\text{guarant.}) = \alpha_1 K_{ij}^{(it,t)};$$

$$T_{ij}^{(it,t)}(\text{equal.}) = \alpha_2 \frac{N_{ij}^{(t)} \sum_l K_{lj}^{(it,t)}}{\sum_l N_{lj}^{(t)}} = \alpha_2 \frac{N_{ij}^{(t)} K_j^{(it,t)}}{N_j^{(t)}};$$

Here $T_{ij}^{(it,t)}(\text{guarant.})$ is the amount of the guaranteed part of the income tax, $T_{ij}^{(it,t)}(\text{equal.})$ is the amount of the equalizing part of the income tax; $K_{ij}^{(it,t)}$ is the contingent of the income tax in the i -th municipality of the j -th region in the t -th year; α_1 is the rate of allocation of the contingent of the income tax, α_2 is the share of the contingent of the income tax redistributed in proportion to the population size; $N_{ij}^{(t)}$ is the size of the population of the i -th municipality of the j -th region in the t -th year; $N_j^{(t)}$ is the size of the population of the j -th region in the t -th year.

Table 5.2

**Capacity to cover adapted municipal expenditures at the expense
of the contingents of major taxes, 1999 through 2001.**

Tax contingents	1999					2000					2001				
	min. (%)	max. (%)	average (%)	coef. of variation (%)	number of municipalities	min. (%)	max. (%)	average (%)	coef. of variation (%)	number of municipalities	min. (%)	max. (%)	average (%)	coef. of variation (%)	number of municipalities
Tax on profits (proceeds) of enterprises and organizations	0,7	462,1	78,5	106,1	59	0,6	381,8	71,2	88,8	43	8,1	255,6	70,2	68,9	68
Personal income tax	19,8	85,7	39,8	29,5	60	19,1	63,4	40,9	26,3	45	22,9	81,9	50,9	25,5	68
VAT	19,2	462,1	108,4	66,0	59	10,2	538,9	111,4	79,3	44					
Excises	0,02	55,5	12,0	97,0	52	0,03	66,0	11,7	93,3	39	0,04	48,9	12,5	88,2	61
Sales tax	1,7	24,2	11,1	45,9	52	1,9	24,2	10,7	49,7	43	1,6	17,5	9,0	46,3	61
Taxes on aggregate income	0,03	15,9	4,4	86,0	59	0,8	24,9	6,7	80,3	46	2,1	24,4	10,5	51,2	68
Property taxes	0,48	33,3	18,6	39,6	60	5,8	40,7	17,7	42,6	46	3,5	35,0	17,8	40,7	68
Land tax	0,03	20,7	5,1	69,7	60	0,1	15,9	4,5	74,8	46	0,3	14,6	3,9	76,7	68

Methods of calculation

The calculations were done at several stages.

At the first stage, there were tested the possibilities to assign existing revenue sources to municipal entities in order to defray their actual expenditures basing on the situation existing in 2001.

At the second stage, there were evaluated the trends of the dynamics of revenue sources. The evaluations took into account both the actual trends observed in 2002, and the potential changes in tax and non-tax revenues in relation to the implementation of different policies of the tax reform.

At the third stage, there was conducted a scenario based analysis of the amount and structure of municipal expenditures, there were detected trends and potentialities of changes in these expenditures both in the case the existing set of functions and powers of municipal entities were retained, and in the case it were revised. There were taken into account the actual trends of changes in expenditures registered in 2002, consequences of implementation of social reforms at the local level, other potential factors of growth and decline in expenditures borne by municipal entities.

At the fourth stage, there were determined several variants of assignment of revenue sources allowing to defray the maximal amount of expenditures on condition that there would be no significant excess in fiscal capacity of individual municipal entities.

Basing on the whole complex of calculations pertaining to cities with populations exceeding 200 thousand persons, there were formulated hypotheses about the best variants of assignment of revenue sources to municipal entities depending on the different sets of their functions and powers. The variants were compared basing on the following indicators:

- the ratio between the minimal and maximal share of adapted expenditures covered by assigned revenue sources
- the coefficient of variation of share of adapted expenditures covered by assigned revenue sources borne by municipal entities;
- the average share of adapted expenditures covered by assigned revenue sources, i.e. that characteristic of the average municipal entity of the given sample;

- the overall share of adapted expenditures covered by assigned revenues, i.e. the ratio between the total amount of revenues from the assigned revenue sources and the aggregate adapted expenditures of all municipal entities included in the sample;
- the overall surplus across the sample, i.e. the ratio between the aggregate surplus of municipal entities where assigned revenues exceed expenditures and the aggregate adapted expenditures of all municipal entities included in the sample;
- the overall deficit across the sample, i.e. the ratio between the aggregate deficit of municipal entities where expenditures exceed assigned revenues and the aggregate adapted expenditures of all municipal entities included in the sample (this indicator characterizes the need for financial aid);
- the number of municipal entities with surplus, including those with surplus exceeding 10 per cent;
- the degree of subsidization of municipal entities, which was determined proceeding from the share of financial aid necessary to finance adapted municipal expenditures.

The hypotheses formulated basing on the data pertaining to the sample of large cities were tested in the framework of the analysis of consequences of the proposed variants of assignment of revenue sources for the RF subjects included in the database. For these purposes, the whole cycle of calculations conducted in relation to the cities where populations exceed 200 thousand persons was repeated in relation to a broader data array pertaining to the municipal entities in the framework of each region. The analysis was conducted basing on the same set of indicators as in the case of large cities. Further, the initial hypotheses were adjusted, if necessary. Basing on the results of the analysis, there were formulated final recommendations on the assignment of revenue sources to municipal entities.

Besides the solution of the primary problem, this study permits to answer a number of other questions important from the viewpoint of the implementation of the reform of municipal finances:

- evaluate the capacity to assign revenue sources without a large-scale reform of the territorial structure of municipal entities;
- determine the most suitable set of functions and powers of municipal entities from the viewpoint of their financial security;
- analyze advantages and disadvantages of the assignment of revenue sources in proportion to the tax contingents or basing on their redistribution on per capita principle;
- forecast the capacity to defray the decline in revenues resulting from the tax reform at the expense of new revenue sources.

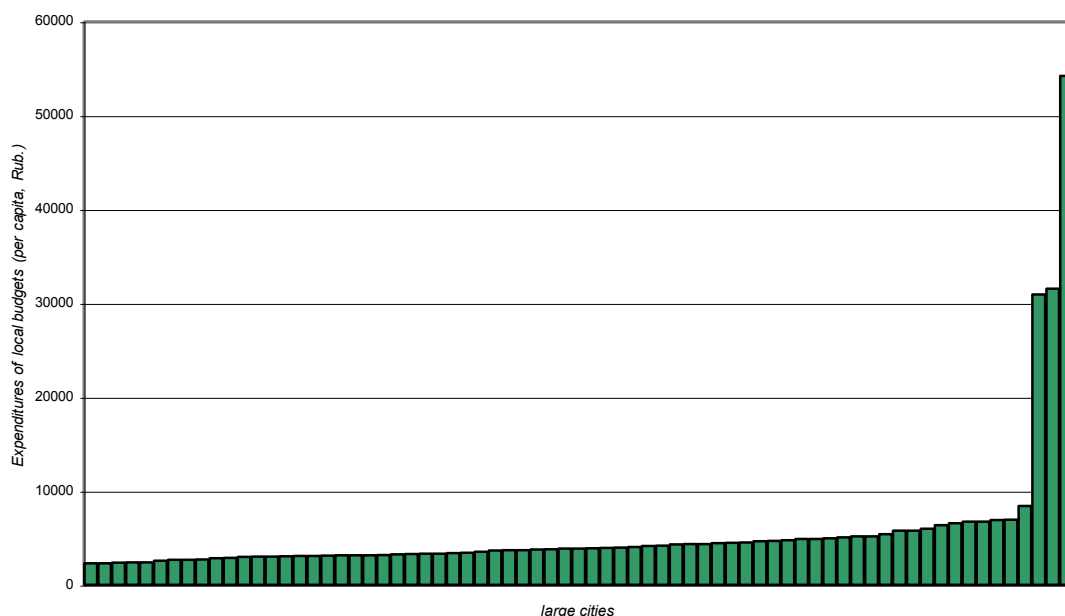


Figure 5.1 Distribution of municipal entities in the ascending order of their fiscal capacity (in terms of expenditures), 2001

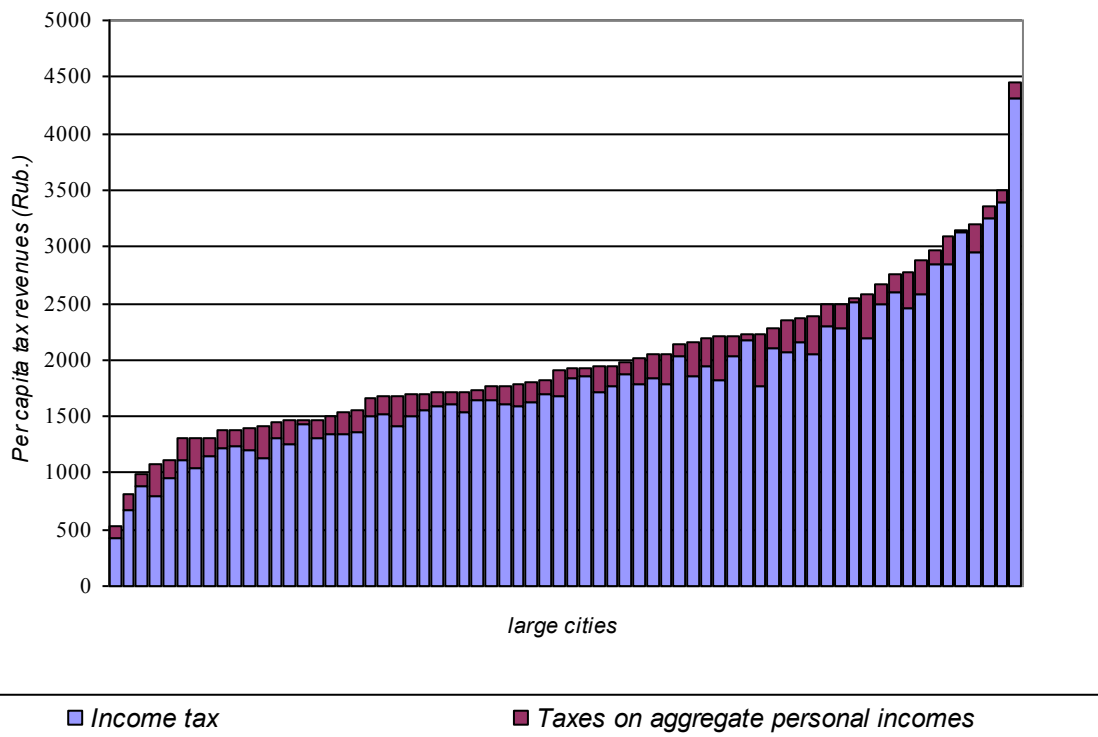


Figure 5.2 Characteristic of the levels of household incomes in municipal entities with populations exceeding 200 thousand residents, 2001

Annex 5.1

The Methods of Selection of Rf Subjects for Inclusion in the Database

Proceeding from the objective of this study, for the inclusion in the database there was formed a sample consisting of 14 RF subjects under the analysis. The sample was formed on the base of the grouping of RF subjects built depending on their financial performance.

Financial performance indicators of RF subjects

In order to build the grouping, there were used two indicators reflecting the financial performance of RF subjects:

- Revenues of the consolidated budget of the RF subject per one resident taking into account the respective subsistence level (SL).
- Share of transfers from the Federal fund of financial support of RF subjects in the respective budgetary revenues.

For the purposes of the calculations, the grouping was build basing on the initial data about execution of consolidated budgets of RF subjects in 2001.

Grouping methods

In order to build the grouping of RF subjects in accordance with the requirements set by this study, there was used the method of cluster analysis. The clustering of RF subjects was conducted in accordance with the Ward's method. In the framework of this method, the within group sum of squared deviations from the mean of a cluster (the sum of squared distances from each object to the mean of the cluster containing this object) is used as the target function. According to the Ward's methods, at each step of clustering, the criterion for fusion of each two clusters is that it should produce the smallest possible increase in the target function, i.e. the within group

sum of squares. In fact, this method is aimed at fusion of closely situated clusters. The Euclidian distance was used as the function of distance in the process of clustering. All calculations necessary for clustering of RF subjects were done using the statistical program package SPSS 8.0.

Results of the clustering

As a result of the clustering, all RF subjects were classified in eight groups corresponding to eight clusters obtained in the result of the cluster analysis (see Table 5.1.1).

Table 5.1.1.

Grouping of RF subjects by budgetary revenues per 1 resident and the share of financial aid from the FFSR (based on the cluster analysis).

Group No.	Number of RF subjects	Diapasons of values of indicators of the grouping across the determined groups	
		Share of financial aid from the FFSR in the revenues of consolidated budget, 2001 (%)	Revenues of the consolidated budget per 1 resident, taking into account SL, 2001 (Rub.)
1	10	50,7-68,4	5107-12112
2	20	26,7-44,5	4848-16226
3	14	13,7-22,5	5551-19704
4	17	5,3-12,7	5457-8681
5	21	0-3,7	6693-13926
6	2	0	23609-25054
7	4	0-18,6	46512-52383
8	1	39,9	37881

The majority of RF subjects were classified in the first five groups, which were used for the sampling. The RF subjects included in groups 6 to 8 were excluded from the sample, since these groups are much less representative in comparison with the first five groups and in some way are exceptions with atypical for the majority of RF subjects combinations of parameters of financial performance. For the distribution of RF subjects across clusters, see Table 5.1.2.

Table 5.1.2.

Distribution of RF subjects by clusters

Region	Group No.	Share of financial aid from the FFSR in the revenues, 2001 (%)	Total revenues per 1 resident taking into account SL, 2001 (Rub.)
Aguinsky Buryat AO	1	64,8	7 008
Yevreyskaya Autonomous Oblast	1	63,0	10 695
Karach Cherkesian Republic	1	53,2	7 440
Komi Permyak AO	1	52,4	12 112
Koryakian AO	1	53,8	11 794
Republic of Dagestan	1	65,1	9 066
Ingush Republic	1	50,7	6 087
Republic of Tyva	1	68,1	9 929
Ust'-Orda Buryat AO	1	68,4	10 357
Chechen Republic	1	58,9	5 107
Altai krai	2	42,8	6 568
Amur oblast	2	38,1	8 638
Bryansk oblast	2	33,3	6 455
Ivanovo oblast	2	26,7	6 774
Kabardian - Balkarian Republic	2	36,9	9 571
Kamchatka oblast	2	28,9	8 844
Kurgan oblast	2	27,9	6 229
Magadan oblast	2	33,3	13 358
Penza oblast	2	29,6	4 848
Primorsky krai	2	31,5	7 611
Pskov oblast	2	32,0	7 673
Republic of Adygea	2	34,2	8 366

Region	Group No.	Share of financial aid from the FFSR in the revenues, 2001 (%)	Total revenues per 1 resident taking into account SL, 2001 (Rub.)
Republic of Altai	2	44,5	11 557
Republic of Buryatia	2	35,5	9 085
Republic of Kalmykia	2	37,8	8 439
Republic of Mariy El	2	28,5	5 863
Republic of North Osetia – Alaniya	2	34,3	10 931
Tambov oblast	2	28,6	6 361
Chita oblast	2	33,8	6 101
Chukotka AO	2	41,4	16 226
Arkhangelsk oblast	3	19,6	7 120
Vladimir oblast	3	13,7	6 569
Voronezh oblast	3	16,8	5 551
Kirov oblast	3	17,2	5 617
Kostroma oblast	3	14,8	6 931
Republic of Mordovia	3	15,3	9 897
Republic of Sakha (Yakutia)	3	20,1	19 704
Rostov oblast	3	15,8	7 502
Ryazan oblast	3	14,4	6 644
Sakhalin oblast	3	18,4	9 708
Stavropol krai	3	15,0	5 663
Tver oblast	3	14,1	6 548
Khabarovsk krai	3	16,1	12 777
Chuvash Republic	3	22,5	6 279
Astrakhan oblast	4	5,5	6 156
Volgograd oblast	4	6,9	5 457
Kaliningrad oblast	4	11,7	7 353
Kaluga oblast	4	12,0	8 681
Kemerovo oblast	4	5,3	7 594
Krasnodar krai	4	8,2	8 342
Kursk oblast	4	6,9	6 026
Novgorod oblast	4	7,7	7 017
Novosibirsk oblast	4	12,3	6 196
Omsk oblast	4	12,7	7 294
Oryol oblast	4	10,6	8 485
Republic of Karelia	4	8,3	8 494
Republic of Khakasia	4	12,0	5 468
Saratov oblast	4	7,6	5 986
Smolensk oblast	4	10,4	6 720
Tula oblast	4	9,9	6 559
Ulianovsk oblast	4	7,6	7 235
Belgorod oblast	5	0,0	7 331
Volgograd oblast	5	0,0	9 707
City of St. Petersburg	5	0,0	9 402
Irkutsk oblast	5	0,9	8 599
Krasnoyarsk krai	5	0,0	11 395
Leningrad oblast	5	3,7	8 292
Lipetsk oblast	5	0,0	9 332
Moscow oblast	5	1,2	10 005
Murmansk oblast	5	0,9	6 918
Nizhny Novgorod oblast	5	0,0	7 774
Orenburg oblast	5	0,0	7 616
Perm oblast	5	0,0	11 674
Republic of Bashkortostan	5	0,0	12 848
Republic of Komi	5	0,0	13 926
Samara oblast	5	0,0	10 278

Region	Group No.	Share of financial aid from the FFSR in the revenues, 2001 (%)	Total revenues per 1 resident taking into account SL, 2001 (Rub.)
Sverdlovsk oblast	5	0,0	7 592
Tomsk oblast	5	2,9	9 124
Tyumen oblast	5	0,0	13 153
Udmurtian Republic	5	3,0	8 868
Chelyabinsk oblast	5	1,1	6 693
Yaroslavl oblast	5	0,0	9 062
City of Moscow	6	0,0	25 054
Republic of Tatarstan	6	0,0	23 609
Nenetsian AO	7	0,0	46 988
Taymyr (Dolgano - Nenetsian) AO	7	18,6	46 512
Khanty - Mansi AO	7	0,0	52 383
Yamal - Nenetsian AO	7	0,0	49 291
Evenk AO	8	39,9	37 881

Selecting RF subjects for the inclusion in the database

The sample of RF subjects for the inclusion in the database was formed basing on three principles:

- Equal (or approximately equal) representation of RF subjects of each of five clusters in the sample;
- Geographical diversity;
- Availability of necessary data.

In accordance with these principles, from each cluster, with the exception of the first, there were selected 3 RF subjects. Because of the unavailability of information pertaining to the regions in the first cluster, only two RF subjects were included in the database. As a result, there was formed a sample consisting of 14 RF subjects, which included:

- **from the first cluster:** Yevreyskaya autonomous oblast, Komi - Permyak autonomous okrug;
- **from the second cluster:** Kabardian - Balkarian Republic, Amur oblast, Tambov oblast;
- **from the third cluster:** Chuvash Republic, Rostov oblast, Tver oblast;
- **from the fourth cluster:** Novgorod oblast, Novosibirsk oblast, Saratov oblast;
- **from the fifth cluster:** Krasnoyarsk krai, Leningrad oblast, Sverdlovsk oblast.

These regions were distributed by federal okrugs in the following way:

- **Central okrug:** Tambov oblast, Tver oblast;
- **North West okrug:** Leningrad oblast, Novgorod oblast;
- **Privolzhski okrug:** Chuvash Republic, Saratov oblast, Komi - Permyak AO;
- **Ural okrug:** Sverdlovsk oblast.

Southern okrug: Kabardian - Balkarian Republic; Rostov oblast.

Siberian okrug: Novosibirsk oblast, Krasnoyarsk krai.

Far East okrug: Koryakian AO, Amur oblast, Yevreyskaya autonomous oblast.

The initial analysis of the data did not revealed serious problems relating to information pertaining to all these regions, however, a more thorough study of the data revealed that the information pertaining to two regions could be unreliable:

- in the Novgorod oblast, municipal per capita expenditures were extremely low (to a certain extent, although not completely, this fact may be explained by the high degree of centralization of HPU financing);
- in the Tambov oblast, the income tax was not entered in the majority of municipal budgets, as a result, it becomes impossible to determine the contingents of the income tax and to do respective calculations.

Accordingly, these two regions were excluded from the calculations, which, as a result, based on the data from 12 RF subjects, out of which 2 were included in the first cluster, 2 were included in the second cluster, 3 were included in the third cluster, 2 were included in the fourth cluster, and 3 were included in the fifth cluster.

Annex 5.2

A Short Description of the Database

Informational support for calculations has been organised in the form of two relational data banks, namely DB-Cities and DB-Municipalities.

DB-Cities contains eight databases: Cities (Cit), Indicators (Ind), Demography (Dem), Revenues (Inc), Expenses (Exp), Funding Sources (Sou), Economical Classification (ECl) and Ratios (Rat).

The Cit Database is an auxiliary database; it contains two fields: CC and C, with the codes and names of the cities, the data on which is stored in the DB-Cities. The CC field is the key.

CC	C
City Code	City

The Ind Database is an auxiliary database, too. It contains two fields, IC and I, with the codes and names of indicators analysed in the DB-Cities. The IC field is the key.

IC	I
Indicator Code	Indicator

The Dem database contains the data on population in the cities under review in years 1999 - 2001. It contains three fields, CC, Y and P with city codes, years and population. The CC and Y Fields form the compound key.

CC	Y	P
City Code	Yr	Population

The Rev database contains the data on plan and actual revenues of city budgets in the cities under review in years 1999 - 2001. There are 68 fields: Y (the year, for which the data is cited), CC (the code of the city, for which the data is cited), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and 65 fields corresponding to the indicators with codes from Ind01 to Ind63, in which data on city budget revenues is cited. The Y, CC and Ind fields form the compound key.

Y	CC	Ind	D01	...	D65
Yr	City code	Plan/ Actual	Value	...	Value

The Exp database contains the data on plan and actual expenses of city budgets in the cities under review in years 1999 - 2001. There are 125 fields: Y (the year, for which the data is cited), CC (the code of the city, for which the data is cited), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and 122 fields corresponding to indicators with the codes from E001 to E122 that show the data on city budget expenses. The Y, CC and Ind fields form the compound key.

Y	CC	Ind	E001	...	E122
Yr	City Code	Plan/ Actual	Value	...	Value

The Sou database contains the data on plan and actual sources of funding of the city budget deficit in the cities under review in years 1999 - 2001. It contains 12 fields: Y (the year, for which the data is cited), CC (the code of the city, for which the data is cited), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and nine fields corresponding to indicators with the codes from I1 to I9 that contain the data on the sources of city budget funding. The Y, CC and Ind fields form the compound key.

Y	CC	Ind	I1	...	I9
Yr	City code	Plan/ Actual	Value	...	Value

The ECl database contains the data on plan and actual expenses of city budgets under economic classification in the cities under review in years 1999 - 2001. It contains 13 fields: Y (the year, for which the data is cited), CC (the code of the city for which the data is cited), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and ten fields corresponding to indicators with the codes from EC01 to EC10 that contain the data on the revenues of the city budget. The Y, CC and Ind fields form the compound key.

Y	CC	Ind	EC01	...	EC10
Yr	City code	Plan/ Actual	Value	...	Value

The Rat database contains the data on the ratios of tax payments to city budgets in the cities under review in years 1999 - 2001. It contains 24 fields: Y (the year, for which the data is cited), CC (the code of the city, for which the data is cited) and 22 fields corresponding to indicators with the codes from N01 to N22 containing the data on the ratios of tax payments to the city budget. The Y and CC fields form the compound key.

Y	CC	N01	...	N22
Yr	City code	Value	...	Value

The structure of the DB-Cities is shown in *Figure 5.2.1*.

DB-Municipalities contains nine databases: Regions (Reg), Municipalities (Mun), Indicators (Ind), Demography (Dem), Revenues (Rev), Expenses (Exp), Funding Sources (Sou), Economic classification (ECI) and Ratios (Rat).

The Reg database is an auxiliary database; it contains two fields, namely RC and R, with the codes and the names of the regions, the data on which is stored in the DB-Municipalities databank. The MC field is the key.

RC	R
Region code	Region

The Mun database is an auxiliary database; it contains three fields: RC, MC and M, with the codes of regions and municipalities and the names of cities, the data on which is stored in the DB-Municipalities databank. The RC and MC fields form the compound key.

RC	MC	M
Region code	Municipality code	Municipality

The Ind database is also auxiliary. It contains two fields, IC and I, with the indicator codes and names analysed in the DB-Municipalities databank. The IC field is the key.

IC	I
Indicator code	Indicator

The Dem database contains data on population in the municipalities under review in years 1999 - 2001. It contains four fields: RC, MC, Y and P with the region and municipality codes, years and data on population. The CC and Y fields form the compound key.

RC	MC	Y	P
Region code	Municipality code	Yr	Population

The Rev database contains the data on municipal budgets plan and actual revenues in the municipalities under review in years 1999 - 2001. It contains 69 fields: Y (the year, for which the data is cited), MC (the code of the municipality, for which the data is cited), RC (the code of the region, in which the municipality is located), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and 65 fields corresponding to the indicators with codes from R01 to R63 containing the data on the municipal budgets revenues. The Y, MC, RC and Ind fields form the compound key.

Y	MC	MR	Ind	R01	...	R65
Yr	Municipality code	Region code	Plan/ Actual	Value	...	Value

The Exp database contains the data on municipal budgets plan and actual expenses in the municipalities under review in years 1999 - 2001. It contains 126 fields: Y (the year, for which the data is cited), MC (the code of the municipality, for which the data is cited), RC (the code of the region, in which the municipality is located), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and 122 fields corresponding to indicators with the codes from E001 to E 122 containing the data on the municipal budgets expenses. The Y, MC, RC and Ind fields form the compound key.

Y	MC	MR	Ind	E001	...	E122
Yr	Municipality code	Region code	Plan/ Actual	Value	...	Value

The Sou database contains the data on the plan and actual sources of financing of the municipal budget deficit in the municipalities under review in years 1999 - 2001. It contains 13 fields: Y (the year, for which the data is cited), MC (the code of the municipality, for which the data is cited), RC (the code of the region, in which the municipality is located), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and nine fields corresponding to indicators demonstrating with the codes from I1 to I9 that contain the data on the sources of municipal budget funding. The Y, MC, RC and Ind fields form the compound key.

Y	MC	RC	Ind	I1	...	I9
Yr	Municipality code	Region code	Plan/ Actual	Value	...	Value

The ECI database contains the data on the plan and actual municipal budget expenses under the economic classification in the municipalities under review in years 1999 - 2001. It contains 14 fields: Y (the years, for which the data is cited), MC (the code of the municipality, for which the data is cited), RC (the code of the region, in which the municipality is located), Ind (the indicator of performance demonstrating whether this is plan data or actual data) and ten fields corresponding to indicators demonstrating with the codes from E1 to E9 that contain the data on the sources of municipal budget funding. The Y, MC, RC and Ind fields form the compound key.

Y	MC	RC	Ind	EC01	...	EC10
Yr	Municipality code	Region code	Plan/ Actual	Value	...	Value

The Rat database contains the data on the ratios of tax payments to municipal budgets in the municipalities under review in years 1999 - 2001. It contains 25 fields: Y (the years, for which the data is cited), MC (the code of the municipality, for which the data is cited), RC (the code of the region, in which the municipality is located) and 22 fields corresponding to indicators demonstrating with the codes from R1 to R22 that contain the data on the ratios of payments to the municipal budget. The Y, MC, and RC fields form the compound key.

Y	MC	RC	R01	...	R22
Yr	Municipality code	Region code	Value	...	Value

The structure of the DB-Municipalities is shown in *Fig. 5.2.2*.

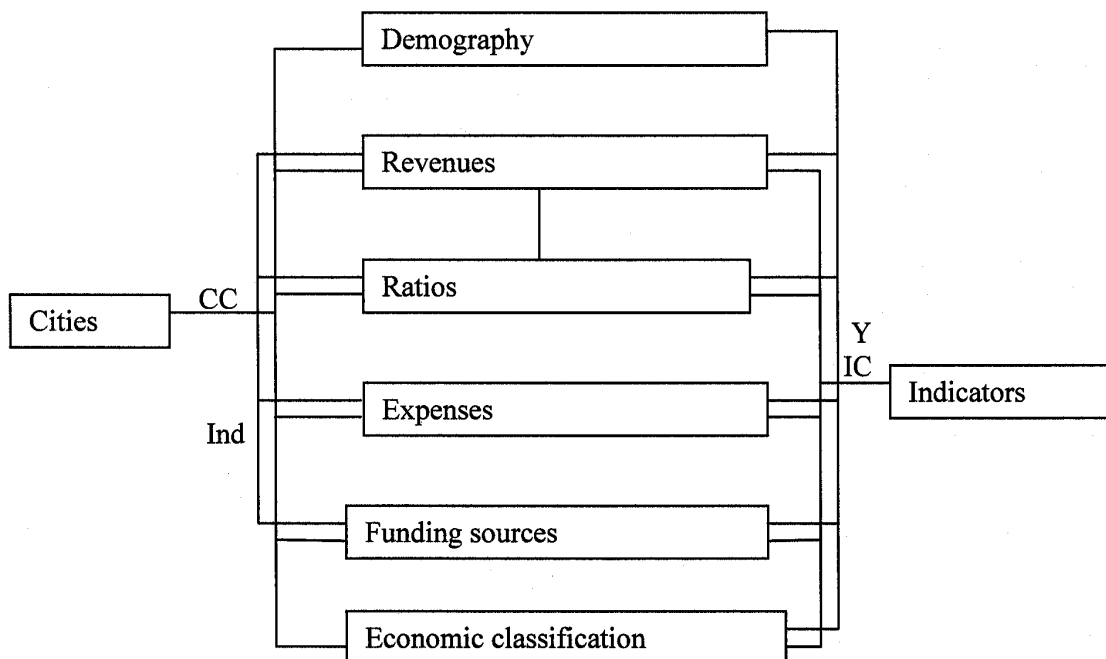


Fig. 5.2.1. Structure of the DB-Cities

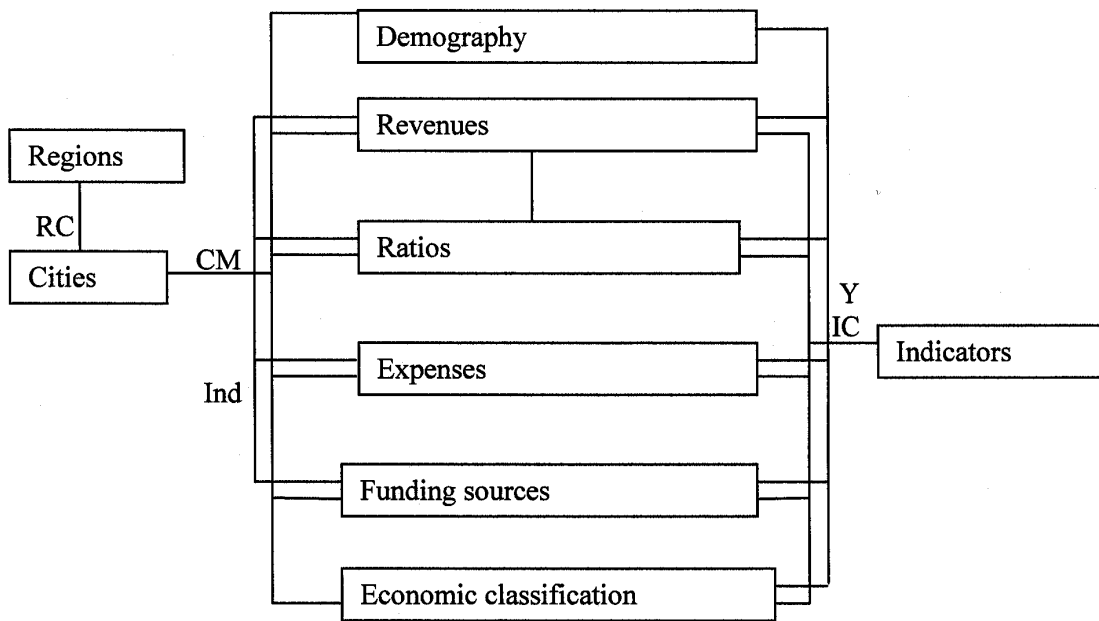


Fig. 5.2.2. Structure of the DB-Municipalities

Chapter 6. Calculations Basing on the Data about Municipal Finances of Large Cities

General characteristic of the budgetary information on large cities

The situation of the cities where populations exceed 200 thousand persons is different from the national averages across a number of parameters. The most significant differences may be reduced to the following.

First, tax and non-tax revenues play a more significant role in the structure of revenues, while the unit weight of financial aid is significantly less. However, there is observed a trend towards an increase in the share of financial aid in revenues of large cities. Thus, while in 1999 and 2000 this share in municipal revenues in Russia at large exceeded the respective indicator of large cities five times, in 2001 there was observed only twofold excess. In some cases, over 50 per cent of expenditures of large cities were financed at the expense of financial aid. Most probably, this fact may be explained by more full financing of federal mandates in 2001 in comparison with the preceding period. For information on the revenue structure of municipal entities having more than 200 thousand residents see *Table 6.1*.

Second, as concerns the structure of expenditures, the main difference is that large cities expend a much higher share of their revenues for housing and public utilities (HUS), which exceeds the national average by almost one third. Other differences are not so significant, although lower shares of expenditures for local government (5.0 and 6.3 respectively in 2001) and industry, power engineering, and construction (in other words, for capital investment, 5.5 and 9.0 respectively in 2001) demonstrate the scale effect in large municipal entities. For the characteristic of base budgetary expenditures of large cities, see *Table 6.2*.

Third, in the group of large cities practically no relation is observed between per capita municipal expenditures and the share of individual expenditures of municipal budgets, and the distribution of expenditures between municipal and regional budgets. It is especially clear in financing of education, as respective regional policies considerably differ across RF subjects. Most probably, this phenomenon may be explained by the fact that financing of expenditures of smaller and less financially secure municipalities is the priority of regional budgets, while relatively large municipal entities defray these expenditures independently in any case.

Fourth, cities with populations below 200 thousand persons are a more homogeneous group than municipalities in the majority of regions. At the same time, while the dispersion of expenditures for education and health care is rather close to the situation existing in the regional framework, the group of cities is significantly more homogeneous in terms of housing and public utilities. The increase in differences relating to the shares of expenditures for HUS across large cities in 1999 through 2001 may be explained rather by differentiation of the pace of the housing reform than differences in objective conditions.

Table 6.1

Revenue structure of municipal entities with populations exceeding 200 thousand residents in 1999 through 2001, in %

	1999 (63)				2000 (47)				2001 (69)			
	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>coef. of variation</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>coef. of variation</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>coef. of variation</i>
Total revenues, including	100,0	100,0	100,0	0,0	100,0	100,0	100,0	0,0	100,0	100,0	100,0	0,0
<i>Tax</i>	36,6	97,4	83,6	12,4	45,5	97,5	82,6	12,6	34,4	97,1	74,8	17,6
<i>Non-tax</i>	1,4	30,0	5,6	85,8	0,5	20,0	5,2	62,7	1,1	14,7	5,6	51,0
<i>Financial aid</i>	0,0	27,5	5,0	97,8	-0,2	24,8	5,1	108,7	0,0	57,1	15,4	85,8
<i>Other revenues</i>	0,0	54,6	5,8	169,6	0,0	48,4	7,1	144,2	0,0	27,4	4,2	132,9

Table 6.2

Expenditure structure of municipal entities with populations exceeding 200 thousand residents in 1999 through 2001, in %

Expenditure items	1999 (63)				2000 (47)				2001 (69)			
	min.	max.	average	coef. of variation	min.	max.	average	coef. of variation	min.	max.	average	coef. of variation
TRANSPORT, ROAD NETWORK, COMMUNICATIONS, AND INFORMATICS	0,0	27,7	6,2	77,7	0,6	11,4	4,5	53,1	0,0	13,2	2,4	103,4
HOUSING AND UTILITIES SECTOR	12,8	52,4	32,0	22,9	13,1	59,7	34,2	26,9	12,3	46,4	30,7	28,1
EDUCATION	18,4	43,3	27,7	20,5	17,8	35,7	26,8	18,0	18,6	36,2	26,3	19,7
HEALTH CARE AND PHYSICAL CULTURE	3,8	33,7	17,5	32,3	3,7	29,6	18,2	33,8	3,8	32,8	16,8	31,3
SOCIAL POLICY	0,3	16,9	4,3	76,1	0,6	9,7	3,3	66,6	0,0	22,7	7,0	63,6
TOTAL EXPENDITURES	100,0	100,0	100,0	0,0	100,0	100,0	100,0	0,0	100,0	100,0	100,0	0,0

Calculations: the first stage

In the framework of the first stage of calculations, there were reviewed the possibilities of assignment of available revenue sources to municipal entities for financing of their actual expenditures. The calculations were done in accordance with three variants. According to the first variant, municipal entities were assigned the full amount of the corporate asset tax, personal asset tax, land tax, rental payments for land, income tax, and 90 per cent of taxes on aggregate incomes and existing at present small local taxes³⁷. The second variant additionally included 100 per cent of the sales tax. The third variant, in addition to the sources according to the second variant included 5.7 per cent of the contingent of the profit tax, what approximately corresponds to 2 per cent rate of the profit tax.

The key characteristics of these variants and their comparison with the actual data for 2001 are presented in Table 6.3. For each variant, there were analyzed three mechanisms of assignment of the income tax:

- Full amount in proportion to the contingent;
- Full amount basing on the redistribution at the regional level in proportion to the population size;
- 50 / 50 ratio between the guaranteed and equalizing parts.

Table 6.4 presents the results of calculations concerning the assignment of revenue sources to municipal budgets. Variants 2 and 3 seem to be most preferable on condition that income tax would be divided in proportion 50 / 50 between the guaranteed and equalizing parts. Financial aid, required according to these variants of tax assignment, slightly differs from its actual level formed in 2001 as concerns this group of municipal entities, the aggregate surplus is below 3 per cent, coefficients of variation are most favorable, the ratio between the maximal and minimal share of expenditures covered by assigned revenues is also among the best values.

The analysis of the results of assignment of income tax basing on different analyzed mechanisms is of interest. For the comparative characteristic of the results, see Table 6.5. Apparently, the assignment of the income tax in proportion to the contingent is most preferable for sufficiently large municipal entities. Such an assignment would on the average allow ensuring rather significant share of expenditures (about 50 per cent), while the coefficient of variation, although not the best out of all possible, is sufficiently close to the best. The worst results in this group are registered in the case the total amount of income tax is assigned on the per capita redistribution principle. The capacity to cover expenditures at the expense of this source significantly deteriorates, while the coefficient of variation increases. It means that out of three mechanisms under observation, this approach ensures the most significant redistribution of the income tax contingent from highly profitable to other municipal entities, and that the unevenness of distribution of the income tax across regions is more significant than across large cities. It is interesting to note that the 50 / 50 variant produces sufficiently positive results, since in this case the coefficient of variation is minimal.

³⁷ It concerns revenue sources included in the budgetary classification item "local taxes." At present, the composition of this item may differ across regions. The calculations did not take into account the repayment of arrears of the tax on maintenance of housing and objects of social and cultural sphere, which continued in 2001 although the tax had been abolished.

Table 6.3

Variants of assignment of taxes to municipal entities in comparison with the actual data for 2001

Tax revenues	Variant 1	Variant 2	Variant 3	Actual, 2001
Personal income tax	100%	100%	100%	63,1%
Corporate profit tax	0%	0%	5,7% (2% of profit)	36,2%
Excises	0%	0%	0%	31,8%
Sales tax	0%	100%	100%	61,5%
Taxes on aggregate income	90%	90%	90%	50,5%
Property taxes	100%	100%	100%	58,4%
Land tax	100%	100%	100%	49,9%
Local taxes	100%	100%	100%	100%

Table 6.4

Variants of financing of adapted expenditures of municipal entities with populations exceeding 200 thousand residents at the expense of assigned revenue sources, 2001.

Conditions:									
Income tax	100% - of the contingent	100% - basing on the per capita redistribution	50% - guaranteed, 50% - equalizing parts	100% - of the contingent	100% - basing on the per capita redistribution	50% - guaranteed, 50% - equalizing parts	100% - of the contingent	100% - basing on the per capita redistribution	50% - guaranteed, 50% - equalizing parts
	Single tax on imputed income	90%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	90%	90%	90%	90%	90%	90%	90%	90%	90%
Property taxes	100%	100%	100%	100%	100%	100%	100%	100%	100%
Land tax	100%	100%	100%	100%	100%	100%	100%	100%	100%
Rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	0%	0%	100%	100%	100%	100%	100%	100%
Profit tax	0%	0%	0%	0%	0%	0%	5,7% (2% - of profits)	5,7% (2% - of profits)	5,7% (2% - of profits)
Results:									
min. share of expenditures covered by assigned revenues (%)	43,3	27,4	36,3	46,2	30,1	39,0	47,9	32,7	41,6
max. . share of expenditures covered by assigned revenues (%)	129,5	125,8	109,6	134,7	133,4	119,1	145,9	140,1	123,8
difference between the min. and max. . shares of expenditures covered by assigned revenues (%)	86,2	98,4	73,3	88,4	103,3	80,0	98,0	107,4	82,2
average . share of expenditures covered by assigned revenues (%)	84,7	71,2	77,9	92,6	79,1	85,9	96,5	83,0	89,8
overall . share of expenditures covered by assigned revenues (%)	82,8	69,7	76,3	90,4	77,3	83,9	94,4	81,4	87,9
coefficient of variation (%)	22,5	24,0	21,7	22,2	22,6	21,2	22,1	22,4	21,1
overall surplus (%)	2,0	0,5	0,6	4,1	1,1	1,9	5,7	1,5	3,0
overall deficit (%)	19,2	30,7	24,4	13,7	23,8	18,1	11,2	20,1	15,1
number of cities with surplus	14	3	10	24	8	16	28	9	20
number of cities with surplus exceeding 10 %	9	1	0	14	2	9	18	5	10

Table 6.5

The share of income tax in the financing of adapted expenditures of municipal entities, 2001 (in %)

<i>Variants of assignment of income tax Indicators</i>	<i>100% - of the tax contingent</i>	<i>100% - basing on the per capita redistribution</i>	<i>50% - guaranteed, 50% - equalizing parts</i>
Min. share of income tax	22,6	8,5	17,4
Max share of income tax	80,2	88,7	72,4
Average share of income tax	50,0	36,5	43,3
Coefficient of variation of the share of income tax	25,2	33,2	24,4

Calculations: the second stage

At the second stage of calculations, there was evaluated the impact of the possible changes in revenue sources related both to the dynamics of revenues generated by different taxes, and measures relating to the tax reform on local budgets. The most significant factors taken into account in this case are the following.

First, there were taken into account the actual changes in the inflow from key tax sources over 10 months of 2002 as compared with the respective period of 2001. The calculation of the income dynamics was done according to the following formula:

$$\tilde{T}_{ij}^{(k,2002)} = T_{ij}^{(k,2001)} \frac{K^{(k,2002,10)}}{1,1501K^{(k,2001,10)}},$$

where $\tilde{T}_{ij}^{(k,2002)}$ is the evaluation of potential revenues from the k -th revenue source of the i -th municipality of the j -th region in 2002; $T_{ij}^{(k,2001)}$ are revenues from the k -th revenue source of the i -th municipality of the j -th region in 2001; $K^{(k,t,10)}$ is the total amount of revenues from the k -th revenue source generated over 10 months of the t -th year in the RF territory; 115,01% is the CPI deflator (October of 2002 to October 2001).

The results of these calculations are presented in *Table 6.6*. Apparently, the growth in tax revenues across the majority of key taxes planned to be assigned to local budgets as revenue sources continued in 2002.

Second, there was taken into account the possible impact of changes in the regulation of the corporate asset tax aimed to diminish the taxation of the active portion of assets. In the case the tax base is reduced to the real assets of enterprises it would have rather significant consequences. Calculations concerning the City of Novgorod the Great demonstrated that the share of real assets in the base of substituted property tax varies from 30 per cent to 80 per cent depending on taxpayers' sphere of activity and makes about 50 per cent on the average. Accordingly, other things being equal, the property tax should decrease by about one half. However, in reality the implementation of the reform of this tax will not result in such significant changes because of the following:

- 1) apparently, the decrease in the tax base will not be so radical, since working capital (partly or in full) are primarily excluded from it;
- 2) reevaluation of fixed assets in 2002 had the most profound impact exactly on the part of the assets remaining subject to the tax;
- 3) the regions where the rate of the corporate asset tax is below maximal may rise this rate as a reaction to the changes in the tax base.

Basing on the estimation of the impact of these factors, there was reached a conclusion that it would be feasible to include in the calculation 75 per cent of the corporate asset tax calculated proceeding from the data accumulated over 10 months of 2002.

Third, there were taken into account the possible changes in taxation of personal assets. These evaluations were made proceeding from the assumption that the optimal strategy for municipal entities would be the exclusion of not more than 1 per cent of the annual income of each resident in the framework of this tax. For respective calculations see Annex 3.1.

Fourth, there was taken into account the possibility that the sales tax may be abolished. Accordingly, there were done calculations both including and excluding the revenues generated by this tax. At the same time, it was assumed that if the sales tax is retained, its total amount would be transferred to budgets of the same level – either RF subjects, or municipal entities.

At the same time, it proved impossible to include in the calculations a number of factors, which obviously would have an impact on municipal revenues. It primarily concerns the land tax and taxes on small businesses. The transition from the existing practice of setting the land tax rates to the evaluation of the tax base according to the cadaster value of land changes the taxation mechanisms so significantly that it is difficult to make any forecasts basing on the available data. The Novgorod experience demonstrated that in transition to the tax on real assets the ratio between the "land" and "property" parts of the tax sharply shifts in favor of land, although the total amount of the tax becomes significantly less than the sum of the substituted taxes. However, it is obvious that the current scale of introduction of the tax on real assets does not provide enough data to make broad generalizations. Therefore, in the frame of the analysis there were used the revenues generated by the land tax evaluated basing on the data accumulated over 10 months of 2002.

The situation relating to the taxes on small businesses (the main directions of the respective reform were analyzed in Chapter 3) is equally vague. According to experts, these revenues may considerably grow, especially under the simplified system, however, not only in relation to the real development of small businesses, but because large structures may use this scheme to conceal revenues and evade taxation. However, it is unclear if this possibility would be utilized in practice and to what extent. Other factors affecting the amount of these taxes in the future are also diverse, vary across different municipal entities, and practically cannot be evaluated in quantitative terms. Therefore, the calculations, as in the case of the land tax, based on evaluations made in 10 months of 2002.

For the changes in revenue sources under the impact of the totality of the factors under observation see *Table 6.7*.

Table 6.6

Evaluation of the changes in tax and non-tax revenues in 2002

	<i>Changes in tax and non-tax revenues over 10 months of 2002</i>		
	<i>Nominal, Rub. mil.</i>	<i>CPI-deflated, Rub. mil.</i>	<i>CPI-deflated, in % of respective period of preceding year</i>
Corporate profit tax	13109	-33545	-9,7
<i>Income tax</i>	78362	42722	21,9
<i>Sales tax</i>	3938	-1391	-3,8
<i>Taxes on aggregate income</i>	11882	7323	31,8
<i>Single tax on imputed income</i>	1484	630	12,5
<i>Single tax levied in relation to the application of the simplified taxation system</i>	10397	6694	37,2
<i>Asset tax</i>	28724	16480	25,3
<i>Land tax</i>	15333	4922	58,5
<i>Revenues from property in state and municipal ownership, or from operations of state and municipally owned enterprises</i>	60686	2072	4,1

* Deflator = 115,01%.

Table 6.7

Changes in revenues of municipal entities

<i>Potential of changes in municipal revenues</i>	<i>Per capita revenues (Rub.)</i>			<i>Deviation from actual revenues in 2001 (Rub.)</i>			<i>Increase / decrease in financing in shares in adapted expenditures (%)</i>			
	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>overall</i>
Sales tax is retained	2396,2	8897,8	4290,3	139,3	748,0	309,8	4,6	14,8	8,7	8,6
Sales tax is abolished	2304,1	8514,8	4120,8	-210,4	584,7	102,4	-6,9	11,1	2,6	2,8

Calculations: the third stage

At the third stage of calculations there were evaluated possible changes in expenditures of local budgets. The analysis made in the preceding chapters revealed the necessity of scenario based calculations allowing to evaluate implementation of different policies in this sphere. There may be singled out four variants of changes in expenditures of municipal entities depending on the changes in the distribution of powers between the regional and municipal levels.

The evolutionary scenario is based on the assumption that municipal entities would retain the previous amount of their functions and authority. The only exception is non-funded federal mandates; own expenditures of municipal entities ensuring their operation are excluded from municipal expenditures at the stage of analysis. Besides, in comparison with the actual situation it is assumed that budgets of municipal entities take into account all objective factors increasing or decreasing respective expenditures. The other three scenarios base on the results of calculations done in accordance with the evolutionary scenario and take into account the redistribution of responsibilities and powers between the regional and local levels.

On the whole, *the radical scenario* is based on the recommendations presented by the Commission for Division of Powers under the RF President. The variant envisages the most significant limitation of the jurisdiction of local authorities. Since the analysis concerns large cities, it was based on recommendations of the Commission relating to city okrugs; therefore the problem of two-tier structure of municipal entities did not influence the results of the analysis.

Along with these two extreme variants, there were also reviewed two intermediate scenarios. On the whole, the *intermediate radical scenario* is based on the recommendations of the Commission for Division of Powers; however, it assumes that the municipal level retains implementation of local social policy, including responsibilities for housing allowances. The *intermediate moderate scenario* assumes, in addition to expenditure powers envisaged by the intermediate radical scenario, that local budgets would retain responsibility for financing of expenditures relating to education process. In fact, it envisaged only a decline in expenditures of municipal entities resulting from the completion of the health care reform, i.e. due to the transition to insurance financing schemes determined by the reform in this sphere and transfer of some powers concerning payments on behalf of unemployed due to the Compulsory Medical Insurance Fund (CMIF) to the regional level.

The calculations relating to the evolutionary scenario take into account factors both increasing and decreasing expenditures of municipal budgets. First, there was determined the impact of factors increasing budgetary expenditures on the total amount of expenditures. For this purpose:

- 1) expenditures of municipal entities were increased by 10 per cent as to form the source of repayment of accounts payable and servicing of the municipal debt, however, in a way that the total amount, including the expenditures for capital construction as defined in accordance with the economic classification, was below 20 per cent of the municipal expenditures;
- 2) expenditures for public utilities as defined in accordance with the economic classification, the share of which was above the average value for the analyzed sample, were retained without changes; the municipal entities' expenditures for public utilities, the share of which was below the average, were reevaluated up to the average value for the analyzed sample;
- 3) expenditures for remuneration of labor with payroll tax in accordance with the item "State administration and local self-governance" were increased 1.2 times, expenditures for remuneration of labor with payroll tax in accordance with other items were increased 1.4 times. Since monthly budgetary reports do not contain data on municipal budgets in accordance with the requirements of the economic classification, these coefficients were obtained in the following way. There were reviewed two items of the functional classification of budgetary expenditures – "state administration and local self-governance" and "education." It was assumed that the total increase in expenditures relating to these items in comparison with the figures registered in 2001 occurred exceptionally at the expense of growth in remuneration of labor with payroll tax. Proceeding from this assumption, the expenditures for remuneration of labor relating to the item "state administration and local self-governance" increased 1.32 times, what was considered to be the coefficient of growth in remuneration of labor of municipal officials. As concerns the item "education," the respective expenditures increased 1.65 times, what was considered to be the coefficient of growth in remuneration of labor of public sector employees.

Next, there were determined the reserves of retrenchment of municipal expenditures. First, these reserves were related to the reform of HUS leading to the increasing share of financing of housing and utility services at the expense of households. In order to evaluate the impact of this reform on budgetary expenditures, 90 per cent of the funds relating to the item "conditional subsidies" of the subsection "Housing" and to the items "subsidies for services rendered to population by energy and heat supply organizations" and the item "subsidies for services

rendered to population by water supply and sewerage organizations” of the subsection “Public utilities” were excluded from the expenditures relating to the HUS item. As a result, 90 per cent of subsidies for HUS services and housing allowances were excluded. The remaining 10 per cent were assumed to be the compensation for inadequate financing of other public utilities relating to excessive expenditures for subsidizing of HUS services rendered to population.

The calculated in this way expenditures relating to the HUS item shall be increased taking into account the expenditures for housing allowances to the low-income households in the situation where the budgetary subsidizing of housing and public utilities services is ceased. Estimates of the total amount of housing allowances after the transition to 100 per cent financing of HUS costs by households make 6.6 per cent of the aggregate municipal expenditures in 2001. However, it is apparent that these expenditures will be distributed very unevenly depending on respective income levels across municipal entities. Therefore, in this case there was used the analysis basing on the classification of municipal entities in three groups characterized by high, medium, and low levels of household incomes. As concerns budgets of municipalities characterized by low levels of household incomes, their expenditures were increased by 10 per cent, budgetary expenditures of municipalities characterized by high levels of incomes were increased by 4 per cent, and 6.8 per cent were added to the expenditures of medium-income municipalities.

The potential of current retrenchment, not related to the HUS reform and not requiring implementation of capital intensive measures, was evaluated at 2 per cent of municipal expenditures. The expenditures of municipal entities are assumed to decline further by 3 per cent due to the cessation of own financing of federal mandates.

Therefore, the aggregate expenditures of a municipality will make, according to the evolutionary scenario ($R_{ij}^{(\Sigma, ev)}$):

$$R_{ij}^{(\Sigma, ev)} = R_{ij}^{(\Sigma, 2001)}(a) + R_{ij}^{(ap)} + R_{ij}^{(pus)} + \Delta R_{ij}^{(H)} - 0,9R_{ij}^{(s, 2001)} + R_{ij}^{(ha)} - R_{ij}^{(cr)}, \text{ where}$$

1) $R_{ij}^{(\Sigma, 2001)}(a)$ are adapted expenditures of municipal budgets in 2001;

2) $R_{ij}^{(ap)}$ are expenditures for repayment of accounts payable and servicing of the municipal debt calculated in accordance with the formula:

$$R_{ij}^{(ap)} = \begin{cases} 0,1R_{ij}^{(\Sigma, 2001)}, & R_{ij}^{(cc, 2001)} \leq 0,1R_{ij}^{(\Sigma, 2001)}, \\ 0,2R_{ij}^{(\Sigma, 2001)} - R_{ij}^{(cc, 2001)}, & 0,1R_{ij}^{(\Sigma, 2001)} < R_{ij}^{(cc, 2001)} \leq 0,2R_{ij}^{(\Sigma, 2001)}, \\ 0, & R_{ij}^{(cc, 2001)} > 0,2R_{ij}^{(\Sigma, 2001)}; \end{cases}$$

At the same time, expenditures for capital construction exceeding 20 per cent of actual expenditures were excluded from the calculations, i.e.

$$R_{ij}^{(cc)} = \begin{cases} R_{ij}^{(cc, 2001)}, & R_{ij}^{(cc, 2001)} \leq 0,2R_{ij}^{(\Sigma, 2001)} \\ 0,2R_{ij}^{(\Sigma, 2001)}, & R_{ij}^{(cc, 2001)} > 0,2R_{ij}^{(\Sigma, 2001)}, \end{cases}$$

where $R_{ij}^{(\Sigma, 2001)}$ are actual expenditures of local budgets in 2001; $R_{ij}^{(kc)}$ are expenditures for capital construction;

3) $R_{ij}^{(pus)}$ are expenditures for public utilities services, defined as

$$R_{ij}^{(pus)} = N_{ij}^{(2001)} \cdot \max \left\{ R_{ij}^{(pus, 2001)}(sd), \frac{\sum_{l=1}^n R_{ij}^{(pus, 2001)}(sd)}{n} \right\} =$$

$$= N_{ij}^{(2001)} \cdot \begin{cases} R_{ij}^{(pus, 2001)}(sd), & R_{ij}^{(pus, 2001)}(sd) \geq \frac{\sum_{l=1}^n R_{ij}^{(pus, 2001)}(sd)}{n}, \\ \frac{\sum_{l=1}^n R_{ij}^{(pus, 2001)}(sd)}{n}, & R_{ij}^{(pus, 2001)}(sd) < \frac{\sum_{l=1}^n R_{ij}^{(pus, 2001)}(sd)}{n}, \end{cases}$$

where $R_{ij}^{(pus)}(sd)$ are average per capita expenditures of local budgets for public utilities services in 2001; $N_{ij}^{(2001)}$ is the population of the i -th municipality, n is the number of municipalities in the region j ;

4) $\Delta R_{ij}^{(rt)}$ is the growth in remuneration of labor with payroll tax of public officials and employees in the budgetary sphere in comparison with the figures registered in 2001:

$$\Delta R_{ij}^{(rt)} = \frac{1}{1,1501} \left[0,32 R_{ij}^{(rpo,2001)} + 0,65 (R_{ij}^{(rt,2001)} - R_{ij}^{(rpo,2001)}) \right],$$

where $R_{ij}^{(rt)}$ are expenditures for remuneration of labor with payroll tax of public sector employees; $R_{ij}^{(rpo)}$ are expenditures of local budgets for remuneration of labor with payroll tax of public officials;

5) $R_{ij}^{(s)}$ HUS subsidies;

6) $R_{ij}^{(ha)}$ expenditures for housing allowances:

$$R_{ij}^{(ha)} = \begin{cases} 0,1 R_{ij}^{(\Sigma,2001)}, & i \in I_1, \\ 0,068 R_{ij}^{(\Sigma,2001)}, & i \in I_2, \\ 0,04 R_{ij}^{(\Sigma,2001)}, & i \in I_3, \end{cases}$$

where I_1 is the group of municipalities with low levels of household incomes, I_2 is the group of municipalities with medium levels of household incomes, I_3 is the group of municipalities with high levels of household incomes;

7) $R_{ij}^{(cr)}$ is the retrenchment of municipal budgets resulting from the potential of current retrenchment and retrenchment of expenditures for financing of federal mandates at the expense of municipal budgets calculated according to the formula:

$$R_{ij}^{(cr)} = R_{ij}^{(pcr)} + R_{ij}^{(fmm)} = 0,02 R_{ij}^{(\Sigma,2001)} + 0,03 R_{ij}^{(\Sigma,2001)} = 0,05 R_{ij}^{(\Sigma,2001)},$$

where $R_{ij}^{(pcr)}$ is the potential of current retrenchment; $R_{ij}^{(fmm)}$ are expenditures for financing of federal mandates at the expense of own funds of municipal budgets.

Table 6.8 presents the results of influence of factors increasing expenditures of municipal entities, those decreasing expenditures of municipal entities, and their aggregate impact on the level of expenditures.

The radical scenario, on the whole basing on the recommendations of the Commission for Division of Powers, was modeled in the following way:

- 1) It was based on the calculations done in the framework of the evolutionary scenario.
- 2) The expenditures for housing allowances, which should be financed by RF subjects in the framework of this approach were excluded.
- 3) As concerns education, 80 per cent of the expenditures for remuneration of labor with payroll tax and for procurement of supplies and expendable materials were excluded from municipal expenditures taking into account that local budgets still bear the larger part of these expenditures relating to preschool education.
- 4) As concerns health care, the funds of compulsory medical insurance and 80 per cent of expenditures for remuneration of labor with payroll tax and for procurement of supplies and expendable materials were excluded from municipal expenditures. It was assumed that municipal entities remain responsible for the full amount of initial (primarily in the framework of paramedic and obstetric dispensaries) and emergency medical aid, while all other types gradually transit to financing from compulsory medical insurance funds.
- 5) The total amount relating to the item "Social policy" was excluded, since in the framework of this approach all respective functions shall be vested with RF subjects.
- 6) The expenditures for law enforcement activity were increased one and a half times.
- 7) The expenditures for environmental protection were increased two times.
- 8) The expenditures for fundamental research and promotion of advance in science and technology, as well as support of mass media were excluded.

Therefore, the aggregate expenditures of a municipality according to the radical scenario ($R_{ij}^{(\Sigma,rad)}$) were calculated in accordance with the formula:

$$R_{ij}^{(\Sigma,rad)} = R_{ij}^{(\Sigma,ev)} - R_{ij}^{(ha)} - 0,8 R_{ij}^{(r,ed)} - 0,8 R_{ij}^{(r,hc)} - R_{ij}^{(tsp)} + 0,5 R_{ij}^{(le)} + R_{ij}^{(envp)} - R_{ij}^{(fr)} - R_{ij}^{(massm)}$$

Here $R_{ij}^{(rt,ed)}$ are expenditures for remuneration of labor in education; $R_{ij}^{(rt,hc)}$ are expenditures for remuneration of labor in health care; $R_{ij}^{(lsp)}$ are expenditures for local social policies³⁸; $R_{ij}^{(le)}$ are expenditures for law enforcement; $R_{ij}^{(envp)}$ are expenditures for environmental protection $R_{ij}^{(fr)}$ are expenditures for fundamental research; $R_{ij}^{(massm)}$ are expenditures for support of mass media.

The *intermediate radical scenario* differs from the radical scenario by the following parameters:

- 1) Municipalities retained the powers to implement social policies at the local level, therefore, only the expenditures for other measures in the area of social policies and state allowances for citizens with children were excluded from the item “Social policy”;
- 2) Municipalities retained the responsibility to finance housing allowances³⁹. Therefore, the calculations also took into account these expenditures differentiated depending on the levels of household incomes in different groups of municipal entities.

The aggregate expenditures of a municipality in accordance with the intermediate radical scenario ($R_{ij}^{(\Sigma,int rad)}$) make:

$$R_{ij}^{(\Sigma,int rad)} = R_{ij}^{(\Sigma,rad)} + R_{ij}^{(lsp)} + R_{ij}^{(ha)}.$$

Here $R_{ij}^{(lsp)}$ are expenditures for local social policies, $R_{ij}^{(ha)}$ are expenditures for housing allowances.

According to the *intermediate moderate scenario*, in addition to responsibilities set forth in the intermediate radical scenario, municipalities retained responsibilities to finance educational process in the sphere of education. Therefore, these expenditures were included in the expenditure items of local budgets.

The aggregate expenditures of a municipality in accordance with the intermediate moderate scenario ($R_{ij}^{(\Sigma,int mod)}$) make:

$$R_{ij}^{(\Sigma,int mod)} = R_{ij}^{(\Sigma,int rad)} + 0,8(R_{ij}^{(rt,ed)} + R_{ij}^{(exp,ed)}),$$

where $R_{ij}^{(rt,ed)}$ are expenditures for remuneration of labor with accruals in education; $R_{ij}^{(exp,ed)}$ expenditures for procurement of supplies and expendable materials in education.

The results of calculations concerning the latter three scenarios are presented in Table 6.9. According to the adopted methodology, the evolutionary scenario was compared with the radical, intermediate radical, and intermediate moderate scenarios. *Fig. 6.1* presents the comparison of the four estimated scenarios of changes in expenditures with the actual data for year 2001 across concrete cities. Apparently, the radical and intermediate radical scenarios envisage a significant retrenchment of financial obligations of municipal entities, what inevitably results in the necessity to make considerable changes in the size and set of tax sources assigned to local budgets. As concerns the intermediate moderate scenario, although it envisages certain entrenchment of municipal expenditures, it does not result in sharp shifts in this sphere. In this case, the estimated amount and structure of revenue sources assigned to municipal entities will most probably undergo no radical changes.

³⁸ Here, the “expenditures for local social policies” are understood as expenditures pertaining to the item “Social policy” excluding the sub-items “State allowances for citizens having children” and “Other measures in the area of social policies,” which reflect expenditures for financing of federal mandates.

³⁹ As it has been pointed out above, these expenditures may be co-financed from the budgets of RF subjects in the case they exceed certain threshold values stipulated in the legislation. However, in this case calculations did not take this possibility into account.

Table 6.8

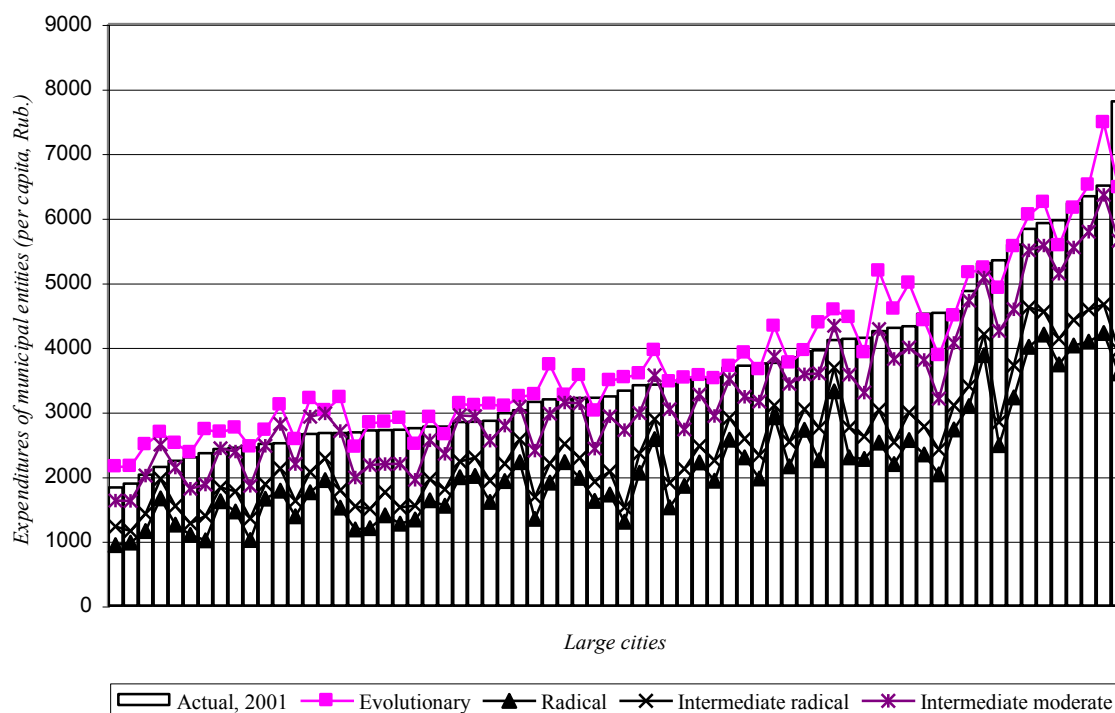
The ratio between factors of increase and decrease in expenditures of municipal entities with populations exceeding 200 thousand residents

<i>Factors behind increase / decrease in expenditures of municipal entities</i>	<i>Average per capita expenditures (Rub.)</i>			<i>Deviation from actual expenditures in 2001 (Rub.)</i>			<i>Decrease / increase in shares of defrayal of adapted expenditures (%)</i>			
	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>overall</i>
<i>Upward reevaluation of expenditures</i>	2409,5	9563,4	4503,8	196,4	1760,0	885,8	3,5	34,1	25,3	23,7
Funds for repayment of accounts payable and debt servicing	2070,77	8643,3	4004,3	-399,8	839,9	386,3	-7,2	13,8	10,9	10,2
Payments for public utilities	1940,7	7803,4	3663,0	0,0	196,8	45,0	0,0	8,3	1,6	1,1
Remuneration of labor with payroll tax	2059,0	8723,5	4072,6	207,8	920,1	454,6	6,9	21,1	12,8	12,4
<i>Reserves of cost entrenchment</i>	1526,5	8643,3	4023,5	-3097,5	-79,1	-735,6	-39,7	-2,8	-19,8	-19,8
Expenditures for HUS	1449,1	6023,8	2816,8	-3013,5	-193,4	-801,2	-38,6	-6,0	-22,1	-21,5
Housing allowances	2040,8	8139,4	3886,5	152,8	464,1	268,5	4,3	13,8	7,9	5,6
Own municipal expenditures for financing of federal mandates	1782,4	7635,4	3536,9	45,6	168,0	81,1	2,1	2,8	2,3	2,2
Reserve of short term retrenchment	1758,4	7551,4	3496,3	68,4	252,0	121,7	3,1	4,1	3,4	3,4
Total	2148,2	7473,1	3768,3	-1337,4	973,2	150,3	-17,1	24,7	5,5	3,9

Table 6.9

Scenario based estimates of adapted expenditures of municipal entities with populations exceeding 200 thousand residents

<i>Scenarios of municipal entities' expenditures</i>	<i>Per capita expenditures (Rub.)</i>			<i>Deviation from the evolutionary scenario (Rub.)</i>			<i>Deviation from the evolutionary scenario in shares of adapted expenditures (%)</i>			
	<i>min.</i>	<i>max.</i>	<i>on average</i>	<i>min.</i>	<i>max.</i>	<i>on average</i>	<i>min.</i>	<i>max.</i>	<i>on average</i>	<i>on whole</i>
Radical	938,9	4220,3	2139,1	-3252,8	-1010,9	-1629,1	-63,2	-25,7	-44,3	-42,1
Intermediate radical	1154,1	4663,3	2469,3	-2809,8	-658,5	-1299,0	-56,8	-19,4	-35,2	-33,4
Intermediate moderate	1622,1	6356,8	3252,8	-1116,3	-38,0	-515,5	-31,1	-1,3	-14,2	-13,1



Calculations: the fourth stage

Fig. 6.1. Adapted expenditures in 2001 and scenarios of expenditures of municipal entities with populations exceeding 200 thousand residents

At the fourth stage of calculations there was reviewed the possibility to assign to municipal entities revenue sources allowing to finance expenditures in accordance with the scenarios calculated at the third stage at the expense of potential revenues evaluated at the second stage of calculations.

Possible approaches to the assignment of revenue sources in the framework of the evolutionary scenario are presented in *Table 6.10*. Although the expenditures relating to the evolutionary scenario are somewhat above the actual expenditures borne in 2001, in this case there is no necessity to cover these expenditures at the expense of the profit tax or assign the full amount of the income tax. In the framework of this scenario, all variants of assignment of revenues include income tax, taxes on small businesses (on imputed income and in accordance with the simplified system), personal asset tax, corporate asset tax, land tax, rental payments for land, existing at present small local taxes. The variants differ primarily by the shares of the income tax assigned as the guaranteed and equalizing parts, and different assignment of the corporate asset tax (the total amount in the case a part of movable property is excluded, i.e. at 75 per cent of the present taxation, or lesser amount (about one half of the reformed amount), i.e. at about 40 per cent of the present taxation). Besides, some variants include the sales tax as an additional revenue source. All variants of assignment of revenue sources are rather close in terms of outcomes. As concerns variant 1.3, the total financing of expenditures of municipal entities is somewhat less, therefore, the need for financial aid is somewhat above the respective indicators of other variants. Variant 1.4 somewhat increases the number of cities where expenditures exceed revenues, however, the excess is below 10 per cent across the majority of these cities, while the total amount of surplus across the whole sample is at the acceptable level.

The variants of assignment of revenue sources in the framework of the radical scenario are presented in *Table 6.11*. Apparently, in the case the total amount of all property taxes and rental payments, including the reformed corporate asset tax (75 per cent of the present amount) is assigned to cover municipal expenditures, there is no need to turn to other revenue sources. This possibility arises only in the case the corporate asset tax is only partially due to local budgets. In this case, either taxes on small businesses, or sales tax may be additionally assigned to municipalities. While in the framework of the evolutionary scenario all variants of assignment of revenue sources are sufficiently equivalent, in this case it is not so. The corporate asset tax begins to significantly affect the unevenness of financing of municipal entities' expenditures. For instance, in the case the total amount

of this tax is assigned to local budgets, the maximal level of cost defrayal will make about 144 per cent, although the overall surplus across the sample is small. At the same time, the minimal level of defrayal is only slightly above 20 per cent, while the total need for financial aid is above 40 per cent, what is too much for the majority of cities. At the same time, in the case the corporate asset tax is partially assigned to local budgets the situation does not change radically. Thus, across all variants of defrayal of costs in the framework of the radical scenario:

- the coefficient of variation of share of municipal expenditures covered by assigned revenue sources exceeds the values of the evolutionary scenario 1.6 to 1.8 times;
- the relative need for financial aid increases 1.7 to 2 times;
- the maximal level of cost defrayal is in the interval from 135 to 144 per cent, while in the framework of the evolutionary scenario the respective values make 111 to 122 per cent;
- the number of cities where surplus exceeds 10 per cent is roughly equal in the framework of both the radical and evolutionary scenarios.

The variants of assignment of revenues in accordance with the intermediate radical scenario presented in *Table 6.12* demonstrate somewhat better, although generally similar characteristics in comparison with the radical scenario. In this case, there is the possibility to assign all property taxes to the municipal level (the corporate asset tax – in full or in part), as well as taxes on small businesses and some part of the income tax, or the sales tax. However, in this case the share of the income tax is insufficient to divide it into the guaranteed and equalizing parts. The calculations demonstrate the following results:

- the coefficient of variation of share of municipal expenditures covered by assigned revenue sources exceeds the values of the evolutionary scenario about 1.4 times;
- the maximal level of share of municipal expenditures covered by assigned revenue sources is rather high, however, it significantly differs across variants of assignment of revenue sources - from about 120 to 146 per cent, while the relative need for financial aid decreases by 20 to 30 per cent in comparison with the radical scenario;
- the number of cities where surplus exceeds 10 per cent is somewhat higher in the framework of variant 3.2 as compared with other scenarios.

In the framework of the intermediate moderate scenario, the situation, as it has been assumed, is rather similar to the evolutionary scenario, although the coefficients of variation and the maximal level of expenditure defrayal are somewhat higher. Accordingly, the larger number of cities has surplus exceeding 10 per cent. It is noteworthy that in the framework of this scenario the assignment of the full or partial amount of the corporate asset tax does not significantly affect the results of the calculations: the coefficient of variation practically does not change under the influence of this factor, while the difference between the minimal and maximal share of municipal expenditures covered by assigned revenues and the overall deficit fluctuate insignificantly. The results of the calculations concerning the assignment of revenue sources in the framework of this scenario are presented in *Table 6.13*.

The calculations of the possible assignment of revenue sources to municipal entities as concerns large cities demonstrate that in the framework of all analyzed scenarios of distribution of expenditure powers between the regional and municipal levels it is possible to assign to municipal entities revenue sources satisfying the theoretical requirements and conforming to the international practice in this sphere. The best variant of assignment of revenue sources may be unambiguously selected not in all cases. However, in the result of comparison of the whole totality of characteristics and taking into account the fact that the sales tax, due to the ambiguity of its perspectives, cannot be viewed as a stable source of revenues of municipal budgets, variants 1.1, 2.2, 3.3, and 4.2 were selected for the further analysis. For the graphical representation of the capacity to cover expenditures at the expense of assigned revenue sources according to these variants see *Fig. 6.2*.

The overall picture of the capacity to cover expenditures of municipal entities at the expense of different revenue sources across all expenditure scenarios is presented in *Table 6.14*. The table demonstrates that in the case the overwhelming majority of types of activities not relating to the municipal infrastructure are excluded from expenditure responsibilities the relationship between municipal expenditures and the amount of income tax naturally becomes more tenuous. In the case the evolutionary scenario is replaced with the radical scenario, the respective coefficient of variation increases from 26 to 34 per cent. However, there was not observed that the similar relationship with property taxes becomes more solid. On the contrary, in the framework of the radical scenario, as compared with the evolutionary one, the respective coefficient of variation of defrayal of municipal expenditures relating to these taxes increases by about 27 percentage points, roughly as in the case of the income

tax⁴⁰. The coefficients of variation relating to the sales tax and the tax on aggregate income are sufficiently high across all expenditure scenarios, however, their specific weight in cost defrayal is significantly below the two major revenue sources: income and property taxes.

The data presented in the table also demonstrate that in the framework of the radical and intermediate radical scenarios the assignment of property taxes across certain municipal entities significantly exceeds the level necessary to defray municipal expenditures, what questions the need for other revenue sources or results in the necessity to assign property taxes to local budgets only in part, thus significantly deteriorating prerequisites for transition to the real estate tax.

Similar calculations concerning municipal entities across regions in order to finalize the detection of the best variants of assignment of revenues sources in the framework of each expenditure scenario will be done at the next stage of the analysis.

Table 6.10

Variants of financing of adapted expenditures of municipal entities at the expense of assigned revenue sources in accordance with the evolutionary scenario

<i>Conditions</i>	1.1	1.2	1.3	1.4
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%
Results:				
<i>min. share of expenditures covered by assigned revenue sources (%)</i>	39,3	40,8	41,0	43,5
<i>max. . share of expenditures covered by assigned revenue sources (%)</i>	119,5	119,6	110,9	122,4
<i>difference between the min. and max. . shares of expenditures covered by assigned revenue sources (%)</i>	80,2	78,8	69,9	78,9
<i>average . share of expenditures covered by assigned revenue sources (%)</i>	80,2	83,2	77,5	85,0
<i>overall . share of expenditures covered by assigned revenue sources (%)</i>	80,4	83,5	77,5	85,1
<i>coefficient of variation (%)</i>	21,3	20,4	21,2	20,6
<i>overall surplus (%)</i>	0,9	1,4	0,5	2,1
<i>overall deficit (%)</i>	20,5	17,9	23,0	17,0
<i>number of cities with surplus</i>	11	11	9	15
<i>number of cities with surplus exceeding 10 %</i>	3	3	2	4

Table 6.11

Variants of financing of adapted expenditures of municipal entities at the expense of assigned revenue sources in accordance with the radical scenario

<i>Conditions</i>	2.1	2.2	2.3
Income tax	0%	0%	0%
Single tax on imputed income	0%	90%	0%
Single tax levied in relation to the application of the simplified taxation system	0%	30%	0%
Personal asset tax (ref.)	100%	100%	100%
Corporate asset tax (ref.)	100%	50%	50%

⁴⁰ In part, this fact may be explained by the approaches to the evaluation of the potential of the real estate tax. For instance, as concerns personal property tax, the forecasted values were related to the income level of the population of municipal entities. However, such a relation will be, no doubt, observed in practice, so the respective hypotheses are rather plausible.

Conditions	2.1	2.2	2.3
Land tax and rental payments for land	100%	100%	100%
Local taxes and charges	100%	100%	100%
Sales tax	0%	0%	100%
Results:			
<i>min. share of expenditures covered by assigned revenue sources (%)</i>	20,7	37,2	21,8
<i>max. . share of expenditures covered by assigned revenue sources (%)</i>	143,8	139,5	134,6
<i>difference between the min. and max. . shares of expenditures covered by assigned revenue sources (%)</i>	123,0	102,3	112,8
<i>average . share of expenditures covered by assigned revenue sources (%)</i>	63,5	70,1	64,4
<i>overall . share of expenditures covered by assigned revenue sources (%)</i>	60,0	65,2	60,5
<i>coefficient of variation (%)</i>	36,9	32,2	35,0
<i>overall surplus (%)</i>	0,5	0,7	0,4
<i>overall deficit (%)</i>	40,4	35,6	39,9
<i>number of cities with surplus</i>	4	6	5
<i>number of cities with surplus exceeding 10 %</i>	3	4	2

Table 6.12

Variants of financing of adapted expenditures of municipal entities at the expense of assigned revenue sources in accordance with the intermediate radical scenario

Conditions	3.1	3.2	3.3	3.4
Income tax	10%	0%	20%	0%
Single tax on imputed income	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%
Sales tax	0%	0%	0%	100%
Results:				
<i>min. share of expenditures covered by assigned revenue sources (%)</i>	38,2	34,3	39,7	35,3
<i>max. . share of expenditures covered by assigned revenue sources (%)</i>	146,1	127,4	137,9	119,5
<i>difference between the min. and max. . shares of expenditures covered by assigned revenue sources (%)</i>	108,0	93,1	98,2	84,3
<i>average . share of expenditures covered by assigned revenue sources (%)</i>	80,5	71,0	78,4	71,7
<i>overall . share of expenditures covered by assigned revenue sources (%)</i>	76,7	67,8	74,4	68,2
<i>coefficient of variation (%)</i>	29,1	30,0	28,3	28,7
<i>overall surplus (%)</i>	1,9	0,6	1,4	0,8
<i>overall deficit (%)</i>	25,2	32,8	27,0	32,6
<i>number of cities with surplus</i>	14	6	14	7
<i>number of cities with surplus exceeding 10 %</i>	7	3	5	5

Table 6.13

Variants of financing of adapted expenditures of municipal entities at the expense of assigned revenue sources in accordance with the intermediate moderate scenario

<i>Conditions</i>	4.1	4.2	4.3
Income tax	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%
Corporate asset tax (ref.)	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%
Local taxes and charges	100%	100%	100%
Sales tax	0%	0%	100%
Results:			
<i>min. share of expenditures covered by assigned revenue sources (%)</i>	39,3	38,3	40,0
<i>max. . share of expenditures covered by assigned revenue sources (%)</i>	128,4	119,1	126,6
<i>difference between the min. and max. shares of expenditures covered by assigned revenue sources (%)</i>	89,1	80,8	86,6
<i>average . share of expenditures covered by assigned revenue sources (%)</i>	83,6	80,0	84,1
<i>overall . share of expenditures covered by assigned revenue sources (%)</i>	81,8	78,1	82,1
<i>coefficient of variation (%)</i>	23,9	23,6	23,6
<i>overall surplus (%)</i>	1,9	1,1	2,3
<i>overall deficit (%)</i>	20,1	23,1	20,2
<i>number of cities with surplus</i>	14	12	14
<i>number of cities with surplus exceeding 10 %</i>	8	6	8

Table 6.14

Capacity to finance adapted municipal expenditures at the expense of the contingents of major taxes

<i>Scenarios of expenditures</i>	<i>Evolutionary</i>					<i>Radical</i>					<i>Intermediate radical</i>					<i>Intermediate moderate</i>				
	<i>min. (%)</i>	<i>max. (%)</i>	<i>average(%)</i>	<i>coef. of variation (%)</i>	<i>Number of municipalities</i>	<i>min. (%)</i>	<i>max. (%)</i>	<i>average(%)</i>	<i>coef. of variation (%)</i>	<i>Number of municipalities</i>	<i>min. (%)</i>	<i>max. (%)</i>	<i>average(%)</i>	<i>coef. of variation (%)</i>	<i>Number of municipalities</i>	<i>min. (%)</i>	<i>max. (%)</i>	<i>average(%)</i>	<i>coef. of variation (%)</i>	<i>Number of municipalities</i>
Personal income tax	24,4	97,6	60,0	26,3	68	43,7	236,3	110,0	34,0	68	38,0	206,1	95,4	33,5	68	31,8	127,8	70,6	28,4	68
Sales tax	1,5	18,5	8,6	57,1	61	2,2	41,4	16,0	60,8	61	2,0	32,7	13,8	60,1	61	1,7	23,5	10,2	58,3	61
Taxes on aggregate income	2,5	34,9	13,3	52,0	68	3,5	64,1	24,4	56,1	68	3,3	55,1	21,0	54,9	68	2,7	43,3	15,7	53,9	68
Property taxes	12,3	62,8	34,4	31,6	68	22,1	145,5	63,5	40,1	68	20,2	126,9	54,8	38,5	68	14,1	73,5	40,7	34,7	68

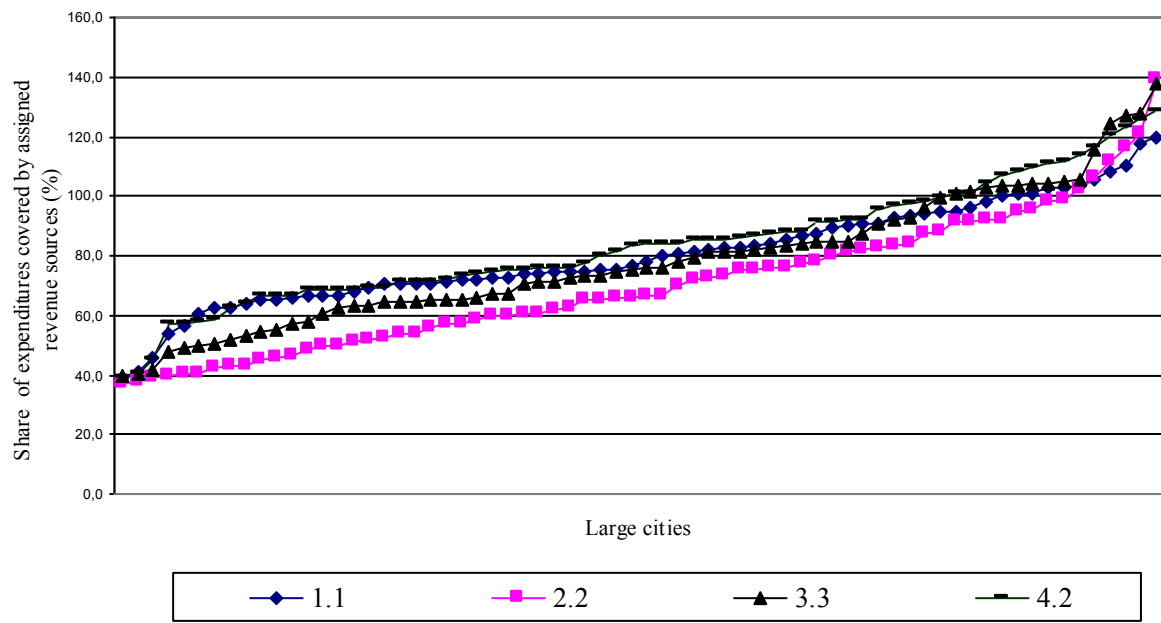


Fig. 6.2. Capacity to finance adapted expenditures of municipal entities in the framework of different expenditure scenarios at the expense of assigned revenue sources

Chapter 7. Calculations Basing on the Data about Municipal Finances Across Regions

Cross-regional characteristic of the budgets of municipal entities

The municipal entities analyzed across regions are a much less homogeneous sample than large cities. The differences in indicators may be explained by different, sometimes even opposite factors, which are often difficult or impossible to single out. This circumstance sets more strict requirements in relation to verification of the initial data and sets limitations on the possibility to analyze and model respective processes. Besides, the scope of information available in large cities is not always readily available for the whole sample of municipal entities.

The analysis of expenditures of municipal budgets proved to be most complicated. First, the level of expenditures and shares of different expenditure items depend both on real differences between municipal entities, and division of powers between the regional and municipal levels, which may vary across municipalities in the framework of the same region. Second, it is impossible to discern the objective impact of the size and location of a municipality from subjective factors relating to municipal policies.

Table 7.1 presents the expenditure sharing arrangements between regional and local budgets across key items of municipal expenditures. Overall, it corresponds to the general trends defined in Chapter 4. The ratios between regional and municipal expenditures significantly vary across different items. For instance, as concerns HUS only in one region (the Kabardian-Balkarian Republic) the share of regional expenditures exceeds 22 per cent, in other regions it is below 8 per cent. In the sphere of education, the Leningrad oblast may be singled out in terms of centralization of expenditures (44 per cent); the Kabardian-Balkarian Republic is second with 22 per cent, in other regions this indicator is below 18 per cent. The unevenness of distribution of expenditures is much more pronounced in the sphere of education and social policies. For instance, the share of regional expenditures in the item "Health care" fluctuates from 30 per cent (the Chuvash Republic, Saratov oblast, Krasnoyarsk krai) to 76 per cent (the Yevreyskaya AO). As concerns social policies, the dispersion is even more significant: in Tver and Sverdlovsk oblasts respective municipal expenditures make about 12 per cent, while in the Chuvash Republic, Rostov oblast, Krasnoyarsk krai, and Yevreyskaya AO – from 70 to 84 per cent. However, the share of two latter expenditure items is not very large. Therefore, although differences in division of expenditure powers between regions and municipalities to some extent affect levels and structures of municipal expenditures, this impact (at least in the framework of this sample) is not so significant as might be expected.

Table 7.2 presents the characteristic of expenditures of local budgets across three key items – "Housing and public utilities," "Education," and "Health care." Apparently, the shares of these items vary significantly in the structures of municipal expenditures, although this fact may be rather easily explained in the majority of regions. For instance, a higher share of expenditures for HUS in municipalities of the Leningrad oblast results from the significant centralization of expenditures for education and health care at the regional level. Accordingly, a high share of municipal expenditures for education in the Kabardian-Balkarian Republic is related to centralization of HUS expenditures. However, the factors behind the extremely low share of HUS expenditures registered in the Saratov oblast (8 per cent) and extremely high share of expenditures for education and health care (62 and 30 per cent respectively) in the Rostov oblast are much less apparent, although in the latter case it may be partially explained by the southern location of the region and high level of defrayal of HUS costs on the part of households, what results in lower municipal budgetary expenditures for housing and public utilities.

Table 7.1

Expenditure sharing arrangements between budgets of RF subjects and budgets of municipal entities across certain items in 2001 (in %)

Group No.	Regions	HUS		Education		Health care		Social policy	
		regional budget	local budget	Regional budget	Local budget	regional budget	local budget	regional budget	local budget
1	Yevreyskaya AO	7,9	92,1	14,9	85,1	75,8	24,2	20,7	79,3
	Komi-Permyak AO	0,0	100,0	13,1	86,9	53,7	46,3	72,4	27,6
2	Amur oblast	2,8	97,2	14,8	85,2	42,6	57,4	72,5	27,5
	Kabardian-Balkarian Republic	22,4	77,6	22,3	77,7	39,1	60,9	77,4	22,6
3	Rostov oblast	0,2	99,8	13,6	86,4	34,6	65,4	16,0	84,0

Group No.	Regions	HUS		Education		Health care		Social policy	
		regional budget	local budget	Regional budget	Local budget	regional budget	local budget	regional budget	local budget
	Tver oblast	0,2	99,8	7,7	92,3	44,0	56,0	87,4	12,6
	Chuvash Republic	0,1	99,9	12,7	87,3	29,8	70,2	30,1	69,9
4	Novosibirsk oblast	0,9	99,1	10,1	89,9	37,2	62,8	61,8	38,2
	Saratov oblast	1,6	98,4	10,6	89,4	30,1	69,9	80,3	19,7
5	Krasnoyarsk krai	0,0	100,0	10,9	89,1	30,6	69,4	21,2	78,8
	Leningrad oblast	0,3	99,7	44,1	55,9	58,9	41,1	64,7	35,3
	Sverdlovsk oblast	5,3	94,7	17,2	82,8	43,8	56,2	87,8	12,2

Table 7.2

Shares of expenditures for HUS, education and health care in the structures of local budgets, 2001 (in %)

Group No.	Regions	HUS				Education				Health care			
		min.	max.	average	coef. of variation	Min.	max.	average	coef. of variation	min.	max.	average	coef. of variation
1	Yevreyskaya AO	7,0	41,9	22,9	65,7	21,9	33,9	27,1	19,3	3,4	8,1	5,5	31,4
	Komi-Permyak AO	3,2	28,9	12,4	99,3	34,1	49,6	42,0	15,2	6,9	20,6	15,0	30,3
2	Amur oblast	7,5	50,5	32,4	31,2	16,2	50,8	29,7	26,3	4,1	20,7	12,4	30,4
	Kabardian-Balkarian Republic	4,0	35,0	13,8	63,5	28,8	56,0	43,9	18,4	13,0	25,7	20,4	18,1
3	Rostov oblast	3,2	35,7	11,9	69,1	18,9	40,7	62,4	7,3	11,0	19,6	30,1	7,8
	Tver oblast	5,9	59,1	26,2	47,3	16,5	47,4	32,3	18,9	6,9	25,6	12,4	27,5
	Chuvash Republic	3,1	41,9	11,7	94,9	24,4	42,9	33,8	15,4	4,4	25,0	13,2	27,5
4	Novosibirsk oblast	3,2	74,0	22,5	64,6	10,9	54,3	40,3	23,1	0,0	21,7	8,9	43,9
	Saratov oblast	0,0	41,1	8,0	128,1	19,7	55,1	43,0	17,2	12,5	31,3	19,0	21,8
5	Krasnoyarsk krai	0,0	51,7	17,7	71,8	12,5	43,3	30,7	22,1	0,3	15,6	7,6	40,0
	Leningrad oblast	16,6	69,9	42,9	25,4	7,9	28,4	21,3	24,7	0,4	14,4	9,4	32,8
	Sverdlovsk oblast	4,1	43,0	25,3	20,3	25,4	54,6	35,6	17,3	5,8	28,2	14,7	27,5

However, the significant dispersion of municipal expenditures in the framework of each analyzed subject of the Russian Federation plays a greater role than the difference in the structures of municipal expenditures across regions. The most significant dispersion was observed not in education and health care where it might be explained by external for municipal entities factors, primarily, the different sets of performed functions and different division of powers between the municipal and regional levels, but in HUS, i.e. exactly the item, which in overwhelming majority of cases is fully financed from municipal budgets.

This dispersion may be attributed to different factors, including urban or rural nature of the municipal entity, its size, and degree of remoteness from the oblast or large district center, share of private small houses, specifics of HUS policies. It is impossible to single out individual role of each factor. The only regularity observed in the majority of regions is that per capita HUS expenditures sharply differentiate between two groups of municipal entities. For comparison of municipalities with high and low levels of per capita HUS expenditures see *Table 7.3*. It appears that in spite of the variety of factors, the major role is played by the degree of urbanization. This factor is rather important for the further analysis since it shall be taken into account in the course of evaluation of the capacity of the personal asset tax, housing allowances, etc.

As concerns the analysis of revenues, the objective differences between municipal entities are supplemented by subjective characteristics of policies pursued by regional authorities. The regional cross-section of the structure of revenue sources of municipal entities is presented in *Table 7.4*. Apparently, no direct relationship between the financial standing of a RF subject (reflected by its positioning in a certain cluster) and the structure of revenue sources of municipal entities. The only case where this relationship is rather unambiguous is poor regions with a high share of financial aid in the structure of regional revenues. Accordingly, at the municipal level the average share of financial aid exceeds 80 per cent. Significant differences, directly related to policies pursued by regional authorities become perceptible starting from the third cluster. Out of three regions belonging to this cluster, the share of tax and non-tax revenue sources of Chuvash municipalities is on the average significantly below

respective indicators of two other regions, while the share of financial aid is correspondingly higher. Novosibirsk and Saratov oblasts included in the fourth cluster also differ significantly in these terms. However, the differences are most apparent in the fifth cluster including the most financially secure regions. While in Leningrad and Sverdlovsk oblasts tax revenues of municipal entities are the major sources of revenues and on the average make 58 and 68 per cent respectively, the situation in the Krasnoyarsk krai is quite different – the share of tax revenues makes less than 30 per cent, while financial aid exceeds 67 per cent.

Clustering of municipal entities depending on the degree of subsidization presented in *Table 7.5* also favors the aforesaid trend. The share of municipal entities with specific weight of financial aid exceeding 50 per cent is in no way related to placing of a region to a cluster. This share in the Krasnoyarsk krai (the 5th cluster) is higher than in Tver and Rostov oblasts (the 3rd cluster). At the same time, in the Sverdlovsk oblast also placed in the 5th cluster it is 2.4 times smaller. Novosibirsk and Saratov oblasts belong to the same (the fourth) cluster, however, the share of heavily subsidized municipal entities in Novosibirsk oblast is a highest in the sample, while in Saratov oblast it is a lowest one. In part, it may be explained by the degree of dispersion of financial standings of municipal entities within a region, however, the analysis of the data presented in *Table 7.4* makes it apparent that the political component also plays a significant role.

Table 7.3

Clustering of municipal entities based on the level of HUS expenditures

Group No.	Regions	Number of municipal entities		
		Total	HUS expenditures	
			Above regional average	Below regional average
1	Yevreyskaya AO	6	2	4
	Komi-Permyak AO	6	2	4
2	Amur oblast	27	14	13
	Kabardian-Balkarian Republic	11	5	6
3	Rostov oblast	54	20	34
	Tver oblast	41	22	19
	Chuvash Republic	26	8	18
4	Novosibirsk oblast	40	12	28
	Saratov oblast	39	17	22
5	Krasnoyarsk krai	56	21	35
	Leningrad oblast	26	12	14
	Sverdlovsk oblast	68	38	30

Table 7.4

Structure of revenue sources of municipal entities, 2001 (in %)

Group No.	Regions	Tax				Non-tax				Financial aid			
		min.	max.	average	coef. of variation	min.	max.	average	coef. of variation	min.	max.	average	coef. of variation
1	Yevreyskaya AO	3,9	26,6	15,9	60,0	0,5	11,1	3,0	134,4	69,9	95,1	81,1	13,7
	Komi-Permyak AO	6,8	35,9	15,0	70,5	0,7	2,7	1,6	50,1	61,4	89,7	82,7	12,9
2	Amur oblast	12,2	61,9	34,1	41,0	0,3	3,5	1,1	65,0	28,1	80,7	57,5	25,9
	Kabardian-Balkarian Republic	0,0	67,5	37,5	67,5	0,2	1,9	0,8	75,9	31,7	93,7	55,8	42,3
3	Rostov oblast	9,4	73,2	35,9	47,1	3,1	21,0	6,1	55,5	15,1	87,0	58,0	30,5
	Tver oblast	9,4	89,8	39,3	57,8	0,6	8,1	3,0	53,9	6,2	87,9	57,7	40,0
	Chuvash Republic	7,9	52,2	20,3	55,4	0,2	6,0	1,2	99,4	36,7	90,7	76,8	17,2
4	Novosibirsk oblast	12,9	98,3	41,1	56,9	0,5	12,2	1,9	104,5	0,5	86,6	56,8	43,0
	Saratov oblast	18,7	97,1	55,0	44,5	1,0	17,2	4,1	73,3	1,0	77,5	40,8	61,0
5	Krasnoyarsk krai	6,9	96,1	29,0	74,9	0,2	11,6	2,1	90,4	0,6	92,8	67,4	34,7
	Leningrad oblast	24,9	95,4	58,2	39,4	1,8	12,0	5,3	43,8	2,3	68,2	36,6	61,8
	Sverdlovsk oblast	22,9	98,8	67,9	37,5	0,7	8,9	2,9	66,5	0,0	76,2	29,2	89,9

Table 7.5

Subsidization of municipal entities, 2001

Group No.	Regions	Share of municipalities with financial aid (%)		
		below 20 %	20 % to 50 %	over 50 %
1	Yevreyskaya AO	0	0	100
	Komi-Permyak AO	0	0	100
2	Amur oblast	0	30	70
	Kabardian-Balkarian Republic	0	55	45
3	Rostov oblast	2	24	74
	Tver oblast	10	22	68
	Chuvash Republic	0	4	96
4	Novosibirsk oblast	12,5	12,5	75
	Saratov oblast	26	33	41
5	Krasnoyarsk krai	5	16	79
	Leningrad oblast	35	23	42
	Sverdlovsk oblast	48	21	33
Sample total		16	21	63

Calculations: the first stage

At the first stage of calculations concerning the cross-regional sample of municipal entities, envisaging the analysis of possibilities to assign existing revenue sources to municipal entities to cover their actual expenditures in fact doubles respective calculations concerning large cities. The only difference is that certain adjustments were made with regard to regions, where division of expenditures between the municipal and regional levels significantly deviated from the overall situation. The respective regional expenditures were taken as the averages of the rest of the sample, what resulted in respective increase in municipal expenditures. However, the scope of adjustment was not very significant – in Leningrad oblast there were recalculated expenditures for education and in Kabardian-Balkarian Republic – HUS expenditures. No changes were made as concerns the structure of revenue sources, although in two regions (Krasnoyarsk krai and Leningrad oblast) it significantly differed because the sales tax was not imposed in the region and the share of local taxes was rather high. In these calculations they account for financing of 10.9 and 9.8 per cent of adapted expenditures respectively, while the average for other regions makes only 0.2 per cent. At the same time, the sales tax, as concerns the sample, covers somewhat above 4 per cent of expenditures on the average.

The results obtained at the first stage of calculations in the framework of two best variants as based on the analysis of the sample of large cities are presented in *Table 7.6*. in 11 out of 12 regions, the variant not including the profit tax produces quite satisfactory results: the overall deficit is below 3 per cent, the number of cities with surplus makes significant share only in 2 regions, on the whole slightly over 6 per cent of municipal entities of the sample have surplus. Sverdlovsk oblast is an exception; the overall surplus there makes over 8 per cent (however, the coefficient of variation is rather low and the need for financial aid is significantly below actual requirements in 2001). The results of calculations in accordance with the variant including the profit tax are even less favorable and present no interest for further analysis.

The results of the analysis of the impact of division of the income tax in the guaranteed and equalizing parts on defrayal of municipal expenditures are of significant interest, see *Table 7.7*. Apparently, the trends observed in this case are opposite to those detected in the course of analysis of large cities. The variant where the income tax is fully redistributed at the regional level in proportion to the size of population appears to be most preferable for 11 regions out of 12 in all aspects: both the share of expenditures defrayed at its expense, and the coefficient of variation. The only exception is Leningrad oblast. If the assignment of the income tax makes 100 per cent of the contingent, in the majority of cases it produces most negative results. The variant of division of the income tax in the guaranteed and equalizing parts in the 50 / 50 proportion for the majority of regions is worse than the 100 per cent redistribution, however, it is significantly better than the assignment of 100 per cent of the contingent. For a quarter of analyzed regions this variant accounts for the best coefficient of variation.

Table 7.6.

Variants of financing of adapted expenditures of municipal entities at the expense of assigned revenue sources, 2001

Variant 1	<i>Income tax - 50% - guaranteed, 50% -equalizing parts, taxes on aggregate income - 90%, property taxes - 100%, land tax and rental payments for land - 100%, sales tax - 100%, local taxes and charges - 100%</i>											
	<i>Yevreyskaya AO</i>	<i>Komi-Permyak AO</i>	<i>Amur oblast</i>	<i>Kabardian-Balkarian Republic</i>	<i>Rostov oblast</i>	<i>Tver oblast</i>	<i>Chuvash Republic</i>	<i>Novosibirsk oblast</i>	<i>Saratov oblast</i>	<i>Krasnoyarsk krai</i>	<i>Leningrad oblast</i>	<i>Sverdlovsk oblast</i>
<i>Min. share of expenditures covered by assign revenues (%)</i>	14,7	12,8	19,2	10,9	23,6	8	21,2	32,6	31	7,4	41	20
<i>Max. share of expenditures covered by assign revenues (%)</i>	48,1	39,4	88,4	47,9	124,7	159,9	74,8	117,3	86,2	92,9	125,4	124,2
<i>Difference between the min. and max. shares of expenditures covered by assign revenues (%)</i>	33,4	26,6	69,2	36,9	101,2	151,8	53,6	84,7	55,1	85,5	84,4	104,1
<i>Average share of expenditures covered by assign revenues (%)</i>	33,4	21,3	39,8	24,4	58,3	52	37,5	50,5	47,3	44,2	77,4	68,4
<i>Overall share of expenditures covered by assign revenues (%)</i>	38,8	23,3	47,7	29	65,7	55,5	55	64,6	62,7	54	77,7	91,7
<i>Coefficient of variation (%)</i>	37,3	43,7	48,1	49,9	41	73	33,1	33,2	28,1	43,4	27,4	32,7
<i>Overall surplus (%)</i>	0	0	0	0	2,3	1,7	0	0,2	0	0	1,8	8,2
<i>Overall deficit (%)</i>	61,2	76,7	52,3	71	36,7	46,2	45	35,6	37,3	46	24,1	16,5
<i>Number of ME with surplus (including over 10 %)</i>	0 (0)	0 (0)	0(0)	0(0)	5(2)	7(4)	0(0)	1(1)	0(0)	0(0)	4(3)	8(4)
<i>Number of ME with financial aid exceeding 50 %</i>	6	6	21	11	21	29	22	24	22	41	1	10
Variant 2	<i>Income tax - 50% - guaranteed, 50% -equalizing parts, taxes on aggregate income - 90%, property taxes - 100%, land tax and rental payments for land - 100%, sales tax - 100%, profit tax - 5,7% (2% of profits), local taxes and charges - 100%</i>											
	<i>Yevreyskaya AO</i>	<i>Komi-Permyak AO</i>	<i>Amur oblast</i>	<i>Kabardian-Balkarian Republic</i>	<i>Rostov oblast</i>	<i>Tver oblast</i>	<i>Chuvash Republic</i>	<i>Novosibirsk oblast</i>	<i>Saratov oblast</i>	<i>Krasnoyarsk krai</i>	<i>Leningrad oblast</i>	<i>Sverdlovsk oblast</i>
<i>Min. share of expenditures covered by assign revenues (%)</i>	14,7	12,8	19,2	10,9	23,7	8,2	21,4	32,8	31,1	7,5	41,8	20,2
<i>Max. share of expenditures covered by assign revenues (%)</i>	48,6	42,3	91,3	49,9	130,1	165,6	77,5	118,5	87,8	94,7	134,8	129,6
<i>Difference between the min. and max. shares of expenditures covered by assign revenues (%)</i>	33,9	29,5	72	38,9	106,4	157,5	56,1	85,7	56,7	87,3	93	109,4

Variant 2	<i>Income tax - 50% - guaranteed, 50% -equalizing parts, taxes on aggregate income - 90%, property taxes - 100%, land tax and rental payments for land - 100%, sales tax - 100%, profit tax - 5,7% (2% of profits), local taxes and charges - 100%</i>											
	<i>Yevreyskaya AO</i>	<i>Komi-Permyak AO</i>	<i>Amur oblast</i>	<i>Kabardian-Balkarian Republic</i>	<i>Rostov oblast</i>	<i>Tver oblast</i>	<i>Chuvash Republic</i>	<i>Novosibirsk oblast</i>	<i>Saratov oblast</i>	<i>Krasnoyarsk krai</i>	<i>Leningrad oblast</i>	<i>Sverdlovsk oblast</i>
<i>Average share of expenditures covered by assign revenues (%)</i>	33,8	22	40,6	25	59,4	54	38,6	51	48,6	44,7	79,8	70,7
<i>Overall share of expenditures covered by assign revenues (%)</i>	39,3	24,2	48,9	29,9	67,3	58,2	56,9	65,5	66,4	55,1	80,5	95,1
<i>Coefficient of variation (%)</i>	37,7	47,3	48,8	50,6	41,9	74,7	34,1	33,3	29,9	43,4	28,8	33,6
<i>Overall surplus (%)</i>	0	0	0	0	3,2	3,2	0	0,2	0	0	2,6	10,5
<i>Overall deficit (%)</i>	60,7	75,8	51,1	70,1	35,9	45	43,1	34,7	33,6	44,9	22,1	15,3
<i>Number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	5(4)	8(4)	0(0)	1(1)	0(0)	0(0)	5(3)	9(5)
<i>Number of ME with financial aid exceeding 50 %</i>	5	6	19	11	21	29	22	24	22	41	1	9

Table 7.7

The share of income tax in the financing of adapted expenditures of municipal entities, 2001 (in %)

Group No.	Regions	100% of the contingent				100% - basing on the per capita redistribution				50% - guaranteed, 50% - equalizing parts			
		<i>min.</i>	<i>max.</i>	<i>average</i>	<i>coef. of variation</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>coef. of variation</i>	<i>min.</i>	<i>max.</i>	<i>average</i>	<i>coef. of variation</i>
1	Yevreyskaya AO	4,6	26,8	17,2	50,4	13,9	23,9	21,0	17,6	9,3	24,5	19,1	28,8
	Komi-Permyak AO	7,7	18,4	11,6	37,5	9,6	14,6	12,1	19,5	9,9	14,4	11,8	15,8
2	Amur oblast	5,2	42,5	17,2	56,3	11,3	45,3	28,5	31,9	8,2	39,8	22,9	36,4
	Kabardian-Balkarian Republic	4,3	21,6	10,2	59,4	23,7	39,8	33,2	17,0	16,7	27,5	21,7	13,9
3	Rostov oblast	6,2	76,3	24,3	67,4	15,9	62,8	39,4	22,4	15,4	61,0	31,8	32,0
	Tver oblast	3,5	119,9	26,8	102,1	6,8	55,8	29,1	36,6	5,2	78,9	28,0	60,3
	Chuvash Republic	5,6	38,8	14,1	67,0	21,4	42,1	32,8	15,4	17,1	31,6	23,5	16,8
4	Novosibirsk oblast	8,4	60,3	22,3	48,8	21,3	74,8	40,7	25,1	22,9	51,1	31,5	21,4
	Saratov oblast	6,7	50,9	20,8	54,1	23,2	56,8	37,8	24,2	18,1	51,0	29,3	23,7
5	Krasnoyarsk krai	1,9	90,8	23,2	88,8	6,9	65,7	43,5	31,0	4,4	74,7	33,4	44,8
	Leningrad oblast	22,7	78,4	42,0	32,1	12,6	78,7	37,2	47,7	19,6	59,1	39,6	25,5
	Sverdlovsk oblast	2,3	121,4	39,4	71,7	11,9	46,7	25,7	26,8	7,1	77,9	32,6	49,0

Calculations: the second stage

The calculations done in the framework of the second stage as concerns cross-regional sample of municipalities were on the whole based on the same approaches as those taken in the case of large cities. There were used the same coefficients of changes in revenues over 10 months of 2002 (Table 6.6). The consequences of the reform of the corporate asset tax and abolishment of the sales tax were evaluated in the similar manner. The principle differences may be reduced to the following:

- In Krasnoyarsk krai and Leningrad oblast revenues generated by local taxes decreased twofold, since approximately such dynamics might be expected after the imposition of the sales tax and respective reduction of the list of local taxes;

- There were used more complex methods of prognostication of growth in revenues due to higher rates of the personal asset tax.

It is very difficult to forecast the dynamics of revenues generated by the personal asset tax, since municipal policies in this regard depend on a large number of different factors, which are much harder to detect and prognosticate as concerns small municipalities. In this case it was attempted to take into account two parameters significant for municipal entities – levels of household incomes and quality of housing. Since evaluation was iterative, it allowed to somewhat objectivize the applied hypotheses.

At the first stage, as in the case of large cities, the existing personal asset tax was increased 20 times for each municipal entity, and the resulting value was increased by 20 per cent in order to take into account the growth in rent (a 30 per cent increase for the sample of large cities).

At the second stage, for each region there was determined the distribution of municipalities by the levels of household incomes. As in the case of large cities, the sum of contingents of income tax and the tax on aggregate personal incomes was used as the indicator of the level of income. Depending on the degree of differentiation of this indicator and taking into account the urban or rural nature of municipalities, in each region the municipal entities were classified in two to four groups. By the method of expert evaluation, there were found out the coefficients characterizing shares of the average aggregate household incomes in each region as the reference points for local authorities as concerns the setting of rates of the personal asset tax. The dispersion of these coefficients for the whole sample made from 0.25 to 1.25.

At the third stage, there were analyzed two groups of municipal entities – those where per capita HUS expenditures exceeded regional averages and those where respective expenditures were below the averages. According to the aforesaid hypothesis, this differentiation primarily depends on the degree of urbanization of respective municipal entities and is therefore indirectly related to the quality of real estate. It was assumed that the coefficient determined at the preceding stage can not exceed 0.5 per cent for municipal entities where the share of per capita HUS expenditures is below the average.

At the fourth stage, the obtained evaluation of the revenue generating capacity of the personal asset tax was compared with the actually collected amount of the tax increased 20 times. In the case the obtained evaluations significantly exceeded this value for a significant part of municipal entities or demonstrated a significant deviation from the formed trend, the coefficients determined at the second stage were adjusted. For two regions - Kabardian-Balkarian Republic and Rostov oblast – this iteration demonstrated the necessity to reject changes made in the framework of the third stage.

Table 7.8 reflects the results of evaluation of factors affecting the changes in budgetary revenues of municipal entities and demonstrates the potential of growth in these revenues.

Calculations: the third stage

At the third stage of calculations there was carried out the scenario based evaluation of changes in expenditures of local budgets depending on the distribution of powers between the regional and municipal levels. In this respect, the cross regional analysis of municipal entities also somewhat differed from the case of large cities. Due to unavailability of exhaustive information and heterogeneity of municipal entities in the region, the modeling of the evolutionary scenario was somewhat simplified. The calculations were done in the following way:

- expenditures of municipal entities were increased by 10 per cent;
- expenditures for remuneration of labor with payroll tax in accordance with the item “State administration and local government” were increased 1.2 times, expenditures for remuneration of labor with payroll tax in accordance with other items were increased 1.4 times;
- 90 per cent of the funds relating to the item “conditional subsidies” of the subsection “Housing” and to the items “subsidies for services rendered to population by energy and heat supply organizations” and the item “subsidies for services rendered to population by water supply and sewerage organizations” of the subsection “Public utilities” were excluded from the expenditures relating to the HUS item;
- expenditures of municipal entities, where per capita HUS expenditures in 2001 were above the average (*Table 7.3*) were increased by 7 per cent for payment of housing allowances;
- expenditures of municipal entities were decreased by 3 per cent for financing of federal mandates and 2 per cent as the reserve of short time retrenchment.

Therefore, the aggregate expenditures of a municipality will make, according to the evolutionary scenario ($R_{ij}^{(\Sigma, ev)}$):

$$R_{ij}^{(\Sigma, ev)} = R_{ij}^{(\Sigma, 2001)}(a) + R_{ij}^{(ap)} + \Delta R_{ij}^{(rt)} - 0,9R_{ij}^{(s, 2001)} + R_{ij}^{(ha)} - R_{ij}^{(cr)}, \text{ where}$$

1) $R_{ij}^{(\Sigma,2001)(a)}$ - are adapted expenditures of municipal budgets in 2001;

2) $R_{ij}^{(ap)}$ - are expenditures for repayment of accounts payable and servicing of the municipal debt determined

as

$$R_{ij}^{(ap)} = 0,1R_{ij}^{(\Sigma,2001)},$$

where $R_{ij}^{(\Sigma,2001)}$ are actual expenditures of local budgets in 2001;

3) $\Delta R_{ij}^{(rt)}$ is the growth in remuneration of labor with payroll tax of public officials and employees in the budgetary sphere in comparison with the figures registered in 2001 calculated as:

$$\Delta R_{ij}^{(rt)} = 0,2R_{ij}^{(rtpo,2001)} + 0,4(R_{ij}^{(rt,2001)} - R_{ij}^{(rtpo,2001)}),$$

where $R_{ij}^{(rt)}$ are expenditures for remuneration of labor with payroll tax of public sector employees; $R_{ij}^{(rtpo)}$ are expenditures of local budgets for remuneration of labor with payroll tax of public officials;

4) $R_{ij}^{(s,2001)}$ HUS subsidies;

5) $R_{ij}^{(ha)}$ expenditures for housing allowances:

$$R_{ij}^{(ha)} = \begin{cases} 0,07R_{ij}^{(\Sigma,2001)}, & R_{ij}^{(hus,2001)}(sd) \geq \frac{\sum_{l=1}^n R_{ij}^{(hus,2001)}(sd)}{n}, \\ 0, & R_{ij}^{(hus,2001)}(sd) < \frac{\sum_{l=1}^n R_{ij}^{(hus,2001)}(sd)}{n}, \end{cases}$$

where $R_{ij}^{(hus,2001)}$ per capita HUS expenditures in the i -th municipality of the j -th region in 2001; n is the number of municipalities in the region j ;

6) $R_{ij}^{(cr)}$ is the retrenchment of municipal budgets determined as

$$R_{ij}^{(cr)} = R_{ij}^{(pcr)} + R_{ij}^{(fmm)} = 0,02R_{ij}^{(\Sigma,2001)} + 0,03R_{ij}^{(\Sigma,2001)} = 0,05R_{ij}^{(\Sigma,2001)},$$

where $R_{ij}^{(pcr)}$ is the potential of current retrenchment; $R_{ij}^{(fmm)}$ are expenditures for financing of federal mandates at the expense of funds of municipal budgets.

The changes in expenditures in the framework of the evolutionary scenario in comparison with the actual expenditures borne by municipal entities in 2001 are presented in *Table 7.9*.

The calculations done in the framework of other scenarios do not differ from the algorithm applied in the case of large cities. The results of scenario based estimates of expenditures are presented in *Table 7.10*.

Calculations: the fourth stage

At the fourth stage of calculations there were reviewed the outcomes of the variants of assignment of revenue sources selected in the course of analysis of different expenditure scenarios for the sample of large cities as applied for municipal entities across regions.

First, there was determined if additional revenues obtained in the framework of the second stage of calculations were sufficient to defray expenditures borne in accordance with the evolutionary scenario, i.e. in the case the current distribution of powers (and therefore financial resources) between the regional and municipal levels was retained. For the results of comparison of additional revenues and expenditures see *Table 7.11*. Apparently, the situation is ambiguous. In the case the sales tax is retained as a municipal tax, additional expenditures may be covered in 7 regions out of 12. In the case the sales tax is abolished, additional expenditures can be covered at the expense of additional revenues only in 5 regions.

Yet another potential financial source is the full assignment of the revenues previously shared not only between regions and municipalities, but also by the federal budget. These means make about 1 per cent of the revenues of the federal budget and do not significantly affect its standing. As the data in *Table 7.12* demonstrate, in this case (proceeding from the assumption that these revenues will be rather evenly distributed among municipalities) revenues of municipal entities may increase by about 2 per cent. This development will significantly improve the situation in 3 other RF subjects, both if the sales tax is abolished and retained. Therefore, in the case the sales tax is retained, only the most deficit regions belonging to the first cluster will encounter the problem of sources for defrayal of additional expenditures. In the case the tax is abolished, this problem will arise in 2 other regions, but will it become acute only in the Chuvash Republic.

Therefore, the analysis reveals that possible increase in expenditure needs of municipal entities in the framework of the evolutionary scenario will not result in a global financial imbalance and in the majority of cases may be compensated at the expense of increases in existing revenue sources and attraction of new ones. This allows proceeding to calculations concerning other expenditure scenarios similar to those for the sample of large cities. The results of calculations in accordance with each variant of each of the four scenarios are presented in Annex 7.1.

The overall result of these calculation is the extremely low level of the overall surplus and, accordingly, small number of cities where revenues exceed expenditures. In all variants of assignment of revenue sources, the total number of such municipalities in all analyzed regions was at or below 11 (2.75 per cent of the sample of municipal entities in selected regions), while the number of municipalities with surpluses exceeding 10 per cent was at or below 5 (1.2 per cent of the sample of the analyzed municipal entities). This result is radically better than that obtained at the first stage of calculations (financing of expenditures formed in 2001 at the expense of revenue sources available in 2001), where in accordance with two best variants the number of municipal entities with surplus made 25 and 28 or, respectively, 6.2 per cent and 7 per cent of the analyzed sample.

The variants chosen as the base ones for each expenditure scenario were compared more thoroughly. For respective key characteristics see *Table 7.13*, and for results of calculations – *Table 7.14*. Six indicators were used to evaluate the results of calculations. As concerns three of these indicators (ratio between the maximal and minimal share of expenditures covered at the expense of assigned revenue source, overall deficit, and coefficient of variation of defrayal of municipal expenditures), there were determined the average value of each indicator across 12 regions and the number of regions where the values of these indicators were the best out of the four compared variants. As concerns three other indicators (the number of municipal entities with surplus, the number of municipal entities with profit exceeding 10 per cent, and the share of municipal entities where less than 50 per cent of expenditures were compensated at the expense of assigned revenue sources (i.e. the need for financial aid in order to defray expenditures exceeded 50 per cent of revenues), for comparison there were used aggregate values across all 12 regions.

The conclusions arrived at in the course of the analysis on the whole correspond to the results of the study of large cities. All variants of assignment of revenue sources are sufficiently viable, although, naturally, their share in defrayal of municipal expenditures is significantly below the respective indicator for large cities, and the average size of the deficit for the sample fluctuates from 49 to 63 per cent.

At the same time, the conclusion that the conditions of financing of expenditures borne by municipal entities deteriorate in the case the evolutionary scenario is replaced with radical ones was on the whole confirmed. For instance, the evolutionary and intermediate moderate scenarios lead across all analyzed criteria as concerns the regional averages. The situation is not so unambiguous as concerns the analysis of each individual region, although the overall trend remains the same. For instance, as concerns the coefficient of variation, the evolutionary and intermediate moderate scenarios produce the best results in all regions, while the indicator of overall deficit (i.e. necessary financial aid) is the best for 8 regions, while the radical scenario leads only in terms of ratio between the maximal and minimal share of expenditures covered by assigned revenues producing the best results in 7 regions.

As concerns municipal budgets where revenues exceed expenditures, the total number of municipal entities, where surplus was registered in the framework of at least one variant of assignment of revenue sources, made 16 (4 per cent of the analyzed sample), surplus exceeding 10 per cent occurred in 10 municipal entities (2.5 per cent). All these municipal entities are located in 5 out of 12 analyzed RF subjects: Rostov, Tver, Novosibirsk, Sverdlovsk, and Leningrad oblasts. These regions belong to the third (2), fourth (1), and fifth (2) clusters.

Beside the number of municipal entities running surplus, there was analyzed the distribution of the whole sample of municipalities depending on the shares of financial aid in revenues of local budgets needed to completely cover expenditures. The results for the whole sample obtained in the framework of different scenarios are presented in *Table 7.15*. From the viewpoint of minimization of financial aid, the evolutionary and intermediate moderate scenarios produce radically better results than the rest. In the framework of these scenarios 41 per cent of municipal entities form more than 50 per cent of their own revenues at the expense of assigned sources. This situation is even somewhat better than in 2001, when the standards of assignment of shared taxes might be differentiated depending on the specifics of each municipal entity, however, in only 37 per cent of municipalities financial aid made less than 50 per cent. As concerns the radical scenarios, the resulting situation is much worse: the share of municipal entities forming more than 50 per cent of their own revenues at the expense of assigned revenue sources makes less than one fifth. It is necessary to note that the share of heavily subsidized municipal entities exceeds 50 per cent across all analyzed variants of assignment of revenue sources.

Table 7.8

Changes in revenues of municipal entities across regions

Potential of changes in municipal revenues	Additional shares of adapted municipal expenditures financed at the expense of growth in revenue sources in the region at large (%)											
	Yevreyskaya AO	Komi-Permyak AO	Amur oblast	Kabardian-Balkarian Republic	Rostov oblast	Tver oblast	Chuvash Republic	Novosibirsk oblast	Saratov oblast	Krasnoyarsk krai	Leningrad oblast	Sverdlovsk oblast
Sales tax is retained	4,7	5,9	13,2	11,6	19,8	15,7	15,0	21,1	20,9	11,0	18,0	25,1
Sales tax is abolished	4,0	3,5	11,9	8,9	15,0	8,8	2,8	12,7	10,7	11,0	18,0	17,7

Table 7.9

The ratio between factors of increase and decrease in expenditures of municipal entities across regions

Factors behind increase / decrease in expenditures of municipal entities	Increase / decrease of financing in shares of defrayal of adapted municipal expenditures in the region at large (%)											
	Yevreyskaya AO	Komi-Permyak AO	Amur oblast	Kabardian-Balkarian Republic	Rostov oblast	Tver oblast	Chuvash Republic	Novosibirsk oblast	Saratov oblast	Krasnoyarsk krai	Leningrad oblast	Sverdlovsk oblast
Upward reevaluation of expenditures	20,2	26,1	20,7	23,9	24,6	22,2	23,8	26,5	25,5	22,3	20,2	23,3
Funds for repayment of accounts payable and debt servicing	11,5	10,5	10,5	10,5	13,0	10,6	12,1	11,2	10,9	11,0	11,0	10,5
Remuneration of labor with payroll tax	8,7	15,5	10,2	13,4	11,7	11,6	11,7	15,2	14,6	11,3	9,3	12,7
Reserves of cost entrenchment	-7,7	-4,7	-5,6	-16,4	-6,3	-24,5	-6,7	-19,0	-7,5	-6,6	-8,7	-7,5
Expenditures for HUS	-6,6	-2,8	-3,9	-15,7	-8,8	-21,6	-6,3	-19,0	-7,9	-4,8	-7,1	-7,0
Housing allowances	4,8	3,4	3,6	4,6	9,0	2,4	5,7	5,6	5,9	3,7	3,9	4,7
Own municipal expenditures for financing of federal mandates	-2,3	-2,1	-2,1	-2,1	-2,6	-2,1	-2,4	-2,2	-2,2	-2,2	-2,2	-2,1
Reserve of short term retrenchment	-3,5	-3,2	-3,2	-3,2	-3,9	-3,2	-3,6	-3,4	-3,3	-3,3	-3,3	-3,2
Total	12,5	21,4	15,2	7,4	18,4	-2,3	17,1	7,4	18,0	15,7	11,5	15,7

Table 7.10

Scenario based estimates of expenditures of municipal entities across regions

Scenarios of expenditures of municipal entities	Deviation from the evolutionary scenario in shares of adapted municipal expenditures in the region at large (%)											
	Yevreyskaya AO	Komi-Permyak AO	Amur oblast	Kabardian-Balkarian Republic	Rostov oblast	Tver oblast	Chuvash Republic	Novosibirsk oblast	Saratov oblast	Krasnoyarsk krai	Leningrad oblast	Sverdlovsk oblast
Radical	-30,2	-40,1	-28,3	-55,1	-58,6	-33,2	-48,3	-43,1	-41,3	-33,5	-22,7	-35,0
Intermediate radical	-25,6	-35,9	-24,6	-46,6	-29,6	-29,1	-42,4	-35,9	-36,0	-28,6	-17,3	-29,1
Intermediate moderate	-9,3	-11,2	-10,4	-16,4	-10,8	-7,3	-24,1	-13,3	-17,3	-10,8	-5,1	-8,8

Table 7.11

Comparison between additional expenditures and additional revenues of municipal entities across regions

	<i>Increase / decrease in shares of adapted municipal expenditures in the region at large (%)</i>											
	<i>Yevreyskaya AO</i>	<i>Komi-Permyak AO</i>	<i>Amur oblast</i>	<i>Kabardian-Balkarian Republic</i>	<i>Rostov oblast</i>	<i>Tver oblast</i>	<i>Chuvash Republic</i>	<i>Novosibirsk oblast</i>	<i>Saratov oblast</i>	<i>Krasnoyarsk krai</i>	<i>Leningrad oblast</i>	<i>Sverdlovsk oblast</i>
Additional expenditures	12,5	21,4	15,2	7,4	18,4	-2,3	17,1	7,4	18	15,7	11,5	15,7
Additional revenues (sales tax is retained)	4,7	5,9	13,2	11,6	19,8	15,7	15	21,1	20,9	11	18	25,1
Additional revenues (sales tax is abolished)	4	3,5	11,9	8,9	15	8,8	2,8	12,7	10,7	11	18	17,7

Table 7.12

Increase in revenues of local budgets at the expense of assignment of federal shares in certain revenue sources to municipal entities (in %)

<i>Tax / non-tax revenues</i>	<i>Increase in revenues of local budgets at the expense of federal shares</i>	
	<i>2001</i>	<i>2002 (10 months.)</i>
Single tax levied in relation to the application of the simplified taxation system	0,28	0,14
Single tax on imputed income for certain types of activities	1,21	0,74
Land tax	0,69	0,41
Rental payments for land	0,66	0,36
Total	2,85	1,65
<i>Memorandum: additional share of adapted municipal expenditures financed at the expense of these sources</i>	<i>3,03</i>	<i>2,07</i>

Table 7.13

Variants of assignment of revenue sources to local budgets selected for analysis

	1.1	2.2	3.3	4.2
<i>Income tax</i>	25% - guaranteed, 50% - equalizing parts	0 %	20% of contingent	20% - guaranteed, 35% - equalizing parts
<i>Single tax on imputed income</i>	90%	90%	90%	90%
<i>Single tax levied in relation to the application of the simplified taxation system</i>	30%	30%	30%	30%
<i>Personal asset tax (ref.)</i>	100%	100%	100%	100%
<i>Tax on enterprises' property (ref)</i>	100%	50%	50%	50%
<i>Land tax and rental payments for land</i>	100%	100%	100%	100%
<i>Local taxes and charges</i>	100%	100%	100%	100%

Table 7.14

Results of the assignment of revenue sources to local budgets in the framework of different expenditure scenarios across regions

	1.1		2.2		3.3		4.2	
	<i>on average across 12 regions</i>	<i>number of regions with the best indicators</i>	<i>on average across 12 regions</i>	<i>number of regions with the best indicators</i>	<i>on average across 12 regions</i>	<i>number of regions with the best indicators</i>	<i>on average across 12 regions</i>	<i>number of regions with the best indicators</i>
<i>difference between the min. and max. shares of expenditures covered by assigned revenues (%)</i>	63,5	1	62,8	7	64,7	0	57,0	4
<i>Overall deficit (%)</i>	48,9	7	63,4	1	56,1	3	53,1	1
<i>Coefficient of variation (%)</i>	38,0	7	58,7	0	55,1	0	39,3	5
<i>Overall across 12 regions</i>								
<i>Number of municipalities with surplus</i>	10		5		4		3	
<i>Number of municipalities with 10 % surplus</i>	4		5		1		1	
<i>Share of local budgets where financial aid exceeds 50 %</i>	59		82		82		59	

Table 7.15

Subsidization of municipal entities

<i>Group No.</i>	<i>Regions</i>	<i>Share of municipalities with financial aid (%)</i>											
		1.1			2.2			3.3			4.2		
		<i>below 20 %</i>	<i>20 % to 50 %</i>	<i>over 50 %</i>	<i>below 20 %</i>	<i>20 % to 50 %</i>	<i>over 50 %</i>	<i>below 20 %</i>	<i>20 % to 50 %</i>	<i>over 50 %</i>	<i>below 20 %</i>	<i>20 % to 50 %</i>	<i>over 50 %</i>
1	Yevreyskaya AO	0,0	0,0	100,0	0,0	0,0	100,0	0,0	0,0	100,0	0,0	0,0	100,0
	Komi-Permyak AO	0,0	0,0	100,0	0,0	0,0	100,0	0,0	0,0	100,0	0,0	0,0	100,0
2	Amur oblast	3,7	18,5	77,8	0,0	3,7	96,3	3,7	0,0	96,3	3,7	7,4	88,9
	Kabardian-Balkarian Republic	0,0	18,2	81,8	9,1	9,1	81,8	0,0	18,2	81,8	0,0	18,2	81,8
3	Rostov oblast	9,3	37,0	53,7	13,0	53,7	33,3	5,6	18,5	75,9	7,4	29,6	63,0
	Tver oblast	9,8	26,8	63,4	2,4	7,3	90,2	7,3	7,3	85,4	4,9	17,1	78,0
	Chuvash Republic	0,0	15,4	84,6	0,0	11,5	88,5	0,0	11,5	88,5	0,0	15,4	84,6
4	Novosibirsk oblast	10,0	27,5	62,5	5,0	7,5	87,5	7,5	7,5	85,0	7,5	12,5	80,0
	Saratov oblast	0,0	23,1	76,9	0,0	2,6	97,4	0,0	10,3	89,7	0,0	10,3	89,7
5	Krasnoyarsk krai	1,8	23,2	75,0	0,0	3,6	96,4	0,0	10,7	89,3	0,0	19,6	80,4
	Leningrad oblast	34,6	57,7	7,7	0,0	46,2	53,8	11,5	38,5	50,0	11,5	57,7	30,8
	Sverdlovsk oblast	16,2	57,4	26,5	0,0	13,2	86,8	7,4	19,1	73,5	10,3	42,6	47,1
<i>Sample total</i>		8,8	32,3	59,0	2,8	16,0	81,3	4,5	13,5	82,0	5,0	23,8	71,3

Annex 7.1

The Results of Assignment of Revenue Sources to Local Budgets in the Framework of Different Expenditure Scenarios

Yevreyskaya AO

Conditions:	Evolutionary				Radical			Intermediate radical				Intermediate moderate		
	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
min. share of expenditures covered by assigned revenues (%)	12,0	10,9	11,2	11,7	1,3	3,8	1,9	4,5	3,9	5,0	4,4	8,5	10,1	9,0
max. share of expenditures covered by assigned revenues (%)	36,9	36,5	38,0	40,0	16,5	27,8	16,0	30,2	26,1	32,9	27,5	37,5	37,7	38,6
difference between the min. and max. share of expenditures covered by assigned revenues (%)	24,8	25,6	26,8	28,3	15,2	24,0	14,1	25,8	22,3	27,9	23,1	28,9	27,6	29,6
average share of expenditures covered by assigned revenues (%)	25,5	24,2	25,2	26,3	8,7	12,6	9,0	15,3	12,8	16,7	13,2	21,7	22,8	22,0
overall share of expenditures covered by assigned revenues (%)	29,7	28,5	29,8	31,0	10,7	16,7	11,0	20,1	17,0	21,7	17,4	26,5	27,2	26,8
coefficient of variation (%)	36,3	38,7	39,1	38,8	67,7	70,5	60,8	62,6	64,9	60,6	62,8	48,4	42,6	47,4
overall surplus (%)	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
overall deficit (%)	70,3	71,5	70,2	69,0	89,3	83,3	89,0	79,9	83,0	78,3	82,6	73,5	72,8	73,2
number of ME with surplus (including over 10 %)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
number of ME with financial aid exceeding 50 to 70 % (including over 70 %)	6(3)	6(3)	6(3)	6(3)	6(6)	6(5)	6(6)	6(5)	6(6)	6(5)	6(5)	6(3)	6(4)	6(5)

Komi-Permyak AO

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	10,5	10,1	10,6	11,1	7,2	7,3	8,0	9,1	7,5	10,3	8,2	9,6	10,3	10,0
<i>max. share of expenditures covered by assigned revenues (%)</i>	29,6	32,8	30,5	35,2	19,5	19,3	21,6	23,5	19,7	24,7	23,4	27,9	26,2	30,8
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	19,1	22,7	19,9	24,1	12,3	12,0	13,6	14,4	12,3	14,4	15,1	18,3	15,9	20,8
<i>average share of expenditures covered by assigned revenues (%)</i>	17,2	17,6	17,0	18,7	12,6	12,2	14,0	14,8	12,8	15,5	14,1	15,9	16,0	16,9
<i>overall share of expenditures covered by assigned revenues (%)</i>	18,4	19,1	18,4	20,3	13,0	12,9	14,8	15,7	13,5	16,4	15,2	17,3	17,1	18,5
<i>coefficient of variation (%)</i>	38,6	45,0	41,6	45,6	38,5	42,7	40,2	41,6	41,4	41,3	43,4	40,3	35,0	43,4
<i>overall surplus (%)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<i>overall deficit (%)</i>	81,6	80,9	81,6	79,7	87,0	87,1	85,2	84,3	86,5	83,6	84,8	82,7	82,9	81,5
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	6(5)	6(5)	6(5)	6(5)	6(6)	6(6)	6(6)	6(6)	6(6)	6(5)	6(6)	6(6)	6(6)	6(5)

Amur oblast

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	<i>1.1</i>	<i>1.2</i>	<i>1.3</i>	<i>1.4</i>	<i>2.1</i>	<i>2.2</i>	<i>2.3</i>	<i>3.1</i>	<i>3.2</i>	<i>3.3</i>	<i>3.4</i>	<i>4.1</i>	<i>4.2</i>	<i>4.3</i>
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	17,8	16,2	16,9	17,5	4,8	6,4	5,3	7,6	6,3	8,5	6,8	13,3	15,2	13,7
<i>max. share of expenditures covered by assigned revenues (%)</i>	86,8	85,8	87,2	91,6	33,0	66,5	34,1	81,1	71,2	85,1	72,3	95,4	94,7	96,3
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	69,0	69,5	70,3	74,1	28,2	60,1	28,9	73,5	64,9	76,6	65,5	82,2	79,5	82,7
<i>average share of expenditures covered by assigned revenues (%)</i>	36,5	34,0	34,8	35,6	14,3	17,4	12,0	23,2	19,8	23,4	17,6	32,3	32,2	30,4
<i>overall share of expenditures covered by assigned revenues (%)</i>	43,4	41,2	41,8	42,9	17,7	23,1	15,0	30,2	26,0	30,3	23,5	39,7	38,7	37,5
<i>coefficient of variation (%)</i>	46,3	48,8	48,5	48,9	66,0	70,6	58,5	70,6	71,6	69,6	73,7	57,8	53,0	57,7
<i>overall surplus (%)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<i>overall deficit (%)</i>	56,6	58,8	58,2	57,1	82,3	76,9	85,0	69,8	74,0	69,7	76,5	60,3	61,3	62,5
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	21(11)	21(15)	21(13)	21(12)	27(24)	26(23)	27(26)	26(19)	26(21)	26(19)	26(24)	22(15)	24(16)	25(16)

Kabardian-Balkarian Republic

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	12,3	11,2	11,5	11,9	5,6	7,9	6,3	8,3	7,5	9,2	8,2	10,3	12,0	10,8
<i>max. share of expenditures covered by assigned revenues (%)</i>	57,8	60,4	59,3	64,4	60,5	81,9	65,1	73,7	66,5	75,3	69,8	60,1	57,8	62,2
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	45,5	49,2	47,7	52,5	54,9	74,0	58,8	65,3	59,0	66,1	61,6	49,8	45,8	51,5
<i>average share of expenditures covered by assigned revenues (%)</i>	28,0	28,2	27,1	29,1	24,6	32,8	26,3	32,7	30,0	32,9	31,5	28,5	28,6	29,4
<i>overall share of expenditures covered by assigned revenues (%)</i>	33,2	33,9	32,4	35,1	27,5	38,4	29,7	39,1	35,6	39,4	37,4	34,1	33,6	35,3
<i>coefficient of variation (%)</i>	51,7	55,5	56,3	57,4	61,6	67,4	62,3	61,0	59,7	62,6	60,7	57,5	53,0	58,4
<i>overall surplus (%)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<i>overall deficit (%)</i>	66,8	66,1	67,6	64,9	72,5	61,6	70,3	60,9	64,4	60,6	62,6	65,9	66,4	64,7
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	9(8)	9(8)	9(8)	9(8)	10(8)	9(6)	10(7)	9(6)	9(6)	9(7)	9(6)	9(8)	9(7)	9(7)

Rostov oblast

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	27,9	27,3	25,3	28,0	11,8	18,7	15,4	13,8	12,9	14,2	14,4	20,9	24,2	23,3
<i>max. share of expenditures covered by assigned revenues (%)</i>	98,1	98,2	91,6	96,2	115,4	129,7	105,5	98,5	90,4	91,3	81,7	102,5	92,9	95,5
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	70,2	70,9	66,3	68,3	103,6	111,0	90,1	84,7	77,5	77,1	67,3	81,7	68,7	72,2
<i>average share of expenditures covered by assigned revenues (%)</i>	50,3	50,4	47,1	51,5	43,4	55,3	48,3	38,1	34,8	37,8	37,3	45,0	46,1	46,9
<i>overall share of expenditures covered by assigned revenues (%)</i>	58,8	58,8	55,4	59,5	54,4	65,1	54,1	49,0	44,6	47,5	44,5	55,1	53,9	55,0
<i>coefficient of variation (%)</i>	31,1	30,8	31,7	29,6	52,9	45,9	40,8	50,3	50,1	46,6	39,4	40,5	33,8	34,3
<i>overall surplus (%)</i>	0,0	0,0	0,0	0,0	1,1	3,0	0,1	0,0	0,0	0,0	0,0	0,2	0,0	0,0
<i>overall deficit (%)</i>	41,2	41,2	44,6	40,5	46,7	37,9	46,0	51,0	55,4	52,5	55,5	45,1	46,1	45,0
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	2(1)	4(4)	1(0)	0(0)	0(0)	0(0)	0(0)	1(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	29(0)	25(1)	34(4)	21(0)	31(7)	18(4)	24(4)	41(12)	42(15)	41(11)	40(8)	35(6)	34(4)	31(5)

Chuvash Republic

<i>Conditions:</i>	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	21,0	21,0	18,7	21,6	9,8	10,5	16,5	12,6	11,6	12,5	17,1	20,6	24,4	25,1
<i>max. share of expenditures covered by assigned revenues (%)</i>	64,8	76,3	62,6	77,1	76,1	64,9	70,8	77,1	72,5	66,0	70,1	75,4	65,4	82,8
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	43,8	55,3	43,9	55,5	66,3	54,4	54,4	64,4	60,9	53,5	53,0	54,8	41,0	57,7
<i>average share of expenditures covered by assigned revenues (%)</i>	34,8	39,0	31,6	39,4	23,9	24,4	36,1	28,8	26,1	27,9	37,6	35,5	37,4	43,4
<i>overall share of expenditures covered by assigned revenues (%)</i>	49,4	56,5	46,0	56,3	42,6	41,2	53,1	50,6	45,4	47,5	54,8	54,8	51,4	62,0
<i>coefficient of variation (%)</i>	33,2	34,1	34,7	32,4	65,9	58,9	42,4	57,8	58,8	52,4	39,2	42,5	30,9	33,6
<i>overall surplus (%)</i>	0	0	0	0	0,0	0,0	0,0	0	0	0	0	0	0	0
<i>overall deficit (%)</i>	50,6	43,5	54,0	43,7	57	59	47	49,4	54,6	52,5	45,2	45,2	48,6	38,0
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	22(10)	21(7)	24(15)	21(6)	24(20)	23(20)	20(10)	22(18)	23(18)	23(18)	20(8)	22(11)	22(7)	19(3)

Tver oblast

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	24,0	23,7	23,4	24,5	6,9	9,5	8,4	11,8	10,7	12,3	10,4	19,1	19,9	19,5
<i>max. share of expenditures covered by assigned revenues (%)</i>	93,7	100,4	93,1	105,3	83,7	125,9	136,4	113,9	101,7	120,4	141,9	90,9	85,6	96,7
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	69,7	76,7	69,7	80,8	76,8	116,4	128,0	102,1	91,0	108,1	131,5	71,7	65,6	77,1
<i>average share of expenditures covered by assigned revenues (%)</i>	44,5	45,4	42,4	47,3	21,3	27,1	26,1	32,9	28,7	33,5	33,1	38,6	39,5	41,4
<i>overall share of expenditures covered by assigned revenues (%)</i>	58,1	61,1	56,5	63,5	29,7	35,3	33,6	45,6	39,5	45,7	43,2	52,5	50,4	55,4
<i>coefficient of variation (%)</i>	39,0	40,8	40,8	41,1	73,7	74,5	82,3	65,5	65,5	65,8	70,8	46,3	43,0	45,6
<i>overall surplus (%)</i>	0	0	0	1	0,0	0,0	0,0	0	0	0	0	0	0	0
<i>overall deficit (%)</i>	41,9	39,0	43,5	37,8	70,3	64,7	66,4	54,4	60,5	54,4	56,9	47,5	49,6	44,6
<i>number of ME with surplus (including over 10 %)</i>	0(0)	1(0)	0(0)	2(0)	0(0)	1(1)	1(1)	1(1)	1(0)	1(1)	1	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	26(6)	25(5)	31(6)	24(4)	38(31)	37(26)	38(29)	34(20)	35(22)	35(20)	35(20)	32(15)	32(11)	30(10)

Novosibirsk oblast

<i>Conditions:</i>	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	25,3	23,1	23,0	24,2	5,4	9,0	6,5	10,6	9,3	11,3	10,4	17,6	20,7	18,4
<i>max. share of expenditures covered by assigned revenues (%)</i>	153,2	148,2	137,8	141,7	114,9	97,0	100,6	120,0	108,6	103,9	101,6	137,4	115,7	115,5
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	127,8	125,1	114,8	117,5	109,5	87,9	94,1	109,4	99,3	92,7	91,2	119,8	95,0	97,1
<i>average share of expenditures covered by assigned revenues (%)</i>	50,0	48,8	46,6	50,0	22,5	27,4	23,2	32,6	28,9	32,2	29,6	40,7	41,6	41,1
<i>overall share of expenditures covered by assigned revenues (%)</i>	70,9	73,7	67,8	75,6	43,5	53,6	47,9	62,9	55,8	61,9	59,7	68,3	66,1	71,2
<i>coefficient of variation (%)</i>	52,1	55,4	50,9	51,1	103,5	76,0	88,1	78,3	78,7	69,7	69,5	65,9	52,4	59,0
<i>overall surplus (%)</i>	0,5	0,6	0,3	1,6	0,2	0,0	0,0	2,8	0,1	1,7	0,7	3,7	0,2	5,8
<i>overall deficit (%)</i>	29,6	26,9	32,5	26,1	56,7	46,4	52,1	39,9	44,3	39,8	41,0	35,4	34,1	34,7
<i>number of ME with surplus (including over 10 %)</i>	2(2)	3(2)	2(2)	3(2)	1(1)	0(0)	1(0)	3(1)	1(0)	2(0)	1(0)	3(2)	3(1)	3(3)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	25(4)	27(7)	26(8)	24(5)	36(32)	35(28)	36(31)	33(26)	35(28)	34(24)	35(25)	32(16)	32(14)	32(14)

Saratov oblast

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	25,8	27,4	24,1	28,4	5,0	10,4	11,2	13,1	11,6	13,6	15,0	21,5	25,8	25,6
<i>max. share of expenditures covered by assigned revenues (%)</i>	68,3	76,2	63,9	76,3	57,8	48,3	51,3	68,9	62,9	56,8	59,2	72,6	63,6	77,0
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	42,5	48,8	39,8	47,8	52,7	37,9	40,0	55,8	51,2	43,2	44,2	51,1	37,8	51,5
<i>average share of expenditures covered by assigned revenues (%)</i>	40,1	42,3	36,4	42,5	19,6	22,9	25,3	30,1	26,7	28,7	32,3	36,4	37,0	40,1
<i>overall share of expenditures covered by assigned revenues (%)</i>	53,3	58,4	49,3	58,0	34,1	36,1	38,5	48,3	42,6	44,5	46,7	54,4	49,7	57,5
<i>coefficient of variation (%)</i>	27,1	29,3	27,8	27,9	64,0	44,3	42,1	47,6	48,0	42,5	35,9	36,1	27,0	31,3
<i>overall surplus (%)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<i>overall deficit (%)</i>	46,7	41,6	50,7	42,0	65,9	63,9	61,5	51,7	57,4	55,5	53,3	45,6	50,3	42,5
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	30(2)	28(1)	36(8)	29(0)	38(29)	38(26)	36(23)	32(18)	35(19)	35(19)	34(11)	33(10)	35(5)	29(2)

Leningrad oblast

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	39,9	38,3	40,8	40,8	13,7	23,1	10,2	31,1	25,8	30,8	22,4	39,2	37,1	36,9
<i>max. share of expenditures covered by assigned revenues (%)</i>	122,1	116,8	107,3	107,3	88,8	77,8	69,8	110,5	97,2	91,3	75,7	120,3	94,5	93,3
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	82,3	78,5	66,5	66,5	75,1	54,7	59,6	79,4	71,4	60,6	53,3	81,1	57,4	56,4
<i>average share of expenditures covered by assigned revenues (%)</i>	72,6	68,3	69,4	69,4	41,2	43,9	33,2	54,4	48,7	52,6	41,2	66,0	62,2	59,5
<i>overall share of expenditures covered by assigned revenues (%)</i>	70,7	67,0	68,6	68,6	40,2	43,9	32,4	54,4	48,4	53,2	41,1	65,2	60,7	58,8
<i>coefficient of variation (%)</i>	27,9	28,4	25,8	25,8	50,5	36,4	47,6	40,3	41,1	35,6	36,7	31,1	26,8	27,8
<i>overall surplus (%)</i>	1,0	0,7	0,3	0,3	0,0	0,0	0,0	0,4	0,0	0,0	0,0	0,9	0,0	0,0
<i>overall deficit (%)</i>	30,3	33,8	31,7	31,7	59,8	56,1	67,6	46,0	51,6	46,8	58,9	35,7	39,3	41,2
<i>number of ME with surplus (including over 10 %)</i>	3(1)	1(1)	1(0)	1(0)	0(0)	0(0)	0(0)	1(1)	0(0)	0(0)	0(0)	2(1)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	2(0)	4(0)	3(0)	3(0)	19(8)	14(3)	21(10)	13(0)	14(1)	13(0)	18(3)	7(0)	8(0)	10(0)

Krasnoyarsk krai

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	7,3	6,5	7,2	7,2	1,8	2,6	1,6	3,3	2,7	3,6	2,5	5,7	6,1	5,5
<i>max. share of expenditures covered by assigned revenues (%)</i>	82,9	77,4	74,2	74,2	79,2	54,5	50,6	79,8	76,5	62,8	50,9	80,6	72,8	69,7
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	75,6	70,9	67,0	67,0	77,4	51,8	48,9	76,6	73,8	59,1	48,4	74,9	66,6	64,2
<i>average share of expenditures covered by assigned revenues (%)</i>	41,4	36,8	37,5	37,5	18,5	18,9	15,3	24,3	21,4	22,9	17,8	34,6	36,1	31,8
<i>overall share of expenditures covered by assigned revenues (%)</i>	51,0	46,4	47,8	47,8	26,9	27,5	23,3	35,9	31,6	34,0	27,0	46,2	45,5	42,4
<i>coefficient of variation (%)</i>	41,1	44,0	40,2	40,2	91,7	65,9	75,8	74,8	78,8	63,9	67,3	50,9	40,8	45,3
<i>overall surplus (%)</i>	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0	0,0
<i>overall deficit (%)</i>	49,0	53,6	52,2	52,2	73,1	72,5	76,7	64,1	68,4	66,0	73,0	53,8	54,5	57,6
<i>number of ME with surplus (including over 10 %)</i>	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)	0(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	42(11)	44(19)	17(46)	46(17)	54(44)	55(47)	49(42)	50(44)	50(42)	50(42)	54(45)	44(25)	45(18)	47(29)

Sverdlovsk oblast

	<i>Evolutionary</i>				<i>Radical</i>			<i>Intermediate radical</i>				<i>Intermediate moderate</i>		
<i>Conditions:</i>	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax (ref.)	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax (ref.)	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%
Results:														
<i>min. share of expenditures covered by assigned revenues (%)</i>	20,5	14,6	18,5	19,2	5,8	7,5	6,3	7,9	7,1	8,3	7,6	14,6	17,3	15,0
<i>max. share of expenditures covered by assigned revenues (%)</i>	112,2	97,9	101,1	108,5	82,1	76,9	70,6	110,2	93,1	105,4	81,1	113,4	99,6	103,5
<i>difference between the min. and max. share of expenditures covered by assigned revenues (%)</i>	91,7	83,2	82,7	89,3	76,3	69,4	64,2	102,3	86,0	97,1	73,6	98,7	82,3	88,5
<i>average share of expenditures covered by assigned revenues (%)</i>	61,1	50,6	56,8	60,0	29,5	30,6	27,7	40,5	35,0	39,6	33,3	52,2	52,7	51,0
<i>overall share of expenditures covered by assigned revenues (%)</i>	79,1	72,1	75,2	81,5	45,9	48,5	45,4	61,7	54,0	60,0	53,5	72,0	68,8	71,6
<i>coefficient of variation (%)</i>	32,0	36,8	33,0	32,7	59,2	51,7	51,8	53,5	54,3	51,0	48,8	39,8	33,9	36,8
<i>overall surplus (%)</i>	0,8	0,0	0,0	3,1	0,0	0,0	0,0	0,3	0,0	0,1	0,0	0,7	0,0	0,1
<i>overall deficit (%)</i>	21,8	27,9	24,9	21,6	54,1	51,5	54,6	38,6	46,0	40,1	46,5	28,6	31,2	28,4
<i>number of ME with surplus (including over 10 %)</i>	5(1)	0(0)	2(0)	5(0)	0(0)	0(0)	0(0)	2(1)	0(0)	1(0)	0(0)	3(1)	0(0)	1(0)
<i>number of ME with financial aid exceeding 50 to 70 % (including over 70 %)</i>	18(2)	21(2)	26(3)	18(2)	57(37)	59(35)	60(40)	47(20)	54(27)	50(21)	57(28)	35(7)	31(3)	36(5)

Part III. Municipal Finances: Reform Directions

Chapter 8. Analyzing Results of Calculations: Economic Policy Considerations

An analysis of the impact of division of powers between the regional and local levels on the assignment of revenue sources to local budgets

The results of the calculations concerning large cities and municipal entities across regions permit to draw certain conclusions relating not only to revenue sources recommended for assignment to the municipal level, but a broader range of issues of tax policies and development of the concept of local self-governance.

The general conclusion following from the analysis of calculations is that for each analyzed scenario of distribution of powers between the regional and municipal level it is possible to assign to local budgets a set of revenue sources answering the generally accepted views and international practices in this sphere. Usually such sources include (in different combinations) the property tax, the income tax, the sales tax, and various business taxes. It is proposed to use exactly this set of tax revenues (in full or in part) and related non-tax revenues in the form of local or assigned to the local level revenue sources as the revenue base of local budgets.

However, the comparison of calculations done in accordance with different scenarios demonstrate that assignment of revenue sources produces different results depending on the scope of responsibilities and powers⁴¹ exercised at the municipal level. The most significant differences may be reduced to the following.

First, the narrowing of the competence of local authorities results in deterioration of capacity to cover expenditures of municipal entities at the expense of own revenue sources. This is especially illustrative as the evolutionary scenario is compared with the radical one, since the former envisages the most broad scope of powers assigned to the local level and the latter – the most considerable narrowing of this scope. In the case the capacity to finance expenditures from assigned revenue sources is analyzed basing on the data relating to large cities, the replacement of the evolutionary scenario with the radical scenario results in an increase in the coefficient of variation of defrayal of municipal expenditures from 20 – 21 per cent to 32 – 37 per cent, while the share of expenditures funded at the expense of financial aid grows from 17 – 23 per cent to 36 – 40 per cent. As concerns municipal entities in 12 analyzed regions, the significantly increasing share of municipalities financing less than 50 per cent of their expenditures at the expense of assigned revenue sources clearly illustrates the deterioration of the self-financing capacity in the case the evolutionary scenario is replaced with the radical one. While in the framework of the evolutionary scenario this share fluctuates from 57 per cent to 74 per cent across variants of assignment of revenue sources, for the radical scenario this value makes from 81 per cent to 85 per cent. Even more illustrative are the data for municipal entities where need for financial aid exceeds 70 per cent: while in the framework of the evolutionary scenario their share makes 16 per cent to 40 per cent, the respective figures for the radical scenario make 57 per cent to 63 per cent.

Second, the narrowing of the competence of local authorities deteriorates the capacity for diversification of revenue sources assigned to the local level. International practices provide examples where municipalities are assigned a very limited set of revenue sources. For instance, in Canada the only local tax is the property tax. However, it is viewed not as an advantage, but as a significant shortcoming of the Canadian system of financing of local expenditures. Under the present conditions in Russia, the impossibility to diversify revenue sources at the local level may have even more grave consequences. The instability of the economic situation, uncompleted formation of markets, including the market of real estate, continuation of the tax reform – all these factors may contribute to rapid and considerable changes in the revenues from individual revenue sources. Diversification may moderate such fluctuations and considerably enhance the stability of local budgets with regard to unfavorable external factors.

Third, the narrowing of the competence of local authorities somewhat complicates the formation of the motivation of local authorities aimed at the improvement of living conditions of the population and creation of the favorable environment for development of small businesses. The present system of interbudgetary relations, where revenues of all levels of the budgetary system are primarily formed at the expense of substantial federal taxes and property taxes are imposed basing on the balance sheet and not market value, primarily orients local authorities towards establishment of good relations with large enterprises situated at their territories. The support and development of local infrastructures are completely unrelated to the revenue base and are most expenditure-

⁴¹ In this case it is referred to own powers of municipal entities financed at the expense of own revenues of local budgets and unconditional financial aid. The problem of delegation of state powers and financing of such powers at the expense of subventions is not discussed, since it does not relate to the subject matter of this chapter.

intensive types of municipal activities. Development of small businesses also does not significantly affect standing of local budgets.

Changes in the tax system and assignment of revenue sources to the local level may affect the motivation of local authorities in the following way:

- exclusion of the profit tax from sources of local revenues makes the relation between the financial performance of the municipal entity and operations of large enterprises situated in its territory somewhat more tenuous;
- exclusion of excises eliminates the distortion of the motivation of local authorities in favor of support of certain (not necessarily creating largest amounts of public goods) types of activities and their interest in rising entry barriers for excisable goods;
- transformation of the taxes on assets evaluated basing on its market value, or (in perspective) of the property tax in a significant revenue source of local budgets will considerably increase interest of local authorities in development of infrastructure, implementation of responsible policies in the sphere of management and use of land, and other measures aimed at the growth in the value of real estate;
- assignment of taxes on small businesses to the local level in the case local authorities are vested with broader powers to regulate these taxes will result in an increase of their interest in creation of favorable business environment;
- assignment of a certain percentage of the income tax increases the interest of local authorities in stimulation of creation of new jobs.

In principle, all recommended variants of assignment of revenue source positively affect motivation of local authorities. However, in the framework of the evolutionary and radical scenarios this impact may be maximally effective, since there arises the possibility to create prerequisites for transition to the full-fledged property tax as a local tax, at the same time assigning taxes on small businesses and a considerable portion of the income tax to the municipal level. The intermediate radical and especially radical scenarios allow to realize the potential of these measures to a much lesser extent. In these cases one has to choose between formation of prerequisites for transition to the property tax and assignment of taxes on small businesses to the local level, while the income tax either is not assigned at all, or its share is so insignificant that it will fail to create any positive incentive.

Fourth, the narrowing of the competence of local authorities will considerably complicate budget management. In the case the evolutionary scenario is replaced with the radical one, the share of property taxes in the structure of assigned revenue sources increases about 1.7 times⁴². Property taxes are collected rather seldom and irregularly: the corporate asset tax – quarterly, other – primarily in the second half year. In the case the share of these taxes in the budget is high, the process of management of such a local budget becomes rather complicated since there inevitably occur large cash gaps, which must be bridged either at the expense of commercial bank credits (in this case the costs of budget management grow considerably), or budgetary loans (in this case budgetary constraints inevitably become more lax). Besides, this situation is more favorable for subsidized municipal entities than financially self-sufficient ones, since grants are allocated more regularly than own revenues.

In this case there may be taken an alternative approach envisaging a revision of principles of assignment of revenue sources to the local level, for instance, a significant narrowing of the list of property taxes and stronger stress on the income tax. However, it shall be taken into account that this approach may significantly deteriorate the revenue generating capacity of property taxes (the tax base may be fully assessed only at the local level) and prevent the formation of an adequate motivation of local authorities as discussed above.

Therefore, it is apparent that effectiveness of assignment of revenue sources varies across scenarios, i.e. different variants of assignment allow settling different problems and creating different prerequisites for enhancement of independence and stability of local budgets. The major factors affecting the effectiveness of the system of assignment of revenue sources are presented in *Table 8.1*. The trend towards a decline in effectiveness of assignment of revenue sources becomes clearly noticeable as the scope of municipal competence becomes narrower.

Since, as it was discussed in Chapter 2, exactly financial factors are of the key importance for enhancement of effectiveness of local authorities, they shall be taken into account as concerns the issue of division of powers between the regional and municipal levels. Therefore it appears that the necessity to form an efficient financial system at the local level shall be also taken into account as yet another argument (the subsidiarity principle is of

⁴² Calculations were done basing on the sample of large cities, there were compared variants 1.1 (the evolutionary scenario, the total amount of the corporate asset tax was assigned) and 2.2 (the radical scenario, a portion of the corporate asset tax was assigned).

importance here) against significant limitation of competence of municipal entities. From this viewpoint, the scope of powers vested with municipal entities in the framework of the evolutionary and intermediate moderate scenarios appears most preferable.

An analysis of consequences of assignment of different revenue sources to local budgets

Variants of calculations envisaged assignment of different combinations of revenue sources to local budgets.

The key differences may be reduced to the following two:

- 1) the corporate asset tax, taking into account the fact that working assets are excluded from the tax base, was assigned to municipalities either in the full amount or in part (75 per cent or 40 per cent of the present tax respectively);
- 2) the sales tax was included or not included in the taxes assigned to the local level.

Table 8.1

Characteristics of effectiveness of the system of assignment of revenue sources to local budgets depending on the division of powers between the regional and municipal levels

<i>Factors of effectiveness</i>	<i>Evolutionary</i>	<i>Radical</i>	<i>Intermediate radical</i>	<i>Intermediate moderate</i>
Diversification of revenue sources	significant	insignificant	average	significant
Adequate motivation of local authorities	real estate + small businesses + jobs	real estate (partially) + small businesses	real estate (fully or partially) + small businesses	real estate (fully or partially) + small businesses + jobs
Prerequisites for transition to the property tax	favorable	unfavorable	uncertain	uncertain
Regularity of inflow of budgetary tax revenues	regularly	irregularly	irregularly	regularly
Coefficient of variation (for large cities, %)	20-21	32-37	28-30	24
Need for financial aid (large cities, in % of expenditures)	17-23	36-40	25-33	20-23
Share of municipal entities with financial aid exceeding 50 % across 12 regions (%)	57-74	81-85	80-84	59-71

Tables 8.2 and 8.3 present the comparison of variants of assignment of revenue sources reflecting alternative approaches discussed above. In the framework of each scenario there were chosen two variants of assignment of revenue sources. The variants were chosen in a way allowing reducing the key difference to the analyzed parameter so the influence of other factors was minimal. The concrete variants of assignment of revenue sources in the framework of each scenario are presented in the table. The list of revenue sources assigned in the framework of each variant is presented in Annex 8.1.

The calculations concerning the corporate asset tax were done basing on the sample of municipal entities in 12 analyzed regions, and the sales tax – in 10 regions (the Leningrad oblast and Krasnoyarsk krai did not introduce this tax).

The analysis was conducted basing on the comparison between pairs of variants of assignment of revenue sources in the framework of each expenditure scenario by taking the approach described in the preceding chapter. Similarly to that analysis, there were used six indicators. As concerns three of these indicators (ratio between the maximal and minimal share of expenditures covered at the expense of assigned revenue source, overall deficit, and coefficient of variation), there were determined the average value of each indicator across all analyzed regions and the number of regions where the values of these indicators were the best in the framework of each compared pair. As concerns three other indicators (the number of municipal entities with surplus, the number of municipal entities with profit exceeding 10 per cent, and the share of municipal entities where less than 50 per cent of expenditures were defrayed at the expense of assigned revenue sources (i.e. the need for financial aid in order to defray expenditures exceeded 50 per cent of revenues), for comparison there were used aggregate values across all analyzed regions.

As concerns the corporate asset tax, the data of *Table 8.2* demonstrate that the assignment of the full amount of this tax produces the best results in the framework of the evolutionary scenario, i.e. in the case the scope of powers vested with municipal entities remain unchanged. In the framework of the intermediate moderate scenario, the assignment of the total amount of this tax results in a gain in terms of amount of necessary financial aid and a loss in the coefficient of variation and self-financing capacity. In other cases variants envisaging partial assignment of the corporate asset tax were more preferable.

However, the difference between variants of full or partial assignment of the corporate asset tax is much less principal than the difference in capacity to cover expenditures in the framework of different scenarios. Thus, after the transition from partial to full assignment of the corporate asset tax in the framework of the intermediate moderate scenario the coefficient of variation increases 1.2 times, and increases 1.5 times in the case the evolutionary scenario is replaced with the radical scenario (in both cases the corporate asset tax is partially assigned). The share of municipal entities defraying less than half of their expenditures at the expense of assigned revenue sources in the framework of the evolutionary scenario increases by 8 per cent in the case the full assignment of the corporate asset tax is replaced with partial assignment. At the same time, in the case the evolutionary scenario is replaced with the radical scenario, the respective increase makes 27 per cent if the amount of tax is assigned in full and 14 per cent if the tax is assigned partially.

As concerns the sales tax, the comparison of variants envisaging its inclusion in or exclusion from the revenues of municipal entities produces uncertain results. On the whole, in the case the sales tax is included, coefficients of variation in the framework of radical scenarios somewhat improve, while slightly deteriorating in the framework of the intermediate moderate scenario, and practically do not change in the framework of the evolutionary scenario. It appears that this development is related to the fact that the sales tax is distributed more evenly than taxes on small businesses and the income tax. However, in the case a part of the income tax is apportioned according to the size of the population, the equalizing effect is even more significant. The indicator of overall deficit (need for financial aid) demonstrates the inverse relationship: the inclusion of the sales tax positively affects it in the framework of the evolutionary and intermediate moderate scenarios and negatively – in the framework of the radical scenarios.

On the whole, the comparison of different variants of assignment of revenues to local budgets has confirmed that the concrete set of revenue sources assigned in the framework of general approaches formulated in Chapter 5 do not affect the results of calculations so significantly as the scope of powers vested with municipal entities.

Table 8.2

Comparison of variants of assignment of revenue sources envisaging full or partial inclusion of the corporate asset tax in the revenues of municipal entities

Compared variants	Corporate asset tax is assigned in full (75 % of the present taxation)						Corporate asset tax is assigned partially (40 % of the present taxation)					
	difference between the min. and max. shares of expenditures covered by assigned revenues (%)		overall deficit (%)		coefficient of variation (%)		difference between the min. and max. shares of expenditures covered by assigned revenues (%)		overall deficit (%)		coefficient of variation (%)	
	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator
1.1.-1.3.	63,5	5	48,9	10	38,0	9	59,6	6	51,0	1	39,2	3
2.1.-2.2.	62,4	5	67,9	2	66,3	5	62,8	7	63,4	10	58,7	7
3.2.-3.3.	64,1	6	62,0	0	59,4	2	64,7	6	58,3	12	55,1	10
4.1.-4.2.	67,7	0	51,6	10	46,4	0	57,0	12	53,1	2	39,4	12
	Overall across 12 regions											
	Number of municipalities with surplus (pcs.)	Number of municipalities with surplus exceeding 10 % (pcs.)	Share of local budgets where financial aid exceeds 50 % (%)	Number of municipalities with surplus (pcs.)	Number of municipalities with surplus exceeding 10 % (pcs.)	Share of local budgets where financial aid exceeds 50 % (%)						
1.1.-1.3.	10	4	59	5	2	67						
2.1.-2.2.	3	2	84	5	5	81						
3.2.-3.3.	2	0	84	4	1	82						
4.1.-4.2.	9	4	71	3	1	59						

Table 8.3

Comparison of variants of assignment of revenue sources envisaging inclusion of the sales tax in revenues of municipal entities or exclusion of the sales tax from revenues of municipal entities

Compared variants	Sales tax is assigned in full						Sales tax is not assigned					
	difference between the min. and max. shares of expenditures covered by assigned revenues(%)		overall deficit (%)		coefficient of variation (%)		difference between the min. and max. shares of expenditures covered by assigned revenues(%)		overall deficit (%)		coefficient of variation (%)	
	on average across 10 regions	number of regions with the best indicator	on average across 10 regions	number of regions with the best indicator	on average across 10 regions	number of regions with the best indicator	on average across 10 regions	number of regions with the best indicator	on average across 10 regions	number of regions with the best indicator	on average across 10 regions	number of regions with the best indicator
1.4.-1.3.	63,8	0	48,2	10	40,6	4	58,2	10	52,8	0	40,4	6
2.3.-2.2.	58,6	5	65,7	3	56,9	7	64,7	4	63,2	7	60,3	3
3.4.-3.3.	62,6	7	60,5	2	54,4	6	65,7	3	58,7	8	56,2	4
4.3.-4.2.	62,9	0	51,5	7	44,7	0	55,9	10	54,3	3	40,5	10

Other conclusions important for the reform of municipal finances

The calculations allow drawing some additional conclusions concerning the issues directly related to the reform of municipal finances. One of such issues is equalizing at the expense of assignment to municipal entities of the guaranteed (i.e. determined as a share of the tax contingent) and equalizing (allocated to each municipal entity in proportion to the respective population size). This study focused on the analysis of the income tax. Basing on the analysis of the data for 2001, it was found out that in 11 out of 12 regions under study the transition from the assignment of the full amount of income tax in proportion to the contingent to its full assignment in proportion to the size of the population results in a significant decline in coefficient of variation, which decreases across regions 2 to 5 times. The only exception is the Leningrad oblast where, as in the sample of large cities, the most profound equalizing effect was produced by division of the income tax between the guaranteed and equalizing parts in proportion 50 / 50.

Yet another consequence of redistribution of the income tax in proportion to the population size is enhanced capacity to defray expenditures of municipal entities at the expense of this source. This effect is detected in 10 out of 12 analyzed regions, at the same time, in 6 regions about 20 per cent of adapted expenditures may be additionally defrayed in the case the full amount of the income tax is assigned in proportion to the population size as compared with its full assignment in proportion to the contingent.

This effect was used in the process of formation of the concept of assignment of revenue sources to local budgets. For instance, for the choice of a variant of defrayal of expenditures of local budgets in the framework of the evolutionary scenario there were reviewed two approaches to the assignment of the income tax: 50 per cent of the income tax in the case it is divided in the guaranteed and equalizing parts in proportion 25 / 25 and 75 per cent of the income tax in the case it is divided in the guaranteed and equalizing parts in proportion 25 / 50. The comparison was made on the condition that all property taxes and charges, 90 per cent of the tax on imputed income, 30 per cent of the tax levied in relation to the application of the simplified taxation system, and existing small local taxes are also assigned to local budgets. As a result of the assignment of additional 25 per cent of the income tax redistributed in proportion to the size of the population the defrayal of municipal expenditures increased from 43 per cent to 51 per cent on the average across 12 regions, at the same time, in certain regions the increase was even more significant (by 10 to 14 per cent). The share of municipal entities defraying less than 50 per cent of their expenditures at the expense of assigned revenue sources declined considerably (from 77 per cent to 59 per cent).

In this case, there was registered no significant increase in surplus of most financially secure municipal entities. As concerns the sample of large cities where overall defrayal of expenditures increased rather significantly (from about 70 per cent to 80 per cent), the overall surplus remained below 1 per cent. On the whole, the number of municipalities with surplus increased from 4 to 10 across all 12 regions and made 2.5 per cent of the total sample of analyzed municipal entities. At the same time, all attempts to increase the share of income tax assigned

in proportion to contingent, even on a smaller scale, resulted in considerable excessive security of the richest local budgets.

Yet another important issue is the impact of the abolishment of the sales tax on local budgets. In different regions this source plays different roles. According to the data for 2001, if the full amount of this source is assigned to the local level, in 5 regions it will defray less than 5 per cent of adapted municipal expenditures, in 3 regions – from 5 to 10 per cent of adapted expenditures, and in 2 regions – over 10 per cent of adapted expenditures. According to our estimates, in 5 of the regions under analysis these losses may be compensated at the expense of the tax on personal property evaluated basing on its market value, in other 4 regions – in the case personal property is evaluated basing on its market value – these losses will be below 3 per cent of the adapted municipal expenditures. Only in one region out of 10 (the Chuvash Republic) the losses are rather significant making over 7 per cent of the adapted municipal expenditures.

At last, it shall be noted that informational limitations did not allow analyzing the situation where local budgets are formed not at the level of districts, but a lower level of settlements. In this situation the problem of division of responsibilities, and, accordingly, the amount and structure of expenditures of different municipalities is even more acute, what, undoubtedly, complicates the problem of assignment of revenue sources to the local level. There may be recommended the following approaches to the resolution of this problem.

First, taking into account the fact that not more than 70 to 80 per cent of municipal expenditures (in the majority of regions – considerably less) are funded at the expense of assigned revenue sources, in many cases this problem may be resolved at the expense of unconditional financial aid provided from regional budgets. There may be used a special mechanism of allocation of financial aid for the municipalities bearing expenditures relating to education and health care. Most probably, at the first stages of implementation of the reform of financial principles of local government this approach would predominate, in spite of its apparent limitations and flaws (for instance, it is feasible only in the regions where a considerable portion of expenditures is defrayed at the expense of financial aid; there arise problems concerning the formalization of the mechanism of allocation of financial aid in such a situation, etc.).

Second, municipal entities at the level of settlements may form associations in the framework of which they may pool resources in order to finance education, health care, and other common functions. In contradistinction to a two-tier structure of municipal entities, such associations may be of different structures and membership depending on concrete functions. It appears that exactly this approach is most feasible in a medium term outlook.

Third, in the way of experiment, in the regions interested to take this approach there may be created special okrugs in the sphere of education and, to a lesser extent, in health care, as special municipal entities disposing of own revenue sources. This practice is most frequent in the USA and Canada, however, its advantages and disadvantages and prospects of its introduction in Russia require further study.

Fourth, it may be assumed that in the long-term perspective, on the condition of transition to the property tax as a local tax, the differentiation of expenditure powers will be to a great extent automatically compensated at the expense of changes in the amount of municipal revenues. Apparently, the value of real estate (not only residential, but also business property) will be also determined by, among other factors, social services provided in the framework of the local community. Accordingly, other things being equal, municipal entities bearing larger social expenditures will receive larger revenues at the expense of taxation of real estate.

Budget legislation: recommendations on assignment of revenue sources to local budgets

The analysis allows formulating the following approaches to the assignment of revenue sources to local budgets. Since it is proposed to make no significant changes in the functions and powers of municipal entities, the assignment of revenue sources shall base on the evolutionary or intermediate moderate scenario. In essence, the key difference between these scenarios is that one takes into account the current state of the health care reform, while in the framework of the other revenue sources are assigned proceeding from the assumption that this reform will be completed in the nearest future.

The second issue is the dilemma of property taxes. Its resolution will also principally affect the set of assigned revenue sources. In the case it is assumed that the problem of unevenness arising in the case of the full assignment of the corporate asset tax to the municipal level is more important than creation of favorable prerequisites for the introduction in the perspective of the property tax, it is necessary to orient towards variants envisaging partial assignment of the corporate asset tax to local budgets. If the formation of favorable conditions for the introduction of the property tax as a local tax (taking into account that in the framework of the evolutionary scenario there were detected no negative consequences of the full assignment of the corporate asset tax, while in the framework of the intermediate moderate scenario the unevenness increased, although not to prohibitive values) is the priority, there shall be selected the variants envisaging the assignment of the full amount of the corporate asset tax to local budgets.

Proceeding from the aforesaid considerations, there are proposed two approaches to the assignment of revenue sources to municipal entities. The first approach proceeds from the full assignment of the corporate asset tax to local budgets and is based on variants 1.1 – 4.1. The second approach envisages a partial assignment of the corporate asset tax to local budgets and is based on variants 1.3 – 4.2.

In the framework of variants 1.1 – 4.1, it is proposed to assign to municipal entities the following base revenue sources:

- income tax: the guaranteed share at 25 per cent, the equalizing share at 50 per cent or 25 per cent (depending on the choice between the evolutionary and intermediate moderate scenario as the base one);
- corporate asset tax at 100 per cent;
- personal asset tax at 100 per cent;
- land tax at 100 per cent;
- single tax on imputed income at 90 per cent; single tax levied in relation to the application of the simplified taxation system at 30 per cent;
- **advertising tax at 100 per cent;**
- **inheritance and gift tax at 100 per cent;**
- **local license fees at 100 per cent;**
- non-tax revenues in accordance with the legislation currently in force adding the full assignment of rental payments for land to the municipal level.

In the framework of variants 1.3 – 4.2, it is proposed to assign to municipal entities the following base revenue sources:

- income tax:
 - guaranteed part at 40 per cent and equalizing part at 40 per cent (the evolutionary scenario),
 - or;
 - guaranteed part at 30 per cent and equalizing part at 20 per cent (the intermediate moderate scenario),
 - corporate asset tax at 50 per cent;
 - personal asset tax at 100 per cent;
 - land tax at 100 per cent;
 - single tax on imputed income at 90 per cent; single tax levied in relation to the application of the simplified taxation system at 30 per cent;
 - **advertising tax at 100 per cent;**
 - **inheritance and gift tax at 100 per cent;**
 - **local license fees at 100 per cent;**
 - non-tax revenues in accordance with the legislation currently in force adding the full assignment of rental payments for land to the municipal level.

The analysis made at the preceding stages of the study demonstrated how proposed variants of assignment of revenue sources defray expenditures estimated for respective expenditure scenarios. However, in the case it is planned to fix this structure of revenue sources at present, it is necessary to estimate the possible financial consequences, what requires to evaluate implementation of variants 1.1 and 4.1, and 1.3 and 4.2 in the framework of the present system of expenditures and presently available revenue sources (not taking into account the possibilities to reform them in the future). The respective calculations based on the data for 2001, at the same time, the major revenue sources as well as expenditures for remuneration of labor with accruals were reevaluated proceeding from the dynamics of these indicators observed in 10 months of 2002. The initial data were adjusted for conditions of 2002 in the same way as it was described in Chapter 6 as concerns major revenues and expenditures in the framework of the evolutionary scenario. The results relating to large cities are presented in *Table 8.4*, the data on 12 analyzed regions – in *Table 8.5*.

Table 8.4

Consequences of different variants of assignment of revenue sources from the viewpoint of financing of municipal expenditures as concerns the sample of large cities (revenues and expenditures were estimated basing on the data for 10 months of 2002)

	<i>100% of the corporate asset tax is assigned</i>		<i>50% of the corporate asset tax is assigned</i>	
	1.1	4.1	1.3	4.2
Income tax	25 % - guaranteed, 50 % - equalizing parts	25 % - guaranteed, 25 % - equalizing parts	40 % - guaranteed, 40 % - equalizing parts	20% - guaranteed, 35% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%
Personal asset tax	100%	100%	100%	100%
Corporate asset tax	100%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%
Sales tax	0%	0%	0%	0%
Results:				
<i>min. share of expenditures covered by assigned revenue sources (%)</i>	36,6	34,2	37,5	31,2
<i>max. share of expenditures covered by assigned revenue sources (%)</i>	104,2	92,7	92,5	78,7
<i>difference between the min. and max. shares of expenditures covered by assigned revenue sources (%)</i>	67,6	58,5	55,0	47,5
<i>average share of expenditures covered by assigned revenue sources (%)</i>	72,9	62,9	67,4	55,3
<i>coefficient of variation (%)</i>	22,0	22,6	21,3	21,9
<i>overall share of expenditures covered by assigned revenue sources (%)</i>	72,6	62,7	66,9	55,0
<i>overall surplus (%)</i>	0	0	0,0	0,0
<i>overall deficit (%)</i>	27,5	37,3	33,1	45,0
<i>number of cities with surplus</i>	3	0	0	0
<i>number of cities with surplus exceeding 10 %</i>	0	0	0	0
<i>number of cities where financial aid exceeds 50 % (pcs.)</i>	7	12	7	28

Apparently, in the case of large cities variant 1.1 is most preferable, primarily because it ensures a higher rate of defrayal of municipal expenditures and the least need for financial aid. As concerns other parameters, all variants are overall similar in terms of results. As concerns municipalities in 12 analyzed regions, the improvement of their financial standing is achieved at the cost of an increase in unevenness of defrayal of expenditures in the case the corporate asset tax is assigned in full. It shall be noted that in the framework of assignment of revenues based on the intermediate moderate scenario (4.1 – 4.2) this unevenness is more pronounced than in the case revenues are assigned on the basis of the evolutionary scenario (1.1 – 1.3). As concerns the excess of revenues over expenditures resulting from the assignment of revenue sources, this problem is not acute in any variant under the analysis. This problem is of importance only if revenues are assigned in accordance with variant 1.1, however, in this case surplus occurs only in 5 regions and its maximal amount makes 1.4 per cent of the aggregate municipal expenditures. In the framework of this variant, the number of municipal entities with surplus (12) does not exceed 3 per cent of municipalities in the analyzed sample and only in three municipalities surplus exceeds 10 per cent. Therefore, the assignment of revenues in accordance with any of the analyzed variants will

not result in a necessity to considerably redistribute financial resources between the regional and municipal levels and will not set additional limitations on provision of financial aid from regional budgets.

The comparison of the assignment of revenue sources on the basis of the evolutionary and intermediate moderate scenarios demonstrates that while variants of the evolutionary scenario (especially variant 1.1) are a significant step towards enhancement of financial independence of local authorities even in the present situation, the intermediate moderate scenario (especially variant 4.2) postpones the ensuring of independence of local budgets to distant future. Even in the case of the sample of large cities, this variant fails to create prerequisites for self-financing of any city, while more than 40 per cent of cities will be able to finance less than 50 per cent of their expenditures at the expense of assigned revenue sources.

Therefore, it appears that from the standpoint of acceleration of the reform of financial principles of local government and taking into account the perspectives of the tax reform, it would be most feasible to assign revenue sources to municipal entities in accordance with variant 1.1. It implies that *the following revenue sources will be assigned to local budgets:*

- income tax: the guaranteed share at 25 per cent, the equalizing share at 50 per cent;
- corporate asset tax at 100 per cent;
- personal asset tax at 100 per cent;
- land tax at 100 per cent;
- single tax on imputed income at 90 per cent; single tax levied in relation to the application of the simplified taxation system at 30 per cent⁴³;
- **advertising tax at 100 per cent;**
- **inheritance and gift tax at 100 per cent;**
- **local license fees at 100 per cent;**
- non-tax revenues in accordance with the legislation currently in force adding the full assignment of rental payments for land to the municipal level.

In addition to this list, there may be also assigned to the local level such revenue sources as the tax on common mineral resources, a portion of the transport tax and ecological payments. It is apparent that at present the amount of these revenue sources is insignificant, while ecological payments shall directly correspond to the amount of expenditures for environmental protection borne by concrete municipal entities. Therefore, the impact of these revenue sources may be ignored.

Table 8.5

Consequences of different variants of assignment of revenue sources from the viewpoint of financing of actual municipal expenditures as concerns 12 RF subjects (estimated for 10 months of 2002)

	<i>100% of the corporate asset tax is assigned</i>				<i>50% of the corporate asset tax is assigned</i>			
	1.1		4.1		1.3		4.2	
	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator	on average across 12 regions	number of regions with the best indicator
Difference between the min. and max. shares of expenditures covered by assigned revenue sources (%)	62,0	0	58,7	0	53,9	0	43,7	12
Overall deficit (%)	52,2	12	60,0	0	55,6	0	63,0	0
Coefficient of variation (%)	40,5	3	47,4	0	37,0	1	31,3	8
<i>Total across 12 regions</i>								
Number of ME with surplus	12		3		1		0	
Number of ME with surplus exceeding 10 %	3		1		0		0	
Share of local budgets with financial aid exceeding 50 %	63		76		70		79	

⁴³ There may be assigned 45 per cent as it is stipulated by the legislation currently in force.

Characteristic of municipal entities with surplus

In spite of the fact that according to the results of the calculations the share of municipal entities where revenues exceed expenditures is not very large, it would be of interest to characterize such municipalities and find out the sources of surplus. At present, there exist two stable assumptions about the nature of municipal entities where revenues exceed expenditures with high probability. First, often promoted by officials of regional administrations, is that large municipal entities where larger tax bases are balanced against broader ranges of functions do not often encounter the problem of surplus, while it is characteristic of small municipalities having small numbers of residents and considerable economic bases. According to the second assumption, the corporate asset tax is primarily “responsible” for excessive revenues of municipal entities. Both these assumptions need to be tested.

The list of municipal entities with surplus resulting from the above variant of assignment of revenue sources based on the data for 10 months of 2002 includes 12 municipalities from 5 regions: 4 municipalities from the Sverdlovsk oblast, 3 from the Rostov and Leningrad oblasts each, 1 from the Tver and Novosibirsk oblasts each. In 8 out of 12 municipalities populations are below 100 thousand persons. All municipal entities with surpluses exceeding 10 per cent belong to this category, it shall be noted that in two of them populations are minimal (about 17 thousand persons) and only in one municipality the number of residents exceeds 50 thousand. Therefore, the assumption that the problem of surplus is more characteristic of small municipal entities proves on the whole true, although in the framework of a small sample.

The problem of sources of surplus is more complicated. First of all, it is necessary to choose the method of analysis. It appears feasible to carry out this evaluation by comparing the structure of tax revenues⁴⁴ (on condition that the sum of these revenues is taken as 100 per cent) in 12 analyzed municipalities with the similar average structure of the sample of large cities. Although this reference is not ideal, it may be better substantiated than, for instance, comparison with the average structure of revenues of each region. At the same time, it is apparent that insignificant deviations across large cities are natural and cannot be reviewed as anomalies. Therefore, the difference was considered significant if the share of given revenue source in the structure of taxes differed from the respective share characteristic of large cities by not less than 5 per cent.

It was found out that sources of surplus are rather varied. Indeed, the share of the corporate asset tax was above the respective share characteristic of large cities in 8 out of 12 municipalities, however, this excess was significant only in 4 cases. As concerns the income tax, in the majority of municipalities the share of this source in the structure of tax revenues was significantly below than in the sample of large cities, although in two cases it clearly was the source of surplus. The share of taxes on small businesses was somewhat above the respective indicator of large cities in three municipal entities, the share of land taxes and payments – in five municipalities, while it should be noted that in two cases this excess was significant. At last, in two cases local taxes clearly were sources of surplus (in one case it exceeded 10 per cent). Therefore, taking into account the conditional nature of such evaluations, there may be singled out the following sources of surplus as broken down by individual municipal entities:

- in 4 – corporate asset tax;
- in 3 – tax on imputed income and land taxes and payments;
- in 2 – local taxes
- in 2 – income tax;
- in 1 – corporate asset tax and land taxes and payments.

Regional differences in sources of surplus are rather apparent. For instance, in Rostov oblast the tax on imputed income and land taxes and payments play decisive role, while the corporate asset tax is less significant. As concerns Leningrad oblast, there the role of local taxes is exceptional – in two cases more than 28 per cent of municipal expenditures were defrayed at their expense, and only in one case the corporate asset tax was a source of surplus. In Sverdlovsk oblast sources of surplus are rather varied and include income tax, corporate asset tax, as well as land taxes and payments.

Therefore, it is apparent that although the corporate asset tax is a significant source of surplus in municipal entities and its assignment as a revenue source must be closely observed, the problem is not reduced to this tax. Sources of surplus are rather varied and it appears that in the framework of the policy “one tax – one budget” surplus will be inevitably generated whatever the combination of assigned revenue sources.

⁴⁴ The land tax was analyzed in complex with rental payments for land, since it is apparent that these two revenue sources can not be analyzed separately.

Annex 8.1

Variants of assignment of revenue sources to local budgets in the framework of different expenditure scenarios

	<i>Evolutionary scenario</i>				<i>Radical scenario</i>			<i>Intermediate radical scenario</i>				<i>Intermediate moderate scenario</i>		
	1.1	1.2	1.3	1.4	2.1	2.2	2.3	3.1	3.2	3.3	3.4	4.1	4.2	4.3
Income tax	25% - guaranteed, 50% - equalizing parts	25% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	40% - guaranteed, 40% - equalizing parts	0%	0%	0%	10%	0%	20%	0%	25% - guaranteed, 25% - equalizing parts	20% - guaranteed, 35% - equalizing parts	25% - guaranteed, 25% - equalizing parts
Single tax on imputed income	90%	90%	90%	90%	0%	90%	0%	90%	90%	90%	90%	90%	90%	90%
Single tax levied in relation to the application of the simplified taxation system	30%	30%	30%	30%	0%	30%	0%	30%	30%	30%	30%	30%	30%	30%
Personal asset tax	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Corporate asset tax	100%	100%	50%	50%	100%	50%	50%	100%	100%	50%	50%	100%	50%	50%
Land tax and rental payments for land	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Local taxes and charges	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Sales tax	0%	100%	0%	100%	0%	0%	100%	0%	0%	0%	100%	0%	0%	100%

Chapter 9. Basic Approaches to Changes in Legislation Aimed to Ensure Financial Guarantees of Local Self-Governance

Methodological approach

At present, the normative and legal system of regulation of municipal finances is rather complicated and inconsistent. The law “On financial principles...” has not been abolished yet, although the base parameters of the financial system at the local level are regulated by the Budget and Tax Codes. Stipulations of different legislative acts may be ambiguously interpreted and often contradict each other. Changes introduced in the normative and legal system are not clearly based on a single concept and are erratic.

Apparently, in this situation the problem of normative and legal regulation of financial guarantees of local self-governance cannot be easily settled both in essence, and from the legal point of view. The law “On financial principles...” was adopted in 1997, in the situation where normative regulation of tax and budgetary issues was underdeveloped. After the enactment of the Tax and Budget Codes the necessity to have a special legislative act regulating the financial system at the local level becomes in principle superfluous. Therefore, it would be more logical to settle the problem of ensuring financial guarantees of local self-governance not via a special law, but by introducing amendments to the basic documents regulating budgetary and tax issues.

At the same time, certain problems arise in the framework of this approach. In the case local budgets are recognized as the third tier of the budgetary system of the Russian Federation (Article 10 of the Budget Code) without defining its specifics, in fact it renders more difficult to implement the constitutionally determined specifics of local self-governance as a non-state level of power, what results in unification of budgetary mechanisms at the level of RF subjects and municipal entities, what often is not feasible. This problem may be partially settled by introducing provisions specific for financial fundamentals of local self-governance in the law “On general principles...” This method was chosen by the Commission for Division of Powers. The same approach is taken in this study.

However, the difficulties relating to the replacement of a single normative and legal act with a set of amendments to different laws cannot be reduced to purely technical problems. In this situation, it is rather difficult to maintain the overall sense of purpose and common ideology allowing to ensure the complex solution of the problem of formation of financial guarantees of local self-governance not infringing upon the basic principles and digressing on less important details to regulate which on the federal level is not feasible. In fact, this problem was not settled in the framework of the law “On financial principles...”, which was primarily designed to regulate procedural issues and was not aimed at creation of a complex approach to the ensuring of financial guarantees of local self-governance.

The basic ideology of this sphere is rather adequately reflected in the Program of Development of Fiscal Federalism till 2005. This study on the whole is based on the principles and approaches defined in this Program seeking, however, to concretize and modify them on the basis of respective calculations and more profound elaboration of individual aspects of the problem. The major differences relate primarily to the rejection of the two-tier model of the territorial structure of municipal entities stipulated by the Program and elaborated in more detail in recommendations worked out by the Commission for Division of Powers. For the discussion of this problem and alternative recommendations relating to this issue, see Chapter 1.

In order to ensure the integrity and complexity of changes in the legislation, it appears necessary to define key principles to be enforced at the federal level. These principles may not be directly reflected in normative and legal acts; however, they should be the ideological basis of the whole system of proposed novations. At the same time, in order to ensure financial guarantees of local self-governance it is necessary to comply with the following conditions:

- all changes introduced in the normative and legal acts regulating financial relations at the local level shall directly stem from these principles;
- legislation shall not contain stipulations infringing upon these principles, or, in the case such norms are present in the legislation, they shall be thoroughly justified;
- at the federal level, it is feasible to regulate only the general framework ensuring compliance with these principles and preventing infringement upon them on the part of state authorities at the federal or regional level, but not concrete financial mechanisms affecting relations between RF subjects and municipalities.

It appears that exactly in this case financial guarantees of local self-governance may be ensured at the federal level without infringing upon the principles of development of federal state and division of powers between the federal and regional levels.

Among the fundamental principles ensuring financial guarantees of local self-governance there may be listed the following:

- ensuring of independence of local budgets;
- fair principles of financial aid to municipal entities;
- availability of financial resources necessary to exercise state powers delegated to local authorities;
- responsibility of local authorities for effectiveness of municipal budgetary policies (tight budgetary constraints).

This chapter focuses on the explanation of these principles and approaches to their reflection in the federal legislation.

Guaranteeing independence of local budgets

Formally, the principle of independence of budgets (including local ones) is set forth in the Budget Code. However, the more detailed interpretation of this principle in Article 31 is rather abstract and does not ensure its practical implementation. However, the task is not to improve the general definitions of the Budget Code, but to substantively interpret the principle of independence of local budgets and its implementation via introduction of respective amendments to the budgetary and tax legislation.

The principle of independence of local budgets means that local authorities shall be able to have adequate revenue sources to finance own expenditure powers and independently determine assignment of funds for these purposes. Apparently, the practical implementation of this principle will require to introduce radical changes in the existing financial mechanisms at the local level. It appears that these changes shall be aimed at attainment of the following objectives:

- to assign to local authorities own revenue sources at the level ensuring the maximal possible defrayal of local expenditures⁴⁵;
- to grant the status of local taxes to some revenue sources important for the formation of local budgets, what will allow to ensure the flexibility of financial system at the local level;
- to grant municipal entities the right to independently administer the formation and expenditure of local budgets, establish municipal tax agencies and municipal treasuries;
- to ensure independence of local authorities as concerns the disposal of unconditional financial aid by limiting control over respective expenditures on the part of higher level authorities to the minimum adequate for implementation of other principles ensuring financial guarantees of local self-governance.

Three former objectives from this list will be discussed in this section; however, it would be more feasible to discuss the latter objective in the contest of fair principles of financial support.

Local taxes as defined in the framework of the existing financial system do not correspond to the generally accepted substance of this term. In Russia, this term is applied to taxes rather tightly regulated at the federal level and distributed between the different levels of the budgetary system, while local authorities, in fact, have rather limited real power over these taxes.

The currently implemented reform shall ensure both the real assignment of own revenue sources to the municipal level, and independence of local authorities as concerns regulation of taxes defined as local taxes.

In fact, the assignment of revenue sources to the municipal level may take several forms:

- assignment of the guaranteed share of federal or regional taxes, in relation to which local authorities have no regulatory powers;
- granting to the local authorities the right to establish own local taxes as surcharge on a federal / regional tax, the marginal tax rate may be either limited or not limited by the legislation of the federal / regional level;
- granting to the local authorities the right to introduce local taxes on tax bases not shared with the federal / regional authorities, the list of such taxes, marginal tax rates and other parameters relating to local taxation may be either regulated or not regulated at the federal / regional levels.

All these forms are in different ways used in international practices; however, evaluations of their effectiveness vary. For instance, the assignment of shares of federal and regional taxes is often criticized as the least flexible and most unstable mechanism of provision of municipalities with own revenue sources, since in practice the

⁴⁵ The level ensuring the maximal possible defrayal of expenditures is defined as that not causing significant redistribution of funds in favor of well-off municipal entities, what would increase their surpluses and destabilize the financial system at the regional and local level. The calculations, the results of which are presented in preceding chapters, were in fact aimed to determine such a level.

assigned shares are regularly changed in spite of declarations of their stability. Therefore, it would be most feasible to implement the principle “one tax – one budget” to a maximally possible extent. Experts are also rather cautious about the idea of an open list of local taxes (although this practice exists in some countries), however, they do not approve of the regulation of local tax rates considering it to be an unjustified limitation of the flexibility of the financial system. At the same time, other parameters of the local taxation may be regulated, for instance, the differentiation of rates across different categories of taxpayers, the overall level of tax burden (in the case the list of local taxes is open), etc.

While the normative regulation of assignment of shares of federal / regional taxes to the local level does not require any substantial modification of the Russian legislation, the problem of local taxes is not sufficiently elaborated. Therefore, it would be feasible to introduce the following changes.

First, the legislation shall contain a clear definition of the local tax including such its characteristics as the power of local authorities to impose or abolish such a tax, to set its rates and tax base (in compliance with the legislation in force), to determine collection procedures and privileges, and the stipulation that the total amount of revenues generated by such a tax shall be due to the respective local budget. The state regulation of concrete local taxes shall not infringe on the competence of municipal entities, or prevent local authorities to implement regulating functions as concerns local taxes⁴⁶.

Second, it is necessary to set forth the list of local taxes and determine if this list is open or closed. The negative experience of setting open lists of local taxes in 1994 through 1996 can not be a serious argument against implementation of this principle at present, because the social situation, nature of the elite, level of qualification of local authorities have changed considerably since that time. However, a certain tradition to use small and insufficiently effective local taxes has been retained. Besides, in the situation where there were implemented policies aimed in fact to curb local taxation, local authorities could not accumulate necessary experience of the usage of this rather complicated and delicate instrument. Therefore, on the whole it would be more feasible to retain the closed list of local taxes at present. A possible way to mitigate negative effects of retention of the closed list of local taxes would be to grant local authorities the right to impose target charges in order to settle concrete problems actual for the local community. For a more detailed description of the mechanism of target charges see Annex 9.1.

Third, the issue of the extent and mechanisms of regulation of local taxes in the legislation shall be clarified. As follows from the analysis carried out above, the determination of the list of local taxes is vested with the federal authorities. The key parameters of the tax base shall be determined at the same level (otherwise this list is meaningless). The issue of regulation of minimal and maximal rates of local taxes is more complicated. In principle, positive results of such regulation are not apparent and it might be abolished in perspective. However, in the present situation it would be a too sharp change of the institutional environment disorienting local authorities and in certain cases resulting in negative effects. Therefore, at present there is proposed the following system of regulation of local tax rates:

- the maximal and / or minimal local tax rates may be regulated at the federal level;
- setting of marginal local tax rates shall not infringe on the rights of local authorities to regulate local taxation, i.e. ensure sufficient potential for changes in the levels of taxation, ensuring of differentiation, etc.;
- the marginal local tax rates determined by the federal legislation may be exceeded by the decision of a local referendum, at the initial stages the size of this excess may be regulated by the federal legislation;
- regulation of local tax rates on the part of local authorities shall neither infringe on the principles of common economic space and free enterprise, nor constrain or distort competition, primarily on local markets.

The analysis carried out in the preceding chapters demonstrated that the tax on imputed income⁴⁷, land tax, and the personal asset tax have the best prospects as local taxes. Yet at this state it is possible to transform the corporate asset tax into a local tax. In any case, in the future all property taxes shall be transformed into the property tax, which is feasible to turn into a local tax. There were also formulated recommendations concerning key approaches to the regulation of local taxes.

⁴⁶ In this case it is very important to comply not only with the letter, but also with the spirit of the law. For instance, in the case state regulation determines the marginal rate of a local law, while local authorities are allowed to vary this rate, the fixation of the marginal rate at a low level, which in practice does not allow to vary it, means in fact an infringement on the rights of local authorities.

⁴⁷ However, in this case it would be more correct to discuss not the transformation of this tax in a local one, but enhancement of rights of local authorities to regulate this tax regime.

As concerns the tax on imputed income, the coefficient previously regulated at the regional level should be set by local authorities, and all revenues generated by this tax (except payments due to social extra-budgetary funds) should be transferred to local budgets.

As concerns property taxes, it is necessary to envisage two stages of regulation – prior to transition to the property tax and in the course of transition to the property tax.

Prior to transition to the property tax, it would be feasible to amend the legislation currently in force in the following way:

- to assign the whole complex of property taxes and related payments: personal asset tax, corporate asset tax, land tax, rental payments for land to local budgets;
- to create real prerequisites for transformation of the personal asset tax into a local tax setting its maximal rate at 2 per cent and vesting the issues of differentiation of this tax and other aspects of regulation with local authorities;
- to create prerequisites for transition to evaluation of personal property basing on its market value and collect land tax and rental payments for land basing on the cadaster value of land.

It is feasible to regulate the property tax in the following forms:

- to set the status of the property tax and related payments as a local tax;
- to set the maximal property tax at 2 per cent;
- to grant local authorities the right to rise the property tax rate up to 5 per cent via local referendums;
- not to set legislatively regulated restrictions on differentiation of this tax at present, however, not excluding the possibility to introduce such a regulation in the future.

As concerns the income tax, the situation is somewhat different. There is a serious theoretical justification of the necessity to concentrate respective regulatory functions at the federal level (Byudzhetny federalizm, 2001, pp. 122 – 157). There are also additional arguments in favor of such a decision relating to the specifics of the Russian situation. First, the income tax will be assigned to municipal entities on a significant scale not in all variants of distribution of powers. Second, the transition to a flat rate of respective taxation in the framework of the tax reform may be undermined in the case tax powers are decentralized. Therefore, it would be feasible to retain the federal status of the income tax ensuring the assignment of its share to municipal entities (possibly dividing it in the guaranteed and equalizing parts).

Along with the assignment of revenue sources in the framework of the federal legislation it would be also necessary to grant regional authorities the right to permanently assign to local municipal entities additional federal and regional taxes due to the budgets of RF subjects both in terms of shares of contingent or the regional portion of the tax, and in per capita terms. A similar recommendation included in the new version of the law “On general principles...” worked out by the Commission for Division of Powers envisages that laws of RF subjects may set forth uniform rates of allocation of revenues generated by federal and regional taxes and charges due to budgets of RF subjects in accordance with the Budget Code of the Russian Federation and (or) legislation of the Russian Federation for all municipal entities (settlements or municipal districts in terms of this law) of the respective RF subject. At the same time, it is prohibited to set these standards in laws on budgets of RF subjects or other laws valid for limited terms.

The problem of the legislative guarantees of the independence of local authorities as concerns formation and execution of local budgets is rather complicated. The new draft law “On general principles...” contains several important stipulations in this sphere. For instance, there is formulated the general thesis according to which the formation, approval, and execution of local budgets and oversight of their execution shall be independently carried out by local authorities in compliance with the requirements set by the federal and regional legislation. However, such a general statement will hardly result in a considerable enhancement of budgetary independence of municipal entities, the more so that regional legislation may contain rather significant restraints in this sphere. However, the stipulation of the law envisaging that local authorities independently set the size and terms of remuneration of labor of municipal officials, employees of municipal enterprises and organizations, municipal minimal social standards, and other expenditure standards of local budgets for settlement of problems within local competence may have much more serious positive consequences.

It is also necessary not only to include new stipulations in the legislation, but to abolish the legislatively fixed provisions setting unjustified restrictions on the budgetary independence of municipal entities. For instance, it would be feasible to exclude Article 39 (2), which in fact envisages the possibility of compulsory centralization of revenues of local budgets actively used by regional authorities in order to infringe on the rights of local authorities. In principle, this article might be replaced with provisions envisaging voluntary centralization, although this necessity is not sufficiently apparent.

It would be feasible to legislatively prohibit regional authorities to set additional restrictions on the budgetary independence of municipal entities not stipulated by federal laws.

The issue of administrative mechanisms related to the formation and execution of local budgets, i.e. the extent of centralization of tax administration and execution of budgets via the treasury, also plays an important role in ensuring budgetary independence of municipal entities.

The law on financial principles of local self-governance stipulates the possibility to establish municipal treasuries and tax agencies. As concerns the treasuries, this stipulation is confirmed by the Budget Code (Article 151 (7)), and there has been accumulated considerable experience of functioning of such treasuries⁴⁸. As concerns tax agencies, at present there is envisaged only the possibility to conclude agreements between local authorities and the federal tax service concerning the issue of collection of local taxes. At the same time, in the case local taxes make a significant portion of local budgets, the creation of municipal tax agencies is a normal alternative to agreements with the federal tax service. Otherwise, monopolistic trends may form in the activities of the latter, what may result in overpricing of servicing of local budgets (in the case agreements are concluded on paid basis), disregard of municipal interests as being of minor importance, etc.

An apparent advantage of local tax agencies is that in the case there are introduced local taxes, respective administrative costs shall be taken into account, what makes unfeasible to impose taxes bringing low profit and requiring complicated administration. The potential flaws of this measure are determined by probable additional expenses borne by taxpayers because there appears yet another agency involved in tax inspections. This flaw may be rectified by separating payers of local taxes and taxes set at other levels. As concerns the recommended approach to local taxes, this flaw could not be neutralized only in the case of real estate owned by legal entities in transition to the local property tax.

In any case, it is necessary to enhance the responsibilities of the federal tax service as concerns the furnishing of information to municipal entities about taxes, including federal and regional taxes, collected in their territories (even in the case one tax agency functions in several municipal entities, the data shall be collected and processed separately for each municipality).

Fair principles of federal aid to municipal entities

The Budget Code only outlines the forms of financial aid provided to municipal entities by RF subjects (Article 139), what does not protect municipal entities from unjustified decisions of regional authorities. At the same time, it would be wrong to regulate the process of provision of financial aid at the regional level in detail, since complete uniformity of approaches, inevitably oriented towards most depressive regions, may in fact result in deterioration of institutional environment in RF subjects where this environment is more favorable. It is not apparent that the legislation shall define a concrete formula of distribution of resources of the fund of financial support of municipal entities as it was in fact done in the law "On financial principles..." It also would not be feasible to set for RF subjects a concrete list of funds of financial aid by analogy with those formed at the federal level. In the most broad way, there may be set forth two funds – the fund of unconditional financial aid (there may be retained its traditional denomination – the fund of financial support of municipal entities) and the fund of conditional financial aid. It appears most feasible to define in the legislation the broad principles of provision of financial aid and introduce restrictions to the maximal extent protecting municipal entities from the subjectivism and unfair decisions on the part of higher levels of authority.

For these purposes it appears necessary to limit the list of forms of financial aid to municipal entities, since otherwise, even in the case the mechanisms of support defined in the legislation are tightly regulated, there will appear additional forms permitting to subjectively distribute financial resources. The forms of financial aid defined in the legislation may include the following:

- unconditional financial aid (financial support)⁴⁹ provided for settlement of problems within local competence;
- conditional financial aid in the form of subventions and subsidies aimed at the compensation of expenditures borne in relation to the exercising of state powers and losses arising as a result of decisions taken by higher level authorities;
- urgent financial aid provided in emergency situations (natural calamities, catastrophes, etc.).

⁴⁸ For discussion of the practice of organization of municipal treasuries in Bratsk, Rostov on Don, Tyumen, Nefteyugansk, and Mezhdurechensk, see *Finansy*, 2000, No. No. 3, 6, 9.

⁴⁹ In this case, it is suggested to define these terms more precisely. It is suggested to define financial support as assignment of unconditional grants for settlement of problems within local competence. Financial aid may be defined in accordance with the Budget Code as all types of funds assigned to municipal entities from higher level budgets, including grants, subventions, subsidies, etc.

It would be possible to allow provision of financial aid to municipal entities not included in this list limiting it by the following conditions. Financial aid may be provided on the basis of separate legislative acts adopted by the Russian Federation or RF subjects. Such a legislative act shall stipulate:

- unified formalized criteria making municipal entities eligible as recipients of financial aid;
- formalized procedures governing the provision of financial aid;
- transparent distribution of financial aid.

At the same time, municipal entities shall not be provided financial aid in any form on the basis of individual decisions of executive authorities of RF subjects⁵⁰.

It is especially important to legislatively fix guarantees of transparency of information about distribution of financial aid. It is necessary to make authorities of RF subjects to monthly publish in regional press and on the regional web sites information about:

- amount of the funds of conditional and unconditional financial aid and other funds formed at the level of RF subjects;
- estimated and actually furnished financial aid to each municipal entity (classified in unconditional, conditional, and other types of aid);
- forms of provision of financial aid (for instance, as concerns unconditional financial aid – in the form of grants or assignment of additional rates of tax allocations, as concerns unconditional financial aid – in the form of subsidies and subventions as broken down by the exercise of concrete powers, etc.).

Since the issues concerning distribution of conditional federal aid are closely related to the delegation of certain state powers to the local level, they will be reviewed in the following section. Here, it is important to define mechanisms of provision of unconditional financial aid from the fund of financial support of municipal entities. It appears necessary to legislatively fix the following provisions.

Financial support of municipal entities from budgets of RF subjects shall be provided in order to settle problems within local competence. It shall be provided basing on federal laws and in compliance with legislation of RF subjects. Legislation of RF subjects shall stipulate the methods of formation and distribution of resources of the fund of financial support. Regulation of financial support shall not be provided on the basis of annually approved laws on budgets of RF subjects for the next financial year and by laws of RF subjects.

Financial support shall be provided basing on the following principles:

- universal character of methods of formation and distribution of funds of financial support, no special arrangements with individual municipal entities shall be allowed;
- formalized character of methods of formation and distribution of funds of financial support – it shall not be allowed to use informal criteria for determination of the amount of financial support due to individual municipal entities;
- long term character of methods of formation and distribution of funds of financial support;
- unconditional character of financial support;
- nondiscriminatory character of financial support – it shall not be allowed to discriminate against individual municipal entities as concerns determination of amount, provision, and transfer of financial support;
- transparent character of formation and distribution of financial support;
- independence of municipal entities as concerns disposal and utilization of funds of financial support.
- These principles might be fixed in the legislation in the following way.

First, it is necessary to regulate the general content of the Methods of formation and distribution of the Fund of financial support. The Methods shall contain:

- sources and procedures of formation of the fund of financial support;
- criteria making municipal entities eligible as recipients of financial support;
- formalized mechanism of calculation of the amount of financial support uniform for all municipal entities.

⁵⁰ There may be exceptions like special types of financial aid furnished in the case of emergencies; however, the respective procedures shall be set forth in the federal and / or regional legislation.

At the same time, it is not necessary to stipulate uniform content of the Methods at the federal level, it is important to ensure that it were regulated by the legislation of RF subjects in order to preclude subjectivism as concerns these issues.

The Methods may be revised oftener than once in 5 years only in the case of:

- major revision of federal approaches to distribution of resources of the Fund of financial support of regions;
- changes in the division of powers between the regional and municipal levels fixed in the federal legislation;
- changes in revenue sources of the regional and local levels fixed in the federal budgetary legislation;
- major changes in tax legislation resulting in changes in amounts of tax revenues being the sources of formation of budgets of RF subjects and / or local budgets.

In the case of a pre-scheduled revision of the Methods on grounds not stipulated by the legislation a municipal entity loses more than 5 per cent of funds of financial support in comparison with the calculations done in accordance with the preceding methods, this loss shall be compensated from the budget of the respective RF subject for the whole term of validity of the Methods stipulated by the legislation.

Second, it is necessary to form realistic and adequate recommendations and restrictions on regional mechanisms of calculation of resources of the fund of financial support due to each municipal entity. It would be feasible to fix in the legislation two methods of allocation of these resources – on per capita basis and using formalized mechanisms of equalization of budgetary security. In the case a subject of RF chooses to use both these mechanisms, the distribution of resources between these mechanisms shall be fixed in the Methods.

Allocation of funds basing on the per capita principle may be extended to all or some municipal entities in the region eligible as recipients of resources from the fund of financial support. In the case this mechanism is extended only to some municipal entities, the Methods shall include formalized criteria of allocation of this portion. At the same time, no differentiation of per capita standards applicable to different municipal entities shall be allowed.

The use of a formalized mechanism of equalization of the budgetary security requires to define indicators suitable for calculation of concrete amounts due to each municipality. In theory, it would be more correct to calculate tax generating capacities and (probably) expenditure needs of each municipal entity. However, these calculations are rather complicated, and it is not apparent that all regions are able to provide reliable information and have personnel sufficiently qualified to adequately do such calculations. At the same time, it would be inadmissible to allocate funds of financial support for defrayal of actual expenditures of municipal entities, what may result in bloating of municipal expenditures and, in particular, prevent optimization of the budgetary network. In this situation, it is recommended to fix in the legislation a compromise variant envisaging the possibility to use regional averages of actual revenues and expenditures of municipal entities for distribution of this portion of the fund of financial support. The following formulation may be included in the legislation: “For determination of the estimated budgetary security of municipal entities, it shall not be allowed to use exclusively indicators of their actual revenue and expenditures as registered in the reporting period or indicators of their revenues and expenditures as estimated for the planned period. Calculation of the budgetary security of a municipal entity shall be based on the use of average indicators of revenues and / or expenditures of budgets of all municipal entities of a RF subject, or groups of municipal entities selected basing on formalized criteria.”

Third, it is necessary to define the forms of allocation of financial support. In principle, it would be feasible to use two similar forms: grants and additionally assigned rates of allocation of revenues generated by federal and regional taxes. At the same time, the estimated amounts of revenues from additionally assigned sources shall correspond to the estimated amounts of grants. The replacement of grants with additionally assigned rates of allocation of revenues generated by federal and regional taxes creates at the municipal level much more stronger incentives to expand the tax base and enhance effectiveness of budgetary policies. However, there arises the problem of the mechanism of such a replacement.

The draft new version of the law “On general principles...” in this relation envisages that grants from the regional fund of financial support may be in full or in part furnished via assignment of additional rates of allocation of revenues generated by federal and regional taxes and charges to budgets of municipal entities. This approach rises a certain objections. Assignment of additional rates of allocation on account of financial support on the part of RF subjects does not require consent of local authorities. At the same time, it is probable that revenues from additionally assigned revenue sources in practice will not correspond to the estimated amount of grants. Therefore, additional financial risks will be passed on municipal entities what, at the same time, may result in misuse of funds.

It appears that in this case there should be used agreement mechanisms. The form of allocation of financial support shall be set basing on mutual agreement of each municipal entity and the respective RF subject prior to the approval of the regional budget for the next financial year. Agreements on full or partial replacement of grants with assignment of additional revenue sources shall be supplemented to the regional law on budget. At the same time, municipal entities may launch initiatives to conclude agreements with RF subjects on long term (not less than for 4 years) assignment of additional rates of regulating taxes on account of financial support. The possibility and terms of such agreements shall be stipulated by the methods of distribution of financial support⁵¹.

Forth, it would be feasible to limit control of RF subjects over the utilization of the funds of financial support to the necessary minimum. It appears that from this point of view in the majority of cases these funds shall be equated with own funds of local budgets. It would be feasible to reformulate Article 140, which grants RF subjects the right to inspect any local budget – recipient of financial aid and revert to the stipulations of the law “On financial principles...,” which granted to higher authorities only the right to inspect utilization of conditional funds (subsidies, subventions), and envisage the right to inspect budgets of heavily subsidized municipal entities and municipal entities unable to service and repay their debts⁵². At the same time, RF subjects shall have no right to introduce additional forms of control, procedures of approval of expenditures of local budgets, requirements of compulsory centralization of certain types of expenditures as a condition of provision of financial support, as well as furnish conditional funds (subsidies and subventions) for the settlement of problems defined by the RF legislation as problems within local competence.

Financing of additional expenditures borne by local authorities due to the delegation of state powers or decisions taken by state authorities

The mechanism of financing of additional expenditures borne by local budgets in relation to the exercise of delegated state powers is a most complicated financial problem of local self-governance. Recent practice has convincingly demonstrated that no simple solutions may be found in this sphere. The RF Constitution contains the general precept that state powers may be delegated to local authorities only in the case the adequate material and financial resources are available. This precept is further concretized in the law “On financial principles...” and the Budget Code (Articles 60 (3), 69, 83, 85 (1 – 3), 130 (4), 131). However, these stipulations do not contain any guarantees that local authorities would be compensated for the exercise of state powers, in fact passing on them the total responsibility for fulfillment of decisions taken by state authorities. At present this problem causes the greatest financial difficulties in the activities of local authorities.

The Commission for Division of Powers took a rather resolute stand on the issue of financing of state powers. The draft new version of the law “On general principles...” stipulates the following:

- delegated state powers shall be financed at the expense of subventions to local budgets from higher level budgets;
- the funds allocated to ensure exercise of powers of local authorities relating to settlement of problems within local competence and funds allocated to ensure exercise of certain state powers shall be allocated, utilized, and accounted for separately;
- laws envisaging delegation of certain state powers to local authorities shall contain the methods of calculation of standards applicable for estimation of the total amount of subventions necessary for exercise of respective powers;
- local authorities shall be responsible for exercise of certain state powers delegated to them within the scope of subventions provided to them;
- subventions shall be provided from the regional compensatory fund created in the budgets of RF subjects;
- in the case normative and legal acts of state authorities are inconsistent with the legislatively established system as concerns the issues related to exercise of certain state powers by local authorities, they may be disputed in court; however, such an inconsistency shall not be the justification of non-compliance with respective acts.

This mechanism is much better in comparison with the current practice, however, it is apparent that it cannot completely settle the problem of financing of state powers. For instance, it remains unclear how the standards of provision of subventions shall be formed in the case of a decision allowing certain categories of residents to

⁵¹ The agreements made for terms exceeding one year shall be annually supplemented to the regional budgets for the respective term of validity and be re-approved in the course of the approval of the budget.

⁵² The characteristics of heavily subsidized municipal entities and municipal entities unable to service and repay their debts will be discussed below.

pay 50 per cent of housing and public utilities charges, or certain privileges are granted basing on the criteria of needfulness.

However, implementation of this approach encounters not only technical obstacles. In the situation where local authorities cannot evade exercise of state powers, the real financial responsibility for their adequate financing becomes blurred. Therefore, many of absolutely correct in their essence ideas included in the draft of the new version of the law may remain only declarations or be complied with only formally and not ensure real financing of state powers (for instance, in the case the standards of financing do not correspond to real expenditures for exercise of respective powers, or in the case the allocation of these funds does not correspond to the real distribution of responsibility for financing of powers, etc.).

In order to understand the real state of the problem and find approaches to its settlement, it is necessary to review the actual situation of state powers more thoroughly.

Apparently, two different but interrelated issues exist in the framework of this problem: exercise of powers, which according to the legislation are vested with state authorities, by local authorities and responsibility of local authorities for financing of decisions taken by state authorities.

As concerns the first problem, its scope is apparently overstated. Taking into account the very broad range of powers the current law "On general principles..." lists among the problems within local competence, the list of state powers is not very long. It includes primarily functions related to registration of residents, civil registration, sanitary and epidemic inspection, mobilization preparedness of the economy, civil defense, etc. Some state functions were not delegated to, but assumed by municipalities compelled by the situation. First of all, it concerns financial support of territorial offices of state agencies.

The new version of the law "On general principles..." envisages that some issues previously included in the list of problems within local competence shall be vested with the state. The proposed changes will most significantly affect the sphere of education: local authorities will be relieved of responsibilities for financing of the educational process, this responsibility shall be vested with regions. It remains unclear how the mechanism of multi-channel financing of education shall function. Moreover, it does not appear feasible to divide this on the whole integral sphere in problems of state and local competence so rigidly. Probably, the settlement of the issue of financing of the educational process may be achieved basing on agreements between RF subjects and municipal entities, at the same time, in the case the financing remains vested with the local level, it shall be assigned additional revenue sources.

In fact, an acute problem is that responsibility for financing of decisions taken by state authorities is passed on local self-governances (so called problem of non-funded mandates). However, these mandates may be of different types, so respective financing shall be organized in different ways.

So called classical mandates are related to rules, standards, regulations, and similar decisions of the central government resulting in additional expenditures of economic agents, for instance, local authorities. These mandates include, for instance, construction and environmental standards, etc. Traditionally, these mandates are not additionally financed, although in many countries it creates serious financial problems for local authorities.

Another type of mandates is decisions of state authorities stipulating concrete financial obligations to certain categories of population. These mandates may include laws on veterans, disabled, etc. For convenience, they may be defined as direct mandates. Apparently, in this case there shall be applied the most strict rules governing the delegation of state powers to the local level – such expenditures shall be in full financed by state authorities via subventions and local authorities shall be granted the right to refuse to finance such mandates.

Between these two extremes there may exist intermediate cases, which are most difficult to analyze, since it is rather difficult to clearly discern problems in local competence and state powers. For instance, there may arise situations where the decision concerning a mandate is taken by a state authority, while the terms of its implementation and factors determining necessary amounts of financing are primarily formed at the local level and depend on decisions of local authorities. In this case it appears feasible that local and state authorities would co-finance such mandates, therefore RF subjects shall respectively subsidize local authorities. The best example of adequacy of this approach is housing allowances.

Therefore, following the logic of the new version of the law "On general principles..." envisaging that local authorities shall exercise state powers, it is necessary to amend the proposed stipulations aiming both to tighten and moderate existing provisions. For instance, it is necessary to introduce the conditions and procedure of refusal of local authorities to exercise state powers in the list of issues to be reflected in the legislative acts envisaging delegation of certain state powers to local authorities.

At the same time, it is feasible to renounce the rigid division of education in problems within state and local competence and envisage alternative variants of financing in this sphere (at least for the present, and more clearly evaluate the situation at the time when it is possible to analyze the gained experience). It is also necessary to

clearly define the conditions under which financing of state powers may be carried out via subsidies and not subventions.

However, in the case the problem of delegation of state powers is discussed in the framework of alternative propositions concerning the reform of local self-governance as presented in Chapter 1, approaches to its solution become more complicated. In the case the state authorities may choose to whom delegate state powers, the process will inevitably acquire agreement character. At the same time, the RF Constitution contains a provision stipulating that state powers may be delegated to local authorities only in the case it is done via legislation. Apparently, the authors of the Constitution intended to curb subjectivism concerns this problem, however, in practice it brought about opposite results. A possible way out of this situation is to adopt regional framework laws stipulating the general principles of delegation and financing of state powers and providing that agreements, which are to be ratified by legislatures of RF subjects, were made with each municipal entity. At the same time, all requirements concerning the normative and legal regulation of this process shall be retained.

Responsibility of local authorities for effectiveness of municipal budgetary policies

Tight budgetary constraints shall be applied as concerns budgets of municipal entities enjoying real autonomy in order to make them really responsible for effectiveness of municipal budgetary policies. In the situation where tighter budgetary constraints are introduced, some administrative methods of control over municipal budgetary policies may be moderated, at the same time, penalties for failures to meet financial obligations and overall ineffectiveness of municipal finance shall be significantly tightened.

First of all, there shall be tightened responsibility for real balancing of local budgets. Such a radical measure as prohibition of deficits of local budgets in fact does not produce positive results; to the contrary, the consequences will be negative. The fact is that the existing budgetary procedures allow passing the real deficit of local budgets on municipal unitary enterprises and organizations, while the resulting accounts payable is not reflected in the budget. Regular bankruptcies of municipal unitary enterprises are in fact a form of defeasance of budgetary debts. At the same time, borrowings, including those for investment purposes, are a source of defrayal of the budget deficit. Therefore, without changes in the legislation, in practice the prohibition of budget deficit means the prohibition of borrowings.

It would be feasible to prohibit not budget deficit *per se*, but budget deficit without clear indication of the sources of its financing, what requires to tighten stipulations of Articles 92 (1) and 96 of the Budget Code. At the same time, it is necessary to maximally limit (and ideally – exclude) possibilities of local budgets to pass own accounts payable on municipal enterprises and organizations. Perhaps, local authorities shall be compelled to become parties of contracts with suppliers of goods / works / services for municipal needs, the procurement of which is in full or partially financed from local budgets, assuming obligations to finance the budgetary share of respective expenditures⁵³. Such a stipulation might be introduced in the law “On general principles...”

The Budget Code sets forth the following limitations on the amount of debt and amount of municipal borrowings:

- deficit of local budgets shall be at or below 10 per cent of the amount of revenues of local budgets excluding financial aid (Article 92 (5));
- marginal amount of municipal debt shall be at or below the amount of revenues of the respective budget excluding financial aid (Article 107 (2));
- marginal amount of expenditures for servicing of municipal debt shall be at or below 15 per cent of the amount of expenditures of municipal budgets (Article 111);
- marginal amount of municipal guarantees to municipal entities receiving financial aid for equalization of budgetary security shall be at or below 3 per cent of expenditures of local budgets (Article 134 (3)).

Such a set of limitations is too detailed and in fact does not allow municipal entities to pursue reasonable debt policies. For instance, in the case the marginal amount of municipal debt is limited, it in fact equates short term and expensive credits with long term and inexpensive ones. Borrowings of municipal entities are strictly limited even in the case they are able to service and repay accounts payable. Regulation of the amount of deficit is also in fact a limitation on borrowings, since exactly borrowings are major source of financing of the budget deficit.

⁵³ The positive experience of implementation of such trilateral agreements exists in heat supply, where the organization managing housing assumes obligations concerning payment for services due from households, while the local authorities assume obligations concerning payments for services due from the budget.

The marginal amount of servicing of municipal debt is the most adequate constraint in borrowing policies. At present it is set at 15 per cent of the expenditures of municipal budgets. However, in this context it would be more feasible to link the capacity to service the debt not to the amount of expenditures, but to the amount and source of revenues. Sources of servicing of the debt may include not only own revenues of local budgets, but also unconditional financial aid, although in this case the reliance on own revenues is preferable. Moreover, taking into account the growing need for borrowings for financing of capital expenditures, this limitation might be relaxed.

Proceeding from the aforesaid analysis, it would be feasible to set base limitations on expenditures for servicing and repayment of the municipal debt at 25 per cent of own revenues of local budgets or 20 per cent of revenues including unconditional financial aid. The legislation shall include both limitations and grant municipal entities the right to use most suitable option (apparently, the first option is preferable for donor municipalities, and the second option – for subsidized municipal entities). For formalized analysis of the impact of such a dual limitation on motivation of municipal entities, see Annex 9.2.

Taking into account the fact that short term motivation of local authorities prevails, the marginal amount of borrowings may be used as an additional limitation, however, the limit shall be significantly increased as compared with the present level. The concrete parameters of such limitations will depend on the final estimation of the scope of powers at the municipal level and, accordingly, sizes of local budgets. It would be feasible to abolish limitations on the amount of deficit and marginal amount of guarantees as concerns municipalities receiving financial aid.

The Budget Code (Article 112 (4)) stipulates the following measures to be undertaken by regional authorities in the case municipal entities exceed aforesaid budgetary parameters and fail to ensure servicing and repayment of municipal debts:

- audit of local budgets;
- passing of control over execution of local budgets to the authority executing the budget of the RF subject;
- other measures stipulated in the budgetary legislation.

The program of development of fiscal federalism till 2005 develops further these ideas introducing three cases when control over budgetary operations of municipal entities may be tightened:

- heavily subsidized municipality;
- municipality experiences financial crisis (fails to meet the standards of balanced budget);
- municipality under the regime of external financial management (fails to meet the obligations to the population, recipients of budgetary funds, creditors, including the federal budget).

On the whole, the approach envisaged in the Program of development of fiscal federalism appears to be absolutely correct – while ensuring broad financial autonomy of local budgets, it is necessary to “penalize” those irresponsibly using this autonomy by introducing stricter control. Moreover, it would be feasible to begin to take this approach exactly at the municipal level. In this case it would be easier than in the case of RF subjects, which, to a certain extent, are independent state entities. However, for practical purposes it would be feasible to modify the aforesaid classification. In the case two former groups of municipalities – heavily subsidized and experiencing financial crisis – characterize their own standing, the latter – under external financial management – is based on the measures undertaken at a higher level. Therefore, this classification is not homogeneous.

It would be more correct if the legislation defined two groups of municipal entities subject to measures relating to rehabilitation of municipal finances:

- heavily subsidized municipal entities⁵⁴;
- municipal entities unable to ensure servicing and repayment of their debts.

The most important issue is to define each category. As concerns heavily subsidized municipal entities, it would be most logical to include in this group the municipalities defraying less than half of their expenditures at the expense of own revenues. However, in the present situation, whatever be the variant of determination of municipal powers and assignment of revenue sources, the majority of municipalities would be classified as heavily subsidized ones. Therefore, at the present state it would be more feasible to set the limit at 30 per cent, i.e. to classify as heavily subsidized the municipal entities where share of financial aid makes over 70 per cent of their budgets. The results of classification of municipal entities where financial aid makes, respectively, 50 and 70 per cent of their budgets are presented in *Table 9.1*. The calculations concerned 12 regions and were based on the

⁵⁴ It is apparent that in relation to heavily subsidized regions where the majority of municipalities conform to this definition, it makes sense to settle this problem in a complex way both at the regional and municipal levels. As concerns regions with high levels of financial self-sufficiency, this problem may be resolved at the regional level.

data for 10 months of 2002; it was assumed that revenue sources were assigned to municipal entities as recommended in the preceding chapter.

Table 9.1

Shares of municipal entities as broken down by the rate of subsidizing (assignment of revenue sources according to variant 1.1 for defrayal of expenditures calculated on the basis of data for 10 months of 2002)

Group No.	Regions	Share of municipalities receiving financial aid (%)		
		below 20%	20% to 50%	over 50%
1	Yevreyskaya AO	0	0	100
	Komi-Permyak AO	0	0	100
2	Amur oblast	0	30	70
	Kabardian-Balkarian Republic	0	55	45
3	Rostov oblast	2	24	74
	Tver oblast	10	22	68
	Chuvash Republic	0	4	96
4	Novosibirsk oblast	12,5	12,5	75
	Saratov oblast	26	33	41
5	Krasnoyarsk krai	5	16	79
	Leningrad oblast	35	23	42
	Sverdlovsk oblast	48	21	33
<i>Sample total</i>		16	21	63

As concerns municipal entities unable to ensure servicing and repayment of their debts, in this case not infringement on the parameters set forth in the federal legislation, but the actual failure to meet debt obligations is of principal importance. Besides, the exceeding of legislatively set limitations shall not automatically result in introduction of financial sanctions, with the exception of the prohibition to make new borrowings for purposes not related to servicing and repayment of the existing debts (as it is in fact stipulated by the Budget Code at present). At this stage municipal entities shall voluntarily introduce the regime of strict economy, attract additional revenue sources, etc. Regional authorities also may choose not to interfere.

Different approaches shall be also taken with regard to municipalities subject to the measures relating to financial rehabilitation.

As concerns heavily subsidized municipal entities, the measures undertaken by the authorities of RF subjects shall be determined by the causes of such acute need of subsidizing. These causes may vary. Probably, the source of financial problems is related to the economic crisis of a municipality, which, in turn, may be caused by temporary or long-term factors. Yet another possible problem is populism in tax policies, misuse of funds, ineffective management of municipal finances. All these factors may also work in complex.

Regional authorities (at least those receiving unconditional financial aid from the federal budget) shall monitor financial standing of heavily subsidized municipal entities and conclude agreements envisaging joint audit of the municipal budget, municipal enterprises, organizations, and agencies with each of them and work out programs of financial rehabilitation of municipal entities basing on the results of the audit. In the situation where such programs fail to ensure the reduction of the rate of subsidization in three years or their practical implementation for three years does not bring results, regional authorities shall have the right to undertake the following additional measures:

- initiate referendums on rising local tax rates above those recommended by the federal legislation;
- initiate referendums on joining to another municipal entity;
- introduce external management of finances of municipal entities.

As concerns heavily subsidized municipal entities, there may be introduced stricter rules governing borrowing to the extent that borrowings may be made only if guaranteed by RF subjects.

Insolvency of local budgets, i.e. its actual failure to meet own debt obligations established by arbitration courts shall result in even stricter measures on the part of regional authorities than in the case of just heavy subsidization. In this situation, authorities of RF subjects shall:

- ensure (jointly with the committee of creditors and local authorities) elaboration of a program of financial rehabilitation of the municipal entity and its approval by the representative body of the municipal entity;
- introduce external management of finances of the municipal entity in the case local administration infringes on the conditions of the approved program;
- ensure compulsory repayment of the debt in amount at or below 20 per cent of revenues of the local budget at the expense of unconditional financial aid and the share of federal and regional taxes due to the municipal entity in case it fails to implement the program.

It is also necessary to introduce in the legislation the stipulation that statutes of municipal entities shall set forth procedures governing the pre-term recall of heads of municipal entities and pre-term elections of representative bodies of municipal entities in the case of implementation of ineffective budget policies resulting in heavy subsidization or insolvency of municipal entities.

Annex 9.1

Recommendations on granting local authorities the right to impose special fees

The law “On general principles...” currently in force and the draft new version of this law stipulate that municipal expenditures may be financed by the way of self-taxation understood as non-recurrent payments of citizens allocated for the settlement of concrete problems within local competence. The decisions concerning the imposition or utilization of such funds shall be taken by local referendums or meetings of citizens. The amount of payments shall be set in absolute terms equal for all residents of the respective municipal entity. No other limitations are set on this source of financing.

In principle, it would be possible to permit to impose similar mandatory payments by decisions of representative bodies of local government⁵⁵. However, in this case the legislation should more tightly regulate the terms and procedures governing the imposition of such payments.

For instance, special fees shall not be imposed to defray budget deficit or finance current standing expenditures, and decisions on the imposition of such fees shall indicate concrete objects of financing. Statements of expenditure of these funds shall be annexed to the reports on execution of budgets. Information relating to the utilization of special fees shall be transparent and the annual report shall be published in the local press.

Payers of such fees shall be clearly defined. It would be feasible that the payers were permanent residents of respective municipal entities. Persons temporary registered in a municipal entity may be payers of special fees in the case the term of the temporary registration exceeds one year. Special fees shall be determined in absolute terms, at the same time there shall be set the maximal limit of the amount of the fee annually paid by a resident. It would be also feasible to permit limited differentiation of the amounts of such fees at the same time taking measures preventing the conversion of such fees in taxes on non-residents, the rich, etc. Special fees may be administered similarly to local taxes.

The possibility to impose special mandatory fees somewhat mitigates the consequences of fixation of a closed list of local taxes offering local authorities an opportunity to attract additional funds ensuring at the same time the conditional character of utilization of these funds and special attention of the population that these funds were expended for stipulated purposes. Special fees are an alternative to shaking funds necessary for settlement of urgent problems out of higher level budgets and therefore they facilitate tighter budgetary constraints in the framework of fiscal federalism. At the same time, since the imposition of such fees is an unpopular step, local authorities will have to seek for alternatives, for instance, pay more attention to attraction of borrowings, private investment, and creation of favorable investment environment.

⁵⁵ Prior to the enactment of the Tax Code, the local authorities had had the right (in accordance with the law on the principles of the tax system of the Russian Federation) to impose special fees on citizens, enterprises, institutions, and organizations for financing militia, improvement of territories, education, etc. However, first, the amount of fees, especially those paid by households, was strictly regulate and could not play a significant role in financing of municipalities (although the scavenging fees generated up to 25 per cent of the total tax revenues of certain municipalities in certain periods). Second, these fees were targeted to finance the day to day operation of municipal entities and not concrete non-recurrent needs.

Annex 9.2

Consequences of the introduction of limitations on municipal borrowings: a formalized analysis

The recommendation to set the base limitation on municipal borrowings as concerns the determination of the annual amount of obligations relating to servicing and repayment of the municipal debt at 25 per cent of own revenues of local budgets or 20 per cent of revenues including unconditional financial aid and grant municipal entities the right to independently choose the most suitable option requires an analysis of consequences of such a decision and its impact on the motivation of municipal entities.

There is the formal substantiation of consequences of apportioning of different shares of municipal budgetary revenues for servicing and repayment of debts.

Here O_1 is the expenditures for servicing of the debt depending only on own revenues of the local budget (D), and O_2 is the expenditures for servicing of the debt depending on the revenues including unconditional financial aid (Tr). Besides, let α_i be the maximal percentage of revenues allocated for servicing of the debt in accordance with the i -th method ($i = 1, 2$).

$$\text{Therefore: } O_1 \leq \frac{\alpha_1 D}{100} \text{ and } O_2 \leq \frac{\alpha_2 (D + Tr)}{100}.$$

In order that the municipal entity could use any criterion, it is apparently necessary that $O_1 = O_2$. Therefore, values α_1 and α_2 shall relate as $\frac{\alpha_1 D}{100} = \frac{\alpha_2 (D + Tr)}{100}$. It follows that $\alpha_2 = \alpha_1 \frac{D}{D + Tr} = \alpha_1 \left(1 - \frac{Tr}{D + Tr} \right)$.

Therefore, in order it would be feasible for the municipality being a recipient of financial aid to choose the second method of estimation of funds for servicing of the debt, it is necessary and sufficient that the formula were as follows:

$$Tr \geq D \frac{\alpha_1 - \alpha_2}{\alpha_2}. \text{ It means that transition to the second method of calculation of funds for servicing of the}$$

debt occurs in the case the amount of transfer exceeds $100 \frac{\alpha_1 - \alpha_2}{\alpha_2} \%$ of own revenues of the municipality. For

instance, in the case $\alpha_1 = 25\%$, $\alpha_2 = 20\%$, the transition to the second method of calculation of funds for servicing of the debt occurs if financial aid exceeds one fourth of own revenues of the municipality.

$$\left(100 \frac{\alpha_1 - \alpha_2}{\alpha_2} = 100 \frac{25 - 20}{20} = 25(\%) \right).$$

In other words, municipalities defraying more than 75 per cent of municipal expenditures at the expense of own revenues may borrow more. On the one hand, it lessens the risks to default on debt obligations, since own revenues may be viewed as a more stable source of funds than financial aid. On the other hand, it adequately motivates local authorities to maximally utilize the capacity of self-financing.

Conclusion

This study was aimed to determinate approaches to the implementation of the financial reform at the level of local self-governance and to formulate recommendations concerning amendment of the legislation in a way ensuring implementation of this reform. Accordingly, the analysis focused on such issues as the current practices in the sphere of municipal finances, normative and legal regulation of financial principles of local self-governance, key guidelines of improving of financial guarantees of local self-governance and respective necessary amendments to the legislation, the impact on local finances of recommendations concerning the municipal reform as elaborated by the Commission For Division of Powers.

In the course of the study there was made an analysis of the possibility to assign revenue sources to local budgets as the scope of powers vested with municipal entities varied. In order to settle this problem, there were done calculations basing on the data about execution of municipal budgets in 2001. The calculations were done for two groups of municipal entities: cities where populations exceed 200 thousand persons and municipal entities in 12 Russian regions. Sampling of regions took into account the necessity to ensure adequate representation of different groups of RF subjects both in terms of their financial performance (both “poor” and “rich” regions), and in terms of their geographical situation (all federal okrugs were represented). On the whole, there were analyzed 471 municipal entities. The reporting data for 2001 were partially adjusted taking into account the trends that became noticeable in 10 months of 2002.

The analysis allowed formulating a number of general conclusions and practical recommendations, which may become the basis of the reform of municipal finances. The key conclusions may be reduced to the following:

1. Over the decade since the start of reforms, there has not been elaborated and implemented an integral concept of transformations in the sphere of municipal finances. This sphere remains one of the least reformed and relies on mechanisms in principle similar to those used in the Soviet time. As a result, in practice municipal finances completely depend on decisions taken at the level of RF subjects, revenues of local budgets are unstable and cannot be forecasted, political factors affect the financial standing of municipal entities much stronger than the effectiveness of operations of local authorities. Although negative impact of this situation is felt by all municipal entities, it is most unfavorable for large and medium sized cities.
2. The lack of financial guarantees of local self-governance is the major factor preventing development of local self-governance at the present stage. Exactly the existing financial mechanisms cause disinterest of local authorities in enhancement of effectiveness of their activities, improve quality of municipal services and create favorable environment for business development. Possibilities to take long-term financial decisions, in particular those concerning attraction of long-term investment are undermined. Populism and political loyalty are encouraged to the detriment of implementation of most important economic and social reforms at the municipal level. Therefore, the transformation of the financial basis of local self-governance shall become the key element of the municipal reform.
3. The most important factors facilitating enhancement of financial independence of municipal entities are permanent assignment of a uniform list of revenue sources and more important role and capacity of regulation of local taxes at the municipal level. According to the theoretical principles relating to this sphere and respective international practices, it would be most feasible to assign to the local level the income tax, the property tax (in conditions of Russia – three property taxes: the personal asset tax, the corporate asset tax, and the land tax), taxes on small businesses, and the sales tax. The analysis confirmed that under Russian conditions these revenue sources (in different combinations) are most favorable for financing of expenditures of municipal entities.
4. Although radical approaches to the limitation of the list of problems within local competence do not prevent assignment of revenue sources to municipal entities, they sharply deteriorate the effectiveness of such assignment across the following parameters:
 - the potential of diversification of revenue sources assigned to municipal entities diminishes, therefore stability of local budgets with regard to unfavorable external factors deteriorates;
 - the unevenness of defrayal of expenditures at the expense of assigned revenue sources increases, what simultaneously makes the problem of surplus more acute and makes the need for financial aid more urgent, there sharply increases the share of heavily subsidized municipal entities;
 - the problem of managing local budgets becomes more complicated;
 - it is impossible to create favorable environment enabling transition to the property tax.

5. Assignment to municipal entities of different lists of revenue sources in the framework of general approaches formulated in item 3 (full or partial assignment of the corporate asset tax, inclusion or exclusion of the sales tax) affects the possibility to finance local expenditures at the expense of own revenues (including amounts of surplus and need for financial aid, the degree of unevenness of defrayal of expenditures), however, this impact is much less significant than limitation of powers vested with municipal entities.

The practical recommendations on strengthening of the financial basis of local self-governance following from the results of the analysis may be reduced to the following key principles.

1. On the whole, the previous composition of functions and expenditure powers of municipal entities shall be retained. In particular, the local level shall retain:
 - financing of local social policies, including housing allowances (probably on condition that they will be co-financed at the expense of subsidies from budgets of RF subjects);
 - financing of the educational process.
2. Municipal entities shall be granted the right to merge funds of local budgets in order to co-finance exercise of certain powers.
3. Municipal entities shall be assigned on the permanent basis the following revenue sources:
 - the income tax: the guaranteed share at 25 per cent, the equalizing share at 50 per cent;
 - the corporate asset tax at 100 per cent;
 - the single tax on imputed income at 90 per cent; the single tax levied in relation to the application of the simplified taxation system at 30 per cent⁵⁶;
 - the tax on common mineral resource at 100 per cent;
 - the transport tax at 50 per cent;
 - ensure the assignment of the full amount of rental payments for land to the municipal level in the framework of non-tax revenues.
4. The property tax shall be added to the list of local taxes. There shall be ensured the assignment of the total amount of local taxes to municipal entities. There shall be stipulated that local referendums shall have the right to raise rates of local taxes above the maximal rates set forth in the legislation. The representative bodies of local self-governance shall have the right to impose non-recurrent targeted fees for settlement of concrete problems within local competence.
5. The possibilities to regulate the personal asset tax at the local level shall be broadened, its maximal rate shall be set at 2 per cent and there shall be created possibilities for transition (on the decision of local authorities) to evaluation of property basing on its market value.
6. The right to levy and regulate the tax on imputed income applicable to small businesses, at present vested with RF subjects, shall be delegated to municipal entities.
7. Municipal entities shall be granted the right to establish municipal tax agencies.
8. There shall be ensured a formalized and long-term character of mechanisms of provision of financial aid. There also shall be ensured the transparency of the process of provision of financial aid.
9. The legislation shall stipulate that municipal entities may refuse to exercise delegated state powers and envisage that state powers may be delegated on the basis of agreements ratified by legislative authorities of RF subjects.
10. Deficit of local budgets without indication of sources of defrayal shall be prohibited.
11. Rights of municipal entities to borrow funds shall be broadened.
12. Control over budget operations of heavily subsidized municipal entities and municipal entities unable to service and repay their debts shall become stricter.

⁵⁶ There may be assigned 45 per cent as it is stipulated by the legislation currently in force.

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Part 4. Municipal Finance — International Experience

Chapter 10. The Legal and Political Setting of Municipalities

Municipalities occupy a unique position in western democracies. They are simultaneously part of the state apparatus and apart from it. Like many other institutions, including private companies, they derive their legal existence from the state. But the governing bodies of municipalities are directly elected by the people, with the result that municipalities achieve a form of democratic legitimacy that is rivalled only by the state itself.

The purposes of this paper are to explore the constitutional status of municipalities, to discuss various ways in which their boundaries can be adjusted, and to outline the meaning of bankruptcy in the context of municipal government. All of this will be done with reference to frequent examples from the real world of municipal governance, especially in the United States, France, Germany, and, most of all, Canada.

There are many different ways of classifying the legal and political settings of municipalities in liberal democracies. But all such classificatory schemes contain two main models, each of which exists in many different variations around the world. These two models can best be labelled «Anglo» and «European.» The Anglo model is found today in Britain, the United States, and most countries that form the British Commonwealth of Nations. The European model is found in continental Europe, but there is considerable variation among different countries. France has historically been the most centralized — legally at least — while northern European countries, including Germany, have appeared to be more decentralized.

The Anglo model

In the English-speaking world municipalities originated as legal entities that were very similar to private corporations. Although they are now universally recognized as being part of the public sector, their constitutional status is quite different from the legislatures that created them. An additional complication is that, in Britain and its former colonies (including the United States), the written constitution does not provide a definition of the «state.» Central governments simply act on behalf of the crown (as in the UK) or of «the people» (as in the US). One point, however, is clear: in contrast to central governments, local governments do not act legally on behalf of the crown or «the people.»

A corollary of this is that local governments are not «departments» of central governments. Central officials are not in a direct hierarchical relationship with any local-government officials; the former can rarely issue legally-enforceable commands to the latter. There is no single public-service hierarchy linking all central and local officials. Indeed, because every local government is a separate corporation, there is no common governmental entity that links them all together; hence there is no such thing as a common local public service, even within the same jurisdiction. Among other things, these factors cause central-local relationships to become exceptionally complicated and difficult to describe.

The starting point is that local governments owe their existence to the central legislature. In Britain and Canada there is no form of constitutional protection for local government. In Britain and in most Canadian provinces, central legislatures frequently change municipal boundaries, functions, and financial arrangements without any form of prior local agreement. There is no protection for local government in the constitution of the United States of America, but most individual states have provisions in their constitutions that protect existing municipalities in varying ways from ordinary state laws that might be aimed at reducing their autonomy or authority. Sometimes the boundaries, structures, and functions of larger urban municipalities are specifically protected by the state constitution against arbitrary change by the legislature. Such municipalities in American parlance are said to benefit from «home rule.» Whether or not American municipalities are protected by «home rule» constitutional provisions, state legislatures have been extremely reluctant to over-ride local preferences as expressed by local municipal councils. In Britain and in many Canadian provinces on the other hand, central action against such local preferences has become common. The fundamental premise of the Anglo model is that the central legislature establishes local governments with defined authority in relation to certain governmental functions within a defined territory.

The European model

In most European countries local government is deemed by the various national constitutions to be a significant institution within the overall structure of the state. How this actually works out in practice varies a great deal from one country to another. In one variant — most commonly associated with Napoleonic France — central-government officials known as prefects closely monitor all aspects of local government. Most public services are

delivered by public officials who are all part of a common state bureaucracy. Elected local councils must often be just as concerned about currying favour with the prefect as they are with satisfying the desires of their electors. A common pattern in France has been for local mayors to accumulate other political offices, especially at the national level, so that they can have more opportunities to influence what the national government does in relation to their own area of the country. Since 1982, French prefects have no longer had the authority to veto any local-government decision – the veto applies only to those decisions that the prefect considers illegal and therefore subject to review by the appropriate tribunal. In short, Napoleonic centralization no longer exists in Europe, not even in France.⁵⁷ But, nonetheless, the essential feature of this model remains that the system of local government is an integral part of the formal structure of the state, starting with the constitution and ending with the role of local government in actually delivering central services to local citizens.

In northern Europe local governments have traditionally had more autonomy than in southern Europe.⁵⁸ Despite the absence of centrally-appointed prefects, however, there has usually been much more integration between the central and local levels of government than is generally found in the Anglo model. In continental Europe, city and town halls have always been the place for citizens to go to seek a particular service from the state, regardless of which level of government – central or local – was actually charged with making policy decisions for that service. In Anglo countries, governments at all levels are now working hard to create just such a system, a system that is colloquially referred to as «one-stop shopping.» Such a trend is one of a number of signs that patterns of central-local relations in the democratic world are becoming more similar to each other. The legal bases of the systems are not changing significantly: it remains the case that in the Anglo model the respective administrative organizations of central and local government are distinct from each other and in the European model they are more integrated. Best practices are being adopted, however, regardless of the legal regime in which they might have originated.

Constitutional status of municipalities

In both France and Germany, each local authority has a separate corporate existence. Without such a corporate status they would merely be decentralized agencies of a central government. But their corporate status does not set them apart from the state as a whole. The French and German constitutions do not so much protect local authorities from the state; they integrate local authorities into the apparatus of the state. In France, Article 72 of the Constitution states that:

- The territorial units of the Republic shall be the communes, the departments and the overseas territories. Any other territorial unit shall be established by statute. These units shall be self-governing through elected councils and in the manner provided by statute.⁵⁹

Just as the rules for all state institutions are subject to amendment by one kind of procedure or another, so too can the rules for local authorities be changed. In both countries, changes in local government since World War II have been dramatic.

In France, national laws have been approved to limit the role of prefects and to decentralize national authority to new regional institutions. Throughout this process of institutional change, the basic building blocks of French local government, the 36,000 communes, have remained largely unchanged. In contrast, in Germany, where the constitutional recognition of local authorities is even stronger, the number of communes (Gemeinden) was reduced by two thirds between 1968 and 1987 (from about 24,500 to 8,500).⁶⁰

Like Canada and the United States, Germany is a federation. It is important to realize that in Germany local government is constitutionally protected by both levels of the federation. Article 28 of the Basic Law (constitution) of Germany states the following:

- In each of the Laender [the units of the federation], counties and communities, the people must be represented by a body chosen in universal, direct, free, equal and secret elections- In the communities the assembly of the community may take the place of an elected body.... The communities must be guaranteed the right to regulate on their own responsibility all the affairs of the local community within the limits set by law. The associations of communities also have the right of self- government in accordance with the law within the limits of the functions given them by law.⁶¹

Of perhaps greater interest is the fact that:

⁵⁷Alan Norton, *International Handbook of Local and Regional Government* (Aldershot, England: Edward Elgar, 1994), p.127.

⁵⁸ Norton, *International Handbook*, pp.8-9.

⁵⁹<<http://www.assemblee-nationale.fr/english/8ab.asp>>

⁶⁰Norton, *International Handbook*, p.252.

⁶¹<<http://www.psr.keele.ac.uk/docs/german.htm>>

- The status of local authorities is given additional support in the constitutions of the Lander. This the Bavarian Constitution of 1946 states that communes are primary territorial public law corporations and have rights of self-government and administration of their own affairs. A sub-article states that «Self-administration in the communes serves to build democracy in Bavaria from the bottom up.» Another... states that communes have the right to meet their own requirements by public levies (taxes, imposts, and fees) and that when state functions are delegated to them the necessary financial means must be made available.⁶²

It has already been noted that municipalities in the «Anglo model» of local government municipalities began as institutions that were outside the apparatus of the state; they might have been established by the crown, but they were not its partners or agents. The federal constitutions of both Canada and the United States provide no guarantees whatever for the existence of local authorities. It is at the state and provincial levels where constitutional provisions differ in the two countries. American states have written constitutions; Canadian provinces do not. This crucial difference seemed largely irrelevant to patterns of municipal organization in the two countries during the first half of the twentieth century because Canadian provincial legislatures were generally no more likely to abolish municipalities without local consent than were state legislatures.

By 1910, however, most American state legislatures no longer had the legal authority to abolish municipalities or to change their boundaries without local consent. This is because their respective state constitutions prohibited such practices. After 1910, most state constitutions contained two types of provisions aimed at protecting municipalities. The first involved restrictions related to «special legislation.» Such provisions prevented state legislatures from approving laws that related to only one municipality or to arbitrary groupings of municipalities. Bans on special legislation were generally supported by progressive reformers who objected to the ability of urban political machines to instruct their local state legislators to fix apparent local political or legal difficulties with special state legislation. As early as 1846, Henry C. Murphy of Brooklyn was quoted at the New York Constitutional Convention as saying that special legislation should be unconstitutional «because no one in Albany ‘except the representatives from the locality cares what it contains’ and such measures ‘are passed without examination because they affect only a particular community.’»⁶³ Such a position was totally consistent with what later became the gospel of progressive reform: the need for clear, open, rules and laws that applied equally to all and that could not be subverted through backroom deals.

Ways around prohibitions on special legislation are well known. For example, a state legislature might approve a law for all municipalities in the state having populations between 150,000 and 175,000, even if such a law would apply to only one municipality. It was then left up to the courts to determine whether the real intent of creating such a narrow category was to enact special legislation. No one can pretend that the constitutional prohibition of special legislation was ever neat and tidy, but it does send a message to legislators: picking out one particular municipality (or arbitrarily chosen group of municipalities) for special legislative attention is constitutionally unacceptable.

Progressive reformers in the United States were actually much more interested in municipal «home rule» as a form of state constitutional protection for municipalities, especially larger ones. There are many different forms of «home rule,» but all of them had the effect of limiting the ability of state legislatures to enact laws that directly interfered with the those aspects of local autonomy that were guaranteed in the home-rule provisions.⁶⁴ At a minimum, home rule for a municipality meant that it could not be abolished, or have its boundaries changed, by ordinary state legislation. For progressives, home rule was not usually seen as an end in itself. It was meant to be the container within which all the reformers’ other favoured structural changes could be implemented, a container strong enough to resist tinkering by state legislators.

A century ago, there was almost as much ferment in Canada about the reform of municipal government as there was in the United States. In Canada, however, the legacies of reformers were different. One searches in vain in the best-known published material relating to, the Canadian reform movement and finds nothing relating to «home rule» or the prohibition of special legislation. An obvious reason why Canadian reformers did not seek constitutional protection for municipalities was that written provincial constitutions did not exist. Any proposal for written constitutions would surely have been considered «anti-British,» an epithet that even those Canadian reformers who were otherwise integrated into the American reform movement would be unlikely to tolerate, let alone court.

⁶²Norton, *International Handbook*, pp.243-4.

⁶³ Jon C. Teaford, *City and Suburb: The Political Fragmentation of Metropolitan America* (Baltimore: The Johns Hopkins University Press, 1979), p.33.

⁶⁴ Gerald E. Frug, *City Making: Building Communities without Building Walls* (Princeton: Princeton University Press, 1999), p.51.

Boundaries

Boundaries of countries and of the constituent units of federations are remarkably stable. Even the break-up of the Soviet Union and of Czechoslovakia did not lead to changes in the boundaries of the pre-existing units, in large measure because most people realized that boundary negotiations would be too difficult, if not dangerous. Such is not the case with municipalities. In many countries municipal boundaries change frequently. But even where they do not, there are usually frequent proposals for change, or at least for the creation of new inter-municipal institutions, such as special-purpose bodies for the provision of specified services to a number of neighbouring urban municipalities.

International boundaries are rooted in history and are rightly seen as having great political, economic, and social significance. Municipal boundaries in most places were designed for functional purposes. Some people at some time thought they appropriately designated an area that was suited for its own local council and, consequently, a common package of local public services. Such functional considerations are most obvious when we examine the original boundaries of urban municipalities: cities, towns, and villages. It was usually precisely because these areas became urban centres requiring different public services from the surrounding countryside that they became established as municipalities in the first place. The original boundaries of rural municipalities are less obviously functional, although they often relate to what were considered reasonable distances for travel at the time they were first drawn. In some European countries they survive from feudal times.

Because municipal boundaries, especially urban ones, were originally drawn for functional reasons, they are invariably the subject of continuing debate. The claim that certain municipal boundaries are outmoded or dysfunctional makes much more political sense than a similar claim about a country's boundaries. Calls for change in municipal boundaries are usually caused by the outward expansion of urbanization beyond an area officially designated as a city, town, or village. Sometimes proposals for change are genuinely motivated by a desire for a more effective and fair way of making local decisions; on other occasions some participants in a conflict about municipal boundaries are manoeuvring for political or economic advantage.

Let us assume that sometime in the past an area of urban settlement is officially designated by the central government as a town. A town council is elected to oversee the provision of local public services. The boundaries include all the territory containing relatively dense (non-rural) residential settlement and all the factories, shops, and offices in which the residents of the town are employed. Because the authors of the boundaries are far-sighted, they even include within the town some land to accommodate future urban growth. Let us also assume that town residents are generally successful in their economic endeavours: businesses grow and more people move to the town because there are good employment opportunities and because the council has helped insure that it is a pleasant place to live.

Sooner or later, there is going to be a problem: the town will have no more land for new development. There are three possibilities. The first is the most unlikely. It might be that new development simply cannot happen: urban development in rural areas might not be allowed and town residents might accept a halt to growth (for the short-term at least, the values of their own properties will rise because they possess a scarce commodity, urban land). The second possibility, much more likely, is that the council of the surrounding rural municipality will be willing and able to approve urban growth, though without a change in boundaries. Depending on arrangements for the financing of municipal services, such a policy might have the effect of lowering taxation levels for current rural residents, because the resulting population growth in the rural municipality means that they would now have more people with whom to share costs. Rural residents owning property near the town would be especially fortunate because their property values would inevitably increase as the official designation of their land changes from rural to urban/industrial use. Even new urban-minded residents in the rural municipality might consider themselves better off than if they had located in the town. They might be able to escape paying for very facilities and services (that is, the ones located in the adjacent urban centre) that were a factor in causing them to want to move to the area.

The third possibility is that the boundaries of the town be extended so as to accommodate the new growth. This process of boundary extension is known as «annexation.» Municipal annexation is rarely easy, but it is less difficult when the land in question is rural rather than already being fully developed. Since the most obvious purpose of annexation is to allow for a single urban municipality to provide for orderly outward urban expansion, it makes sense that, ideally at least, annexation should occur prior to development rather than after.

If annexation is to be allowed at all, central governments must provide a procedure for it. Such a procedure might involve the necessity of some form of local negotiation and agreement. The agreement could involve only the two councils or there might be a requirement for approval by various local referenda, especially involving those residents and property-owners most directly affected by the proposed change. The problem with requiring local agreement is that there is rarely any incentive for the municipality that is losing land to agree. Compensation

payments, however, can sometimes be used to purchase agreement. The position adopted by landowners in the affected area usually depends on whether or not annexation will increase the value of their land. If development is only possible if the land is within the boundaries of the central urban municipality, then they will likely be in favour. If development is possible whatever the outcome of the annexation dispute, then their position will depend on taxation levels and particular local political circumstances. Most (probably all) states and provinces in the United States and Canada have legislation in place to provide for the implementation of annexations that are agreed to locally. The main point in dispute when such legislation is debated is exactly what constitutes local agreement. For example, American jurisdictions would generally require local referenda while, for Canadian ones, approval by the local councils is usually sufficient.

An alternative to local agreement is for the central government to allow annexation issues to be settled by the courts, that is, by some form of administrative or quasi-judicial tribunal or by some special authority created only to deal with municipal boundary disputes. The use of quasi-judicial tribunals has been common in the past in Canada and Britain, but is not much in use now. The problems here are fairly obvious. The process can be very expensive, especially when highly-paid lawyers and experts become involved in public hearings. Sometimes, however, the issues at stake are fundamentally political, rather than technical, and it is simply inappropriate in a democracy for unelected people (such as those appointed to sit on tribunals) to make such decisions about the political futures of significant urban areas. This last problem can always be overcome by insuring that the process allows a relevant minister in the central government to over-rule the tribunal's decisions. Such a provision can make life politically difficult for a minister as he or she is pressured to over-rule various controversial decisions, but coping with such difficulties – and being accountable for their resolution – is exactly what central-government ministers are paid to do.

As long as municipalities are not constitutionally protected against changes in their boundaries without their consent, central governments can always use their legislative authority to sort out boundary disputes. The main difficulty is that most of the members of any central legislature will, almost by definition, have no interest in a local issue that does not affect their own constituencies. At best, such legislation is a waste of their time; at worst it is an opportunity for them to extract favours from one side or another in return for their vote. Only when a the resolution of a boundary dispute creates significant precedents, or when it affects the future of the very largest of cities, would such an issue seem appropriate for legislative settlement.

We have seen that, in the United States, such legislative settlements directed at a particular boundary in a particular city would violate prohibitions in some state constitutions relating to «special legislation.» There appear to be no constitutional prohibitions against legislated boundary changes in France and Germany. Indeed, as has already been noted, the number of German municipalities was dramatically reduced between 1968 and 1987. This was accomplished by legislation approved in the various Lander. Alan Norton has described the process in these words:

- Lander set up their own commissions to work out the principles of reorganisation. Norms were set with functional needs in mind. In North Rhine-Westphalia the needs that determined the set minimum of 8,000 [population] included a primary school with a gymnasium and swimming pool for learners, an old people's home and a pharmacy. At a minimum size of 30,000 a secondary school, a school for the handicapped, an abattoir and a cultural centre were considered possible.
- The minimum size to support an effective full-time staff was set by Lander variously at 1,500, 5,000, 7,500, and 8,000 inhabitants....
- In South Germany the stress was on voluntary amalgamation, use of joint bodies... and consolidation of...[counties]. The result in rural areas was a pattern of 'federated' villages or farmstead communities around an administrative centre. When large rural...[municipalities] have been created by amalgamation it has been common to allow each of the constituent villages to retain its own council. Few services may be left for these councils to administer but there will still be a village...[mayor] to attend to simple citizen needs, carry out administrative tasks, represent the interests of the village to the outside world and provide some leadership and ceremony.⁶⁵

In 1985, both France and Germany became signatories of the Council of Europe's European Charter of Local Self-Government. Article 5 of this Charter states the following: «Changes in local authority boundaries shall

⁶⁵ Norton, *International Handbook*, pp.252-3. For details of how these changes affected particular rural areas in West Germany, see Peter H. Merkl, ed., *New Local Centers in Centralized States* (Lanham MD, University Press of America), Part One.

not be made without prior consultation of the local communities concerned, possibly by means of a referendum where this is permitted by statute.»⁶⁶

In France there have been very few changes to boundaries of communes without local consent. In 1982, when there more than 36,000 communes in France with an average population of less than 2000, an official government report stated that: «no authoritarian suppression of the commune must be envisaged. One of the objectives which we must pursue is to make the participation of citizens more active and more effective.»⁶⁷ Alan Norton also notes:

- The report argues that to wipe out communes with fewer than a thousand people would wipe from the map nearly 29 thousand of them, and also eliminate the same number of mayors and some 300 thousand councillors. ‘The will to participate would indeed be compromised. Independently of all criteria of money, titles or education, people are chosen by their compatriots to take responsibility for the common interest. A nation is rich to have been able to give life and sustain such a texture of responsible persons.»⁶⁸

Even in 2002, the number of communes in France has not been reduced. Boundaries are rarely changed. Instead, the French government has provided a wide array of mechanisms – some compulsory, some voluntary – through which communes can work together to provide common services.

The United States is like France in that boundary changes to municipalities are rarely – if ever – decreed by some central authority. In Canada, especially in the eastern provinces in recent years, such legislated boundary changes have become commonplace. In the United States, new municipalities are still being created while in Canada forced mergers have been much more common. It is important to look in some detail at historical developments in these two North American federations.

Early patterns of municipal incorporation in the United States and Canada are remarkably similar, and the experience of both these countries is quite different from that of Europe. These tendencies can be explained by the fact that European states evolved prior to the establishment of democratic local government, while the settlement of the United States and Canada took place at roughly the same time as municipal governments were created. In European cities, municipal governments were generally established incrementally and represented the efforts of urban elites to gain freedom from various forms of feudal control. Municipal government came later to more rural areas, often as the result of a deliberate national policy to establish a complete and uniform system of democratic local institutions for the entire country.

By the nineteenth century, once settlement in North America got beyond the original colonial outposts on the St. Lawrence and the eastern seaboard, state and colonial legislatures became committed to establishing municipal governments as a matter of course in response to local demand. For the United States, Teaford describes the process this way:

- Whereas prior to 1800, incorporation and urban self-government had been privileges, by the close of the nineteenth century they had become rights.... During the nineteenth century... most state legislatures abdicated responsibility for the grant of municipal privileges through the passage of general laws that authorized local voters to decide questions of incorporation. Under the general incorporation laws, municipal government was available to any community of voters that chose to exercise it.... Any cluster of a few dozen houses and stores with urban aspirations had the right to incorporate itself.⁶⁹

For anyone having even a passing acquaintance with American local government, there can be nothing very surprising about Teaford’s description.

What is perhaps less well known is that Canadian practices were – and in theory, still are – very similar. This is how one of the best-known texts on Canadian municipal law describes the process of establishing a municipality:

- The first step is generally the presentation and filing of a petition or application signed by a specified number or proportion of the inhabitants of the territory proposed to be included within the limits of the municipality.... The petition is presented to the appropriate incorporating authority which then determines whether jurisdictional matters have been properly completed or demonstrated.... If

⁶⁶ <<http://conventions.coe.int/Treaty/EN/CadreListeTraites.htm>>

⁶⁷ The Guichard report, as quoted in Norton, *International Handbook*, p.143.

⁶⁸ Norton, *International Handbook*, p.143.

⁶⁹ Teaford, *City and Suburb*, p.6.

all the statutory preliminaries have been complied with, an order, proclamation, or letters patent may be issued giving effect to the application.⁷⁰

Hundreds of Canadian municipalities were created as a result of such procedures. From the mid-nineteenth to the mid-twentieth century, this was standard Canadian practice. Except in British Columbia, however, very few municipalities have been established in this way in recent decades.

In both the United States and Canada, these easy-incorporation procedures were established primarily so that the inhabitants of newly-settled towns and villages could begin to govern themselves as soon as they felt ready. But landowners in areas on the outskirts of incorporated cities and towns had different ideas. Teaford documents almost every conceivable reason why residents and industrialists in suburban areas opted for incorporation.⁷¹ Surprisingly, however, he does not refer to the benefits of incorporation to owners of vacant land. Evidence for such benefits exists for Montreal, and it would be surprising indeed if similar practices did not take place elsewhere as well. In suburban Montreal prior to 1920, owners of suburban vacant land incorporated an area as a municipality prior to selling and/or developing their land. They used the credit of the municipality to borrow funds for expensive infrastructure such as roads, public buildings, markets, etc. Such «improvements» dramatically increased the value of the lots that they then sold off for considerable profits. As ratepayers in the new municipality, the new landowners were ultimately responsible for its debts.⁷² In many cases, the new resident owners were unable to pay, forcing their municipality into bankruptcy or, more likely, annexation by a neighbour, often the central city. For the original landowners, the key feature of this process was their ability to use municipal incorporation as a device to increase the value of the property they wanted to sell. For the process to work to their benefit, the original landowners had to be well connected politically so as to negotiate the incorporation of the municipalities, and financially so as to insure that banks or other investors would lend their money to these same municipalities, even when they had no obvious means of repayment.

By 1900, dozens of separate suburban municipalities had sprung up around many American central cities and around Toronto and Montreal. Their numbers kept increasing even though in any given year almost as many were annexed as were created. In both the United States and Canada, the resulting municipal «fragmentation» was seen as a serious problem. But, prior to 1920, it was the Americans who acted. In 1854, the state legislature in Pennsylvania approved a law that amalgamated 28 neighbouring municipalities with the city of Philadelphia. In 1898, fifteen cities and towns and eleven villages in five separate counties were merged by the New York state legislature to form a new city of New York with the same boundaries that it has today. In 1901, a Colorado constitutional amendment, approved by state voters in a referendum, required six municipalities to join the city of Denver. In 1907, the Pennsylvania legislature forced the city of Allegheny, against the will of its residents, to join Pittsburgh. In 1910, the Alabama legislature merged twelve municipalities with Birmingham after conducting a metropolitan-wide referendum by which the merger was approved by an overall majority, but not by a majority in the municipalities being merged.⁷³ Although there have been many occasions since 1910 in the United States when municipalities (or their ratepayers/residents) have voluntarily surrendered their municipal corporations (through annexation or by disincorporation), there have been no examples whereby such an action has been forced by a state legislature. Indeed, as we have seen, provisions in many state constitutions would prevent such action by the state legislature.

There is a wide variety of possible procedures whereby annexation and/or disincorporation can take place. The Ontario Municipal Act, as an example, establishes a procedure whereby a municipality may be dissolved either by action of its council or by direct action of the Ontario government. When a municipality applies for dissolution, the Ontario Municipal Board, a quasi-judicial body charged with regulating a wide range of municipal activities, can grant the request either by eliminating all municipal jurisdiction within the area in question or by attaching the area to another municipality. The Board must conduct a public hearing on the matter; it has the option of conducting a local referendum. All issues relating to the disposal of the assets and liabilities of the municipality are decided by the Board.⁷⁴ The rights of employees are determined by existing collective agreements between the municipality and its workers and/or whatever labour legislation applies within the jurisdiction. Whatever disincorporation procedures are in a particular jurisdiction, they can always be over-ridden by a special law approved by the legislature (except in those states in the United States where such special legislation is constitutionally prohibited).

⁷⁰ Ian M. Rogers, *The Law of Canadian Municipal Corporations*, 2nd ed. updated (Toronto: Carswell, 1995), pp.11:1-2.

⁷¹ Teaford, *City and Suburb*, pp.10-29.

⁷² Andrew Sancton, *Governing the Island of Montreal: Language Differences and Metropolitan Politics* (Berkeley: University of California Press, 1985), p.26.

⁷³ Teaford, *City and Suburb*, pp.49-50, 74-75 and 86.

⁷⁴ Rogers, *Law*, pp.75-6.

In actual practice, when a municipality is not financially viable, the most likely course of action is for it to be annexed by a neighbour (in a heavily urbanized area) or for it to be absorbed into the wider local jurisdiction that surrounds it (in the United States these jurisdictions are generally known as counties, in rural parts of Canada they are counties or townships). Occasionally, an isolated municipality is disincorporated (dissolved) and the area simply reverts to being «unorganized.» This happens, for example, when a mining company closes a mine and there is no further reason for anyone to continue living in the area. There is no point in having a municipality for an area in which there are virtually no residents or businesses.

In Canada, there were no examples of provincial legislatures abolishing municipal corporations against the declared wishes of their residents until 1935, when the Ontario legislature approved a law to merge municipalities in the Windsor area (across the Detroit river from the city of Detroit in the United States). The scholars who have documented this case describe the pre-1930 situation in these words:

- ... municipalities had considerable scope to initiate services, respond to their citizens' needs and to seek authority for changes. While the process recognized the legal authority of the provincial legislature to approve changes, the initiative lay with the municipalities, which were building up their budgets and their administrative capabilities.
- In such key issues as the establishment of municipal boundaries and the changing of structures of government, the initiative also lay at the local level. Before amalgamations and annexations could occur it was necessary for local plebiscites to be held and for majority approval of those in the affected areas to be given before new and enlarged municipal units came into being.⁷⁵

Between 1917 and 1933 intermunicipal issues in the area were handled by a body known as the Essex Border Utilities Commission. During this period the area prospered but in the early 1930s, it was especially hard hit by the Great Depression. By 1933 all the municipalities in the area except Walkerville, which had been the most adamantly opposed to annexation by the central city of Windsor, were effectively bankrupt and under the financial supervision of the province. In 1934, a new the Ontario provincial legislature enacted a law to establish a Windsor Finance Commission and to amalgamate the four central municipalities, including Walkerville, into a new city of Windsor. The legislation was introduced with no local consultation. It was announced on April 11, 1935 and was approved in its final form on April 16, there being virtually no debate in the legislature apparently because it was introduced right at the end of the session.⁷⁶

Walkerville had the most to lose since its debts were less than the others in relation to its tax base and it had not defaulted on interest payments up to 1934. Walkerville feared that its tax assessment would be increased to help pay for the debts of weaker municipalities and that its own services would deteriorate to a lower uniform level, once all services had been merged in a new Windsor.⁷⁷

Walkerville residents fought the legislation in the courts, all the way to the Judicial committee of the Privy Council in London, England, then Canada's highest court of appeal. The residents advanced the ingenious argument that the amalgamation legislation was really about bankruptcy, a subject under federal jurisdiction. By amalgamating municipalities to stave off bankruptcy, the provincial legislature, the residents argued, was somehow invading federal jurisdiction. Everyone knew, however, that main objective of the Walkerville residents was to protect local autonomy and that the arguments about bankruptcy were the slender legal reed to which they could attach their real concern. They claimed that:

- Quite apart in from its many financial inequities both the act itself and the methods used in securing its enactment... were so un-British in character that it had become imperative... to take action in order to preserve (community) rights, if the long tradition of British justice and fair play is to be maintained in this country.⁷⁸

The residents lost at all levels, with each court declaring that provincial legislatures had the unfettered authority to alter municipal structures in whatever way they wanted. In 1939, the Judicial Committee upheld the amalgamation legislation by stating that, «It is not only the right, ... but it would appear to be the duty of the provincial legislature to provide the necessary remedy, so that the health of the inhabitants and the necessities of organized life should be preserved.»⁷⁹

Recent judicial rulings on related matters in Canada have been remarkably consistent with the rulings made decades before with respect to Windsor, even though the Windsor case has not appeared in the judgements. What

⁷⁵ Larry Kulisek and Trevor Price, "Ontario Municipal Policy Affecting Local Autonomy," *Urban History Review* 16-3 (February 1988), 257-8.

⁷⁶ Kulisek and Price, "Ontario Municipal Policy," 261 & 268-9.

⁷⁷ Kulisek and Price, "Ontario Municipal Policy," 261.

⁷⁸ As quoted in Kulisek and Price, "Ontario Municipal Policy," 262.

⁷⁹ As quoted in Kulisek and Price, "Ontario Municipal Policy," 262.

is perhaps more important about the Windsor case is that it establishes a real difference in Canadian and American practice with respect to forced municipal amalgamation. After the creation of various forms of protection for American municipalities in state constitutions, Canadian and American practice for a few decades remained the same: no forced amalgamations. But the Windsor case proved that constitutions make a difference. In the absence of «home rule» and/or prohibitions on special legislation, the residents of Walkerville had no ammunition with which to fight.

In the conclusion to their important (but largely unnoticed) article, Kulisek and Price state that municipal autonomy was eroded in Ontario because it stood in the way of economic progress.⁸⁰ They go on:

- The concept of local autonomy which emerged in Ontario was one which did not allow [after 1935] for complete local self-determination of political boundaries. It was a concept which implicitly assumed that without an effective area-wide decision-making process and some redistributive mechanism for applying resources to solve metropolitan problems, local autonomy was not worth very much. This view is in marked contrast to the approach taken in the United States.⁸¹

The Windsor amalgamation was the precursor in Ontario to the legislated creation in 1953 of the two-tier metropolitan government in Toronto and of an annexation process whereby the Ontario Municipal Board could order annexations without the approval of all affected municipalities. Such developments never could have occurred in the United States. In 1965 in Quebec, the provincial legislature merged 14 municipalities on the Île-Jésus (immediately to the north of the Island of Montreal) to create the new City of Laval, with a population of 170,000.⁸² Most of the affected municipalities were opposed, but there were no claims that the provincial legislature was acting beyond its jurisdiction. Starting in 1966 for a period of almost a decade, the Ontario government was involved in a process whereby it legislated the amalgamation of dozens of municipalities while, in many cases, simultaneously establishing upper-tier regional governments modelled after the metropolitan government in Toronto. In 1971, the Manitoba legislature approved a law merging twelve municipalities to create a new «unicity» of Winnipeg.⁸³ Once again, no provision was made for any form of local approval and no court challenges were launched.

In 1982, as part of a wider process of constitutional reform, the Canadian Charter of Rights and Freedoms was added to the Constitution of Canada. Like the American Bill of Rights, it made no reference to any rights relating to local self-government. The creation of this new constitutional structure at the federal level had no impact on the internal constitutions of provinces. There was no mechanism to entrench rights relating to local self-government before 1982 and that is still the case now. However, in the 1990s in Canada, there has been another wave of forced municipal amalgamations, especially in New Brunswick, Nova Scotia, Ontario, and Quebec.⁸⁴ Legislated mergers in Toronto and Montreal have spawned court challenges based in part on the Charter, but none have been successful.

Bankruptcy

In the previous section we have seen that impending municipal bankruptcy has often in North America been the cause of boundary changes. A small rural or suburban municipality finds itself unable to repay its debts; a nearby larger municipality wants to extend its territory for future development; the makings of a deal are clear: the larger municipality absorbs the smaller and takes over its debts. The Walkerville case in Canada in the 1930s was unusual because Walkerville – a relatively wealthy suburb of Windsor – was not itself bankrupt but was amalgamated against its will with other municipalities that were in order to help solve the others' financial difficulties.

For municipalities operating under the «European model» bankruptcy is almost impossible. For Germany, Alan Norton explains that until the late 1980s (when Norton did his research) Lander had never used their legal authority to take over a city's finances in a severe financial crisis, because such action would be «politically unthinkable.» He explains:

- One reason is the closeness of the local land officials to the individual local authority. In critical situations Land and municipal officials work out in detail ways to tide over difficulties, taking a realistic view of local political pressures. Another reason is the closeness between the Land and the mu-

⁸⁰ Kulisek and Price, «Ontario Municipal Policy,” 267.

⁸¹ Kulisek and Price, «Ontario Municipal Policy,” 268.

⁸² For details, see Andrew Sancton, *Merger Mania: The Assault on Local Government* (Montreal and Kingston, McGill-Queen's University Press, 2000), pp.51-57.

⁸³ Meyer Brownstone and T.J. Plunkett, *Metropolitan Winnipeg: Politics and Reform of Local Government* (Berkeley: University of California Press, 1983).

⁸⁴ Sancton, *Merger Mania*, ch.4-6.

municipal politicians. The means is usually found to work out a consensual solution within the framework of the party machine.⁸⁵

For France, Norton notes that «There have been cases in the past of civic bankruptcies.»⁸⁶ But, given the tight integration of French municipalities with the national state, it would appear that a French municipal bankruptcy has a very specialized meaning. If a French municipality does not meet its debt charges, a creditor can appeal for payment to the appropriate legal authority. If a municipality remains unwilling or unable to pay, then the prefect steps in and takes whatever action is required to adjust the municipal budget so as to make the required payments.⁸⁷

Canadian provinces operate within the «Anglo model» of municipal government in which there are no prefects and in which central and local authorities remain relatively isolated from each other. Nevertheless, municipal bankruptcy in Canada is virtually impossible. In part this is because provincial governments limit short-term borrowing for very specific purposes and generally require that municipalities obtain their approval before engaging in any long-term borrowing. More significantly, provincial agencies of one kind or another would simply take over the financial operation of any municipality whenever bankruptcy might emerge as a possibility. A more precise description of the process in Canada (especially in Ontario) follows:

- Upon the request of the Ministry [of Municipal Affairs], or of a council by resolution, or of the creditors of a municipality having claims representing not less than 20 % of its indebtedness, the [Ontario] Municipal Board, if it is satisfied upon inquiry that the municipality has i) failed to meet its debenture debt, ii) or has failed to discharge its other debts by reasons of financial difficulties, or iii) has or may become financially embarrassed to the extent that default may ensue or difficulty may arise in providing for current expenditures, may make an order vesting in the Ministry control and charge over the municipality's affairs.⁸⁸

At this point the municipality is protected against legal action by its creditors. Similar procedures are in place in the provinces of Manitoba and Alberta. In Quebec, the Quebec Municipal Commission, the quasi-judicial equivalent of the Ontario Municipal Board, itself takes over the financial affairs of the relevant municipality. Local councils remain in office under such conditions but they no longer can make financial decisions unless authorized to do so by the controlling authority.

To help ease municipalities out of their financial difficulties, the relevant provincial agencies generally also have the authority to restructure municipal debt arrangements, with or without the approval of all of the creditors. The Ontario Municipal Board ... **has the power to authorize and direct a consolidation, the issue of new debentures for outstanding ones, the retirement and cancellation of existing debt, the postponement or variation in terms, time and places for payment and interest thereon.**⁸⁹

In recent years in the United States, municipal bankruptcy has appeared to have been much more of a practical possibility than in Canada. New York City was virtually bankrupt in 1975. In 1994, Orange county, California, with a population of 2.5 million, actually did go bankrupt. Not surprisingly, the issue has received more academic attention in the United States than anywhere else. Much of this literature addresses how American cities became so indebted in the 1970s, culminating in New York's financial crisis. There are a number of accounts of how the state and federal governments intervened by providing emergency funds and by placing the city under a form of financial trusteeship until the early 1980s.⁹⁰ New York and other major municipalities in financial difficulties in this period were not subjected to normal legal procedures relating to bankruptcy. They were ultimately rescued from this fate by politicians at other levels of government.

The most comprehensive account of the law of municipal bankruptcy in the United States was published in 1993, just prior to the bankruptcy of Orange county. McConnell and Picker conclude that current federal bankruptcy law relating to municipalities «imposes a series of filing requirements – state authorization, insolvency, best interests of the creditors, and good faith – so stringent that few significant municipalities have been able to make use of it.»⁹¹ Ironically, one year after the article was published, the Orange county bankruptcy appeared directly to contradict such a conclusion. In Orange county, the state of California did not intervene in any signifi-

⁸⁵ Norton, *International Handbook*, pp.274-5.

⁸⁶ Norton, *International Handbook*, p.171.

⁸⁷ Association des maires de France <http://www.amf.asso.fr/editions/guides/guide_du_maire/Le_guide_du_maire.pdf>, p.11

⁸⁸ Rogers, *Law*, p.610.

⁸⁹ Rogers, *Law*, pp.610-11.

⁹⁰ One of the best is Martin Shefter, *Political Crisis, Fiscal Crisis: The Collapse and Revival of New York City* (New York : Basic Books, 1985).

⁹¹ Michael W. McConnell and Randal C. Picker, "When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy," *The University of Chicago Law Review*, 60 (1993), 494.

cant way and the bankruptcy law took its course. Local taxpayers refused any quick or burdensome tax increases. But, within eighteen months, Orange county had emerged from bankruptcy and was once again borrowing large amounts of money (to pay off its original creditors), albeit at higher than normal interest rates.

The Orange county bankruptcy has been brilliantly analyzed by Mark Baldassare, who makes the important point that the near bankruptcy of New York City and the real bankruptcy of Orange county were really quite different phenomena. Baldassare's brief account of the story in the Introduction to his book follows:

- The Orange County government backed into a massive financial crisis in a most unusual manner. County Treasurer Bob Citron was in charge of the Orange County Investment Pool. By 1994 he had gathered about \$7.6 billion in deposits from the county government and nearly 200 local public agencies. Citron had a track record of providing high-interest income to his local government investors. He boasted, «We have perfected the reverse repo procedure to new levels.» He did this by borrowing money and investing it in derivatives, inverse floaters, and long-term bonds that paid high yields. Then he borrowed more money with the borrowed money. By 1994 the size of the county pool had ballooned to \$20.6 billion as he borrowed \$2 for every \$1 on deposit. He was on a desperate mission in which he took more risks to raise more interest income for local governments that had recently seen their tax allocations cut by the state. The Federal Reserve Board kept raising interest rates throughout 1994. Bob Citron kept buying securities on the hunch that the Fed would lower rates at the end of the year.

In the spring of 1994 the challenger in the county treasurer's [election] race issued warnings that the county pool had suffered massive losses and did not have the cash to pay back the massive short-term loans to the Wall Street firms. No one listened. Citron won reelection and kept betting on lower interest rates throughout the summer months. The Board of Supervisors and other county officials did not stop him until it was too late. By November 1994 county officials found out that he had lost about \$1.64 billion in government funds through these risky investments. The county did not have the cash on hand to withstand a run on the money by the Wall Street lenders and local government depositors. County officials went into panic mode in early December. They urged and sought their treasurer's resignation. They unsuccessfully tried to sell off the risky securities. The banks that had lent Citron the money threatened to seize the securities from the county pool that they held as collateral. The county government declared bankruptcy after the first bank took this action. Their hope that the bankruptcy filing would halt other fund seizures by the Wall Street lenders proved to be misguided. The bankruptcy, however, did stop the fund withdrawals by the local government depositors. The county government, twenty-nine of thirty-one Orange County cities, all of the school districts, and most of the transportation, water, and sanitation agencies had large sums of money on deposit. Their \$7.6 billion in government funds were now frozen.

The days after the bankruptcy declaration in Orange County were filled with chaos and confusion. The county supervisors were seeking a way to keep the county government functioning. They were also trying to limit the financial meltdown of the county pool, which had a real possibility of experiencing further massive losses if interest rates rose again. Officials from the schools, cities, and special districts were trying to assess the damage that would be done to their local operations by the bankruptcy. Their feelings of betrayal and distrust toward the county officials who held their money were growing. The public was venting its anger and frustration toward local elected officials, whom they blamed for allowing such an irresponsible use of taxpayer money. There were threats of a state takeover and the temporary appointment of a state trustee if the fiscal crisis in Orange County grew worse. But there was no signal that the state government would provide a bailout for this struggling county.

The Orange County fiscal crisis had many twists and turns from the dark days in December 1994 to the emergence from bankruptcy eighteen months later, in June 1996. The county's credit rating immediately fell to «junk status,» and the Wall Street firms continued to sell off the billions of dollars in securities they held as collateral for the county's borrowing. A former state treasurer, Tom Hayes, was called in to manage the county pool. By late January Hayes had sold off the risky securities and established the pool loss at \$1.64 billion. He set up a mechanism allowing the local governments to withdraw some of their funds from the pool on an emergency basis. In December the Board of Supervisors appointed the county sheriff [police chief] and two other county officials to a crisis team to keep the county government working. They made sure that the county programs had the funding they needed and recommended a first round of budget cuts. A local financial executive, Bill Popejoy, was appointed to the new position of chief executive officer of the county government in early February. He set in motion the severe staff and budget cuts that were needed to balance the budget and made a sweeping housecleaning of the county officials who were tainted by the fiscal collapse. Three local business leaders headed up a negotiating team that arranged a settlement between the county government and the cities, schools, and special districts on how to divide the remaining county pool funds. Local governments could get most of their deposits right

away, with promises to get the rest back at a later date, if they agreed not to sue the county government. This settlement plan was approved by all parties.

By March 1995 the Board of Supervisors reluctantly placed a proposal for a half-cent sales tax increase on the ballot as part of the financial recovery plan for Orange County. They had run out of other ideas to pay for the mounting debts of their bankrupt county government. A worse financial crisis seemed imminent, since there were \$1 billion in bonds coming due in the summer months and no way to borrow this money. Local voters overwhelmingly defeated the sales tax increase on June 27, 1995, after a campaign that saw local elected officials distance themselves from this county ballot measure. This would create a mad scramble for another recovery plan. The governor refused to bail out the county and threatened a state takeover. The bond investors agreed to roll over the county's debts for another year in exchange for more interest earnings.

After a few false starts, a recovery plan was shaped by the county government in August 1995. They would divert tax funds from other county agencies to the general fund so they could borrow the money to pay bondholders and vendors. The local governments who lost money in the county pool agreed to wait for the county to win the lawsuits they had filed against Wall Street firms to be paid back in full. The state legislature passed the bills that were needed to divert the current tax dollars to a recovery fund, and the governor signed the bills in October 1995. The county presented its recovery plan to the U. S. bankruptcy court in December 1995, a year after its Chapter 9 filing. In June 1996 the county government sold the \$880 million in bonds it needed to pay off its debts. The Orange County bankruptcy officially ended on June 12, 1996.⁹²

New York's financial problems had been dramatically different. They had been caused by huge demographic and economic shifts to which local political politicians were incapable of responding, at least in the short term. If they responded in ways that creditors favoured, they would be voted out of office. Without outside help and intervention, creditors would have no faith that anything would change. The financial problems in Orange county were not caused by demographic and economic factors that weakened the county's ability to repay its debts. Once this was fully understood and new financial managers were in place in the county, creditors were willing to lend again. Orange county was treated not as part of a wider governmental system in which insurmountable social problems were territorially manifested. It was treated like a corporation quite outside government that had made a serious financial mistake. This was the kind of problem American bankruptcy law was designed to deal with and it did so very well.

Conclusion

The characteristics of the two models outlined at the beginning of this paper would suggest that municipalities in the «European model» would be relatively weak politically and subject to considerable control by the central government while those in the «Anglo model» would be politically stronger and more autonomous. There is little or no empirical evidence that this is the case. French and German municipalities derive their political strength not so much from the fact that they are constitutionally recognized but rather from the ways in which local elected politicians, primarily through their party affiliations, are able to influence central governments such that little is done without their assent or cooperation. American municipalities are generally not much subject to central control, a fact eloquently testified to by the Orange county bankruptcy. Americans do seem strongly committed to local autonomy, but such commitment is expressed constitutionally at the state level, not in the federal constitution.

Canadian municipal councils are generally elected on a non-partisan basis. This means that local elected officials are not integrated with federal and provincial political parties, which, in any event, are not integrated with each other. This is one source of municipal weakness in Canada. The other is that municipalities have no constitutional protection at either level and Canadians (except possibly in British Columbia) have demonstrated little or no sustained interest in protecting their municipal institutions against various forms of arbitrary provincial legislation, especially with respect to boundaries.

What all this means is that constitutional and legal provisions for municipalities can only go part way in shaping their role within a national (or federal) political system. Presumably, the objective is to enable municipalities autonomously to make decisions on matters of exclusively local concern and to be able to influence significantly how certain central-government policies are applied within their respective territories. If municipal offices can also act as a place where citizens can be served with respect to a wide range of national- and regional-level policies (as in Germany and France), this is an important bonus.

In the real world, policy-makers in a particular country do not have to choose between the «European» and «Anglo» models of local government. This theoretical choice will largely be made for them on the basis of the

⁹² *When Government Fails: The Orange County Bankruptcy* (Berkeley: University of California Press, 1998), pp.2-4.

traditions, practices, and constitutional provisions within their own countries. In any event, within the «Anglo» model, policy-makers are searching out ways to accomplish what the «European» model takes as a given: citizens should be able to access virtually all branches of the state apparatus in their local municipal buildings. Meanwhile, policy-makers working within the «European» model have been working for decades (especially in France) to free local authorities from the excessive rigidities of tight central control and to create some of the legal autonomy found within the Anglo model. In short, creating systems of municipal government is about solving practical problems, not about choosing between abstract models.

Chapter 11. Municipalities: Status and Responsibilities, Budgeting and Accounting

A. Introduction

The current situation in which local governments in most countries have experienced increased expenditure responsibilities without compensating grant increases has heightened the pressure on the local revenue base.⁹³ To cushion the impact of higher local taxes and user fees, municipalities have become more and more vigilant in searching for efficiencies and cost savings in the way in which local services are provided. In some municipalities and in some countries, this has led to contracting out specific municipal services and the use of public-private partnerships.⁹⁴ In virtually every municipality and every country, it has led to a search for improved efficiencies and effectiveness in the delivery of municipal services. At the core of these initiatives, is an important role for municipal budgets and accounting systems. Although budgets have always been important as a means of controlling municipal expenditures and identifying revenues, the way they are structured, the information they provide, and their importance in managerial decision-making has grown significantly over the last few years and is certain to increase as municipalities face increasingly critical expenditure and revenue decisions.

This paper is divided into a four parts following this introduction. Although the analytical part is devoted to budgeting and accounting issues as identified in the title, part B provides an overview of municipalities and their relationship to senior levels of government in selected federal countries – Australia, Germany, Switzerland, United States, South Africa and Canada. The constitutional status of municipalities is summarized, as is the nature and extent of federal and provincial/state involvement in municipal spending and revenue activities. Fiscal imbalance and fiscal sustainability are also discussed.

Part C outlines the important role that municipal budgets ought to play and comments on the way in which they ought to be structured. Part D describes and examines the importance of municipal accounting systems and reporting and how this is tied into the municipal budgeting process. Part E describes and comments on the importance of using municipal budgets as a monitoring and control mechanism.

The paper is both descriptive and prescriptive. Part B is primarily descriptive. Parts C, D and E are more prescriptive because they concentrate primarily on the design or structure of municipal budgets and accounting systems that will best enhance the efficiency, accountability, transparency and effectiveness of municipal government operations. Part F summarizes the paper.

B. Overview of the Municipal Sector

This overview of the municipal sector concentrates on the above mentioned federal countries. It starts with a brief review of the constitutional status of municipalities in these countries. This is followed by a summary of the nature and extent of the federal role and then, the nature and extent of the provincial/state role. A brief summary of municipal expenditure responsibilities and revenue sources is provided as is a discussion of fiscal imbalance and its relevance.

B.1 Constitutional Status in Federalist Countries

There is no singular or uniform approach to the constitutional status of municipalities. In some countries, municipalities are explicitly recognized in the constitution, while in other countries, they are not recognized.

Australia: Municipalities receive no formal recognition in the national constitution (1901) except for the Australian Capital Territory (primarily Canberra) which does have autonomous representation in the Senate. In the recent past, constitutional entrenchment has been proposed as a measure to enhance the financial security of local government, enshrine its autonomy, and protect its existence from dismissal by state governments. A 1988 referendum to include local government in the national constitution, however, was defeated decisively.

Germany: Local government is formally recognized in the constitution and the right of local government to regulate local affairs is expressly guaranteed. The primary relationship of local government, however, is with the land (middle level of government) and not the federal government (Berlin, the capital city, has autonomous representation in the Senate). The laws on local self-government explicitly permit different patterns of institutionalized cooperation between local authorities. These include ‘working groups’; ‘public law agreements’ by which

⁹³ Janice Caulfield, “Local Government Finance in OECD Countries”, a paper presented to ‘Local Government at the Millennium’, International Seminar, February 19, 2000, University of New South Wales, at 1.

⁹⁴ Harry Kitchen, “Local Government Enterprise”, a paper prepared for the World Bank, November 2001. This paper is available in English and Russian from www.worldbank.org/wbi/publicfinance/decentralization/fiscalfederalism_Russia.htm

one participant assumes the administrative responsibility for one or more common functions or permits use by other units of its facilities; 'special-purpose associations' which are public corporations created for the purpose of executing one or more public tasks; and the 'association of villages' which assumes responsibility for tasks that require greater resources in personnel and revenue than the member villages possess on their own.

A major motivation behind Germany's constitution was to provide a federal framework in which the lander have considerable autonomy, but the historical outcome has been different. In most areas, the primacy attached to federal legislation leaves little room for individual state autonomy. At the same time, states are collectively allowed an important say in federal decision-making through representation in the second chamber of government where each state has between 3 and 6 representatives depending on size. German federal relations, therefore, are based on inter-governmental cooperation and co-ordination of policies.

Switzerland: Under the constitution (1848), cantons retain all responsibilities unless these are specifically ceded to the central government. As such, there is no constitutional recognition of municipal government and municipalities are essentially creatures of the cantons.

United States: Municipalities receive no explicit recognition in the American Constitution (1789). They fall within the residual powers exercised by state legislative assemblies. Washington, D.C., has no independent or special Senate representation.

In several U.S. states, municipalities have the option of adopting Home Rule status or remaining under general law. Home Rule status is a legal right that gives greater discretionary authority to municipalities by allowing them to draft, adopt and amend constitutional Charters and govern their own affairs without legislative interference by the state government.⁹⁵ While this provision is designed to increase local autonomy, it does not prevent the State from controlling the fiscal capacity of local governments.

South Africa: While municipalities are creatures of the province with their responsibilities amounting to those devolved to them by the province and/or federal government, section 174(3) of the Interim constitution states that local government should be autonomous.

Canada: Section 92 of the *Canadian Constitution Act* mentions that "Municipal Institutions in the Province" are under exclusive jurisdiction of the provinces. Therefore, any powers or responsibilities that municipalities have are solely at the discretion of provincial governments. Ottawa, as distinct from capital cities in some other countries, is identical to all other Canadian municipalities in that it does not have representation as a capital city in either national or provincial legislatures.

B.2 Nature and Extent of Federal Role

To illustrate the relative importance of federal or central governments vis-à-vis state and local governments, *Table 11.1* records the percentage of tax revenue by each level of government in our selected federal OECD countries. More specifically, the relative importance of the federal or central government varies considerably. Ignoring Australia because social security funds are not reported separately, the range extends from a low of 29% in Germany to a high of 45% in the United States. The relative importance of state/ provincial governments range from a low of 19% in the U.S. to a high of 36% in Canada and for local government, it extends from a low of 3.5% in Australia to a high of almost 15% in Switzerland.

In most countries, the federal government has little involvement with the affairs of local government. Local government tends to be creatures of the province or state and therefore, independent of the federal or central government jurisdiction, although federal or central governments do play a role in some instances.

Australia: The distribution of state, municipal and central government expenditure responsibilities has left Australia with an extreme vertical fiscal imbalance. The Commonwealth government has exclusive use of income and consumption taxation. About 78% of all tax revenues go to the Commonwealth government, 18% to state governments and 3.5% to local governments (*Table 11.1*).

The federal (Commonwealth) government is directly involved in the fiscal activities of local government through the provision of direct grants to municipalities; grants to state governments earmarked for local use; and general purpose (unconditional) grants. Direct grants are provided under the authority of the *Grants Commission Act 1973*, which marked the first peacetime interaction to take place directly between the Commonwealth and local governments. The list of major direct grants include the *Aged or Disabled Persons' Home Act*, the *Home Nursing Subsidy Act*, the *Delivered Meals Subsidy Act*, the *Handicapped Persons Assistance Act*, and the *Homeless Persons Act*.

Commonwealth grants made to state governments and earmarked for local programs cover home services, senior citizens' centers, preschools and child care centers. General purpose grants are dispensed through

⁹⁵ "Comparison of powers and revenue sources of selected cities", CAO's office, Toronto, Oct. 2001.

structures that require the Commonwealth government to set conditions for the use of monies by local governments, thus ensuring the importance of the federal government in local activities.

Table 11.1

**Share of Tax Revenues by Level of Government
in Federal OECD Countries, 1998 (%)**

Country	Federal or Central Government	State or Provincial Government	Local Government	Social Security Funds*
	%	%	%	%
Australia	78.4	18.0	3.5	---
Canada	41.0	36.3	8.9	13.7
Germany	29.4	22.0	8.0	40.5
Switzerland	39.1	19.5	14.8	35.7
United States	45.1	19.2	12.0	23.7

* Social security funds are frequently separated from other levels of government because it is sometimes a federal responsibility and sometimes a regional responsibility. Where its responsibility rests depends on the constitution of the country. As well, it is almost always treated as a separate tax and evaluated independently of income or payroll taxes.

Source: OECD (2000), *Revenue Statistics*

The Commonwealth Government also provides untied general revenue assistance (or financial assistance grants) to the States and the Northern Territory for distribution to municipal councils. This is divided into general purpose grants and local road grants. General purpose or unconditional grants are divided among the States and Territories according to population. The allocation of road grants across all States and Territories is fixed at a specific percentage of the total for each of the recipients. In each state or territory, a State/Territory Grant Commission is responsible for allocating Commonwealth general revenue assistance to municipal councils in accordance with the *Local Government Act 1995* and approved national distribution principles.⁹⁶ Each Grant Commission is an independent statutory body that operates under the provisions of the *Commonwealth Local Government (Financial Assistance) Act, 1995*.

Given the important role played by the Commonwealth government in local financing, it is not surprising to observe that local government has become increasingly interwoven with the federal bureaucracy. This has generally arisen because local actions and initiatives have been driven, from time to time, by the presence or availability of grant funding.

Germany: In assigning expenditure responsibilities to various levels of government, the German constitution follows the subsidiarity principle (the government closest to the people provides the service). In practice, however, taxation powers are largely centralized and there is only limited regional and local fiscal autonomy. Slightly more than 29% of all tax revenues go to the central government; 41% to social security; and 22% to the lander and 8% to local governments (*Table 11.1*). Furthermore, the Federal government has virtually nothing to do with local governments. Lander are closely involved with local governments.

Switzerland: From *Table 11.1*, it is noted that 39% of all tax revenue goes to the federal government; 36% to social security; 20% to the cantons; and 15% to local governments. Switzerland has a highly decentralized federal structure. The Swiss Confederation consists of the Federation, Cantons and Communes (local government) that share executive, legislative and judicial powers. Several government tasks and responsibilities are shared by both Cantonal and Federal authorities. Co-operation between governmental bodies can be horizontal (between bodies at the same level, for example, Cantons) or vertical (between bodies of different levels such as between Cantons and Federal authorities). Under the constitution (1848), cantons retain all responsibilities unless these are specifically ceded to the central government. The central government has no direct dealings with municipalities.

United States. From *Table 11.1*, it is noted that 45% of all tax revenue goes to the central government; 24% to social security; 19% to state governments; and 12% to local governments. While Federal intervention through fiscal aid to municipalities dates from the 1930s and President Roosevelt's New Deal Programs, its relative importance has declined from the 1970s when it reached a peak. At that time, federal grants to large cities had increased as a result of general revenue sharing, community development block grants, and employment and training programs.

Although revenue sharing (this program operated from 1972 to 1986, but after 1980, it allocated a federally determined amount of money to local governments only) was terminated in 1986, many metropolitan cities and urban counties (called entitlement communities) continue to benefit from federal direct grants under the

⁹⁶ The Act requires that the allocation of grants to local governing bodies (councils) conform to an agreed upon set of national distribution principles. All monies for these grants come from the general revenues of the Commonwealth government.

Community Development Block Grant (CDBG). This program provides grants designed to revitalize neighborhoods, expand affordable housing and economic opportunities, and/or improve community facilities and services, principally to benefit low- and moderate-income persons. Each year, grant funds available for entitlement communities are allocated to communities who can demonstrate relative need on the basis of the higher of two formulas. The first considers the presence of overcrowded housing in the locality, population and poverty rate. The second uses housing age, population growth lag, and poverty rate. Recipients of entitlement funds include local governments with 50,000 or more residents, other local governments designated as central cities of metropolitan areas, and urban counties with populations of at least 200,000. Local governments may carry out all activities themselves or award some or all of the funds to private or public nonprofit organizations as well as for profit entities. A separate component of the CDBG provides program funds to the States which they, in turn, allocate among localities that do not qualify as entitlement communities.

Since 1996 when the federal government devolved to the states all responsibility for public assistance to families with dependent children (AFDC), it has provided the States with a block grant for funding this program. This was intended to permit states to design their own public assistance and training programs for needy families with children. Since then, several states have increased the responsibilities of local governments in administering or funding certain government functions. This shift has occurred in different ways:

- through a direct devolution of increased responsibilities to local government in some states;
- other states have converted state aid programs into block grants, thus transferring responsibility for the management of specific programs to localities;
- still other states have combined funding streams for local aid programs to permit municipalities to have greater flexibility and control over local budgets and local provision of services.

Despite this trend toward greater devolution in the majority of states, a few have increased the role of the state and reduced the role of local government. In summary, there is no single uniform and consistent direction or trend that has emerged.

What has emerged more recently, however, are problems created by a lack of a clear definition of responsibilities for federal, state and local government. The result has been increased federal involvement in activities historically considered to be state and local affairs. While Federal involvement usually begins with financial aid to achieve national goals, more recently it has taken the form of direct orders (mandates) to meet federal requirements, often without federal assistance. The extensive and complex nature of this involvement has been illustrated by the U.S. Advisory Committee on Intergovernmental Relations (ACIR) compilation of 3,500 decisions that refer to more than 100 federal laws that have impacted state and local government.⁹⁷

There is no question that there is a role for the federal government in activities that are important to the national interest or where problems transcend state lines such as dirty air or dirty water. The tendency has been, however, for the federal government to pass laws on highly visible and emotional issues that may have significant impacts on state and local governments without their consent and without regard for their ability to comply. While these actions have led to deteriorating intergovernmental relations, they serve to point out the powerful role of the federal government in the United States. Certainly, there tends to be less discussion, negotiation and consensus building between the three levels of government when compared with other federal jurisdictions. This may be noted, for example, in the recent devolution (1996) to the state governments of all responsibility for public assistance to families with dependent children (AFDC), and in the number of federal mandates that impact on the way in which both state and local governments conduct their business.

South Africa: Intergovernmental responsibilities and relations are very much in their infancy given the relatively recent Constitution in South Africa. In brief, there are three levels of government with each of them assigned specific powers, functions and financial resources. Some of these are shared and some are exclusive. Given the vertical fiscal imbalance between revenue generating powers and expenditure responsibilities of the three levels of government, the federal government provides grants to sub-national governments. Frequently, however, these transfers go directly to local governments, thus bypassing the province and consequently, reducing provincial power/control.

Canada: from *Table 11.1*, it is noted that 41% of all tax revenue in Canada goes to the federal government; 14% to social security; 36% to the provinces illustrating the relatively important role played by this level of government in the federalist system; 9% to municipalities. Other than some conditional grant assistance from the Federal government, there has been limited direct involvement between municipalities and the Federal government. Federal conditional grant assistance has almost always been in the form of infrastructure funds – witness the recent three way (provincial, municipal, federal) funding of municipal infrastructure programs. The

⁹⁷ ACIR (1996), “The Role of Federal Mandates in Intergovernmental Relations”.

Federation of Canadian Municipalities (FCM) has often exerted pressure on the federal government to grant federal assistance to local governments. In the mid-1980s, the FCM unsuccessfully exerted pressure on the federal government to permit municipalities to have direct access to income tax revenues. The mid-1990s infrastructure program, however, may be viewed as a success. The most recent example of direct federal assistance to municipalities was announced in the Federal Budget of 2000 and culminated in the signing of two agreements between the FCM and the Federal government on March 31, 2000. The agreements establish two multi-million dollar funds to encourage investment in best practice and innovative municipal environmental projects. Further, federal/ provincial/municipal cooperation has recently been observed in the three way capital infrastructure financing initiative (announced in 2001).

1. *Discretionary and Ongoing Federal Commitments*

Of the countries considered, the Commonwealth government in Australia is committed through the use of grants to direct and ongoing financial support for municipal governments. In the United States, there is also considerable financial support for local governments although it tends to be discretionary and may change according to federal interests and initiatives. In other words, there is no constitutional or long time commitment for these initiatives. In Canada, federal involvement through the use of specific purpose grants has been much more 'ad hoc' and infrequent with support almost always restricted to capital infrastructure projects and generally, in response to perceived national interests and concerns (safe water and environmental issues, for instance). The central government in South Africa has tended to provide grants directly to local governments although there is no firm constitutional basis for this - it has been the preferred choice of the central government. Central governments in Germany and Switzerland appear to have no ongoing involvement with local governments.

B.3 Nature and Extent of Provincial/State Role

While central or federal governments have limited, if any, involvement with local governments in most federalist systems, this is not true for the middle level of government in this structure - state/province/land/canton. Municipal government in every country is in some way, a creature of the province/state/land/canton with responsibilities and powers tightly controlled and restricted by this middle level of government.

Australia: In Australia, municipalities are creatures of state governments. The states are responsible for assigning expenditure responsibilities to municipalities and for determining the revenue sources that municipalities may use to fund these expenditures.

Germany: It is the Land and not the national government that decides whether federal laws will be implemented by local governments or by the state. While Land governments share a portion of their revenues with local governments, much of this is done in a way that equalizes the local governments' fiscal capacities and helps meet local needs. Wealthier communities qualify for fewer grants because of their higher fiscal capacity, generally these grants are only for infrastructure. Finally, all tax administration in Germany is at the land level, rather than federal or local.

Switzerland: In Switzerland, cantons have considerable autonomy. While cantonal and local government structures have remained almost unchanged over the past 150 years, pressures for change have surfaced. Recently, some cantons have transferred (downloaded) additional tasks to municipalities even though municipalities have protested in order to retain their local autonomy and viability. These additional tasks may create serious problems for many small municipalities because they do not have the necessary resources to carry out the new responsibilities on their own. Further devolution of responsibilities to municipalities may revitalize inter-municipal cooperation that already has a long tradition in the areas of health, education, planning and sanitation. Similarly, many Cantons realize that they need to establish forms of horizontal cooperation to cope with certain problems that they cannot cope with individually. This recent willingness to move towards horizontal cooperation at both the municipal and cantonal level is largely driven by a reluctance of lower tier governments to transfer responsibilities to a higher level of government and to preserve the status quo in governing structures.

Local governments deal directly with the Cantons and not the central government. In Switzerland, grants are used to reduce differences in tax burdens across governing jurisdictions. Fiscal equalization in Switzerland is intended to compensate governments for services that benefit citizens in other jurisdictions (to compensate for spillovers) as well as to reduce differences in wealth across the country. Most transfers are from the federal government to the cantons. These 'vertical transfers' amount to around 3 percent of GDP with about 75 percent of these transfers linked to expenditures. About 1/3 of these transfers is dependent on the cantons' index of fiscal strength (based on tax burden and potential resources available – the higher the tax burden, the larger the equalization payment). Fiscal equalization arrangements also exist between municipalities within each canton.

United States: Once again, municipalities are creatures of the state with spending and revenue raising powers permitted by state legislation. In some states, this legislation permits municipalities to implement sales taxes, income taxes, and fuel taxes, for example.

South Africa: Municipalities are creatures of the province with their responsibilities consisting of those devolved to them by the province and/or federal government.

Canada: Even though expenditure responsibilities and revenue generating opportunities for municipal governments are tightly controlled by provincial legislation and regulations, interprovincial differences exist in both expenditure responsibilities and the extent to which local governments rely on the different revenue sources (property taxes versus user fees) available to them. As well, there have been shifts in the provincial-local fiscal environment within some provinces over the past decade with most of the changes arising from provincial initiatives to decentralize additional spending responsibilities without the provision of additional provincial transfers or direct access to provincial revenue sources.⁹⁸

B.4 Expenditure Responsibilities and Revenues of Local Government

Municipalities are responsible for a range of services and have access to a limited range of revenue sources. The more important of these are identified for each country.

Australia: The persistence of a multiplicity of small municipalities in conjunction with the high priority placed on equity considerations in the provision of public services (achieved through centralized/state supply) has contributed to local governments playing a relatively modest role in Australia. For example, schooling, policing and firefighting, in some cases, are provided by the State, whereas regional services that encompass numerous municipalities have been met through special-purpose statutory authorities. Municipal expenditures tend to concentrate on general government; health and welfare; housing and community amenities; recreation and culture; roads (construction and maintenance combined); and debt charges plus a variety of small miscellaneous expenditures.

At the local level, property taxes generate over 50% of all revenues. Conditional and unconditional grants from the Commonwealth and state governments provide another 20% as do special charges (user fees). The remainder comes from a variety of miscellaneous charges (permits, licenses, rents, and so on).

Germany: Municipalities and counties constitute the two levels of local government in Germany. Except for 87 county-free cities that operate with only one level of local government, all other municipalities operate within a two-tier structure. In the two-tier systems, the county or upper-tier provides some services and the lower tier or municipalities the remainder. In the county-free cities, inter-community partnerships, inter-municipal agreements or some type of special purpose body exists for the provision of services that are more appropriately the responsibility of a level of local government larger than the city and large enough to capture spillovers, to ensure uniform standards, and to benefit from economies of scale in service provision.

The list of local expenditure responsibilities includes those that are mandatory and those that are voluntary. It is typical and includes such things as culture, recreation and parks, streets and public transportation, waste management and utilities and public housing. Other responsibilities involve somewhat more complex arrangements. For example, county-free cities are responsible for school facilities, but the state is responsible for the teachers; they share the cost of hospital construction, but are solely responsible for hospital administration and personnel; and they are also responsible for social welfare required beyond social insurance programs (for example, support of families, the aged and youth, as well as day care and kindergarten). County free cities are also responsible for safety and fire protection, whereas the state is responsible for police and other emergency services (although some of these services may be delegated to the county-free cities as well).

Of all local expenditure responsibilities, social programs frequently represent the largest expenditure category. This is followed closely by general finances (including debt service) and by public services that include such things as drainage, garbage, recycling and public buildings.

Municipal revenues come from a variety of sources. The business tax (primarily a tax on corporate profits who's base is determined by the central government with the local rate set by individual municipal governments) accounts for about 40% of local tax revenue after sharing. Income taxes are next in order of importance. They represent the local share of the national income and wage tax that is determined by the state and federal governments. Overall, local governments receive 15 percent of these revenues (this is stipulated in the Constitution) but the share for each municipality may vary. Revenues are distributed by state governments to

⁹⁸ Harry Kitchen, "Municipal Finance in a New Fiscal Environment", *Commentary* in the Urban Paper Series, C.D. Howe Institute, Toronto, November 2000.

local governments in originating municipalities (that is, where the taxpayer resides) up to a limit approximating 15 percent of national GDP per capita. This limits the amounts distributed to high income communities and introduces an equalizing effect. Local property taxes also exist but are considerably less important than the business tax - in many municipalities, the property tax raises about 1/6 of the revenue generated by the business tax. Fees and charges are another important source of local funds, generally accounting for considerably more revenue than the property tax.

Switzerland: The Constitution gives the federal government exclusive right to a general consumption tax, customs duties, a withholding tax on capital income and stamp duties. The federal government shares with other governments the right to levy taxes on personal income and on a firm's profit and net worth. Cantons often allow municipalities to impose their own direct taxes by means of municipal surcharges on cantonal direct taxes. Cantons collect federal income tax on behalf of the federal government (and under its supervision) and retain 30 percent of the proceeds. Of this revenue collected by the Cantons, 17/30 remains in the canton where the tax was collected and the remainder is returned to all cantons through fiscal-equalization arrangements. Cantons and municipalities get most of their revenue from income taxes. Most of remaining canton/municipal tax comes from a tax on personal wealth and corporate net worth (net wealth tax).

Municipal direct tax revenue comes in the form of a surcharge on cantonal direct taxes. Major cities, however, tend to have structural budget problems because of inadequate revenues to fund expenditures whose benefits spillover into neighbouring communities.

United States: Municipalities within the U.S. are responsible for a range of public services including police and fire protection, local streets and roads, public transit, public recreation, libraries, water, sewer, solid waste management, land use planning, economic development and so on. Their major source of local tax revenue is the property tax, although some municipalities, mainly larger cities in some states, have access to income and sales tax revenue, and motor fuel taxes. More specifically, nearly 3700 local governments in 14 states levy income taxes. In Ohio and Pennsylvania, this tax generates over 20 percent of local tax revenue. In Maryland, it generates about 30 percent of all tax revenue. In a few cities, local income taxes are so important that they account for between 33% and 50% of city own source revenues. The state government defines the tax base, any limitation on rates and the treatment of nonresidents.⁹⁹

Local sales taxes are levied by 6500 jurisdictions in 31 states with the revenue yield generating more than 10% of local tax revenue nationally. As a local revenue generator, its importance varies widely in states where it is used - providing from 0.1% to about 25% of local own source revenue. Local sales tax revenue is especially important for many cities. In six states, it generates 50% of local tax revenue and 25% of own source revenue. The tax base and permitted rates are set by the state.¹⁰⁰

South Africa: The national government raises the bulk of the tax revenue although its expenditure responsibilities are much lower. Provinces are responsible for most public expenditures but receive relatively little direct tax revenue. Local governments have access to property taxes, user fees and special local levies. Outside of major cities and towns, however, little is known of local government because local government administration for billing for services and receiving payment has been non-existent in many areas.

Canada: Municipalities are responsible for a range of local services including fire and police protection, building and safety inspection, local roads and streets, sidewalks, water and sewers, solid waste, public recreation and libraries to name the most noteworthy. Furthermore, many of these services must be provided at levels that meet provincially imposed regulations and standards. Policies affecting elementary and secondary schooling and health services are set by each province with delivery done locally, generally through special purpose bodies such as school boards and health boards (these bodies have very limited discretion in policy-making). Except for one province (municipalities in Ontario fund about 25 percent of the total costs of provincially imposed and mandated social service programs), social service programs are a provincial responsibility and funded entirely by the province.

To meet increasing expenditure commitments and offset the declining importance of provincial grants over the past decade, municipalities have increased their reliance on property taxes and user fees for water, sewer, solid waste, public recreation and public transit.¹⁰¹

⁹⁹ Robert L. Bland (1989), *A Revenue Guide for Local Government* (Washington, D.C.: International City Management Association), at 89-101; and James D. Rodgers and Judy A. Temple "Sales Taxes, Income Taxes, and Other Nonproperty Tax Revenues", in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Fourth Edition (Washington, D.C.: International City Management Association, 1996), 229-258; and *State Tax Guide*, CCH Canadian Limited, 2000.

¹⁰⁰ Ibid.

¹⁰¹ Kitchen (2000), supra footnote 6.

B.5 Fiscal Imbalance - Municipalities

Municipalities in every country spend more money on local services than they generate from own source revenues. As noted above, local revenue sources include local taxes – in Canada, South Africa, and Australia, this is the property tax only while in Germany, Switzerland and the United States, it is the property tax plus income and/or sales taxes – and user fees. In addition, small sums of revenue are generated from a miscellaneous collection of permits, licenses, special charges and so on. Finally, grants from senior levels of government make up the remaining revenue although there is considerable variation (as reported in *Table 11.2*) in the extent to which the local public sector relies on these grants.

Borrowing to finance an annual operating deficit is a source of revenue for senior levels of government, but it is not a source of revenue for annual operating purposes for municipal governments. Municipalities, in these countries, are not permitted to budget for an operating deficit (expenditures exceed revenues). If, however, an operating deficit unexpectedly occurs during a fiscal year, municipalities may borrow short-term to cover the shortfall but their next budget must be set to generate sufficient revenues to repay this short-term borrowing.

Table 11.2

Grants As A Percent of Local Government Revenues, %

Australia ¹	14.1
United States ²	37.3
Germany ¹	34.3
Switzerland ²	16.9
Canada ³	38.9
South Africa ¹	14.5

¹ for the year 1999; ² for the year 1998; ³ for the year 1997.

Source: *Government Finance Statistics Yearbook*, (Washington: D.C.: International Monetary Fund, 2000).

Long-term borrowing, on the other hand, is permitted for capital projects even though it is frequently subjected to regulations and controls imposed by senior levels of government (discussed under capital budgeting in the next section of this paper).

Fiscal imbalance is defined to exist when a municipality's expenditure responsibilities exceed its own source revenues (locally generated taxes, user fees, and a host of small miscellaneous revenue sources). *Table 11.2* provides a crude illustration of the degree of local government fiscal imbalance. There are at least two reasons why an inter-country comparison of these grant figures should be treated with caution, however. First, the universe of what constitutes local government may vary from country to country – education may be included in some and not in others; social services may be included in some and not others; and so on. Second, municipal governments in some countries may be responsible for providing services that are fully or almost fully funded by grants from senior levels of government; whereas in other countries, these same expenditures are a direct and fully funded responsibility of a senior level of government. In the former, grants will be high but they may offset all or almost all expenditures. Examples include education, hospitals, and social services.

Even if this measure of fiscal imbalance is accepted, it is not clear what it tells us. If the municipal sector is relatively more reliant on grants, is this an indication of fiscal problems or potential fiscal problems? Or does it mean that senior levels of government are simply more supportive of the municipal sector? Or does it mean that municipalities have not had to raise local tax rates or user fees as much as they could have? Surely, the more important issue is not whether there is a fiscal imbalance, but whether municipalities are fiscally sustainable.

Fiscal sustainability refers to the capacity of municipalities to generate sufficient revenues to meet expenditure needs, obligations and commitments. This, in turn, is impacted by the cyclical sensitivity of municipal funding responsibilities - do expenditure programs vary with the growth or slow down in economic activity (social services, social housing, for example)? Second, is there enough revenue elasticity in the local tax base to permit revenues to rise and fall with expenditure requirements? Third, do municipalities have sufficient control over their expenditure responsibilities and revenue sources to meet changing fiscal circumstances?

Fiscal imbalance and fiscal sustainability may be quite different. Fiscal imbalance refers to the difference between local expenditures and own source revenues. If this imbalance exists because of the generosity of senior governments (through the provision of grants), it is not a problem and should not be a concern as long as municipalities have the capacity to raise enough own source revenue to meet their expenditure needs and commitments. Here an imbalance exists, yet municipalities may be fiscally sustainable.

While the meaning of fiscal imbalance is uncertain and a measure of fiscal sustainability is unclear, some issues around municipalities are much more certain and apparent. For example, municipalities in every country examined have little control over their expenditure responsibilities. Some are mandated by senior levels of government; others are influenced by the availability of grants, especially conditional grants; and still others are nec-

essary to ensure a safe and healthy standard of living and to meet specific standards (building codes, fire inspections, safety protection, water quality, and so on) set by senior levels of government. In any case, all expenditures are needed to meet the needs and expectations of local residents. Nor do municipalities have control over their tax sources. These are determined by senior levels of government although tax rates are generally set locally as are user fees for specific services. Grants are at the discretion of the senior levels of government.

The general inability of the municipal sector to shed expenditure responsibilities and to acquire additional revenue sources has led to an increased emphasis on efficiencies in service delivery. Not only has this included contracting out and a growing interest in public-private partnerships, it has led to a heightened awareness of the importance of municipal budgeting and accounting systems and the information they provide in ensuring that municipalities are providing services in a transparent, efficient, effective and accountable manner. It is these issues that will be considered in the remainder of this paper.

B.6 Rights and Limitations of Municipalities in Determining Tax Sources and Tax Rates

In the constitution of each of the countries examined in this paper and indeed, in other federal countries, all local tax sources are determined and established by the middle level of government. In other words, municipalities are not free to choose their tax sources although they may be free to set local tax rates. For example, in countries where municipalities rely mainly on property taxes – in particular, Canada, United States and Australia - the tax rate is set by the local municipality and without restrictions or limitations (by a senior level of government) on its level or annual rate of increase. Where municipalities have the power to use variable tax rates for different property classes (single residential versus multi-residential versus commercial versus industrial and so on) as in a few Canadian provinces, there may be limitations on the size of the differential tax rate that may be applied to residential versus commercial/industrial properties, for example. This is to prevent municipalities from overtaxing the commercial/industrial sector – a practice that has been common for some time - and thus minimize tax exporting which is deemed to be inefficient and unfair.¹⁰² Determination of the property tax base, by comparison, is the responsibility of the middle level of government and removed from local government responsibility. The only choice made by the latter, then, is that of the tax rate – set at a level that will generate the amount of locally raised revenue required by the municipal government.

In countries where municipalities have access to income and/or consumption-based taxes, two practices dominate. In the majority of jurisdictions, local taxes are administered and collected by a senior level of government with the revenue from a prescribed number of percentage points refunded to municipalities. This is often referred to as revenue or tax sharing and is the way in which income tax revenues are shared in one Canadian province (Manitoba where 1 percentage point of personal income tax and 2 percentage points of corporate income tax are refunded to municipalities in the form of a grant) and in Germany (15 percent as set constitutionally). In some other jurisdictions, municipalities have some type of independent control – sometimes over the rate through a locally determined income tax surcharge on a tax base set by a senior level of government (this is the approach in some states in the U. S. and for local governments in Sweden, Denmark, Norway, Finland and Iceland); other times, they have control over both the rate and the base (the State of Maryland in the United States follows this approach for the income tax).

From this, there are two general approaches to generating local revenues to finance municipal services. One involves some form of revenue or tax sharing where the municipality has no say in setting its tax rate. The other permits municipalities to set their own tax rate – in most cases, applied to a tax base set by a senior level of government. More specifically, where local governments rely primarily on property taxes, they are generally free to set their own tax rates without limitations or restrictions although the differential between rates across property types or classes may be controlled. Where local governments have access to local income and sales taxes, they may or may not be free to set their own rates.

While revenue or tax sharing has the advantage of simplicity and guarantees municipalities some degree of revenue certainty, it does little to enhance transparency, autonomy, accountability¹⁰³ and efficiency in municipal government spending decisions. Municipalities receive revenues regardless of their tax effort and have no responsibility for setting their tax rate or tax base. If they view these revenues as costless, as is almost certain, a

¹⁰² Harry Kitchen, *Municipal Revenue and Expenditure Issues in Canada*, (Toronto: Canadian Tax Foundation, forthcoming in fall of 2002), ch. 5.

¹⁰³ Melville McMillan, "Financial Relationships between Regional and Municipal Authorities: Insights from the Examination of Five OECD Countries", a paper prepared for the CEPRA I project under the auspices of AUCC, August 2002, p. 29.

municipality's incentive to spend efficiently is minimal.¹⁰⁴ To elaborate, where a municipality is prevented from setting its own tax rate, it is unlikely to meet the expectations of its local taxpayers. Locally generated revenues will almost certainly be more or less than would be desired and efficient. If they are higher than needed, municipal expenditures will exceed the efficient and desirable level. If they are lower than needed, expenditures will be lower than they should be and local taxpayers will forgo services that they might desire otherwise. On the other hand, if municipalities are able to set their own tax rate, they will be more accountable for their spending and funding decisions. This, in turn, will increase transparency and autonomy and should lead to a more efficient and effective level of local public services. Permitting municipalities to set their own tax rate, then, is important if one is to lay the groundwork for an autonomous, accountable and efficient municipal governing structure.

C. Municipal Budgeting

Because municipalities are responsible for a range of services, budgets are needed to plan for and control the receipt and expenditure of monies to fund them. Each municipal government's budgetary process may be affected by a number of variables including the constitutional relationship with senior levels of government, the revenue importance of intergovernmental transfers, the type of services for which municipalities are responsible, and the personalities of the principal decision-makers. In the presence of these differences, it should be noted that municipal governments in every country are controlled by a senior level of government (province/canton/state/land). These controls require, amongst other things, the provisions of annual budgets. This generally involves the preparation of two budgets – an annual operating or current budget (recurrent) that consists of projected revenues and expenditures plus relevant capital asset transactions for the upcoming fiscal year plus a capital budget that lays out future capital expenditure projects and anticipated revenues for funding these projects. As well, the two budgets may be consolidated for certain purposes. The consolidated budget indicates the amount of total estimated revenues available for the current period and the source of additional revenue for financing current and future capital projects.

Operating budget expenditures include wages and salaries, pension contributions, the purchase of short-life equipment, the purchase of services from other agencies, materials and supplies, and expenditures on repair and maintenance. They may also include recurring financial transactions such as servicing the long-term debt (annual interest cost and principal repayment) and contributions to reserve funds established for specific purposes. Current funds may also be transferred to the capital budget to 'up-front' finance a portion of capital projects. In Canada, municipalities may also establish reserves to fund contingencies or other obligations that may or may not become due or are difficult to estimate precisely.

The capital budget details the local government's acquisition or rehabilitation of long term assets (roads, water/sewer lines and treatment plants, public buildings, and sanitary landfills). Usually, it is for a period of at least five years and it outlines the public facilities, infrastructure, and land purchases that the jurisdiction intends to implement during this period given the availability of funds. At the same time, this plan should indicate how all capital expenditures are to be financed (own source revenues, borrowing, grants and so on).

C.1 Capital Budgeting –Problems and Resolution

In most municipalities in every country examined, annual capital budgeting practices and techniques suffer from greater inadequacies and deficiencies than do annual operating budgets. For example, municipalities frequently fail to consider future operating and maintenance costs in making decisions on the wisdom of spending on capital projects. This happens most often when municipalities undertake capital projects in response to the availability of grants from senior levels of government or when they make decisions without the aid of a carefully developed and detailed capital budget. As well, very few municipalities consider opportunity costs (the value of forgone alternatives if a municipality chooses this project) in their capital budget, although almost all of them take into consideration debt costs. Finally, municipalities all too frequently ignore depreciation or asset replacement costs in calculating annual operating costs. This is especially important for those projects that are funded from user fees (water, sewers and so on) and whose fee should include all costs (including those to replace the asset or facility) associated with the operation of the facility.¹⁰⁵

¹⁰⁴ Richard M. Bird, Robert D. Ebel, Christine I. Wallich (1995), "Fiscal decentralization: from command to market" in *Decentralization of the Socialist State*, edited by Richard M. Bird, Robert D. Ebel, Christine I. Wallich (Washington: World Bank), 1-68, at 46-47.

¹⁰⁵ Patrick C. Mann, "Financing Mechanisms for Capital Improvements for Regulated Water Utilities", a report prepared for The National Regulatory Research Institute, Ohio State University, Columbus, Ohio, December 1999, at 5.

An important policy objective of municipal decision-makers should include the integration of capital infrastructure programs and growth management objectives. The latter are generally designed to control 'urban sprawl' and promote 'infilling' or higher density development. The availability of (or lack of) local infrastructure including water and sewer lines, roads and streets can control the type of development.¹⁰⁶

Unfortunately, this integration is often less than it should be. First, capital programs and budgets are frequently drawn up or altered without the consent or involvement of all local departments or officials. Lack of coordination between local departments or local departments and special purpose bodies such as utility commissions creates situations where capital maintenance or construction of a specific project may not be coordinated with other capital projects in the same years. For example, one frequently observes the construction or maintenance of sidewalks or roadways and shortly afterward the tearing up of these facilities to construct or replace sewers or water mains. Such uncoordinated efforts prove to be costly and difficult to justify. Second, further problems exist if capital projects represent political compromise and compliance with legal approval dates (calendar) rather than well thought-out plans for community improvement. The notion that capital projects flow smoothly from well-organized community plans to implementation is often not borne out. Among the reasons for this is the likelihood that a number of development or management decisions are made in a public forum (public meetings, for example) or influenced by public input from special interest groups. These forums or the public input, however, seldom cover all aspects of community planning such as the maintenance, renewal, and construction of new projects. While the overall policy may include an integrated approach to capital programs and growth management objectives, this objective is paid only lip-service. The sheer numbers of people involved and their interest in only selected aspects of the overall plan place constraints on the actual achievement of this objective.

Finally, the largest proportion of capital spending tends to be devoted to short-term rehabilitation and renewal projects even though longer-term projects may generate greater net gains for society. Emphasis on short-term projects as opposed to longer-term projects arises for two reasons. First, the relatively short term of office for municipal politicians means that they are generally more interested in short term projects because they coincide with their term of office and provide visible signs of political initiatives. Second, municipal decision makers are reluctant to become locked into long-term projects without guarantees of future funding and concern about the impact of future annual interest and debt repayment charges on local budgets.

A carefully developed capital budget should involve the following five steps.¹⁰⁷

1. *Inventory of Capital Assets.* An inventory of capital assets provides information on the capacity of existing infrastructure and the appropriate timing for its replacement. Surprisingly, a large number of municipalities do not have detailed or accurate records on the age and condition of much of their important infrastructure, especially that which is underground (water and sewer pipes, hydro-lines and so on).
2. *Development of a Capital Investment Plan (CIP).* This would include information on the urgency of building or rehabilitating a capital project, the benefits derived from it, the cost and financial impact of the project, and its acceptability to the local constituency.
3. *Development of a Multi-Year CIP.* This plan establishes the time schedule and all costs for capital investment projects being considered. This would permit the municipality to choose the most cost-effective option and it would provide the municipality with information that would assist it in developing a prudent financial plan for funding the project. This multi-year plan should be integrated with a multi-year operating budget to avoid the common problem (as noted above) of failing to provide information on future operating and maintenance costs. As well, integrating these two budgets would lead to better decisions over the optimal size of potential capital assets or facilities.
4. *Developing the Financial Plan.* For each capital project, the municipality should develop a detailed financial plan that includes information on the municipality's capacity and ability to finance the project, sources of funds for the project (user fees, local revenues, grants, borrowing and so on), and procedures to be followed if revenues fall short of the target or if surpluses are generated.
5. *Implementing the Capital Budget.* The success of any capital budgeting process is highly dependent on public participation and acceptance of the proposed projects.¹⁰⁸ Public acceptance may depend on the urgency of the project; for example, crumbling underground sewers that have caused basement backups or leaky water pipes that produce insufficient water pressure to fight fires may be deemed to be more urgent than repairing roads or sidewalks that have deteriorated over the winter.

¹⁰⁶ Enid Slack (February 2002). "Municipal Finance and The Pattern of Urban Growth", *Commentary* (Toronto: C.D. Howe Institute).

¹⁰⁷ More detail is provided in Michael Schaeffer, "Municipal Budgeting", World Bank Background Series, number 4, April 2000, at 20-24.

¹⁰⁸ Almos Tassonyi (2002), "Municipal Budgeting", *Canadian Tax Journal*, Vol. 50, No. 1, 181-198.

a) *Restrictions or Controls on Borrowing for Capital Projects*

It was noted earlier that municipalities (in the countries discussed) are permitted to engage in long term borrowing for capital projects only. Where capital projects provide services that benefit future generations, borrowing is an ideal financing instrument because the annual repayment of principal and interest charges can be recovered through taxes or user fees collected from future users or beneficiaries of the projects. In other words, those who benefit are those who pay.

While borrowing is important for financing municipal capital projects and is used frequently, local borrowing in most countries is subject to a variety of restrictions or controls that are imposed by senior levels of government. These are in place because municipalities are creatures of the province/state/canton/lander and the latter do not wish to be responsible for unlimited municipal borrowing and possible repayment of municipal debt. As well, unrestricted municipal access to capital markets may in some circumstances crowd out private sector borrowing or impact on borrowing of more senior levels of government.

Local borrowing is monitored in a variety of ways. *Table 11.3* lists the types of restrictions imposed on local borrowing in a few countries.

Table 11.3

Local Borrowing Restrictions in Selected Countries

Type of Restriction	Description	Countries
Affordability Formulae	Ceilings on (i) debt service/local revenues; (ii) debt service/local current spending	Argentina, Brazil, Italy, Japan, Spain, Lithuania, Poland, Columbia, Canada
Indebtedness Formulae	Limit on outstanding debt/net revenues	Brazil, Columbia, Italy, Canada
“Golden Rule” Provision ¹	Borrowing for capital expenditures	Brazil, Canada, USA, Austria, South Africa, Switzerland, India
Balanced Budget	Local councils are required to pass balanced budgets	Brazil, Canada, Germany, Netherlands, USA
Local Approval	Local councils are required to approve borrowing for individual projects	Canada, Switzerland, USA
“No Bailout” Provision	National government does not guarantee subnational debt	South Africa, Mexico

¹ Local government borrowing cannot exceed the amount spent on investment.

Source: Dana Weist, “Borrowing and Capital Financing”, a power point presentation on Intergovernmental Fiscal Relations in East Asia, ASEM Sponsored Workshop (World Bank), Bali, Indonesia, January 10-11, 2002.

In general, restrictions on municipal borrowing relate to the dollar value of outstanding debt that is permitted and/or annual debt service charges as a percent of own-source revenue or operating (current) expenditures. Since Canadian restrictions are not unlike those in most developed and developing countries and tend to vary from province to province, it may be worth hi-lighting them.¹⁰⁹ In Ontario, the current limit for municipal debt servicing charges is 25 percent of own-source revenues. For municipalities with pressing infrastructure needs and wishing to borrow beyond this limit, they may do so as long as their additional debt is approved by a provincial authority (the Ontario Municipal Board). In Alberta, provincial regulation specifies both the total indebtedness (1.5 times municipal revenue) and the annual level of debt service (25 percent of revenues) that is permissible. In Alberta, as in Ontario, municipalities who wish to exceed these limits may do so only after approval by the provincial Local Authorities Board. In British Columbia, long-term capital borrowing requires both provincial approval and a two-thirds council majority (and sometimes a referendum). In the province of Quebec, either voter approval or provincial approval is required for municipal borrowing except in the two largest cities – Quebec City and Montreal. In many other countries, similar restrictions or controls exist.

A general question that emerges in discussion of local borrowing is whether or not controls should exist or whether municipalities should be free to borrow and hence, be subject to the discipline of the market. As long as municipalities are creatures of a senior level of government, an argument exists for controlling their borrowing behaviour primarily to prevent bankruptcy and a potential need to be ‘bailed-out’.¹¹⁰ In this regard, controls that restrict annual debt servicing charges to an fixed percentage of own-source revenues with provisions for additional borrowing approved by a senior level of government if it can be demonstrated that a municipality needs additional infrastructure to meet pressing needs has been appropriate and effective in countries where it has been

¹⁰⁹ For more detail, see Richard M. Bird and Almos T. Tassonyi (2001), “Constraints on provincial and municipal borrowing in Canada: markets, rules, and norms”, *Canadian Public Administration*, Vol. 44, No. 1, at 84-109.

¹¹⁰ In countries where municipalities are creatures of a senior level of government with the latter ultimately responsible for all outstanding liabilities/debts of the municipal sector, failure to impose controls over municipal borrowing provides an incentive for municipal officials to borrow more than they should.

used. It has permitted municipalities to remain solvent and to function in a more or less normal and expected manner.

b. Issuance of Municipal Debt

The way in which long term municipal debt is issued varies from country to country. In some countries, a provincial or state organized authority or agency may borrow on behalf of all municipalities; in other countries, municipalities borrow on their own. The advantages of a state or province-wide body are significant. Municipalities borrow from the authority who, in turn, totals up all the requests for local funds and issues long-term debentures against the authority itself. In some countries, debentures are guaranteed by a senior level of government. When the proceeds are received from the sale of these debentures, the funds are dispersed to the requesting municipalities usually under a loan agreement with the borrowing municipality.

Pooling of municipal debt through a provincial or state-wide organization can produce significant benefits for many municipalities, especially the smaller ones. These organizations or authorities generally issue bonds on a regular basis; some only for municipal units but others include schools, hospitals, utilities, and other municipal bodies. The administration costs may be funded by a senior level of government or by earnings on reserve funds, participants, or a combination of these.¹¹¹

Borrowing costs are lowered by the ability to issue debt in national and international markets and from lower administration costs in issuing debt. A large finance authority substitutes one contract with an underwriter for separate contracts between each borrower and debt issuer. It economizes on transactions costs because it issues debentures more frequently than individual municipalities would if they had to borrow themselves and it provides stability in volatile capital markets that are subject to uncertainty. It can exercise a greater degree of flexibility over issue terms and costs to municipal clients.

A recent study¹¹² compared the cost of municipal funds for pooled versus stand-alone issues using data from the province of Ontario, Canada. The findings show that pooled financing through a hypothetical municipal financing corporation or authority in Ontario would significantly lower costs to municipal borrowers when compared with the actual cost of capital for municipal issues in that province. The authors concluded that the benefits of municipalities participating in a municipal finance authority that issues ten-year debentures through investment dealers varied inversely with population size and credit rating (a measure of the credit worthiness of a municipality). Issue size was not a factor. In other words, the largest savings would accrue to municipalities with smaller populations, those that are un-rated (no bond rating for debt purposes), and those that borrow for longer periods of time.

C.2 Budget Roles or Objectives

Municipal budgets should be designed to achieve the following:¹¹³ (1) to provide for the maintenance of financial control; (2) to provide information essential for useful and efficient management decisions; and (3) to improve program and financial planning.¹¹⁴

a. Financial Control

Historically, financial control has been the primary and sole concern of municipal budgets. The fact that local officials have control over local funds has necessitated the implementation of certain controls (statutory or otherwise) so as to regulate and monitor expenditures on particular functions and at particular times throughout the year.

Control budgeting tends to be input oriented, as opposed to goal or output oriented, and is frequently negative in its approach. Emphasis is placed on restricting expenditure increases with very little attention, if any, being devoted to the benefits accruing as a result of the programs or services affected. While this may be a laudable objective, especially in times of restraint, it is far from obvious that it is in fact the most desirable or effective approach. A line-by-line or item-by-item assessment of expenditures usually ensues when inputs are identified and budgeted figures established on an incremental basis.

¹¹¹ M. Gilbert and R. Pike, "Financing local government debt in Canada: pooled versus stand-alone issues – an empirical study", *Canadian Public Administration*, vol. 42, 1999, pp. 529-552.

¹¹² *Ibid.*

¹¹³ Paul L. Solano and Marvin A. Brams, "Budgeting", in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Fourth Edition (Washington, D.C.: International City Management Association, 1996), 125-168, at 163-164.

¹¹⁴ A more detailed discussion of budgeting is included in Tassonyi (2002), *supra* footnote 16.

Incrementalism in the budgeting process has been, and still is, fairly common, particularly in smaller communities with a less specialized and relatively small managerial staff. Although there are some noticeable problems with using one year's expenditures as a base on which to add an incremental value in determining the budgeted figures for the following year, it is defended by local officials if there is a lack of any other information relevant to the budgetary decision-making process. Their argument suggests that in the absence of useful 'other information' (see discussion below) on existing programs and services, there is no basis for reducing or eliminating on-going expenditures since costs alone do not provide a sufficient rationale for that exercise.

In addition, the incrementalist approach creates some further problems; for example, it provides no mechanism for assessing the benefits from existing expenditures and, therefore, no rationale for encouraging local officials to allocate their resources in an efficient manner. As well, the information provided (as discussed under accounting) is frequently incomprehensible to all but the most sophisticated readers.

In essence, control budgeting is important but it often creates a narrow and cumbersome financial management system, characterized by paperwork, detail, duplication, complexity, and inflexibility. It also lacks the truly relevant information necessary for proper planning and efficient management of local government activities.

b. Operational Management

To improve managerial decision making at the local level, budgets should be designed to reflect both past and projected expenditures on outputs or goals achieved or to be achieved rather than on the cost of inputs as has been accepted traditionally. This involves the establishment of workloads or targets; for example, a council may set as one of its targets a 5 per cent reduction in crime rates at an average cost of X man-hours per investigation or it may state that all garbage must be collected with a minimum amount of inconvenience to all residents at an average cost of \$Y per ton. Similar targets may involve a reduction in per capita fire losses of a fixed percentage at an average cost of \$Z per alarm or the completion of road maintenance that ensures smooth riding at a cost of \$K per kilometre.¹¹⁵

The establishment of targets or workloads allows local budgetary officials to make decisions on budgeted expenditures not solely on the basis of costs but rather on the basis of costs (efficiency) with some notion of returns (effectiveness). Budgets, therefore, should be built around the kind of work to be undertaken in the next fiscal year. These workload targets dictate the programming part of budget preparation, which involves scheduling work, developing an organizational structure, and establishing procedures to reach the proposed plans.¹¹⁶ Alternative methods of achieving the volume of work to be undertaken should also be considered. This budgeting arrangement allows local budgeters faced with scarce resources to allocate their funds among the various services in a managerially efficient and effective manner.

Once such targets or objectives have been established, the task of achieving these objectives begins. Workloads or targets must be defined in quantifiable terms (see discussion on performance measures below). Such quantification requires data on both inputs and outputs for it is the ratio of inputs to outputs that defines the target to be met.

Estimates of workload and other performance indicators ought to be measured, established, and monitored periodically to make certain that targets are adhered to or that actual changes of a justifiable nature are being incorporated into the budget. Such periodic reporting also provides a basis for evaluating improvements or discovering deviations that must be corrected. These deviations might exist because of unplanned inflationary cost pressures, inadequate financial control, unrealistic revenue or expenditure estimates, and/or simply because of foolish management decisions. Once the reason for the deviation has been determined, local officials should either alter the targets or adjust their operation to achieve the previously stated objective. Finally, an independent external audit by an individual or firm not employed directly by the municipality is necessary in order to guarantee that the objectives or goals have been achieved in an effective and efficient manner.

Budgeting to facilitate managerial decisions of the type outlined in this section is a relatively new idea. Because of tradition, bureaucratic inertia, or an inability or unwillingness to change, municipalities, by and large, have concentrated on budgeting for control purposes alone. The objectives of control budgeting are understood and generally pose no threat to local officials who may view the exercise of performance budgeting as something beyond their comprehension and expertise.

While performance budgeting is used in relatively few countries, municipalities in Australia, New Zealand and the province of Ontario, Canada are required to provide their provincial/state governments with annual per-

¹¹⁵ These examples are drawn from Ontario, Municipal Budgets and Accounts Branch, Ministry of Municipal Affairs and Housing, *Performance Measurement for Municipalities* (Toronto: the Ministry, 1981), at 22-26.

¹¹⁶ Solano and Brams (1996), supra footnote 21, at 164-16.

formance measurement information and to report the results to their taxpayers. Although the adoption and implementation of performance measures has been established to improve efficiency and productivity in the provision of local services, this information should be linked to the budgetary process.¹¹⁷ The tighter financial environment facing local governments along with greater pressure for public accountability will provide an impetus for municipalities to outline clearly their targets, goals or objectives and to relate these to performance measures. At the same time, municipalities should employ cost-benefit analysis in evaluating alternative means of achieving their stated objectives in order to provide those services yielding the greatest return given their revenue constraints.

c. Financial Planning

Planning in the budgetary sense has two meanings - forecasting and assessment. First, it is an attempt to shape the future; to forecast the type of expenditures that will be made and the revenue sources that will be tapped. Each annual budget represents a one-year installment in a longer-range plan with the goal ultimately being reached sometime in the future. Second, it is an attempt to assess the impact of current expenditure decisions on future revenue sources. To achieve this, impact studies are an invaluable input into the budgetary allocation process. All too often, local governments commit themselves to current programs without any indication of the financial requirements that these programs will impose on future revenues.

C.3 Budget Formation

The preparation or formation of the budget passes through a series of stages and involves both elected and appointed officials as well as the taxpaying public.

a. Budget Cycle

Preparation of the budget goes through a series of stages before it is formally delivered to council for discussion, debate and approval. It begins with some kind of policy direction or guidance from the local council; for example, a focus on water and sewers, transit, roads, zero tax increase and so on. The first stage of the budgetary cycle involves the preparation of initial requests for funds on a department-by-department basis. The preparation of these budgetary requests depends on a number of factors including the size of the municipality's budget, the degree of sophistication involved in providing and evaluating local programs or services, the importance attached to budgeting, the size of the department, and even the style of the department head. If departments are reasonably large, there may be an identifiable department budget staff. In smaller municipalities, budget requests may be made by department heads or staff members on an 'ad hoc' or a part-time basis. The adoption of performance measures (discussed later) and cost/ benefit techniques as a basis for making budgetary decisions tends to be correlated positively with the size of the municipal budget.

During the second stage of the budget cycle, the various departments or individuals responsible for administering the local programs and services submit their budgetary requests to the chief administrative or financial officer. This officer and his staff (if one exists) compile, combine, and coordinate all requests for funds. Since municipal governments are required by law to approve a balanced budget for the annual operating activities of the municipality, it is the responsibility of the chief financial officer and his staff to estimate revenue yields and acceptable increases. Once this revenue constraint has been established, the objective becomes one of considering the alternative requests and selecting those (sometimes after much trimming) that are felt to be most important. Inevitably, conflicts arise and resolutions must be sought. After dialogue and debate by department heads or their delegates, requests may be denied, rearranged or the financial constraint expanded. Ultimately, the chief financial officer arrives at a budget that is generally presented to the budget committee of the municipal council.

The third stage is the adoption of the budget. At the local level, and particularly for smaller communities, this exercise may be much less sophisticated than in larger centers or than at more senior levels of government. In some municipalities in all countries, the public (taxpayers) is invited to comment (at public meetings) on the proposed budget prior to council approval. This type of public participation is designed to add more transparency and accountability to the budgetary process.

The execution and monitoring of the adopted budget throughout the fiscal year constitutes the fourth stage of the budget cycle. The responsibility for these activities along with the presentation of an updated picture of the municipality's financial position to the local council rests with the chief financial officer and/or his staff.

Finally, legislation generally requires that municipalities have their financial records audited by an independent auditor after the completion of the fiscal year. This ensures that the municipality has adhered to legal

¹¹⁷ Tassonyi (2002), supra footnote 16.

requirements regarding local expenditures and that local officials have not misappropriated (deliberately or accidentally) local funds.

b. Role of Elected Versus Appointed Officials

Throughout the budgetary process, there are a number of participants, each performing different roles. Elected officials should play a different role than appointed officials. Elected officials should be responsible for setting policy and establishing the strategic directions of council. As a representative of a local constituency, they play a major role in the communication process between the council and local taxpayers and through this process are responsible for translating the desires and needs of the local constituents into appropriate budgetary policies. Local input is frequently solicited through public meetings on the annual budget. As well, the media and the internet play a role in informing the public about on-going budget deliberations. Ultimately, the elected councilors must approve the budget and be responsible for monitoring the overall financial performance of the municipality.

Elected officials should not, however, be involved in the day-to-day management activities of the municipality or its special purpose bodies. This should be left to appointed officials. In this regard, New Zealand has probably gone further than other countries because it has implemented legislation (1989) that decouples local council decision-making from day-to-day management. Here, the council's job is to set policy and monitor the performance of the council appointed chief executive officer. The chief executive officer is on a performance-based contract for up to five years and is the employer of all other staff.¹¹⁸ The responsibility of the chief executive and other officers is to manage the municipality within policies set by the local council.

D. Accounting and Reporting

While the budget is the heart of municipal resource administration, municipal accounting systems and practices and their subsequent reports are central to the budget-making process. For example, past accounting records furnish important data for revenue and expenditure forecasts used to construct the budget. Accounting records provide information on debt and debt service charges and serve as a basis for estimating a municipality's ability to carry further debt. Sound accounting reports provide timely information on whether budget plans are on target or amiss, when capital funds are diverted to operating expenditures, when expenditures are outpacing revenues, and when the municipality is incurring financial obligations beyond its fiscal capacity.¹¹⁹ The focus of reporting and accounting, then, is to document, classify and summarize transactions so users of the resulting financial reports are able to understand and evaluate municipal operations.

D.1 Standards

Internationally, accounting and financial reporting standards are often established by independent standards setting authorities or boards. In the United States, for example, the Government Accounting Standards Board (GASB) establishes financial reporting standards for the public sector. In Canada, public sector accounting standards are set by the Public Sector Accounting and Auditing Board (PSAAB) of the Canadian Institute of Chartered Accountants. Many other countries have established similar Public Accounting Standards. Municipal accounting differs from private sector accounting because the emphasis in the former is on cash flow and transparency and accountability to the local constituency while the emphasis in the latter is on profit or loss reporting. More specifically, the following practices have become the norm for most public sector accounting.¹²⁰

- Fund accounting should be used to ensure legal compliance with restrictions on the use of revenues and to enhance sound financial administration of diverse governmental operations.
- Fixed asset accounts should be maintained separately from current assets. All tangible assets should be depreciated.
- Long-term obligation bonds (debt) should be recorded in a separate group of accounts as obligations of the entire governmental unit. Revenue bonds are obligations of specific funds and should be recorded as such.
- Different accounting methods are used for matching revenues and expenditures over a specific time period. On a cash basis, revenues are recorded when cash is received and expenditures are recorded

¹¹⁸ Pallot, J. (2001). "Local Government Reform in New Zealand: Options for Public Management as Governance." www.willamette.org/ipmn/test/papers/salempallot.htm, at 5.

¹¹⁹ William W. Holder, "Financial Accounting, Reporting and Auditing" in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Fourth Edition (Washington, D.C.: International City Management Association, 1996), 169-200.

¹²⁰ Schaeffer (2000), *supra* footnote 15, at 5.

when cash payments are actually completed. On a full accrual basis, revenues are recorded when earned and expenses are recorded when liability is incurred. The modified accrual basis records expenditures when liability is incurred but does not record most revenues until cash is received (discussed in more detail below).

- Financial reports should be issued regularly and an annual report covering all funds and operations should be published.

D.2 Objectives

Public sector accounting standards are generally designed to achieve a number of objectives. As an example, the PSAAB in Canada has set the following objectives¹²¹ for municipal financial statements:

- Provide reliable, understandable, timely, and consistent information that meets the needs of persons for whom the statements are prepared.
- Provide an accounting of the full nature and extent of the financial affairs and resources for which local government is responsible.
- Demonstrate the accountability of local government for the financial affairs and resources entrusted to it.
- Account for the sources, allocation, and uses of financial resources in the period.
- Provide information that shows the state of local government's finances.

A number of financial management functions have to be fulfilled to meet these objectives. Municipalities need to have in place systems for accounting, auditing and analysis of financial information. Accounting systems are needed to record revenues and expenditures in a consistent way that permits comparisons between budgets and actual figures. Financial audits are needed to determine whether the municipality's financial statements provide an accurate and reasonable picture of the municipality's financial position and activities for the reporting period. The financial audit is designed to detect deficiencies in the system of internal financial control, failures to comply with accounting principles and standards or with reporting requirements of senior levels of government and instances of errors or misappropriation of funds. In that the focus of the financial audit is on the financial statements, these audits do not address the issues of efficient resource utilization and the achievement of performance standards.¹²²

D.3 Users of Accounting Information

To facilitate the discussion of users and their respective financial information needs, it may be useful to categorize these users into the following groups: external users, internal users, and senior governments. Each of these will be considered separately.

a. External Users

External users include constituents, creditors, suppliers, and others engaged in business transactions with the government. This group is external to the government and generally lacks any effective control over the type of financial information available. The kind of information of greatest use to these users includes information on performance measures. This permits an inter-municipal comparison of unit costs, efficiency, and effectiveness of local programs or services. It permits users to assess the financial health and fiscal viability of their community. In addition, external users benefit greatly from the provision of information on such things as the impact of current capital projects on future operating budgets; the ability of local governments to be able to draw on future resources (taxes, grants, and user charges) and the extent to which these revenue sources may be substituted for each other; and the impact of inflation on future expenditures and revenue requirements.

b. Internal Users

This category includes all individuals engaged in the managerial and administrative functions of local government. Specifically, it includes policymakers, managers, and administrators. Their functions involve the planning, organization, execution, and evaluation of the diverse programs and services provided by local governments.

¹²¹ Public Sector Accounting and Auditing Board (1997), *An Illustrative Guide to Municipal Accounting and Financial Reporting*. Canadian Institute of Chartered Accountants.

¹²² Issues of efficiency and performance are addressed in management and performance audits, or special audits such as an environmental audit.

The financial information needs of these users are more comprehensive than those of external users. Not only do policymakers and administrators require the same information as external users, they also require cost estimates for alternative ways of achieving specific goals. Cost/benefit analyses of proposed and existing programs, forecasts of current and capital expenditures, and the impact these will have on local revenue sources both in terms of the effect on tax rates or charges and their distributional impact on local residents are important. With the exception of some larger urban or regional municipalities, impact studies, cost/benefit analyses, and careful revenue and expenditure forecasts are seldom attempted. As pressures mount for more accountability and cost-efficient programs, however, increased emphasis should be placed on more useful and relevant financial information - information that will assist in making local administrators and policymakers more responsive to users' desires and needs.

c. Senior Levels of Government

Since local governments are creatures of the provincial or state level of government in federalist countries and since local governments receive grant support from their senior counterparts, there is both an expectation and a requirement that local governments provide financial, economic, and statistical information to the donor government in a consistent and uniform manner. Much of this information may be of little use to external users. Indeed, in its initial stages it may be of limited use even to the municipality actually supplying it. Once collected and compiled by the senior level government, however, it is useful because it indicates different trends in expenditure and revenue categories over time; differences in the extent to which municipalities support different expenditure programs; and differences in the dependency of municipalities on their various sources of revenue. Such inter-municipal comparisons on a uniform basis will allow municipalities, provincial analysts, and others to assess the feasibility, cost, level, and quality of current programs. If specific expenditures, costs, or dependence on a particular revenue source, tend to be out of line for one or some municipalities vis-a-vis other municipalities, this information may provide a base for pursuing a more in-depth analysis of the reasons for this difference - reasons that may generate improvements in the quantity and/or quality of local services or programs or improvements in the funding of these services or programs.

Senior levels of government in exercising their legal and statutory responsibilities also require information that will allow them to oversee and control certain activities of local governments. These governments, for instance, may require detailed information on capital budgets and debt capacities to ensure that local governments do not commit themselves to future excessive financial burdens. As well, other information is required as a basis for determining the recipients of many grant programs. Equalization grants, for example, are established only after economic, financial, and statistical data have been supplied, compiled, and evaluated.

D.4 Accounting Bases

The basic difference between municipal (and other levels of government) accounting systems and personal/business accounting is the use of fund accounts.¹²³ In conventional accounting systems, all monies go into one account from which all expenses are paid. A single set of accounts is usually sufficient to disclose transactions and details of financial conditions. Legal restrictions on the use of government monies, on the other hand, make co-mingling of monies an obstacle to a clear demonstration of compliance with prescribed rules and conditions.

Under fund accounting, a separate fund is used to report financial transactions for a particular aspect or activity of government such as water or sewage operations. Fund accounting features self-balancing double entry accounts from which a balance sheet and statement of operations can be prepared. Separate budgets are prepared for each fund.

The fund basis of accounting has two important advantages. First, it recognizes that a considerable amount of government revenue is not fungible - that is, available for purposes other than those budgeted - and that data on budgeting compliance are an important part of the stewardship responsibility of government. Second, distinct fund accounting and reporting is necessary to control resources for their designated use and to demonstrate compliance with legal and budgeting constraints affecting municipal governments.¹²⁴ The funds that are used may be categorized into three basic types: i) governmental; ii) proprietary; and iii) fiduciary. *Table 11.4* defines these funds and their respective categories.

¹²³ Michael Schaeffer, "The Budget and Public Sector Performance", Washington: World Bank, March 7, 2000, at 15.

¹²⁴ William W. Holder (1996), supra footnote 26, at 174-175.

Municipal Funds

Fund	Definition
<i>Government Funds:</i>	
1. General Fund	Consists of general revenue sources such as taxes, fines, licences and fees The general fund is usually the largest municipal fund.
2. Special Revenue fund	Consists of revenues that are resources for special purposes. Examples include transportation trust funds or senior government grants.
3. Debt Service Fund	Consists of resources used to repay long-term general obligation debt (general obligation bonds).
4. Capital Project funds	Consists of resources restricted for construction and acquisition of capital facilities.
5. Special Assessment Funds	Consists of resources received from special charges or fees levied on persons that benefit from a particular capital improvement project
<i>Proprietary Funds:</i>	
1. Enterprise Fund	Contain financial records of self supporting operations (water and sewer funds).
2. Internal Service Fund	Account for the financing of goods and services provided by one department or agency to other departments or agencies on a cost reimbursement basis (building maintenance
<i>Fiduciary Fund:</i>	
	Account for assets held by a governmental unit in a trustee capacity (law enforcement fund).

Source: Susan L. Riley and Peter W. Colby, *Practical Government Budgeting*, State University Press, 1991.

In essence, commonly used funds are those for general municipal activities, revenue funds for special activities, utility operations, sinking funds, capital funds, reserves, trusts and agency funds.

Since financial transactions associated with a specific fund are subject to legal or administrative restrictions, a reserve fund is used to record the proceeds from, for example, charges on specific properties or users and their application to designated capital works, while a utility fund would be used to report the transactions of a municipal service that has been set up as a self-financing department.

Cash, accrual, and modified accrual accounting form the three possible accounting bases that can be used for municipalities and their enterprises. As noted above, *cash accounting* involves the recording of expenditures and revenues when funds are actually disbursed or received. It is the simplest of the accounting bases but it is not recommended under generally accepted public sector accounting principles because it gives a misleading picture of municipal accounts. For example, cash received as a loan would be reported as revenue in the operating statement but not as a liability on the balance sheet.

Accrual accounting is the more commonly accepted approach internationally. It records transactions when they occur regardless of when expenditures are made or funds received. For example, the cash expenditure to finance an investment in a fixed asset may take place within one year but the associated expenses reported in the financial statement of operations takes the form of annual depreciation charges incurred over the life of the asset. Since depreciation is a charge that is used to recover the original cost of an asset and associates the annual flow of benefits with costs, it is incorrect to interpret depreciation as a charge to cover replacement costs since this would entail double counting. Moreover, the cost of asset maintenance and repair is recovered directly as an expense.

Modified accrual accounting is somewhat different. It adopts the same principles and approach as accrual accounting with the exception that depreciation and a return on capital are not included as costs. Instead, interest costs and principal repayments on debt are recovered directly in the year in which they are due through user fees and local taxes. These are generally set to generate revenues in excess of expected operating and maintenance costs and debt service costs, thus resulting in operating surpluses which are transferred to a capital fund to finance ongoing investments or into reserves or reserve funds to finance planned future investments. Because principal repayments are recovered directly each year as chargeable expenses, municipalities are less likely to face cash flow problems. Capital financing does not therefore depend on the flow of funds from a depreciation charge and a return on equity

The adoption of accrual or modified accrual accounting does not suggest that absolutely every revenue source or expenditure item be accrued. For very small revenue and expenditure items, a simple recording on a cash basis along with proper notation of the approach followed may be sufficient.

Under both the full accrual and modified accrual accounting systems, the treatment of operating and maintenance costs is identical. As well, both systems can accommodate capital contributions from outside sources. In the modified accrual system, these take the form of grants from senior governments or transfers from the municipality's general revenue or reserve funds (such transfers are not customary where municipalities run utility operations on a self-financing basis). Under the full accrual-based system, capital contributions are normally equity injections from private or public sector investors.

The main difference between the two methods lies in the treatment of capital. As well, whether a municipality uses the modified or full accrual method of accounting can affect the timing and amount of costs that are written off as expenses in a given year, and hence the timing and size of capital costs passed on to customers.

At the same time, the sum of principal repayments and the operating surplus in the modified accrual system can be equated to the sum of depreciation charges and retained earnings in the accrual system. These two sources of funds are similar and both accounting methods can be made to work effectively given the appropriate level of financial management.

Table 11.5 presents an overview of the differences between the two accounting methods. Currently, municipalities in some countries (Canada to name one specifically) are required to follow the modified accrual basis for accounting. However, given the ability to match benefits with costs over the service life of assets, and the importance of fully recovering costs each fiscal year, the full accrual method may present the greater opportunity to achieve the objective of service delivery related to equity.¹²⁵ The adoption of this accounting standard, it should be noted, is not universally supported for local governments.¹²⁶

Table 11.5

Comparison of accounting methods

Item	Accrual Basis	Modified Accrual Basis
Treatment of investment costs in statement of operations	<ul style="list-style-type: none"> ▪ An annual depreciation expense is included in costs over the expected life of the asset. The sum of depreciation expenses should equal the original cost of the asset less its scrap value. ▪ The annual depreciation charge does not correspond to any expenditure in the year for the asset in question. 	<ul style="list-style-type: none"> ▪ The statement of operations will show actual capital expenditures for the asset drawn from the capital fund. ▪ Money in the capital fund is transferred from the revenue fund or a capital reserve fund, or it comes from newly issued debt or a capital contribution such as a grant.
Treatment of fixed assets in balance sheet	<ul style="list-style-type: none"> ▪ The original cost of the fixed asset is recorded when the asset is commissioned and this value is then reduced each year by the amount of the corresponding depreciation charge. ▪ At the end of its service life, the assets value goes to zero. 	<ul style="list-style-type: none"> ▪ The value of the fixed asset does not appear in the balance sheet. ▪ Only current assets are reported (e.g., inventories, cash, accounts payable).
Treatment of long-term debt in statement of operations	<ul style="list-style-type: none"> ▪ Only the interest portion of debt service cost is reported as a cost but not the principal repayment. ▪ Principal is repaid using cash originating from depreciation charges and profit. 	<ul style="list-style-type: none"> ▪ Both the interest and principal portion of debt service cost are reported as costs.
Treatment of long-term debt in balance sheet	<ul style="list-style-type: none"> ▪ Reported as a liability and diminished as principal is repaid. 	<ul style="list-style-type: none"> ▪ Reported as a liability and diminished as principal is repaid.
Cost recovery through user fees and taxes (assuming no grants)	<ul style="list-style-type: none"> ▪ All of it in the form of depreciation charges. ▪ The period of recovery extends over the service life of the asset, which may be considerably longer than the repayment period of debt to finance the investment. 	<ul style="list-style-type: none"> ▪ All of it in the form of principal repayments and transfers from the revenue fund to capital and reserve funds to finance the investment. ▪ The period of recovery matches the period of debt repayment and revenue fund transfers and actually commence prior to the investment when reserves built in advance.
Financing costs	<ul style="list-style-type: none"> ▪ Interest charges on debt and a return on the equity portion of the investment including retained earnings (if any). 	<ul style="list-style-type: none"> ▪ Interest charges on debt.

Source: "Financing Water Infrastructure", by Strategic Alternatives et. al., Issue Paper 14 commissioned by the Walkerton Inquiry, Toronto, Ontario, Canada May, 2001, chapter 8.

¹²⁵ Public Sector Accounting and Auditing Board (1998). *Capital Assets, Implementing PSAAB's new accounting standards*. Canadian Institute of Chartered Accountants.

¹²⁶ Beauchamp, T. (2000). "The Infrastructure Web." *CA Magazine*, June-July.

a. International Experience

The PSAAB in Canada recommends accrual-based accounting based on historical cost for senior governments in Canada, but not local governments. The United States Federal Accounting Standards Advisory Board requires accrual-based accounting based on historical cost, but the U.S. Government Accounting Standards Board allows a non-depreciation renewal approach for the infrastructure of local governments. In New Zealand and Australia, accrual-based accounting is required, but an allowance is made for asset revaluation to offset inflation.

Interest in full accrual-based accounting for municipalities is generally motivated by concerns over the state of aging infrastructure and a lack of reliable information that could be used to evaluate this concern. In New Zealand and the United States, these concerns have led to reforms in accounting standards for local government.

In 1993, the New Zealand Audit Office reported to parliament that it could not vouch for the long-term financial viability of local governments because there was no information on the condition of assets and inadequate strategic planning for future investment requirements. In response, the Local Government Amendment Act (no. 3) was passed in 1996. Among other things, this Act required local government to adopt fixed asset accounting and to prepare and approve a long-term financial strategy every three years providing long-term financial and asset management plans.¹²⁷ Under the Act, depreciation charges are estimated and funded through local taxes and user charges. The depreciation charge provides an estimate of the decline in service potential of assets, while its funding assures that “users of the service pay the real cost.”¹²⁸ Currently, local authorities are allowed to use the long run average cost of asset renewals as an alternative to depreciation charges. To use this approach, the local authority must develop a twenty-year capital plan. In the case of long life assets, the twenty-year plan has not provided a realistic estimate of the average annual renewals cost. Conversely, where a realistic depreciation charge is set and funded, local authorities have complained that very large reserve funds will accumulate long before they are needed.

Accounting reforms in the United States are similar.¹²⁹ The requirement for full accrual accounting by local government was established by the U.S. Government Accounting Standards Board (GASB) in *GASB Statement No. 34*, which concluded that reporting infrastructure assets is essential to provide information for assessing financial position and changes in financial position, and for reporting the costs of programs or functions.¹³⁰ Asset reporting requirements are retroactive to 1980 for large municipalities but not for those with less than \$10 million in annual revenues. As in New Zealand, an alternative approach is approved for infrastructure assets.

In the U.S., governments may choose to report expenses for repairing and maintaining infrastructure instead of depreciation expense for that infrastructure provided they manage the infrastructure using a suitable asset management system including an assessment of the physical condition of assets every three years; and establish a minimum condition level for those assets and demonstrate that it is maintaining those assets at or above that condition through appropriate investments.¹³¹

Asset management planning figures prominently in both the New Zealand and U.S. approaches. In New Zealand it is mandatory, and in the U.S. it is mandatory so long as depreciation is not charged for infrastructure. As a source of information on the condition of infrastructure, asset management planning goes well beyond fixed asset accounting in that it requires an assessment of the physical condition of the infrastructure. Fixed asset accounting uses accounting standards and conventions as a basis for estimating depreciation charges, and therefore provides only a proxy measure of the condition of physical assets. Asset management planning goes one step further by developing a strategy and financing plan for asset maintenance and replacement. In contrast, fixed asset accounting generates cash funds that are available for capital finance, but this doesn't mean that they will be used for that purpose or that they are needed when received.¹³² Asset management planning is therefore a more effective tool than fixed asset accounting as a means of providing information on the condition of infrastructure and the fund-

¹²⁷ Pallot, J. (2001).supra footnote 26.

¹²⁸ Office of the Controller and Auditor General of New Zealand (1999). *Reports to Parliament*, Second Report for 1999.

¹²⁹ ICMA, *GASB: What it Means For You*, Service Report, Vol. 332, No. 12, Dec. 2000 (Washington: International City/County Management Association).

¹³⁰ Johnson, L.E. and D.R. Bean (1999). “GASB Statement No. 34: the Dawn of a New Governmental Financial Reporting Model” *The CPA Journal*.

¹³¹ Government Accounting Standards Board (2001). “New rules for reporting infrastructure information enacted for State and local governments.” www.rutgers.edu/Accounting/raw/gasb/repmodel/infrastructure.html; and Patton, T.K. and P.S. Wardlow (1999). “Why Infrastructure Reporting?” *GASB Action Report* 16(5), www.rutgers.edu/Accounting/raw/gasb/repmodel/viewpoints.html.

¹³² Jordan, J.L. (1995). “Do you use your depreciation funds wisely?” *Opflow*, 21(12).

ing required for its maintenance. Financial accounting for fixed assets based on an accrual system of accounting can be useful but is not necessary for this purpose.

D.5 Financial Reporting Practices

In general, the following three objectives should be met in the financial reports produced by municipal governments.¹³³

- Financial reporting practices should provide information to determine whether current revenues are sufficient to pay for current year expenditures. This would improve transparency and provide an incentive for municipal officials to be accountable for their actions.
- Municipal financial reporting should provide information about the sources and uses of financial resources and about how the government financed its activities and met its cash requirements. Financial reporting should also provide information necessary to determine whether the jurisdiction's financial position improved or deteriorated as a result of the current year's operation.
- Financial reports should provide enough information for users to assess the ability of the municipality to meet future commitments. This should include information about the financial position and condition of the municipal government, about the physical and non-financial resources that have useful lives that extend beyond the current fiscal year.

Requirements that municipalities report all budgetary information, the extent to which their budgetary goals were met and information on performance measures (discussed in the next section) to the local citizens on an annual basis should improve the efficiency, accountability and transparency of local government activities. This reporting could take a variety of forms including mail outs to all residents; through tax and/or utility bills; notices in local newspapers; and postings on the municipality's website.

E. The Budget As A Monitoring Instrument

Municipal budgets, accounting systems, and financial reports are all necessary ingredients for monitoring a municipality's behaviour. Of particular importance are performance based budgets. Local governments in Australia and New Zealand have developed fairly extensive performance based budgets and processes.¹³⁴ Municipalities in the province of Ontario, Canada are now required to provide performance measures for a wide range of municipal services.

Further restrictions have been placed on the behaviour of local governments through legislation that requires municipalities to enter into competitive tendering for the provision of municipal services. This has happened in Great Britain. In New Zealand, recent legislation has had a significant impact on the way services are provided but it does not go as far as Britain in requiring mandatory competitive tendering. Here, delivery exclusively by local council departments declined from 70 percent in 1989 to 26 percent in 1994 while delivery by business units rose from 2 percent to 18 percent.¹³⁵ The core services of water supply, sewage systems, stormwater and drainage were delivered by business units in over 50 percent of the councils surveyed while the majority of councils that provided legal services, refuse collection, commercial forestry and refuse disposal used external providers.¹³⁶ In the province of Ontario (Canada), the list of contracted out services is likely to expand as a result of the *Public Sector Accountability Act* which requires public sector agencies (municipalities, hospitals, school boards, universities and social services agencies and other large public institutions) to consider hiring private firms to lower costs.

E.1 Performance Measures

Performance measurement is relatively new at the municipal level although its importance has been widely recognized for some time.¹³⁷ A performance measure, if correctly set, records the output rather than the input of municipal spending on specific programs or services. *Table 11.6* describes a number of municipal services for which performance measures could be calculated. Where performance measures are required, municipalities are also required to report the results annually to taxpayers.

¹³³ Robert A. Reny, "Municipal Accounting" in Jack Rabin et al, editors, *Budget Management* (Athens, Georgia: Carl Vinson Institute of Government, 1983), p. 120; and reported in Schaeffer (2000), supra footnote 15, at 10.

¹³⁴ Ed Campos and Sanjay Pradhan (1996), *The Impact of Budgetary Institutions on Expenditure Outcomes: Binding Governments to Fiscal Performance* (Washington, D.C.: The World Bank), at 29.

¹³⁵ Department of Internal Affairs (1994), "Territorial Authority Service Delivery 1993-1994" (Wellington, N.Z.; Department of Internal Affairs).

¹³⁶ Pallot (2001), supra footnote 26.

¹³⁷ Harry Hatry, *Performance Measurement* (1999), (Washington, D.C.: The Urban Institute Press.)

Implementation of a performance measurement system has a number of advantages. It permits local officials and taxpayers to monitor the municipality's public sector activities over time and vis-à-vis each other (sometimes referred to as benchmarking).¹³⁸ It strengthens accountability because taxpayers will be in a better position to evaluate the services provided by the municipality given the cost of producing these services and therefore, in a better position to judge whether local service provision is effective and efficient. Performance measures reinforce managerial accountability¹³⁹ and provide an incentive to stimulate staff creativity and productivity. Finally and as mentioned earlier, performance measures help municipalities develop budgets based on realistic costs and benefits rather than on historical patterns (incrementalism). When combined with benchmarking, performance measures provide a more competitive environment in which municipalities will operate, thus leading to more cost efficient ways of providing services.

Performance measures require accurate and complete data on input costs and measures of outputs. Input costs include the total cost of an activity. Measures of output, which is the denominator of the unit cost ratio (total costs divided by output), may be relatively straightforward for services such as sewage disposal, garbage collection, snow removal, and water provision - services in which the unit of output subject to quality standards can be measured. Output measures, however, are considerably more difficult to measure for education, social services, crime prevention and fire protection where the unit of output is not clearly defined. For example, what is the unit of output for education - number of students taught annually or number of students who passed? What is the output measure for crime prevention? How is fire prevention measured? What is the output measure for social services? Obviously, these are difficult measures to develop. In spite of potential measurement problems especially with the so-called 'soft services', attempts should be made to establish surrogate output measures subject to quality standards. Recognizing the subjectivity inherent in defining output measures for services of this nature, these are necessary if one is to establish targets or goals as benchmarks against which comparisons of actual performance may be measured to assess the technical efficiency and effectiveness of providing local public services.

While technical efficiency¹⁴⁰ is an important ingredient of a performance measurement system, performance measurement also is used for measuring the effectiveness of municipal services. The term effectiveness measures the extent to which an activity contributes to the achievement of the stated goals, objectives, or targets. For example, an activity such as building a road may be very efficient in terms of cost per kilometer, but its effectiveness will depend on the usefulness of the road in providing convenience, safety, and economy for vehicular transportation. When a direct evaluation of the benefits arising from local services is not possible, the demand for services subject to quality standards might be measured through citizen surveys, studies of local economic conditions, reports on the number of applications, requests or complaints received, expert evaluations, and so on, of specific needs. In this way, a measure of the value of the service provided can be estimated. Thus, effectiveness will measure the success of not only doing things, but of doing them to citizens' satisfaction.

Table 11.6

Examples of Performance Measures

Service Areas	Intended results	Definitions
Solid Waste Management:		
- Operating cost for waste collection	Efficiency of municipal waste collection services	Operating cost for waste collection per tonne or household (if tonnage information is not available)
- Operating cost for waste disposal	Efficiency of municipal waste disposal services	Operating cost for waste collection per tonne or household (if tonnage information is not available)
- Operating cost for recycling	Efficiency of municipal recycling services	Operating cost for recycling per tonne or household (if tonnage information is not available)
- Test Results		Test results for solid waste disposal sites

¹³⁸ Vijay Jog, "Performance Measurement and The Municipal Sector", a presentation at the Ontario East Municipal Conference, Kingston, Ontario, September 21, 2000.

¹³⁹ Solano and Brams (1996), supra footnote 21, at 164.

¹⁴⁰ Technical efficiency measures the relationship between inputs and outputs. While this can be measured by the ratio of outputs to inputs (productivity ratio) or inputs to outputs (unit cost ratio), the latter tends to be used more commonly as an indicator of technical efficiency. An activity is defined as being more technically efficient if the output to input ratio rises or the input to output ratio declines.

Service Areas	Intended results	Definitions
<ul style="list-style-type: none"> - Complaints concerning the collection of garbage and recycling - Waste diversion rate (a) - Waste diversion rate (b) 	<p>Effectiveness: municipal solid waste services do not have an adverse effect on the environment</p> <p>Effectiveness: municipal solid waste services meet household needs</p> <p>Effectiveness: municipal waste reduction programs divert waste from landfills and/or incineration</p> <p>Effectiveness: municipal waste reduction programs divert waste from landfills and/or incineration</p>	<p>Number of complaints concerning the collection of garbage and recycling per tonne or per 1000 households</p> <p>Percentage of residential solid waste diverted for recycling and tons of waste recycled</p> <p>Percentage of commercial, industrial and institutional solid waste diverted for recycling and tons of waste recycled</p>
<p>Sewage:</p> <ul style="list-style-type: none"> - Operating costs for collection - Operating costs for treatment and disposal - Sewer-main backups - Test results - Untreated sewage released 	<p>Efficiency of municipal sewage and stormwater collection</p> <p>Efficiency of municipal sewage treatment and disposal services</p> <p>Effectiveness: municipal sewage-management practices prevent environmental and human health hazards</p> <p>Effectiveness: municipal sewage-management practices prevent environmental and human health hazards</p> <p>Effectiveness: municipal sewage-management practices prevent environmental and human health hazards</p>	<p>Operating costs for collection of sewage and stormwater per kilometre of sewer lines</p> <p>Operating costs for treatment and disposal of sewage and stormwater per cubic metre treated</p> <p>Number of sewer-main backups per kilometer of sewer line</p> <p>Test results for sewage treatment operations</p> <p>Number of hours when untreated or partially treated human sewage was released into a lake or natural water course</p>
<p>Water:</p> <ul style="list-style-type: none"> - Operating cost for water treatment - Operating cost for water distribution - Approximate water loss - Test results - Water leaks - Boil-water advisories 	<p>Efficiency of municipal water treatment services</p> <p>Efficiency of municipal water distribution services</p> <p>Effectiveness: minimize water loss</p> <p>Effectiveness: water is safe and meets local needs</p> <p>Effectiveness: water is safe and meets local needs</p> <p>Effectiveness: water is safe and meets local needs</p>	<p>Operating costs for water treatment per million litres of water treated</p> <p>Operating costs for water distribution per kilometer of distribution pipe</p> <p>Percentage of water produced that is not billed</p> <p>Test results for water treatment plants and distribution systems</p> <p>Number of breaks in water mains per kilometer of water pipe</p> <p>Number of days when a boil-water advisory issued by the medical officer of health and applicable to a municipal water supply was in effect</p>

Service Areas	Intended results	Definitions
Transportation: - Operating cost for paved roads - Adequacy of roads - Operating cost for unpaved roads - Operating costs for winter control of roadways - Effective snow and ice control for winter roads - Conventional transit ridership per capita - Operating costs for conventional transit	Efficiency of municipal paved (hard top) road maintenance services Effectiveness: safe and secure roads Efficiency of municipal unpaved road maintenance services Efficiency of municipal winter road maintenance services of roadways Effectiveness: safe and secure roads Effectiveness: maximum utilization of transit services Efficiency of municipal transit services	Operating costs for paved roads per lane kilometer Percentage of paved-lane kilometers of roads rated adequate Operating costs for unpaved roads per lane kilometer Operating costs for winter control maintenance of roadways per lane kilometre Percentage of winter-event responses that meet or exceed municipal road-maintenance standards Number of conventional transit passenger trips per person in service areas Operating cost for conventional transit per regular-service passenger trip
Fire: - Operating costs for fire services - Fire loss	Efficiency of municipal fire services Effectiveness: minimize loss of property due to fires	Operating costs for fire services per \$1,000 of assessment Total dollar loss due to structural fires, averaged over three years, per \$1,000 of assessment
Police: - Operating costs for police services - Cases cleared	Efficiency of municipal police services Effectiveness: safe communities	Operating costs for police services per \$1,000 of assessment Percentage of cases cleared for each of the following categories: violent crimes, property crimes, other Criminal Code crimes (excluding traffic), Criminal Code traffic, drugs, crimes under other government statutes
General Government: - Operating costs for municipal administration - Operating costs for council members	Efficiency of administration supporting local service Efficiency of municipal council	Operating costs for municipal administration as a percentage of total municipal operating costs Operating costs for members of council per capita and as a percentage of total municipal operating costs
Land Use Planning: - Percentage of new lots created - Percentage of agricultural land retained in an agricultural designation	Effectiveness: new lot creation in settlement areas Effectiveness: preservation of agricultural land	Number and percentage of new lots approved that are located in settlement areas Percentage of agricultural land preserved

Ontario Government, Ministry of Municipal Affairs and Housing, (January 2001) *Municipal Performance Measurement Program* (Ontario: The Ministry), at 8-10.

F. Summary

There is no singular or uniform approach to the constitutional status of municipalities in the six Federalist countries examined - Australia, Germany, Switzerland, United States, South Africa, and Canada. In some countries, municipalities are explicitly recognized in the constitution, while in others, they are not. Regardless of their constitutional status, however, municipal expenditure responsibilities and access to revenue sources are strictly controlled by the province/state/canton/lander.

Within this restrictive environment, variation does exist in municipal spending responsibilities – social services and income distributional programs, for example, are a partial funding responsibility of municipalities in some countries and not in others. Similar variation is noted in access to local taxes. In three of the countries (Australia, Canada, South Africa), municipalities have access to the property tax only. In the other three countries, municipalities have access to income and/or sales taxes as well. In addition, municipalities in all countries rely on user fees and grants from senior levels of government with the relative importance of the latter varying from country to country and generally dependent on the types of spending responsibilities assigned to municipalities.

Because municipalities are responsible for a range of services, budgets are needed to plan for and control the receipt and expenditure of monies. In practice, there are two budgets – an annual operating or current budget that consists of projected revenues and expenditures and a capital budget that lays out future capital expenditure projects and anticipated revenues for funding these projects. As distinct from senior levels of government, municipalities are not permitted to budget for an operating deficit – hence, long term borrowing for operating purposes is not permitted. For capital purposes, however, long-term borrowing is used although it is subject to a variety of controls and restrictions in every country.

In recent years, municipal budgets have become more sophisticated and comprehensive in their design and hence, more useful as a management tool for controlling municipal expenditures and for assisting in municipal decision-making. More emphasis is now placed on the importance and usefulness of designing budgets to reflect past and projected expenditures on outputs or goals to be achieved rather than on the cost of inputs. The establishment of targets or workloads (goals) permits local decision-makers to make decisions on the basis of both efficiency (costs) and effectiveness (returns).

Quantification of targets or workloads requires data on both inputs and outputs for it is the ratio of inputs to outputs that defines the target to be met. Once these targets have been established, municipal spending activities must be monitored to ensure that targets are met or that changes of a justifiable nature are incorporated into the budget. Implementation of a performance measurement system based on carefully defined targets has a number of advantages. It permits local officials and taxpayers to monitor the municipality's public sector activities over time and vis-à-vis each other (sometimes referred to as benchmarking). It strengthens accountability because taxpayers are in a better position to evaluate the services provided by the municipality given the cost of producing these services and therefore, in a better position to judge whether local service provision is effective and efficient. Performance measures reinforce managerial accountability and provide an incentive to stimulate staff creativity and productivity. Finally, performance measures help municipalities develop budgets based on realistic costs and benefits rather than on historical patterns. When combined with benchmarking, performance measures provide a more competitive environment in which municipalities operate, thus leading to more cost efficient ways of providing services.

While the budget is the heart of municipal resource administration, municipal accounting systems and practices and their subsequent reports are central to the budget-making process. For example, past accounting records furnish important data for revenue and expenditure forecasts used to construct the budget. Accounting records provide information on debt and debt service charges and serve as a basis for estimating a municipality's ability to carry further debt. Sound accounting reports provide timely information on whether budget plans are on target or amiss, when capital funds are diverted to operating expenditures, when expenditures are outpacing revenues, and when the municipality is incurring financial obligations beyond its fiscal capacity. The focus of reporting and accounting, then, is to document, classify and summarize transactions so users of the resulting financial reports are able to understand and evaluate municipal operations.

Municipal accounting differs from private sector accounting because the emphasis in the former is on cash flow, and transparency and accountability to the local constituency while the emphasis in the latter is on profit or loss reporting. The basic difference between municipal accounting systems and personal/business accounting is the use of fund accounts. Under fund accounting, a separate fund is used to report financial transactions for a particular aspect or activity of government such as water or sewage operations. The fund basis of accounting recognizes that most government assets are not fungible – that is, available for purposes other than those budgeted – and that data on budgeting compliance are an important part of the stewardship responsibility of government. Distinct fund accounting and reporting is necessary to control resources for their designated use and to demonstrate compliance with legal and budgeting constraints affecting municipal governments.

Cash accounting, accrual accounting and modified accrual accounting form three possible accounting bases used by municipalities. Cash accounting, however, is the weakest of these alternatives because it often fails to provide a true or complete picture of the financial health and fiscal sustainability of the municipality. This, and a concern that municipalities do not have reliable information on the age and quality of much of the local infrastructure (especially that which is underground – water and sewer pipes) has motivated senior levels of govern-

ment in some countries to pass legislation requiring municipalities to move to full accrual accounting or a version of it that would provide local decision-makers with more reliable information for making efficient and effective decisions in managing municipal assets.

Chapter 12. Municipal Governance in Canada, United States, France and Pakistan: Some Lessons for Russia

Introduction

The purpose of this paper is to examine the responsibilities and associated financing found at the municipal level in Canada, the United States of America, France and Pakistan. These four countries were selected for two reasons. First, they are well known to the authors and the information on them is available in either English or French. Second and more importantly, they present a range of institutional arrangement susceptible of yielding lessons useful to Russia. Canada and the United States are mature federations of a physical size that is similar to that of Russia; they can thus be seen as possible models for the long term. France and Pakistan are, respectively, a unitary country and a federation where attempts are made to change the municipal sector; they may thus yield lessons on transition paths. The paper is divided in four main sections, one for each country, followed by a lessons and conclusion section. Each country section examines the legal framework within which municipalities functions and the typical responsibilities of municipalities, as indicated by their expenditures and the associated revenues. The content of each sub-section will vary according to the nature of the institutional arrangements and the availability of data. Table 12.1 presents key characteristics of the four countries studied.

Table 12.1

Key Characteristics of Canada, United States, France and Pakistan,

2000

Country	Population	Size (KM ²)	Population Density	GDP US \$(000)	GDP per capita US \$
Canada	30 493 000	9 970 000	3.0	694 600 000	22 705
United States	274 028 000	9 363 123	29.3	8 018 600 000	29 710
France	58 683 000	547 026	107.3	1 321 100 000	22 464
Pakistan	144 616 000	803 940	179.6	282 000	195

Sources: Bird, Vaillancourt (2002) U.S. Census Bureau, Statistical Abstract of the United States: 2000 The World Factbook, CIA, 2000.

1. Canada :

Legal Framework :

Established since 1867, the Canadian federation counts today 10 provinces and 3 territories. Canada is the second largest country in the world with an area of 9 970 000 KM² and with a little more than 30 millions in population. 80% of Canada's population live in urban areas with nearly two thirds residing in 27 of these. Local government is currently organised in approximately 4500 local authorities.

The constitutional recognition of local government as an order of government in federal countries is a modern phenomenon.¹⁴¹ Thus, not surprisingly, the Canadian constitution adopted in 1867 identifies local authorities as an exclusive function of the provincial level. Provincial legislation and regulations determine the expenditures and revenues generated by Canadian municipalities. This means that municipalities are « creatures of the province» and can or will do whatever it is that province permits or requires them to do.¹⁴² Constitutional recognition of the municipal sector has been raised when constitutional amendments were discussed in 1981, 1987 and 1992 but nothing came of it.

Since local government is an exclusive provincial function, there is a wide array of municipal organisation across the country. For example, in British Colombia three types of local authorities are to be found: incorporated municipalities, regional districts and improvement districts. Most provinces make a distinction between cities and other municipalities. Winnipeg in Manitoba and Montreal in Québec are “charter-cities”. Based on the policy that

¹⁴¹ Steytler (2002) paper prepared for the Forum of Federations: An International Network on Federalism.

¹⁴² Kitchen (2002)

one legislative framework does not fit all municipalities, charter status recognises the uniqueness of a city and customizes the governing legislation to the needs and responsibilities of a particular city.

Each province decides its number of municipalities, shown in table 2 for 1999; this number can change over time. For example, in the province of Ontario, the number of municipalities declines from 815 in 1995 to 537 in 1999 while the province of Québec had 1451 municipalities in 1999 and 1130 in 2002. In 1999, almost 85% of municipalities, where 21% of Québec's population lives, had less than 5000 residents and 58% less than 2000.

Table 12.2

Number of Local Governments by provinces Canada,1999

Provinces	Total	Per capita
Canada	4672	1/6527
Newfoundland	466	1/1160
Prince Edward Island	75	1/1834
Nova Scotia	55	1/17085
New Brunswick	103	1/7324
Quebec	1451	1/5065
Ontario	537	1/21457
Manitoba	199	1/5740
Saskatchewan	836	1/1226
Alberta	361	1/8198
British Columbia	455	1/8852

Source: *Finances of the Nations*, Canadian Tax Foundation, 1999 Statistics Canada, Cansim 2, Matrix 051-0001

At the national level, the interest of local governments are advanced by the Federation of Canadian Municipalities, a voluntary self-financing association of 1000 municipalities representing 80% of the Canadian population. At the provincial and territorial level, municipalities are also organised in voluntary bodies, like the "Association of municipalities of Ontario" or the "Union des municipalités du Québec".

Intergovernmental relations between the local level and the others level of government in Canada are mainly with the provincial authority. In some provinces, the relationship between local and provincial have been formalised. In Québec, there is the "Pacte municipal" while in British Columbia the provincial government and the Union of British Columbia Municipalities signed in 1996 a protocol of recognition for local government as an « independent, responsible and accountable order of government ». The protocol states that:

- There must be a clear division of responsibilities which leaves the Province and the local governments accountable for specific policies and gives them the authority and the financial capacity to effectively perform their role ;
- For matters that local governments are responsible for, they must have adequate authority and independence to act ;
- New responsibilities will not be allocated without discussing the required funding thereof ;
- Proposed significant changes in legislation, policy or programs must be preceded by consultation.

The third item alleviates the problem of « unfunded mandates », that is when a province increases the responsibilities of municipalities, without increasing their revenues.¹⁴³

Given the fact that local governments fall within the exclusive control of the provinces, the capacity of the federal government to interact directly with municipalities is limited. Note, however, the May 2002 statement by the federal minister of Finance: « Equally compelling is the fact that local governments are being asked to do more than ever before in our history...these challenges simply cannot be met just with the property tax base, user fees and development charges currently at your disposal...The fact is that a New Deal now provides Canadians with a new capacity to move together as a country, seeking national objectives at the local level. »¹⁴⁴

There are two approaches to municipal powers. The first is the so-called "laundry list", municipalities have only those powers that are specifically granted and the ultra vires doctrine applies. This approach is followed in Ontario. The second approach is to grant municipalities plenary powers. In 1995 Alberta introduced the "natural person" powers that give municipality the powers of a natural person unless specifically excluded by legislation. Legislation in British Colombia gives municipalities broad powers including those facilitating public-private

¹⁴³ Hyman and Strick (1994), p. 171.

¹⁴⁴ Speech by Paul Martin, Minister of Finance for Canada, 2002

partnerships and giving more flexible revenue raising authority. A further variation is that some provinces are making a distinction between cities and other municipalities. The “charter-cities”, mentioned above, are given greater powers than other municipalities in their provinces, although they must still obtain the consent of the provincial authority prior to introducing new revenue sources and new regulations.¹⁴⁵

To present the different functions and powers of the local government is preferable to use expenditures and revenues of municipalities, since responsibilities are different for a province to another. The local authority powers varied widely between provinces.

Expenditures:

Table 12.3 represents the overall expenditures of municipalities. If we look at expenditures of municipalities per capita, we note a large difference between Canadian provinces. This depends of many factors, such as different responsibilities, higher costs or greater needs (urban regions). Thus, in 2000 the expenditures in Prince Edward Island are 245 US\$ per capita while in Ontario they are the highest, at 1287 US\$, a difference of 1000 US\$ per person. One partial explanation is the greater use of volunteers to produce public services such as fire fighters in PEI than in Ontario. Between 1988 and 2000, expenditures per capita of municipalities increased; the biggest increase is in Ontario and British Columbia. Measured in Canadian \$ they increased by 44% while the CPI increased by 33%. Expenditures as a percent of gross domestic provincial product (GDPP) reflect the relative importance of this sector within a province.

Table 12.3

Canada, Municipal expenditures by province, 1988 and 2000

Provinces	(2) 1988 per capita (US\$)	(3) 2000 per capita (US\$)	(4) 1988 % of GDPP	(5) 2000 % of GDPP
Newfoundland	462	456	4.0	3.0
Prince Edward Island	207	245	1.8	1.7
Nova Scotia	710	686	4.5	4.3
New Brunswick	453	559	3.3	3.4
Québec	823	839	4.9	4.5
Ontario	970	1287	4.6	5.6
Manitoba	715	761	4.5	4.2
Saskatchewan	669	697	4.5	3.5
Alberta	1073	1053	5.2	4.0
British Columbia	682	852	3.8	4.2
Average-Canada	850	1004	4.6	4.8

Source: Kitchen (2002), column 2,3,4 and 5 in Canadian dollar

Exchange rates: 1988: 1\$US = 1.217\$CAN

2000: 1\$US = 1.478\$CAN

We have to underline the fact that the municipal sector of the province of Ontario grew more than that of any other province over the past 12 years. By and large, this change was driven by a number of provincial initiatives introduced in 1998. The province took over direct tax funding of elementary and secondary public schools by imposing a province-wide education (property) tax. Having done this, and to meet its objective of maintaining revenue and expenditure neutrality¹⁴⁶ in provincial-municipal responsibilities, the province transferred to municipalities responsibilities for a wide range and variety of services with little say in services standards (social housing, 50% of land ambulances, 50% public health prevention, provincial highways).¹⁴⁷ Note here that since these various responsibilities have different expenditure growth rates, notional revenue neutrality (that is the one calculated for a given cost/quantity goal) may be met. However, actual revenue neutrality is not observed in a given

¹⁴⁵ Steylerr (2002) paper prepared for the Forum of Federations: An International Network on Federalism

¹⁴⁶Revenue neutrality in public finance is when various tax mixes are examined under the constraint that they all yield the same total amount of revenue. In this case, it is used to denote a situation where various mixes of spending by local governments were considered, with the total amount unchanged

¹⁴⁷ Kitchen (2002)

year. *Table 12.4* presents expenditures by municipal functions for Canada as a whole, and for the two largest provinces, Ontario and Québec.

The following points are drawn from it:¹⁴⁸ :

- Social services (welfare) are not the responsibility of municipalities, except for the province of Ontario. Elsewhere, they are an exclusive or quasi-exclusive provincial responsibility ;
- Health expenditures are small, mainly for preventive health programs;
- Expenditures on transportation, protection and environmental services account for over 50 percent of municipal expenditures in every province;
- Expenditures on recreation and cultural services account for between 8% and 12 % of municipal spending in all provinces;
- Debt charges show considerable variation, debt is incurred only for capital projects since municipalities are not permitted to borrow for, nor incur budget operating deficits.
- Difference in debt charges between Québec and Ontario is due in part to the financing of infrastructures in new developments by the municipalities in Québec and by developers in Ontario(public versus private debt).

Table 12.4

Municipal Expenditures by functions, Canada, Ontario and Québec, 1988 and 2000

	1988 Québec	1988 Ontario	1988 Canada	2000 Québec	2000 Ontario	2000 Canada
Per capita expenditures (US \$)	671	970	780	834	1287	831
Percentage growth, 1988 to 2000	-	-	-	24.3%	61.9%	30.0%
Distribution of spending %:						
General administration	13.1	8.7	9.9	13.4	9.4	11.0
Protection	14.4	15.0	14.8	18.6	14.2	15.9
Transportation	22.5	21.6	22.3	23.5	17.4	19.8
Health	0.1	2.9	2.0	0.1	3.3	2.0
Social services	0.5	14.6	7.4	0.8	25.0	12.6
Resources conservation	1.3	2.4	2.1	2.2	1.5	2.0
Environment	15.9	14.2	14.6	12.9	12.2	14.0
Recreation/ culture	9.7	11.2	11.6	11.9	8.4	11.1
Housing	2.6	2.3	1.8	3.3	3.5	2.6
Regional planning	1.9	1.9	2.1	2.2	2.0	2.2
Debt charges	14.1	4.1	9.5	10.6	2.8	5.9
Other	4.0	1.2	2.0	0.4	0.3	0.9
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Kitchen (2002), Appendix table 2 in Canadian dollar

Exchange rates: 1988: 1\$US = 1.217\$CAN

2000:1\$US = 1.478\$CAN

Revenues :

Revenues of Canadian municipalities are broadly divided between grants (transfers), which can be conditional or unconditional, and “ own source” revenues, which include property taxes and user fees. Conditional transfers must be spent according to the priorities of the government providing the transfer. The “condition” can be more or less vague (general area, specific program, precise item, ...). Unconditional, or general-purpose transfers, may be spent according to the recipient government’s priorities or, as is sometimes the case, simply used to provide tax relief

The importance of the two types of revenues for 2000 is 17.9% in transfer mainly from provincial government and the 82.1 from own source municipal resources¹⁴⁹.

¹⁴⁸ Kitchen (2002)

Table 12.5 presents the revenues of municipalities and their evolution between 1988 and 2000 for Canada, Ontario and Québec.

This table shows that:

- The proportion of transfers and own sources of revenues has changed in the last 12 years with an increase of 5.0% points of own sources of revenues for Canada and 7% points for Ontario. This increase is due principally to property tax revenues;
- The other major component of own sources, user fees, has been stable for the past 12 years, with a small increase of 1.3% points for Canada and a little drop of 0.4% for Ontario;
- Unconditional transfers drop for Ontario but not for Québec.

Table 12.5

Municipal Revenue Sources and Their Distribution Canada, Québec and Ontario, 1988 and 2000

	1988 Québec	1988 Ontario	1988 Canada	2000 Québec	2000 Ontario	2000 Canada
Revenues sources (%)						
Property taxes	68.8	41.7	48.6	67.3	49.8	53.3
Other taxes	1.0	1.3	1.4	0.3	1.3	1.3
User fees	16.5	20.0	20.0	16.9	19.6	21.3
Investment income	3.0	5.1	6.0	2.3	4.3	5.0
Other	2.0	0.7	1.1	2.4	0.8	1.2
Total of own source revenues	91.3	68.8	77.1	89.1	75.8	82.1
Grants						
Unconditional	0.5	7.3	5.8	0.8	3.3	2.7
Conditional	8.3	23.8	17.1	10.0	20.9	15.2
Total	8.7	31.1	22.9	10.9	24.2	17.9
Total revenue	100.0	100.0	100.0	100.0	100.0	100.0

Source : Kitchen (2002), Appendix table 3

1. *United States of America* :

Legal Framework

Established since 1789, the United States of America is the oldest federal republic comprised of 50 states and a federal district, Washington DC. This country has an area of 9 363 000 KM² with a population of 274 028 000, more than 9 times the Canadian population. More than 80% of the population lives in 329 metropolitan areas. In 1997 there were 87 453 local government of various types.¹⁵⁰

Like the Canadian Constitution, the American Constitution does not recognise local authorities; it considers them a responsibility of the states. The municipalities are “creature of the states” that are recognised in state constitutions. In this regard, the USA states are different than the Canadian provinces in having their own distinctive constitutions. The state constitutional provisions have three general aims. First, creating and protecting local autonomy, second, enshrining political accountability for certain activities and third regulating and controlling finances. Local autonomy is usually referred to in the state constitutions as “home rule”, or more recently “local self-government”.

To date, 36 states have adopted home rule provisions in their constitutions while a further 12 have home rule by statute.¹⁵¹ For example, the Illinois State Constitution defines home rule powers as: “a home rule unit may exercise any power and perform any function pertaining to its government and affairs including, but not limited to, the power to regulate for the protection of the public health, safety, morals and welfare; to licence; to tax; and to incur debt”¹⁵². The principal strength of home rule provisions is to give communities substantial freedom to shape the structure of local government institutions. With regard to functional powers, conflicts between state and local enactment are usually resolved in favour of the state.

Table 12.6 presents numbers for the United States and for 5 large states; evidence for all 50 states is found in Appendix table 1. In 1997, 87 453 local government structure was divided in 3 043 counties, 19 372 munic-

¹⁴⁹ The oldest and most important federal transfer to municipalities is a grant in lieu of taxes for federal buildings located in a given municipality :see Kitchen and Vaillancourt (1990).

¹⁵⁰ Steytler (2002) paper prepared for the Forum of Federation : An International Network on federalism.

¹⁵¹ Steytler (2002) paper prepared for the Forum of Federation : An International Network on federalism.

¹⁵² Constitution of the state of Illinois, article 7, Local Government.

palities, 16 629 towns and townships, 34 683 special districts and 13 726 school districts. There are also an estimated 180 000 semi-private residential community associations that provide a limited number of community-type services.¹⁵³

Table 12.6

Number of Local Governments in Five US States and US 1997

States	All govern- mental units	County	Municipal	Township	School District	Special Dis- tricts	Unit per capita municipal
US	87453	3043	19372	16629	13726	34683	1/14146
California	4607	57	471	-	1069	3010	1/68509
Michigan	2775	83	534	1242	584	332	1/18303
New York	3413	57	615	929	686	1126	1/29491
Ohio	3597	88	941	1310	666	592	1/11887
Pennsylvania	5070	66	1023	1546	516	1919	1/11749

Source: U.S. Census Bureau, Statistical Abstract of the Unites States, table No. 26 and No 491. www.census.gov

Each state is divided in counties, except the states of Connecticut and Rhode Island. Counties were first seen as a political subdivision of the state administration, but they have changed in most states to local self-government that may adopt home rule charters. The number of county governments per state ranges widely. Texas has the highest total at 254 while several states have fewer than 20. The average population served by a county government for the US as a whole is 79 100.

Municipal governments are political subdivisions within which a municipal corporation has been established to provide general local government for a specific population concentration in a defined area. The number of municipalities per state also varies widely. Illinois Texas and Pennsylvania each has more than 1000 while at the other extreme are eight states with fewer than 50 municipalities. In the United States, nearly 164 million people live in areas with municipal governments.¹⁵⁴

Township governments exist to serve inhabitants of areas defined without regard to population concentration, as distinguished from municipal governments. Township governments are found in the northeastern and north central states.

Special district governments are independent, limited-purpose local governmental units that exist as separate legal entities with substantial administrative and fiscal independence from general purpose governments. Most perform a single function (social housing, fire protection, public library, public hospital,..), but in some instances their enabling legislation allows them to provide several, usually related, types of services.¹⁵⁵

The main association is The National League of Cities which group together 49 state municipal league and approximately 1800 members cities town and villages. The principal mandate of this association is to improve the relationship between the different level of government, mainly by conflict resolution.¹⁵⁶

Each state decides the functions and services offered by the municipalities. To avoid the problem of unfunded mandates, some states introduced constitutional limits. For example, a 1978 amendment to the Hawaii Constitution requires that when the state imposes a new function or increases the required level of a service, such determination must also provide that the state shares in cost. The New Mexico Constitution was amended in a similar vein in 1984.

Local governments are the dominant provider of the following services: primary and secondary education, utilities, police protection, fire protection, sewage, other sanitation, parks and recreation and libraries. As well, the three levels of government, acting in varying forms of partnership, provide certain services summarised in the table 12.7:

Table 12.7

Functions and powers

Federal/state/local	State/local	Federal/local
Health services	Roads	Provision of housing
Environmental protection	Streets	Community development
Financial and judicial administration	Highways	Airports and transportation services

Source: Kitchen (2002)

¹⁵³ Steytler (2002) paper prepared for the Forum of Federations: An International Network on Federalism.

¹⁵⁴ Steytler (2002) paper prepared for the Forum of Federations: An International Network on Federalism.

¹⁵⁵ Compendium of Government Finances, Census of Governments, U.S. Census Bureau.

¹⁵⁶ Giuliano (2002) Speech for « Cities and Federalism »Conference

Expenditures :

Table 12.8 presents the relative importance of local expenditures for the USA as a whole and for each of five states, California, Michigan, New York, Ohio and Pennsylvania :we note that all five states have lower per capita expenditures than the average state in the USA. This may be due to the fact that they are larger than the average sate and can thus benefit from economies of scale.

Table 12.8

Local Government Expenditures and Distribution in Five US States and Total US 1996 (%)

Functions	US Total	California	Michigan	New York	Ohio	Pennsylvania
Per capita expenditures	3.120	2.179	1.436	2.905	1.400	1.291
Administration	8.0	9.9	11.1	5.2	12.1	10.1
Protection	17.3	18.8	16.2	16.9	18.7	15.2
Transportation	12.1	8.4	12.7	8.9	10.8	9.0
Health	5.6	6.0	11.3	3.2	9.9	7.8
Hospitals	9.5	8.1	4.3	8.1	4.9	1.1
Public Welfare	4.4	14.9	3.5	16.3	9.8	9.2
Environment	18.1	19.7	17.9	16.3	18.5	20.8
Libraries	1.0	1.0	1.8	1.2	1.8	1.0
Interest on debt	8.5	6.9	7.6	8.5	5.7	14.3
Others	15.5	6.0	13.3	15.1	7.8	11.4
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Kitchen (2002) Table 4 U.S. Census Bureau, Statistical Abstract of the United States: 2000, Table No 48 and No 494 www.census.gov.

Table 12.8 shows the following results :

- Protection, and environment are the two most important function in the USA as a whole and in all five states.
- The social services is the only function of local governments which shows big difference between states, ranging from 16.3% for New York state to 3.5% for Michigan state.

Revenues :

At the beginning of the 20th century local governments were almost entirely self-sufficient financially. A century later, they receive a third of its income from the state and the federal government, with the bulk coming from the states. While state constitutions may in principle provide that municipalities are authorised to levy and collect a wide array of taxes and fees, these powers are closely circumscribed either in the constitutions themselves or laws authorised by the constitutions. Rates on property have been the mainstay of own income of municipalities.¹⁵⁷

Table 12.9 presents local government revenues by source for the USA as a whole and the same five US states. Own source revenues account for the largest part of the revenues of American local authorities, usually in the 65-70% range while grants from the federal and state governments are in the 30-35% range. Property taxes and user charges tend to be the main own source revenue of the municipalities even in California, where proposition 13 adopted twenty years ago makes it difficult to have high property tax rates. Income taxes, found under the label other taxes and sales taxes are used but with great variability from one state to another. Finally, between 4.1% to 9.9% of revenues are from grants from the federal government comparatively to 24.1% to 36.0% from the states.

Table 12.9

Local Government Revenues, Distribution by Source, Five US States and USA, 1996

Source	US Total	California	Michigan	New York	Ohio	Pennsylvania
Local revenue source :						
Property taxes	23.7	13.8	24.4	21.3	16.3	16.5
Sales taxes	9.1	9.5	0.4	11.3	6.4	1.2
Other taxes	5.1	3.3	4.8	12.0	19.0	14.5
Charges (non-utility)	22.1	22.4	23.8	16.2	19.5	19.7
Other	9.8	10.9	11.7	6.8	9.4	12.4

¹⁵⁷ Steytler (2002) paper prepared for the Forum of Federations: An International Network on Federalism.

Source	US Total	California	Michigan	New York	Ohio	Pennsylvania
Total own sources	70.0	59.9	65.1	67.6	70.6	64.3
Grants :						
Federal	5.5	4.1	5.8	4.6	5.3	9.9
State	24.5	36.0	29.1	27.8	24.1	25.8
Total grants	30.0	40.1	34.9	32.4	29.4	35.7
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Compendium of Government Finances, Census of Governments, U.S. Census Bureau, Table 48.
www.census.gov

School district had be subtracted from the total:

US property taxes = Property taxes of local governments - Property taxes of school districts

208 524 416 - 92 722 086 = 115 802 330

US General revenue = local general revenue - school districts general revenue

747 030 290 - 257 342 476 = 489 687 814

% Property taxes =

US property taxes / US General revenues

$(115\,802\,330 / 489\,687\,814) * 100 = 23.648\%$

3. France

Legal Framework

France is a unitary republic with a low level of decentralisation. With a population of more than 58 millions and an area of 547 000 KM², French density is 106.7 people by kilometre in 2000.¹⁵⁸ From 1962 to 1999, France has become more and more urbanised. In 1999 with 48.8 millions inhabitants, the 354 urban area account for 83.3% of the French population¹⁵⁹. Municipal governments in France are extremely numerous cur as shown in *table 12.10* with almost 37 000 local authorities, or one per 1596 inhabitants.

Table 12.10

Number of Local Government , France 1999

Regional Level	Departmental Level	Community Level
26	100	36 779

Source: Mauroy (2000), p. 34.

France has approximately half of Europe's municipalities. While most European countries have reformed local authority in the half of the century and diminished the number of local governments, France has not done this but has carried out other reforms at the municipal level. The number of municipalities has gone from 37 708 in 1971 to 36 394 in 1999, a diminution of only 3%. In comparison, the 1975 reform in Belgium lowered the number of municipalities by more than 75% and the German reform of 1970 by 41%.¹⁶⁰

Municipalities provide , either alone or with other local authorities, public services. As shown in *table 12.11*, since 1972, France uses inter-municipal co-operation as a substitute to the amalgamation of municipalities to attain economies of scales and to account for externalities. This co-operation allows municipalities to manage facilities and public services jointly. Municipalities transfer powers to these inter-municipal groupings bodies and either financial resources or the power to raise their own taxes.

Table 12.11

Evolution of number of groupings of municipalities, France, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Own Taxes groupings	466	866	1102	1235	1446	1577	1681	1846	2000
Other groupings	5071	8973	11516	13566	16240	17760	19127	21328	23486
Population covered (millions)	16	22	25	27	30	31	33	37	40

Source: Direction générale des communautés locales (2002) www.dgcl.interieur.gouv.fr.

¹⁵⁸ État du Monde, Annuaire économique et géopolitique mondial, (2000)

¹⁵⁹ Julien (2000), p. 11

¹⁶⁰ Mauroy (2000), p. 35

There are three types of local governments. Municipalities are the smallest, but oldest of the French local governments, going back to Middle Ages cities and town. Since 1884, municipalities have been independent bodies.¹⁶¹ Departments (prefectures) are creations of the revolution; they became independent local bodies in 1871. Regions are the more recent French local government, becoming one in 1986.¹⁶² Relation between local bodies and the national state is handled by “La Direction générale des collectivités locales.

Expenditures:

French budgetary rules distinguish two sections in the local budget: the current expenditures section and the investment section. The current expenditures section includes salaries, interest payments and transfers¹⁶³ while the investment sections include capital outlays.

Table 12.12

Municipal, Departmental and Regional Expenditures in US \$ per capita, France, 2000

	Municipal	Department	Region
Current Spending Budget	862	415	99.5
- Personnel (1)	418	72	7
- Interest (2)	53	15	8
- Transfers (3)	163	124	75
- Social Services (4)	-	258	-
- Colleges (5)	-	19.5	-
- Secondary Schools (lycées) (6)	-	-	15
- Professional training(7)	-	-	38
Investment Budget	438	243	125
- Debt Refund (8)	123	76	31
- Equipment (9)	288	92	36
- Colleges (10)	-	28	-
- Secondary School (lycées) (11)	-	-	39
- Professional training(12)	-	-	2.3
Total	1301	658	223

Source: Direction générale de la comptabilité publique and Direction générale des collectivités locales. (2001) p. 53
www.dgcl.interieur.gouv.fr

Exchange rate: 1 Euro = 0.9785 US \$

Current spending section: (1)+(2)+(3)+(4)+(5)+(6)+(7)+ others(not shown here)

Investment section: (8)+(9)+(10)+(11)+(12)+others(not shown here)

Expenditures of the three different level of local government are linked to their responsibilities which are linked to their physical size. Hence, department are responsible for the construction and maintenance of colleges, while municipalities are responsible for these expenditure for primary schools.¹⁶⁴

Revenues:

Table 12.13

Municipal, Departmental, Regional Revenues in US \$ per capita, France, 2000

	Municipalities	Department	Region
Current spending Budget	1011	565	176
- Transfers (1)	205	114	47
- Taxes and Income Taxes (2)	622	398	123
- Direct Taxes (3)	437	239	68
- Charges (4)	-	33	-
- Real estate transfer taxes (5)	-	71	0.35
- Automotive registration fees(carte grise) (6)	-	-	13
Investment Budget	268	100	24
- Subsidies (7)	101	36	45
- Loan (8)	121	52	21
- Debt Total (9)	890	377	21
Total	1296	665	221

¹⁶¹ Direction générale des collectivités locales, Organisation territoriale (2000)

¹⁶² Direction générale des collectivités locales, Organisation territoriale (2000)

¹⁶³ Copé and Werner (1990) P. 18

¹⁶⁴ Direction générale des collectivités locales (2001)

Source: Direction générale de la comptabilité publique and Direction générale des collectivités locales. (2001) p. 53
 www.dgcl.interieur.gouv.fr www.finances.gouv.fr

Exchange rate: 1 Euro = 0.9785 US \$

Current spending section: (1)+(2)+(3)+(4)+(5)+(6)+others(not shown here)

Investment section: (7)+(8)+(9)+others(not shown here)

4 direct taxes included: housing taxes, property taxes built and unbuilt and professional taxes

Table 12.13 shows the importance of each source of revenues of local government. Municipalities have the biggest budget, at 1296 US\$ per capita, while at the regional level it is 1/6th at 221 US \$. The own sources of municipalities represented the most part of the revenues of French local authority. Transfers between government are used but less than other resources, like taxes.

Table 12.14

Relative importance of Local Taxes ,France 1998

	Income	Sales	Property	Other	Local taxes as a % GDP
France	0	10.2	50.6	39.1	4.7

Source: Kitchen (2002), p. 164

Table 12.14 represents the importance of each tax in French local revenues. In France, local governments do not have access to income taxes, like many other OECD countries. Property taxes accounts for more than 50 % of all local revenues and other taxes, mainly on business, for 39.1%. The main business tax is the «taxe professionnelle». This tax is a modern form of the «patente», an old tax applied to businesses on the basis of a table that listed specific amounts to be paid by for specific activities and size. It is imposed on the value of inputs, that is both capital and labour but the taxable share of labour is being reduced to 0% in 2003, progressively since 1999. As a result, this is mainly a tax on capital inputs and no longer a quasi-VAT.

4. Pakistan

This section of the paper differs from the previous three since we are describing the conception, birth and first year of existence of a new system of local governments.

Pakistan is under the 1973 constitution a two-tier federal state with 4 provinces, which are Punjab (57.3% of the population), the largest, Sindh (23.7%), North -West Frontier Province-NWFP (13.9%) and Balochistan (5.2%). One also notes the presence of the Islamabad Capital territory ,of the Northern territories and of Federally Administered Tribal Areas(FATA). Provinces can create both administrative units through decrees and local governments through local government ordinances (LGO); such bodies have no constitutional status.

In 2000, provinces (4) were divided into three levels of administrative units: divisions (26), sub-divided into districts (105), and the later subdivided into tehsils (354). These administrative units covered the whole of Pakistan's provinces

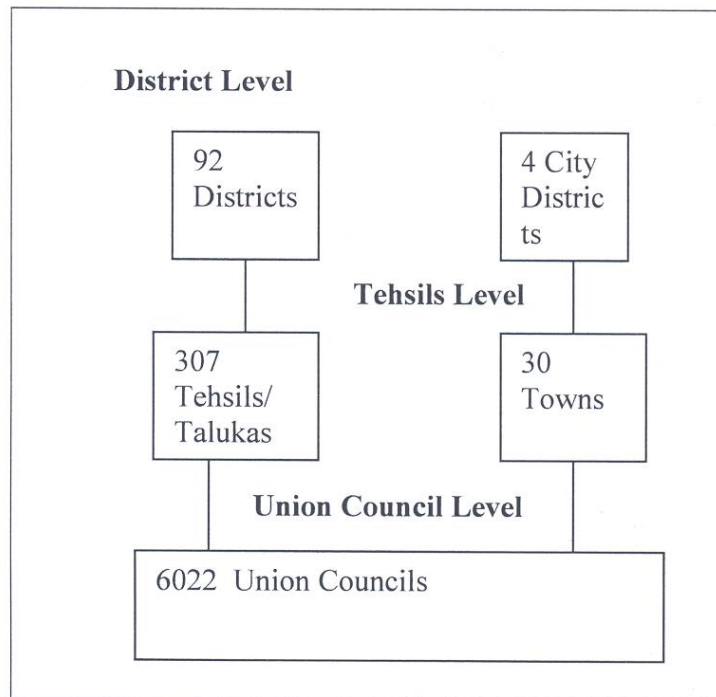
Local government bodies also existed mainly in urbanised areas (32.5% of the population lived in urban areas in 1998). Thus, in decreasing order of size, one encountered metropolitan municipal corporations, municipal corporations (, municipal committees and towns committees . There were and still are, untouched by the reform, cantonment boards (41), where un-elected Boards presided by the commanding officer, administer the civilian part of military cantonments. Such cantonment areas are imbedded in larger urban areas. Finally, one found in some rural areas Zila councils responsible for local services as well as union councils.

Following the fall 1999 military take-over, and beginning in March 2000, with the publication of a discussion paper, the National Reconstruction Bureau (NRB) undertook the creation of three countrywide levels of governments, districts, tehsils and union councils. This was accompanied by the abolition of three levels of provincial administrative units, divisions, districts and tehsils and the replacement of the existing municipal bodies by these new local governments. Thus, while one uses similar names for mainly unchanged geographical entities; the reality underlying these names has changed. The legal framework used is the Local Government Ordinance (LGO) promulgated by each province on August 2001.

The official goals for devolution put forwards by NRB are known as the fives Ds:

- Devolution of Political Power -elected politicians articulating the goals of their population;
- Decentralisation of Administrative Authority;-autonomy of district departments;
- Distribution of Resources to Districts –Taxation powers and transfers;
- Deconcentration of Management Functions-specialisation of staff, performance –based appraisal;
- Diffusion of the Power Authority Nexus-monitoring by citizens, checks and balances.

The Structure of the System is as follows:



Note: Districts are governed by the District or Zila council

Figure 12.1. Local government Structure of Pakistan 2001

This structure presently does not cover Islamabad capital territory, which is to be included in August 2002 following elections, FATAs which could be included in late 2002 and cantonments, which will be included as towns/tehsils/talukas in 2003.

Responsibilities of the three new levels of governments are found in the LGO.

The responsibilities of Districts are not as clearly spelled out in the LGO as those of Tehsils (Article 54) or Union Councils (Article 76) in the LGO but can be deduced from their organisational chart. *Table 12.15* presents their responsibilities

It is important to note that the 3 councils - District, Tehsil and Union are not intended to be in a hierarchical relationship. Although funds will flow to Tehsils via a District Provincial Account, the District is to pass these funds to the Tehsil without conditions. The only co-ordinating mechanism between District and Tehsils (there may be a number of Tehsils in any District, although some Districts may have only one Tehsil) is the Committee of District and Tehsil Nazimeen¹⁶⁵ (the Mushariat Committee). This committee has the potential to integrate planning functions and implementation plans between levels. Thus, although there is a political link between the levels as a result of the interlocking membership of Union, Tehsil and District Councils (see *Table 12.16*) there is no administrative/managerial relationship at the official level. Staff of the Tehsils and towns are employees of that tehsil while the district officers are (at present) provincial civil servants and will eventually become district employees.

Direct elections to Union Councils were held in five waves from December 2000 to September 2001, four of which predated the adoption of the LGO. The election of Nazims, Naib Nazims and reserved council seats at the district level took place after the election of Union Councils(UC) in August (82 districts) and September (14). The qualifications of the politicians (literacy, education level) are higher for Nazim and Naib Nazim than for councilors and for districts than for UC. Local politicians cannot be provincial or national assembly members.

¹⁶⁵ Plural of nazim

Table 12.15

Inter-Level Relationships, Local Government, Pakistan, 2001.

Assume a district with 60 Union Councils (UC), regrouped in three equal Tehsils (20 UCs per Tehsil)

1.	The electorate directly elect the UC: 21 councilors: of which 19 councilors are elected at large. Also elected at large is one UC Nazim(Mayor) and one UC Naib Nazim(Deputy Mayor) on a joint ticket
2.	By virtue of this direct election, the UC Naib Nazim, is also (concurrently) directly elected to the Tehsil council as Tehsil councilor;
3.	Each of the three Tehsil councils is made up of one Tehsil Nazim, one Tehsil Naib Nazim, 20 UC Naib Nazim, and 9 additional councilors: 7 women councillors. The Tehsil Nazim, the Tehsil Naib Nazim and the additional 9 councilors are elected by the 1260 (21X60)UC councilors (thus of the 31, 20 of the councilors were directly elected by the people)
4.	The UC Nazim is also directly (and concurrently under step 1) elected to the District council as District Councilor;
5.	The District Council is thus made up of one District Nazim, one District Naib Nazim, 60 UC Nazim and 26 additional councilors:20 women councilors, 3 peasants and 3 minority councilors for a total of 88 members.
6.	The District Nazim, the District Naib Nazim and the additional 26 councilors are elected by the 1260 UC councilors(thus of the 88 councilors, 60 are directly elected)

Under devolution, district staff continues to be provincial civil servants and for the first year of devolution, was paid directly by the province. Provincial line departments similarly have been slow to relinquish the reigns of direct management and control over their staff in the districts. Tehsil Councils however, are staffed in an entirely different manner. Many Tehsils are successor bodies to the former Tehsil Municipal Corporations. As such they inherit the staff and organizational structures of these bodies as well as their financial. Senior staff appointed to District governments is drawn from both Federal and provincial cadres, which remains their employer and ultimately pays their pension. Junior staff (teachers) are provincial civil servants. Senior staff is used to a high geographical mobility linked to promotions and thus is not as such very loyal to a given district.

Table 12.16

Responsibilities of Districts, Tehsils and Union Councils, Pakistan, 2001

Responsibility	District	Tehsil	Union Council
Education	Primary and secondary education, Literacy	X	X
Health	Dispensaries and local hospitals	X	X
Roads	District roads	Local roads and street	Local streets
Water	X	Water supply systems	Wells and Ponds
Sewers and Sanitation	X	Yes	X
Fire services	X	Yes	X
Parks playgrounds	X	Yes	Yes
Animals	X	Slaughterhouses, Fairs	Cattle pounds and grazing areas
Cultural and sport services	X	Fairs, cultural events	Libraries
Street services	X	Street lighting ,signals	Street lighting
Varia	X		Register births and deaths

Source: Analysis of Local government Ordinance Authors Note: an X indicates no direct spending responsibility

Districts are entirely funded by the transfers of resources by the provincial government in 2001-2002. Until devolution, districts were budgetary units of provincial governments and as result, did not have autonomous revenues. Now as then, the Districts rely primarily on provincial funds, then as budget line items, now as accounting/real transfers. Indeed, district budgets for 2001-2002 were prepared by the provincial finance departments and then approved by the Zila councils in the fall of 2001. Tehsils have inherited from their various predecessor urban bodies both the Urban Immovable property tax (UIPT) and the Octroi/ZilaTax(OZT) replacement grant revenues. Union Councils have little own revenues; they appear to be mainly dependent on development funds granted by the district councils.

The funding of districts almost entirely by transfers is in the tradition of fiscal federalism in Pakistan. The main source of provincial revenues is a transfer based on a share of federal tax collections. The decision on the list of taxes to be shared (the “divisible pool”), the ratio of the provincial/federal share of the pool, and the for-

mula for its distribution to the provinces is to be fixed at least once every five years (Constitutional provision) by the National Finance Commission (NFC). The NFC members are the federal Finance Minister, the finance ministers of each of the four provinces, plus other members as the President chooses. The NFC last rendered an Award in 1997, allocating to the provinces 37.5% of the divisible pool with the distribution to the provinces by population (based on the 1981 Census of Population). This divisible pool, which is about 430 million Rs in 2001-2002, is made up of the income tax (150 billion RS), sales tax (180 bn. Rs), and revenues from customs (70 bn. Rs), and federal excises, wealth, and capital value taxes (30 bn.Rs. In addition, various other tax transfers and grants are also made by the federal government to the provinces. This includes some federally ceded taxes that are returned to the provinces on a derivation basis net of a 2% federal collection charge(e.g., royalties on petroleum and on natural gas, surcharges and excise on natural gaz. The current NFC Award, announced in February 1997 and implemented starting with the 1997/98 budget, brought some major structural changes in the formula and modalities for revenue sharing between the federal and provincial governments. Under the new revenue sharing arrangement, the divisible pool of tax revenues has been expanded to incorporate all federally collected taxes, including customs duties that had previously been retained by the federal government in their entirety. As against the previous Award, which allocated 80% of net receipts of taxes in the divisible pool to the four provinces, the new formula allocates 37.5% of the enlarged divisible pool to the provinces. The 1997 National Finance Award is now under review. Until the new award is made, the existing one remains in place. *Figure 12.2* present the main financial links between levels of government in Pakistan

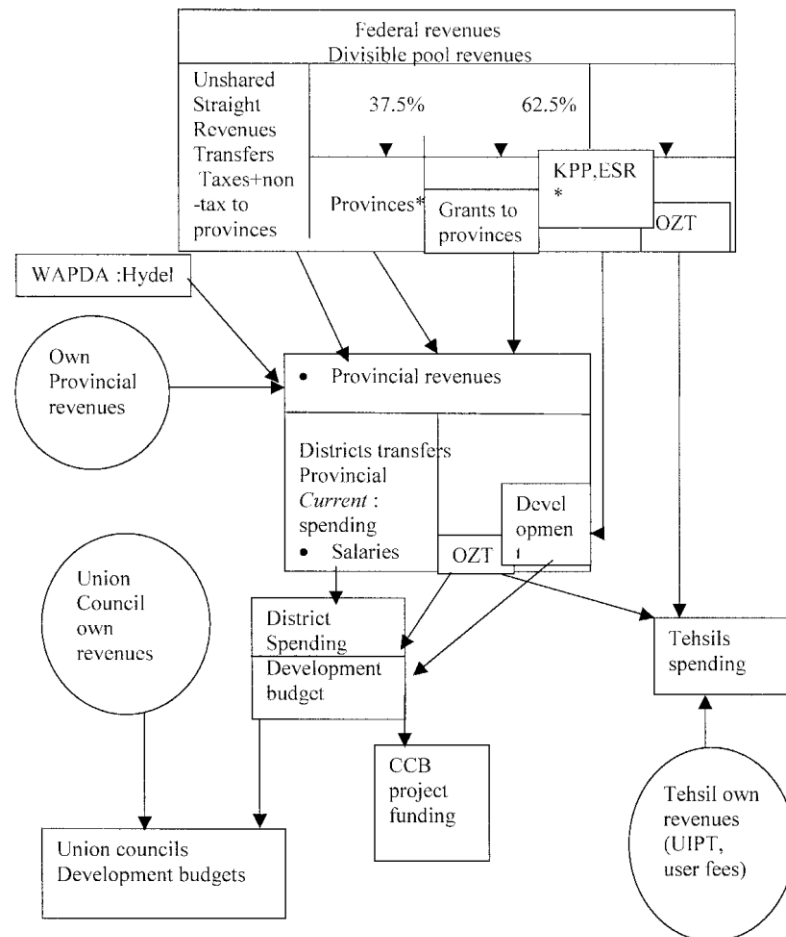


Figure 12.2. Intergovernmental financial relations in Pakistan, 2002: a schematic exposition

Notes on distribution keys:

NFC award: the revenue assigned to the provinces is distributed among them on the basis of their respective populations according to the 1981 Census. The smaller provinces of NWFP and Balochistan also receive NFC-mandated revenue deficit grants amounting to Rs 3.3 billion and Rs 4.1 billion, respectively, from the federal government in 1997/98 (to be increased annually by 11 % in nominal terms, subject to subsequent adjustment for inflation in each of the following four years).

WAPDA Hydel: This amount represents the share of the Water And Power Development Authority profits generated from hydroelectric production, which is located in NWFP; it is capped at 6 billions Rs per year, the amount paid in the first year this was done(1992), an amount less than the full amount due.

KPP: Khushal Pakistan Program; The KPP is a job creation program that uses small schemes to create employment across Pakistan .The funds are allocated as follows between provinces:

- 70 % according to population (NFC award) and 10% each for Baluchistan, NWFP and FATA areas (in addition to NFC determined amounts for Baluchistan and NWFP).

KPP spending is allocated according to a formula in each of the provinces(they make their own choice) as follows:

- Punjab uses population(20%) and backwardness (80%)
- Sindh uses population(90%) and backwardness(10%)
- NWFP uses population(30%), social development(40%) and Infrastructure needs(30%)

Districts then allocate the funds to UC according to their own criterions. A common practice appears to be to allocate some funds equally to all UC and some funds according to the appropriateness of the scheme.

ESR: Punjab and Sindh have signed contracts with districts to ensure that Education Sector Reform funds are spent according to national priorities ; this is the first time such contracts have been signed but they are seen as a mechanism to ensure respect of nationally agreed priorities with donors by implementing districts

OZT: Until 1999, Urban bodies such as municipal corporation or town committees collected Octroi (import taxes levied by municipal entities at their borders on goods imported for resale) while rural ones collected Zila Export taxes on agricultural goods exported out of rural (then called “ Zila”) councils.They were abolished in as of fiscal 1999-2000 with the agreement that the federal government would come up with a replacement grant to be paid to the urban bodies

As of 1999-2000, the federal government implemented a 2.5 % point increase (from 12.5% to a 15%) in the General Sales Tax (GST) in all of Pakistan ,that was distributed directly to local bodies as a “hold harmless” revenue replacement grant. This amounted to 14.4 Rs billion in OZT revenues (provincial unaudited figures). Then, for 2000-2001 and subsequent years,, arguing that the 2.5 percent of the GST was generating an amount well in excess of the initial 19 billion Rs (30 billions Rs in 2000-2001), the federal government broke the direct link between the OZT and 2.5% points of GST by placing the 2.5% of the GST proceeds in the divisible pool to be then divided between provinces according to the NFC formula. The federal government argues that since 37.5% of the GST surcharge is in the divisible pool, it now becomes responsible for direct grant equal to only of 62.5% of OZT revenues; and the provinces will get the other 37.5% through the NFC Award. Thus the replacement grant to the provinces has fallen to 62.5% of the 14.4 billion Rs OZT amount (capped in nominal terms) to the provinces—i.e., about 9 billions Rs (14 x .625).

We now turn to an examination of the budgets of the major new level of governments, districts. Districts budgets for 2001-2002 were prepared using line ministry information on past budgets and information from the accountant general on spending in each district. Total district budget is thus an aggregation of line items. Until then, Finance was not involved in allocating current spending across districts. Some line departments for these allocations used formulas. For example, each school or Basic Health Unit was given an operations budget (Rs per classroom or per bed). This implies that current budgets are a function of past infrastructure spending; indeed, one explanation of the non completion of schemes is that once completed, they create a demand for current expenditures;

The district budgets for 2001-2002 prepared by the provinces Finance departments then had to be approved by the Zila councils. This approval led to demands for more resources by some councils which were met in some cases. *Table 12.17* presents the overall size of the provincial and district budgets for 2001-2002. Examining *Table 17*, one finds that district shares per province in the total budget are respectively 43%, 28%, 36% and 26%. These expenditures can be divided in three items: salaries (current non-salaries), expenditure (petrol, electricity, school supplies, medications,...) and development expenditures. Salaries while appearing as district expenditures are paid by the provinces in 2001-2002. As a result, non-salary current and development expenditures are sometimes referred to as transferables. One should note that these numbers are those found in provincial budget books prepared in June 2001. Districts voted on these budgets in the Fall of 2001 and in some cases, may have obtained larger transfers at that time of their respective provincial governments. One should also note that these budgets are for expenditures funded by the provinces; they do not include district, tehsil or UC spending funded by Local funds, which are revenues raised by their own taxes or obtained from the OZT replacement grant.

Table 12.17

Pakistan Provincial and District budgets,2001-2002,millions Rs

Province	Provincial, Total (1)	District ,Total (2)	District transferables (3)	Wage component (2) - (3) Which the Wage Bill is a (%) of total District	Total Provincial and District (4)
Baluchistan	14313	10937	NA	NA	25250
NWFP	31771	12289	1714	10,575 (86.1)	44060
Punjab	77269	43044	14914	28130 (65.4)	120313
Sindh	51464	17959	2788	15171 (84.5)	69413

Source: Local Government Fiscal Transfers, volume 1 ADB, Table II-V.

Note (4)=(1)+(2);(3) is subset of (2)

Source: Local Government Fiscal Transfers, volume III ADB, Summary Tables

How do the districts spend their budgets is presented in *Table 12.18* for 3 provinces Examining it one notes immediately that education is the major function of districts, with 50% in Punjab, 70% in NWFP and Sindh of current spending. Health follows in the 10-15% range; other items are less than 5% of spending. This breakdown reflects the responsibilities of districts outlined in *Table 12.15*.

Table 12.18

Budgetary Allocations by Function, Pakistan, 3 Provinces, 2001-2002(millions of Rs)

Budgetary items As % of Total	NWFP	Punjab	Sindh
Total(1)	100.0 %	100.0 %	100.0 %
Development-total(2)	8.9	8.8	16.0
Current-total (3)	91.1	91.2	84.0
Education-current(4)	63.4	43.8	59.0
Health-current(5)	10.3	9.4	12.9
Public works-current(6)	1.6	3.3	1.1
Other(7)	15.8	34.7	10.0

Source: Data spreadsheet, World Bank office, Islamabad. Police expenditures removed from Sindh data for purposes of comparability Note: (3)=(1)-(2); (7)=(3)-((4)+(5)+(6))

Conclusion and lessons

The first conclusion is that there is a diversity of structures, as shown in the *table 12.19* to deliver government services and that not one in particular is preferable in the absolute to another(Bird and Vaillancourt,1998). The appropriateness of a structure depends on the characteristics of the countries.

Second, one notes that there are various ways to do away with lack of economies of scales in the delivery of services .One is to reduce the number of municipal governments, the Canadian approach. Another is to create larger bodies than local governments, the USA (special district) and French approach. One can then go around opposition to amalgamations while getting some of its benefits.

Third, reforming local governments has three main components: institutional/political, human resources and financial resources. Pakistan carried out the first reform fully but not the other two. As a result, the politicians do not have the full support of their top civil servants and have little control over their budgetary decisions and financial resources. Ideally, reforms should be carried out simultaneously on all three fronts.

What is the best possible outcome to ensure the effective delivery of public services? There is no clear answer to this since there is no indicator of efficiency or effectiveness that can be used across all countries. Some countries may prefer medium quality roads in all parts of the country while others may be willing to accept high quality roads in some cases and low quality ones in others. Either outcome is acceptable if it represents the informed choices of the electorate. Informed control by the population is what ensures in Canada , France and the United States that local government output is not too far from what is socially desirable, not control by bureaucrats or by funding schemes. This belief is what inspired the reform in Pakistan. Supervisory bodies such as municipal affairs departments must be available to investigate complaints of illegal/fraudulent behaviour and to produce comparable statistics on taxes and spending per capita by local entity. This last activity is an important

informational output and an input in the decisions by citizens. Such decisions will be of better quality if these citizens must bear at the margin a substantial part of local expenditures.

Table 12.19

Percentage of expenditures by level of government Canada, United States, France and Pakistan, 2000

	Federal /national	Province/state	Local government
Canada	40%	45%	15%
USA	55%	20%	25%
France	80%	-	20%
Pakistan	70%	20%	10%

Source : Canada and USA Steytler(2002), paper prepared for the Forum of Federations : An International Network on federalism.

France: Finances Locales dans l'Union Européenne Crédit Local de France <http://www.clf.fr>.

Pakistan Approximation based on budgetary information, Federal Ministry of Finance and presuming that districts expenditure are broken out.

Annex

Table 1

Number of Local Governments by States, United States of America, 1997

States	All governmental units	County	Municipal	Township	School District	Special Districts
US	87453	3043	19372	16629	13726	34683
Alabama	1131	67	446	-	127	491
Alaska	175	12	149	-	-	14
Arizona	637	15	87	-	231	304
Arkansas	1516	75	491	-	311	639
California	4607	57	471	-	1069	3010
Colorado	1869	62	269	-	180	1358
Connecticut	583	-	30	149	17	387
Delaware	336	3	57	-	19	257
District of Columbia	2	-	1	-	-	1
Florida	1081	66	394	-	95	526
Georgia	1344	156	535	-	180	473
Hawaii	19	3	1	-	-	15
Idaho	1147	44	200	-	114	789
Illinois	6835	102	1288	1433	944	3068
Indiana	3198	91	569	1008	294	1236
Iowa	1876	99	950	-	394	433
Kansas	3950	105	627	1370	324	1524
Kentucky	1366	119	434	-	176	637
Louisiana	467	60	302	-	66	39
Maine	832	16	22	467	98	229
Maryland	420	23	156	-	-	241
Massachusetts	861	12	44	307	85	413
Michigan	2775	83	534	1242	584	332
Minnesota	3501	87	854	1794	360	406
Mississippi	936	82	295	-	164	395
Missouri	3416	114	944	324	537	1497
Montana	1144	54	128	-	362	600
Nebraska	2894	93	535	455	681	1130
Nevada	205	16	19	-	17	153
New Hampshire	575	10	13	221	166	165
New Jersey	1421	21	324	243	552	281
New Mexico	881	33	99	-	96	653
New York	3413	57	615	929	686	1126
North Carolina	952	100	527	-	-	325
North Dakota	2758	53	363	1341	237	764
Ohio	3597	88	941	1310	666	592
Oklahoma	1799	77	592	-	578	552
Oregon	1493	36	240	-	258	959
Pennsylvania	5070	66	1023	1546	516	1919
Rhode Island	119	-	8	31	4	76
South Carolina	716	46	269	-	91	310
South Dakota	1810	66	309	956	177	302
Tennessee	940	93	343	-	14	490

States	All governmental units	County	Municipal	Township	School District	Special Districts
Texas	4700	254	1177	-	1087	2182
Utah	683	29	230	-	40	384
Vermont	691	14	49	237	279	112
Virginia	483	95	231	-	1	156
Washington	1812	39	275	-	296	1202
West Virginia	704	55	232	-	55	362
Wisconsin	3059	72	583	1266	442	696
Wyoming	654	23	97	-	56	478

Source: U.S. Census Bureau, Statistical Abstract of the United States, table No. 491

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Chapter 13. Financial Relationships between Regional and Municipal Authorities: Insights from the Examination of Five OECD Countries

Introduction

The intergovernmental fiscal relations of local governments are diverse. They vary substantially across countries as do expenditure responsibilities and revenue generating powers. To the uninitiated, the picture can be quite confusing, especially if one is in search of best practices or exemplary cases. The situation is eased somewhat when one realizes that intergovernmental fiscal relations (notably transfers), expenditure responsibilities and revenue generating powers are, or at least should be, an integrated package but a package that can, indeed must, vary to suit different circumstances. Well designed packages can enable local governments to function effectively. Unsuitable arrangements will hamper performance.

This paper reviews the intergovernmental fiscal arrangements of local governments in five countries and provides a comparative assessment with the objective being to derive lessons to aid in the structuring of better fiscal arrangements between local and other governments. Although most local governments are municipal governments, there are often many other types of local governments that are also important but for which arrangements may differ. Hence, because the distinction is often important, the practice here is usually to refer to local governments or local authorities unless a specific type (e. g., municipalities) is under discussion. Federal countries get most of the attention here so relations between local and regional (provincial and state) governments are particularly important because they usually dominate, but those with the federal government are not neglected. Financial relations dominate the attention here but important intergovernmental fiscal relationships extend beyond those and so some attention is paid to other matters.

Four of the countries reviewed are classic federal states. There is Australia, which has a small local government sector; Canada and the United States, in which the local governments are of intermediate size, somewhat similar though by no means identical, and which have some unique features; and there is Germany in which local government is also of intermediate size but with rather different expenditure and revenue assignments. Denmark is also considered. Although not a federal state, it is an interesting example of a country having a large local government sector with somewhat unconventional responsibilities.

The paper begins with the country reviews. In the effort to establish some direction from those examples, the section following those reviews undertakes a comparative and more normative assessment of intergovernmental relations in the five countries. So as to understand better the patterns and trends observed, the structure of that analysis is based on the theory of fiscal federalism and the implications arising from the study of many countries. That theory and evidence provides a framework for looking (in particular) at the assignment of responsibilities, the revenue sources, the possible need for and place of transfers of different kinds.

The short concluding section itemizes the main lessons to emerge from the paper and the scope for relations between local and regional authorities.

Country reviews

Australia¹⁶⁶

Local Governments and Their Relationships with Other Governments

By international standards for developed countries, Australian local government is small. Expenditures of Australian local governments amount to about 2.5 percent of GDP and their tax revenues amount to about 3.1 percent of the tax revenues of all governments. Still, local government there plays a significant role although it is primarily limited, as some characterize it, to «roads, rates and rubbish.»

Currently, there are 727 local governments in Australia. Most of them are rural councils (usually referred to as shires) and 20 percent are urban (cities, towns, etc.). Certain regional bodies and the Australian Capital Territory are excluded. There is a tremendous diversity among Australian local governments. In particular, populations and population densities vary greatly with the vast majority of the population concentrated in urban areas but with many still living in rural and sometimes very remote and sparse areas. Many local authorities have only a

¹⁶⁶ Extensive discussion of Australian local government are found in Australia, National Office of Local Government (2001) and Jones in Hesse (1991). For a broader perspective on Australian government and public finance and the role of local government within that, see Craig in Ter-Minassian (1997), Mathews and Grewal (1997) and OECD (1997). While Norton (1994) does not specifically focus on Australia, a number of useful insights into the Australian system can be found there.

few hundred residents and numerous rural shires have only a few thousand. Despite the larger urban agglomerations of Melbourne and Sydney, Brisbane, with a population of about 865,000, is the most populous municipality and no other exceeds more than half that size.

Local governments derive their authority from the state governments. There is no recognition of local governments in the nation's constitution and an effort to incorporate local government into the constitution in 1988 failed in a referendum with only one-third favouring the proposal. However, since the late 1970s, several state governments have modified their state constitutions to protect their local authorities from arbitrary dismissal.

Local governments' responsibilities and revenue generating powers are determined by the state governments. The role of local government is relatively small because Australian local government is not responsible for schooling or policing (even fire protection in some cases) which are state functions and they have very limited responsibilities for health or social welfare. Local responsibilities are dominated by roads, drainage, waste management, recreation and cultural activities, housing, care of the elderly, and local regulation of business and development. In most states, local government does not have responsibility for water and sewerage. In fact, the authority to engage in profit making functions (electricity) was removed from the Brisbane City council. Such local services are commonly provided through special purpose state authorities.

Given the state authority over local government, there are differences among the states in local government's role. This is illustrated, in part, by the variation in the per capita expenditures of local governments across states. For example, that in Queensland is almost twice that in Victoria; \$1216 vs \$650, with a large amount of that difference resulting from a large difference in the sales of goods and services. Overall, the average per capita expenditure is \$837. Despite the clear emphasis on «property services» across Australian local governments, a review by the Commonwealth Grants Commission found a marked increase in the local provision of human services during the past 35 years.

Property taxes, user fees and revenues from sales of goods and services are the revenue sources available to local councils to exercise. Property taxes (rates) represent over 99 percent of tax revenues. Revenues from these three sources continue to represent a relatively constant portion (about 75 percent) of local government own revenue but the share from rates has fallen since 1975 from 55 percent to about 45 percent while that from sales and fees has increased.

Since 1974—75, the Commonwealth (federal) government has provided general purpose grants (through the state governments) to Australian local governments. Since then, while local own-revenue shares appear to have been maintained, the contribution from state grants has declined.

State governments occasionally intervene quite extensively in local affairs. In the mid 1990s, Victoria mandated a reduction in local rates. Also, state governments have periodically imposed or seriously considered (often large scale) amalgamations of their local governments; e. g., New South Wales and, more recently, Tasmania and Victoria.

Efforts over the past two decades to enhance the efficiency and effectiveness of Australian government at all levels have impacted particularly upon local government. Combined federal, state and co-operative initiatives have instituted various programs to increase accountability and efficacy. For example, a minimum share of local budgets must be exposed to competitive bidding (market testing), management reviews are undertaken by the states, there is a national benchmarking program to identify best practices and relative performance, and comparative reporting is being practiced. Efforts to identify performance measures are widespread and there are various efforts being made to improve service quality.

Local Governments' Expenditures and Revenues

The IMF data for Australia in *Table 13.1* demonstrates the magnitude and pattern of local government expenditures in 1998. Total expenditures were \$12,846 million (Australian) which constituted 6.1 percent of consolidated government expenditures and 2.2 percent of GDP that year. That modest amount of expenditure is concentrated in transportation (27.5 percent), housing and community amenities (18.7 percent) and recreation and culture (17.7 percent) which, along with general services (13.7 percent) represent more than three-quarters of total outlays. Note that education, health and social security and welfare together amount to less than nine percent of the total with most of that (6.3 percent) for social security and welfare. Public order and safety comprises only 2.4 percent of expenditures.

Table 13.1

Local Government Expenditures, Selected Countries, 1998 (Percentage Distribution and Amount)

	Australia	Canada	Denmark	Germany (1996)	United States
General Public Services	13,7	5,5	3,9	7,4	5,7
Public Order and Safety	2,4	9,1	0,3	3,4	10,9
Education	0,4	42,0	12,4	13,0	43,3
Health	2,1	1,4	16,2	14,5	8,9
Social Security and Welfare	6,3	7,0	57,5	24,6	7,8
Housing and Community Amenities	18,7	5,5	1,0	15,3	2,0
Recreation, Culture, Religious	17,7	6,4	2,9	5,7	3,4
Fuel and Energy	0,2	3,4	0.0 ^b	0,1	0,0
Agriculture, Forestry, Fishing	1,3	0,3	0.0 ^b	0,6	0,6
Transportation and Communications	27,5	11,3	2,7	6,0	6,0
Other Economic Affairs and Services	3,9	3,1	2,2	4,1	0,5
Other	5,8	5,1	0,7	5,3	10,9
TOTAL					
— percent ^c	100,0	100,0	100,0	100,0	100,0
- millions (domestic currency)	12 846	73 988	379 479	329 900	750 980
- as % consolidated gov't expenditure	6,1	18,1	59,2	18,0	26,2
- as % of GDP	2,2	8,1	32,6	9,2	8,8
Other Government Expenditure as a % of GDP ^d					
- state	15,7	19,2	—	10,6	4,3
- federal/central	15,5	18,3	24,8	31,8	17,9
- total government	33,4	45,6	55,9	51,2	30,9

Source: Calculated from data in the Government Finance Statistics Yearbook, (Washington, D. C.: International Monetary Fund, 2001).

Notes: a) Except Germany which is for 1996.

b) Negligible amounts.

c) May not sum to 100.0 due to rounding.

d) Expenditure net of grants to other governments.

The revenue picture is shown in *Table 13.2*. Own revenues from taxes and nontax own-revenue sources account for just over three-quarters of total revenue. Taxes, effectively entirely property taxes (rates) are 44.8 percent of the total while 24.3 of the 32.6 percent coming from nontax sources is from fees, sales and fines. Intergovernmental grants contribute 16.4 percent. The 6.2 percent which is capital revenue, and which is not clearly specified, confuses the picture somewhat. In Australia (2001), capital revenue is said possibly to include some capital grants although, as noted later, it is suspected that such is not the case here.

Table 13.2

Local Government Revenues, Selected Countries, 1998 (Percentage Distribution and Amount)

	Australia	Canada	Denmark	Germany (1996)	United States
Total Tax	44,8	43,2	50,9	30,6	38,9
- income and profit	—	—	47,7	23,9	2,4
- property	44,8	40,3	3,2	6,4	28,4
- goods and services	—	0.0 ^b	0.0 ^b	0,3	8,1
- other taxes	—	2,8	—	0,1	—

	Australia	Canada	Denmark	Germany (1996)	United States
Non Tax Income	32,6	17,5	8,1	32,8	23,9
- enterprise and property	3,0	2,9	1,2	3,4	10,8
- fees, sales, fines	24,3	13,9	5,8	24,7	11,7
- other non tax	5,3	0,7	1,1	4,7	1,4
Capital Revenue	6,2	—	0,7	4,2	0,1
Grants	16,4	39,3	40,3	32,5	37,0
Total Revenue					
- percent ^c	100,0	100,0	100,0	100,0	100,0
- millions (domestic currency)	12 572	73 049	361 943	321 240	774 290
- as % of consolidated gov't revenue	5,9	17,9	54,3	18,8	25,0
- as % of GDP	2,1	8,0	31,1	8,9	9,0
Other Government Expenditure as a % of GDP					
- local	1,8	5,0	18,6	6,1	5,7
- state	10,1	18,6	—	10,1	9,4
- federal/central	23,9	21,5	38,6	31,6	21,1
- total government	35,8	45,1	59,8	47,7	36,1

Source: Calculated from data in the *Government Finance Statistics Yearbook*, (Washington, D. C.: International Monetary Fund, 2001).

Notes: a) Except Germany which is for 1996.

b) Negligible amounts.

c) May not sum to 100.0 due to rounding.

The Australian Government's own numbers for 1999-2000 (see *Table 13.3*) present a slightly different picture. Revenues from taxation, sales, and grants are each somewhat smaller than reported in *Tables 13.2* while other revenues, at 15.7 percent, are larger. Expenditures for that year also show some variation from that in *Table 1*. In *Table 13.3*, transportation, housing and community amenities and general public spending are relatively more important and recreation somewhat less.¹⁶⁷

Table 13.3

Australian Local Government Revenue, Expenditure and Grants, 1999-2000

Revenue	Millions	Percentage			
Taxation	6 001	37,2			
Sale of Goods and Services	5 143	31,9			
Interest	406	2,5			
Grants and Subsidies	2 050	12,7			
Other Revenue	2 529	15,7			
Total Revenue	\$16 129	100,0			

¹⁶⁷ Data from the IMF, like that in *Tables 13.1* and *13.2*, provides information that is internationally comparable. Domestic data is often compiled in ways that vary somewhat across countries and can make cross-country comparisons based on such data questionable. Domestic sources, however, often provide additional useful information. Hence, as here, resort is made to both domestic and IMF sources.

Expenditures	Supporting Grants				
			Common wealth and State Grants	Common wealth Spec- ific Purpose Grants (2000- 01)	Total Amounts as % of Ex- penditure
	Millions	Percenta ge	Millions	Millions	Millions
General	2 588	17,4	20	—	7,7
Public Order and Safety	281	1,9	65	—	23,1
Education, Health and Welfare	1 051	7,1	16	68,1	8,0
Housing and Community Amenities	3 390	22,8	900	—	26,5
Recreation and Culture	1 938	13,1	128	—	6,6
Transport and Communication	4 378	29,5	549	39,7	13,4
Other	1 212	8,1	782	3,7	19,9
Total Expenditure	\$14 838	100,0	\$2 460	\$111,4	17,3

Source: Australia, National Office of Local Government (2001, Ch 2).

Interesting is the contribution of grants to specific local expenditure areas. *Table 13.3* reports combined Commonwealth and state government grants which in 1999-2000 amounted to \$2460 million. That grant funding is shared approximately 50:50 by the two senior levels of government although the Commonwealth's share is allocated through the states. In addition to those funds, the Commonwealth provides small amounts of separate specific purpose grants (largely for support of services for children, the aged, and the disabled). For 2000-01 those specific purpose grants amounted to \$111.4 million and this amount is taken to be representative of that spending. Under this assumption, total grants amounted to 17.3 percent of expenditures. The largest proportions of expenditures by category that are funded by grants are, at about one-quarter, for housing and community amenities and for public order and safety. Transportation is next, at 13.4 percent (somewhat smaller than the 16.4 percent reported in the appended table, *Table 7*, for 1993).¹⁶⁸ Other transfers most likely consist of unconditional grants.

Of the \$2,460 million in grants provided to local governments through the states in 1999-2000, \$1,244 million came from the Commonwealth government and \$1,216 from state funds. The Commonwealth (financial assistance) funds are distinguished as those for general purposes, \$866 million, and those to support the provision of roads, \$378 million. Despite the designation of the latter, the total amount is effectively untied funding because local governments are not required to use the Commonwealth road grant funds for roads.

The total amount of the Commonwealth financial assistance grants is currently escalated each year for population growth and inflation. In the early years after the Commonwealth first began making general purpose equalization transfers to the local governments (1974-75), the amount of the funding was based on revenue sharing (a share of federal personal income taxes) but, by the mid 1980s, tax sharing was replaced by financial assistance grants (in part to provide more stability and predictability to the revenues).

The distribution of the Commonwealth local financial assistance grant among the states differs by component. The general purpose component is allocated on a per capita basis (about \$45 per person in 1999-2000) but the road component for that year was based on the relative magnitudes of Commonwealth grants to the states for state (not local) assistance. The road grant averages about \$20 per capita but the per capita amounts ranges across the states from 83 to 230 percent of that. The road relativities are now fixed as a result of the new Goods and Services Tax (a value added tax introduced in 2000) that is distributed among the states with somewhat different state relativities replacing the previous state financial assistance program. Currently, and likely temporarily, the local road grant annual component is simply an escalation of the previous year's amount.

The Commonwealth local financial assistance grants are allocated by the states, through state local grants commissions, following basic federal principles and subject to federal government approval. For the general purpose component, there are four principles to be followed. First, the funds are to be distributed to enhance horizontal equity among local governments. Second, assessments for the grant is to ignore local tax effort and expenditure levels (i. e., be effort neutral) to permit local authorities to pursue their own fiscal policy and not be

¹⁶⁸ Among other potentially interesting data, the appended table (entitled *Table 13.7* for convenience) shows the share of certain local government expenditures which are funded by intergovernmental transfers. However, because the information exists for only three expenditure subcategories and dates back to the early 1990s, the table is relegated to appendix status.

penalized or rewarded by this grant for their choice. Third, other grants are to be counted in determining local financial capacity. Fourth, each council is to receive a minimum general purpose grant which on a per capita basis is not less than 30 percent of the per capita general purpose grant to the state. The principle governing the road component is that it be distributed according to road expenditure needs including considerations of length, type and use. The road component, however, need not be used for road expenditures.

The state local government grant commissions allocate the Commonwealth financial assistance grants subject to the principles outlined. With each state using its own methods, these commissions estimate the expenditure required of individual local governments to provide a standard range and quality of local services. They also estimate the revenue potential assuming standard tax rates and other revenues. The difference is the assessed general purpose grant need. These values plus the minimum grant requirement are the basis for the distribution of the general purpose grant. The road component is distributed on the basis of estimated road expenditure need. Determining these estimates is a complicated process as reference to the methodologies described in Australia (2001) readily illustrates.

At about 70 councils, or just under 10 percent of local governments, few councils are subject to the minimum grant. Those which are tend to be in the metropolitan areas and often are capital cities. Year to year variations in local circumstances (data) or methods can result in significant changes in the amount of grants which a local authority might receive. Therefore, the local grant commissions commonly «cap» the year to year changes that are permitted; e. g., minus five percent to plus 10 percent.

As noted, the Commonwealth also provides some specific purpose funding to local governments. At about nine percent of the total Commonwealth funding to local governments, its specific purpose funding is relatively minor. The states' funding to local governments appears to be essentially entirely of the specific purpose type.

Especially since 1974, the Commonwealth government has come to play a more significant role in local government affairs despite local government being under the constitutional jurisdiction of the states. This shifting contribution may reflect a less clear distinction of the roles and responsibilities for the various levels of government on the expenditure side than the distinction on the tax powers side or it may reflect a greater willingness to accommodate Commonwealth assistance in aid of local (and indirectly to the state level of) government. Regardless, the federal government's contribution is important and its criteria provides valuable guidance for grant allocations.

Canada¹⁶⁹

Local Governments and Their Relationships with Other Governments

There are approximately 4000 municipal governments in Canada. The most typical forms are cities, towns and villages and, in the rural areas, counties and rural municipalities. In addition to these general purpose municipalities, there are a large number of special purpose local authorities, boards and commissions that have responsibility for schools, police services, public utilities, conservation areas, local health services, etc. Among these specific purpose bodies, school boards dominate in that they are ubiquitous and their expenditures often almost match those of the municipalities and their members are directly elected. The role and even presence of other special purpose bodies varies substantially among the provinces and the degree of their independence from (or integration with) general purpose local governments varies but they are usually minor authorities. Thus, municipalities and school boards are typically regarded as the major forms of Canadian local government.

Local school boards are responsible for schooling (i. e., elementary and secondary education) and municipalities are responsible for a broad (but conventional) range of local services. Municipal services focus on transportation (roadway and public), protection (police, fire and emergency services), environmental services (water, sewerage, garbage collection and disposal), recreation and culture, land use planning and business regulation, local health and social services. Beyond schooling, local (i. e., municipal) government typically plays a very small role in social services such as health or social assistance where the provinces effectively are the suppliers.¹⁷⁰ As a share of GDP, local government own revenue (usually 4 to 5 %) and expenditure (typically 7 to 8 %) have remained relatively constant since 1970. During that time, however, its share of total government spending has declined from one-quarter to about one-sixth largely due to the growth of provincial expenditures primarily in the areas of social expenditures, notably health.

¹⁶⁹ For a broad discussion of local government in Canada see Higgs in Hesse (1991), Norton (1994), OECD (1997) and Tindal and Tindal (1995).

¹⁷⁰ Ontario is somewhat of an exception in that local governments there carry a much larger responsibility for social services/assistance than in the other provinces.

The authority of local government in Canada is derived entirely from the provinces. The Constitution only mentions municipalities to declare that they are the exclusive jurisdiction of the provinces. As «creatures of the provinces,» their responsibilities and powers are only those delegated to them by the incorporating province and to which their actions must conform. The provinces have the power to modify those responsibilities and powers and, indeed, to create, change and abolish municipalities at the province's will. The provinces have not been reluctant to «reform» local government by changing boundaries, responsibilities, powers and funding. Besides, the provinces control their municipalities closely with a host of laws and regulations.

The provincialization of schooling, which has crept across the provinces especially during the 1990s, illustrates the authority and intervention of the provinces in local affairs. As recently as 15 years ago, the conventional arrangement for schooling could be described as shared local and provincial responsibility in that the province provided (usually) most of the funding (on an equalizing basis) with the local school board generating additional funds as required from a local property tax levy. This shared funding arrangement now only characterizes two provinces. Elsewhere, the provinces have assumed full funding responsibility for schooling but, in doing so, have usually taken over the local school property taxes in the form of a provincial property tax. Local school boards have been stripped of their taxing powers and local voters and taxpayers of any discretion in school finance. Now, only the provincial government decides on the level of school expenditures. Within the bounds of the provincially provided funding, school boards have discretion in spending to deliver schooling subject to substantial oversight by the provincial ministries of education. Provincial oversight includes, for example, defining curriculum, requirements for common exams, teacher qualifications, requirements for the schooling of challenged students, etc.

The loss of local governments' access to sales and income taxes further illustrates the provincial control. During the World War II, the federal and provincial governments came to an agreement giving the federal government full control over (primarily) the personal and corporate income taxes. The provinces were compensated. However, the local governments, some of which employed income taxes and sales taxes, were excluded from those fields thereafter. Since then, the property tax is essentially the only source of taxation available to Canadian local governments.

A consequence of provincial authority over local government is the considerable interprovincial variation in local government. While the major features are (typically) quite parallel, there are a host of minor (and some not so minor) variations which often make generalizations tenuous. Another consequence is that direct relations between the local and the federal government are minimal, in part because the provincial governments carefully guard their authority. Regardless, the municipalities lobby the federal government (e. g., the Federation of Canadian Municipalities) and some, typically relatively modest and sporadic, federal funding is directed to municipalities. Typical of this is the federal government's infrastructure program of the late 1990s (and soon to be renewed).

Local Governments' Expenditures and Revenues

The pattern of local government expenditures in Canada can be seen from *Table 13.1*. Education expenditures, essentially entirely by school boards, represented 42 percent in 1998. Municipal government is essentially responsible for all the rest. Transportation and communication, which for Canadian municipalities is only transportation, is the largest expenditure area (at 11.3 percent of local government expenditure). Protective services is the second largest expenditure area. Other areas (with the exception of health and of agriculture, forestry and fishing which are quite small) are more modest and relatively uniform. Note, the importance of social services spending is due primarily to the importance of social services spending by Ontario municipalities (25 percent of their municipal expenditures). In contrast, social security and welfare represents less than one percent of municipal expenditures in most provinces. Although it is not reported separately in Table 1, note that debt servicing constituted 6.8 percent of municipal expenditures. In all provinces, municipal governments are permitted to borrow for capital expenditure purposes only.

In total, local government expenditures were 8.1 percent of GDP in 1998 and 18.1 percent of total consolidated government expenditure in Canada. Municipal government outlay was 4.7 percent of GDP while school board spending was 3.4 percent.

Looking simply at local government masks the considerable differences between municipal and school authorities. These differences are more apparent from the data in Table 13.4 which reports the revenue sources for the two form of local government. School boards receive about 75 percent of their funding as grants. These grants come almost entirely from the provincial government. The other 25 percent is from their own revenues. One must be careful in the interpretation of this number because, with the provincialization of school finances, most of that money is really from provincial school property taxes attributed to school boards and are not proper-

ty taxes levied by the boards under their own authority or over which they have any discretion. In contrast, municipal governments raised 56.7 percent of their revenue in 1998 from locally determined property (and property related) taxes. User fees, again decided by the municipal government, generate over 20 percent. Property taxes, user fees and various other sources of income constitute the own revenue of municipal governments which represents almost 85 percent of total municipal revenue. The remaining 15 percent comes from grants. In a decade, as a result of the austerity programs of senior governments, the contribution of grants has dropped from 23 percent to 15 percent. Again, the transfers are almost entirely from the provincial governments. Also, most of the transfers are conditional with less than 20 percent of grants being unconditional (down from 25 percent in 1988).

Table 13.4

Revenues of Canadian Municipal Governments and School Boards, 1998

	Municipal Governments	School Boards
Property Taxes	56,7	21,8
Other Taxes	1,2	—
User Fees	20,7	3,1
Investment Income	4,9	0,1
Other	1,1	0,1
Total Own-Source Revenue	84,6	25,1
Unconditional Grants	2,9	—
Conditional Grants	12,4	74,9
- provincial	11,8	74,7
- federal	0,7	0,2
Total Revenue		
- percent	100,0	100,0
- millions of dollars	42 914	31 074
- % of GDP	4,7	3,4

Source: Kitchen (2000).

Provincial conditional grants have typically provided a large and confusing array of incentives to municipal governments. The number or variety, if not the complexity, of these transfers has diminished over the years, in part with the levels of funding. Usually, grants are available to support aspects of the full range of services. Transportation is traditionally an area relatively well supported by transfers. Turning to the somewhat dated but internationally comparable data in the appended table (*Table 13.7*), the final column reveals that 25 percent of Canadian local government spending on transportation (and communications) in 1991 was provided by grants. Even of the small amount of spending by local government on health care (1.4 percent), 46 percent came from transfers. The education spending by school boards, of course, is heavily funded by grants and that share has increased; from 67 percent in 1991 to 75 percent in 1998.

Unconditional funding is normally only a fraction of conditional grants. In only three provinces does unconditional funding dominate conditional. Even if the amounts are small, unconditional funding is usually allocated in an equalizing fashion designed to assist (or assist more) the fiscally disadvantaged localities. Equalization played a particularly important role in the assistance to school boards when the boards had access to and utilized extensively local tax sources. With the provincialization of school finances, uniform provincial financing has recently taken over most of that role. Equalization plays a role in the allocation of unconditional funding among municipal governments in most provinces. Auld and Eden (1987) provide an overview of equalization across the provinces. They identify three types of programs being used — relative fiscal disparity equalizing, fiscal gap equalizing and fiscal need equalizing. The relative fiscal disparity approach allocates the available grant funds inversely to the relative fiscal capacities of the municipalities; e. g., inversely to the ratio of the per capita tax base of a municipality to the average. All municipalities receive some funds. The fiscal gap equalizing method looks at the difference between each municipality's own and a standard per capita tax base and allocates funds to those municipalities having a deficiency in proportion to the deficiency. The fiscal need approach determines standardized expenditures and standardized revenues for municipalities and provides grants to those with a deficiency between the two. Largely because of inadequate funding, most of the programs were found not to generate

substantial equalization. One of the main difficulties with equalization is determining an equitable distribution between rural and urban municipalities and between small and large urban centres.

Revenue sharing is the basis of unconditional, largely equalizing, transfers in three provinces. Normally the shared revenue is defined as a small share of specific provincial taxes (particularly the personal and corporate income taxes as well as other revenues) and the funds are distributed among all municipalities in an equalizing fashion. In three provinces, selected vehicle revenues (e. g., gasoline taxes) are shared with their major cities (Calgary, Edmonton, Montreal and Vancouver).

The United States¹⁷¹

Local Governments and Their Relationships with Other Governments

As of 1997, there were 87,453 local governments in the United States. Of those, 39,044 (44.6 percent) were general purpose authorities, 13,726 (15.7 percent) were school districts and 34,683 (39.7 percent) were other forms of special districts. General purpose authorities are classified as counties (3,043), municipalities (19,372) and townships (16,629). Although some other types exist, municipalities are usually cities, towns and villages. Counties, which exist in all but three states, originated as administrative units of the states but became general public service providers outside municipalities. In large urban/metropolitan areas, county and city governments have often merged in various forms. Townships occur in 20 states, largely in the northeast and the midwest. They originated largely to provide roads but their responsibilities expanded with population and needs. Single purpose school districts exist in all but four states and are a major form of local government. Other special districts are numerous, typically designed to provide one or two services (e. g., conservation, fire protection, water and sewerage), growing in number (17 percent more than a decade earlier), and may be hived off general purpose governments as a way of dealing with cross-boundary issues, achieve scale economies, and separate often largely self-financing functions. Their visibility is relatively low as the members of these bodies are not often directly elected unlike those for general purpose local governments and school districts.

School districts are responsible for elementary and secondary education. The school districts operate under the authority and supervision of state departments of education but as separate local governments with locally elected boards. Local authorities may administer community and vocational colleges. The general purpose local governments are responsible for a broad range of services including transportation (roads and public), public health services (often, especially counties, including hospitals), social welfare (often administration and sometimes significant financing), police and fire protection, recreation and culture, and land use planning and local business regulation. Local governments may also operate public utilities through their departments but often through special districts and special authorities or as public enterprises.

Local governments get their authority from their state governments. There is no recognition of local governments in the constitution of the United States. The state governments assign their responsibilities and powers; that is, local governments are the legal creatures of the states. Unless provision is made otherwise, local powers are narrowly interpreted — following the Dillon Rule (the guidance of John Dillon, a 19th-century jurist and authority on municipal law) — to be only those which the state has explicitly granted. To avoid the restrictions of the Dillon Rule, states have adopted some form of home-rule provisions. The strongest form is incorporation of home-rule authority into the state constitution. Home rule allows local government discretion in local affairs and limits state intervention in local matters and may even allow local action in any area not excluded by state law. Only a few states have adopted the strongest version of home rule but most have adopted provisions that relax the impact of the Dillon Rule. Some degree of home rule exists for municipalities in 48 states for municipalities and in 37 for counties. The legal interpretation of such provisions have not always been uniform so the practice and what may have been the original legislative intent may vary and seemingly similar provisions can be interpreted differently across states.

Towards meeting their responsibilities, total local government expenditures were 8.8 percent of GDP in 1998 with about 44 percent of that accounted for by school districts. In contrast, state government expenditures (net of intergovernmental transfers to local government) were 4.3 percent and federal expenditures (net of transfers) were 17.9 percent. While local governments exceed the states in final spending, state governments are larger on the revenue side accounting for 26 percent of total (consolidated) government own revenues versus 16 percent for local governments (and with 58 percent of the total raised by the federal government). Local governments, especially school districts, rely heavily upon state government particularly for grants to fund their expenditures.

¹⁷¹ Sources of information include Gunlicks in Hesse (1991), Norton (1994), OECD (1997), Ter-Minassian (1997), Fisher (1996), International City/County Management Association (2000), Tax Foundation (2000) and U.S. Bureau of the Census (2001).

The role of intergovernmental grants has changed substantially for local governments and in the U. S. federalism generally over the past half century. Federal assistance to state and local governments rose from 11 percent of state and local expenditures in 1958 to 18 percent in 1968, to 25 percent in 1978 but dropped to 17 percent by 1988 only to rise again reaching 22 percent by 1998. For a short period, a «revenue sharing» program was the basis for distributing federal funds to state and local general purpose governments (i. e., school districts were not included). No specific revenues were shared but rather designated amounts of monies were allocated. The program operated from 1972 to 1986 but, from 1980 on, it distributed funds to local governments only. The revenue sharing funds amounted to less than three percent of local expenditures. The decline in federal support for the subnational governments is associated with the President Reagan's «new federalism» which was aimed at reducing the federal governments role and its influence over state and local governments. During the Reagan administration, federal transfers were simplified (as well as reduced) by consolidating many categorical grants into a small number of block grants. In 1998, federal direct assistance to local governments amounted to about 10 percent of total assistance and 4 percent of revenues (less than half the contributions in 1978).

State government grants to local authorities have been larger and more stable at about one-third of revenues for many years. The increase in the transfers to school districts prior to the 1980s came from the state governments but that contribution has been stable at about half of school revenues for the past 20 years. Special districts are the only category of local government for which federal grants exceed state grants.

The bulk of intergovernmental assistance to local governments, about 60 percent of the total, goes to schooling. Ninety percent of that comes from the state governments. The role of the states in school finance was growing but received a boost with a wave of court decisions beginning in the early 1970s which declared that local school financing should not depend unduly upon the local property tax base. Thereafter, state aid for schooling rose from 37 percent in 1962 to 50 percent in 1982 and remained at 50 percent in 1998.

Unfunded mandates have become a serious concern of local governments.¹⁷² The problem might be traced back to a decline in federal transfers to the subnational governments and, as some see it, a switch to the federal use of unfunded mandates to exert its influence over the state and local governments. Especially with financial pressures on the states, unfunded mandates quickly emerged as a tool of the state governments to exercise on local governments. Mandates emerged as a problem throughout the U. S. federal system.

Being at the end of the line, unfunded mandates are a particular problem for local governments. Mandates are seen as distorting priorities, restricting flexibility and imposing costs. Estimates exist that between 20 and 90 percent of local expenditures are to satisfy federal and state mandates and that a high proportion of state laws impact financially upon local governments. A difficult problem in deriving such estimates is making a distinction between the legitimate assignment of responsibilities and illegitimate mandates. Clearly, some of the mandates are designed to realize political gains for state legislators at local governments' expense. Cases where generous exemptions from the property tax base are granted or the level or growth of property taxes are constrained with no compensation offer examples.

Local governments have been active politically and legally in resisting the abuse of mandates. Both the federal and many state governments have taken some steps to reduce the adverse impacts. The federal government passed the Unfunded Mandate Reform Act in 1995. Over 40 states require fiscal notes be attached to proposed legislation showing the estimated cost to local authorities. Some states call for reimbursement or, at least, allow local tax increases to cover all or part of the added costs. Reimbursement requirements are sometimes simply ignored. Requiring a two-thirds majority to pass an unfunded mandate may be a more effective deterrent. The effectiveness of these options is being questioned. Presently, surveys of local officials reveal that large numbers see the mandate problem as not improving if not getting worse.

Some limitations on local governments come not from the state governments but from citizens through voter initiatives and referendums. A majority of states have the option of issues being proposed by citizens and, if they gather sufficient support via petitions, being decided by statewide referendums. Many fiscal issues impacting state and local governments go to referendum ballots. One of the best known cases is Proposition 13 in California (1978) which severely restricted property taxation and property tax growth and which, as a result, considerably changed local and state finance there. Evidence suggests that in states where there is a greater potential for using voter initiatives, the levels and composition of taxes and spending is different (Matsusaka, 1995).

Local Governments' Expenditures and Revenues

The pattern of local government spending is reported in Table 1. Schooling is the single largest item at 43.3 percent of the total for 1998. This leaves about 56 percent accounted for by general local government. Pro-

¹⁷² See, for example, Berman in International City/County Management Association (2000).

tection and safety (i. e., fire and police protection) is almost 11 percent of the total. The other large identified categories are health (8.9 percent), social services and welfare (7.8 percent), transportation (6.0 percent) and general public services (5.7 percent). Relatively less important are recreation and culture (3.4 percent) and housing at (2.0 percent). In total, local expenditures are about one-quarter of consolidated government expenditures.

As in the Canadian case, local school authorities are typically distinct from local general government and the two are funded quite differently. Hence, it is useful to distinguish between the two especially on the revenue side. School district and general purpose local government revenues are separated in *Table 13.5*. More than half of school district finances come from intergovernmental transfers with essentially half (49 percent of school expenditures) from state grants. Charges and miscellaneous revenues provide six percent. Taxes, almost all property taxes imposed by the individual school districts, provide 30 percent of school revenues. This percentage likely understates the importance of taxes to school finances because the contributions of supporting local governments (8.4 percent of school expenditures) must be financed and that contribution comes from other governments (hence the subtraction of a corresponding portion from general purpose revenues which fund the contribution).

Table 13.5

Revenues of School Districts and General Purpose Local Governments in the United States, 1998 (Percent)

	School Districts (1997-98)	General Purpose Local Governments (1998)
Taxes		
property taxes	28,9	26,8
taxes on sales		10,3
income taxes		4,0
other taxes	1,1	2,3
Contributions of parent gov't	8,4	-6,0
Charges	2,6	25,0
Miscellaneous	3,4	10,8
Intergovernmental Transfers		
federal	6,6	1,9
state	49,0	24,4
Total Revenue		
percent	100.0 ^a	100.0 ^a
dollars (billions)	\$327,2	\$467,1
% of GDP	3,8	5,4

Source: Authors Calculations from US Bureau of the Census, Annual Survey of Government Finances <http://www.census.gov/>

Note: a) May not sum to 100.0 due to rounding.

In contrast to the school boards, general purpose local governments rely heavily on their own sources of funds. Only about one-quarter of local government revenues come from transfers with the state providing over 90 percent of the grants. Charges provide another quarter of the revenues and miscellaneous sources 10.8 percent. Contributions from user charges have grown relatively over the past 30 years. Locally imposed taxes provide the remainder. Property taxes provide over 60 percent of the tax revenue for the general purpose governments. Local sales taxes account for about 25 percent. Local (personal) income taxes raise almost 10 percent.

Separating school and general purpose authorities as in *Table 13.5* demonstrates the quite different circumstances of the two types of local government. Those differences tend to be obscured when the data are combined as in *Table 13.2*. *Table 13.2*, however, does indicate the revenue picture for local government overall.

Local tax structures vary considerably across states. Property taxes dominate. Taxes on real property (land and improvements) based on market value are the conventional form but personal property taxes (i. e., on furniture, vehicles, inventories, financial assets) still persist in some places and generate small sums. General sales taxes are widely used but almost entirely by general purpose local governments. Somewhat dated literature refers

to 6500 local jurisdictions in 31 states using sales taxes but the «Local Government Revenue by State» table from the U. S. Census shows local governments in almost all states realizing some sales tax revenue.¹⁷³ In many cases, however, the contribution to local taxes are small but in three states local sales tax revenues amount to close to half of local tax revenue. Tax bases (usually the state sales tax base) are state determined and rates are often restricted to a specific range. Four states require local sales taxes. Local income taxes are less common but still important. They are extensively used by local authorities in three states (Maryland, Ohio and Pennsylvania) where they account for between 20 and 30 percent of local tax revenue. They are also particularly important revenue sources in Kentucky and New York (about 30 percent of tax revenues) and in Washington D. C. (37 percent). In many states, local income taxes are used by cities for which they are a significant revenue source often amounting to one-third or more of own revenue. School districts in three states have access to local income taxes. Income tax rates are normally low; e. g., 1.0 to 2.5 percent. While local income taxes are occasionally piggybacked on state income taxes, the payroll form with filing by the self-employed is more common.

The federal government allows local property and income taxes to be deducted (if personal expenses are itemized) in the calculation of federal personal income taxes. This provision provides a federal subsidy to local governments by reducing the cost of local taxes to the federal income taxpayer and shifting a portion of that cost to the federal government and federal taxpayers generally. Since 1986, local (and state) sales taxes have not been deductible. The federal government also subsidizes local debt in that the interest paid on local government bonds is not subject to federal income tax thus allowing local debt to be issued at lower than market interest rates. Both these deductibility provisions have been criticized on efficiency and sometimes on equity grounds.

Direct aid to local governments comes from both the federal and the state governments. The federal transfers are relatively small, about 3.8 percent of total local revenues, and about 70 percent of that is directed to schools. Almost 90 percent of the grants to schools come from the states. Of the \$160.2 billion in state aid to schools in 1997-98, \$112.2 billion was formula assistance (while the remainder is directed to specific programs such as the handicapped, vocational education and transportation). Formula assistance is typically based on need and fiscal capacity and is distributed in an equalizing fashion. Especially since the 1970s, considerable attention has been paid to these distribution formulas and their ability to reduce local school funding from the local property tax base.¹⁷⁴

Federal aid to local general purpose governments amounts to only 1.9 percent of revenues while state grants account for 24.4 percent in 1998. Federal grants are specific purpose (categorical) and often aimed at such objectives as urban redevelopment, roadways and public transit. Federal grants are directed primarily to state governments and those funds may percolate down to local governments through state programs and funding. In the late 1990s, over 60 percent of federal grants to state and local governments went to funding federal programs making payments to individuals (notably Medicaid and income security) and less than 40 percent went towards assistance specifically for state and local governments. For example, in 1996, the federal government devolved responsibility for aid to families with dependent children (AFDC) to the states, many of which passed part of that responsibility on to their counties. Local governments particularly are concerned that the increasing demand upon them to provide social assistance will become an onerous burden especially if economic conditions deteriorate.

State transfers provide over 90 percent of the intergovernmental aid to local governments. About 75 percent of that aid is categorical. Social welfare accounts for about one-third of total state grants, aid for roadworks about 12 percent, other specific purposes 30 percent and general support about 22 percent. The nature of the programs vary considerably across the states but matching funding requirements are typical of specific purpose grants. A few states have revenue sharing arrangements with their local governments (e. g., Arizona, Alabama). Arizona's municipalities receive 15.4 percent of the state's income tax revenues but have had to politic vigorously to prevent that share from being reduced (further as it was recently reduced from 15.8 percent).

¹⁷³ See Table 439 of the U.S. Census Bureau's *Annual Survey of Government Finances* at <http://www.census.gov/gov/>.

¹⁷⁴ For example, see Dumcombe and Yinger (1998) and, for a general discussion, McMillan (2001).

Germany¹⁷⁵

Local Governments and Their Relationships with Other Governments

Germany has a federal system of government with federal, state (Land, 16 with three city-states) and local levels of government. The local level consists primarily of two tiers; the counties (Kreise) and the municipalities (Gemeinden). Municipalities can be of two types — unitary or an association of municipalities (a local mini-federation). As a result, fewer than half of the 8500 Gemeinden in old/west Germany have their own administrations. In addition to the 329 Kreise and the 14,915 Gemeinden, there are 115 county-free towns/cities (Kreisfreie Städte or Stadtkreise) which have the combined powers of municipalities and counties.

Local government in Germany underwent a period of consolidation and amalgamation between 1968 and 1987 (though concentrated in the initial decade). By 1987, for example, the number of municipalities had been reduced to almost one-third of that in 1968 and the number of counties from 425 to 237. Still, in 1987, over 85 percent of municipalities had populations less than 10,000 persons. The objectives of the consolidations were to create local governments of a more efficient size for the provision of local services while maintaining an adequate sense of representation and to establish local governments capable of handling functions to be decentralized. To a considerable extent, the consolidation of local government was renewed following the reunion with the east German states. As in many aspects of German politics and government, there was considerable regional variation in the approaches and outcomes of the consolidation initiative; for example, the amalgamations yielding unified versus associations of municipalities. Also, partly in response to local government consolidations, in the larger urban jurisdictions, it is common to have (sub-) districts many of which have directly elected representatives and certain decision-making powers within the local government; that is, a form of internal decentralization.

The responsibilities of German local governments largely fall into three categories; delegated, obligatory or mandated, and voluntary. The delegated functions are those which are the responsibilities of the federal and/or state governments but which those governments have delegated to the local governments to provide, typically with considerable direction and often financial aid. Examples of delegated functions are registration of births, deaths, marriages, etc., vehicle and property registrations, passport administration, building inspection, social assistance and housing allowances (paid for federally), public transport, some roads and highways, and some police services. Services that local governments are required or obliged to provide include school facilities (lower levels primarily by the municipalities and senior levels more by the counties; teachers are provided by the state governments), vocational training (the counties), aspects of health care, food inspection, day care for children, local roads, fire protection, water, sewerage and waste disposal, and cemeteries. In addition, local governments may voluntarily undertake a wide range of (discretionary) services such as sports and recreational services, cultural facilities and programs, homes for the aged, youth programs, public housing, economic development, markets, further support for education, and various additional public utilities (e. g., electricity, gas, heating). Voluntary services can even extend to saving banks, post offices and health insurance. There is a considerable degree of both horizontal and vertical integration of services — horizontal in the sense that both levels of local governments are engaged (typically cooperatively) in services to local residents and vertically in the sense that many services delivered by local authorities are services for which state or state and federal governments are involved. One consequence is that responsibilities for services become blurred.

Social services dominate local government spending. One-quarter of local outlays go to social security and welfare with somewhat smaller amounts (14.5 and 13.0 percent) going to health and education (*Table 13.1*). Those three areas represent fully half of expenditures. In addition, there is housing (and community amenities) which represents another 15.3 percent. In contrast, transportation amounts to 6.0 percent, recreation and culture 5.7 percent, and protection 3.4 percent. Total expenditures by local governments represents 18.0 percent of consolidated government expenditures and 9.2 of GDP. Interestingly, despite the intention of local government consolidation to prepare local governments for expanded responsibilities and reference to the expansion of the responsibilities delegated and mandated to local governments, the 9.2 percent of GDP figure is only slightly larger than the 8.5 plus percent values observed from 1965 to 1980 (and values below the 8.5 percent level have been observed during the 1990s). Any significant down loading of responsibilities is not immediately obvious in local government spending as a percentage of GDP. Social services have expanded as a share of local budgets since the 1960s while infrastructure investment has declined.

¹⁷⁵ Particularly valuable references include Bennett and Krebs in Gibson and Batley (1993), Gunlicks (1989), Hesse (1991), Norton (1994), OECD (1997), Spahn and Fottingre in Ter-Minassian (1997), Wurzel (1999) and Zimmerman in King (1992).

Excluding the small amount (4.2 percent) of capital revenue, the revenues of local governments are split almost evenly among taxes, nontax revenues and grants (*Table 13.2*). This pattern has been quite stable although the tax share may have diminished somewhat during the 1990s after reunification. The major locally determined tax is a tax on local businesses (a portion of which is shared with senior governments). Local governments also levy a property tax. In addition, local governments receive a share of the personal and corporate taxes and the VAT (among some other minor shared taxes). This shared tax revenue is considered in the data comprising *Table 13.2* as local taxes although local influence on the taxes and their shares is minimal. The taxes and tax sharing arrangements have also been quite stable. Nontax income is relatively high and quite important in local budgets. Intergovernmental transfers come in a variety of forms. Local governments may borrow but debt is generally used carefully and tends to be subject to at least the informal scrutiny of state governments.

Local government is a constitutionally recognized level of government in the German federation. Directly elected representatives are to manage local affairs.¹⁷⁶ The responsibilities of the three levels of government are defined under the Basic Law. Local government, however, is the responsibility of the state governments (although both the federal and the state governments legislate in areas that impact upon local government; e. g., taxation, education). As a result of the state responsibility, there is considerable variation (often regional) among the specific provisions across the states. The federal and state governments can delegate their responsibilities and many are delegated to the local governments, often with a considerable degree of supervision making the local governments effectively agents of the senior government in those areas. In addition, the state governments frequently use local governments, the counties particularly, as a level within their own administration. Beyond delegated and mandated responsibilities, the local governments are guaranteed the right to manage their own affairs. That is, manage their own affairs within the limits of the law. This authority is interpreted as being able to act in those areas not explicitly assigned to or reserved for another level of government. Local government is also granted the right to self-administration within the law; that is, it has the right to address its problems in those ways that it sees fit. Sources for own revenue and the distribution of major shared taxes are set in the Constitution. While following subsidiarity has resulted in the devolution of responsibilities in the German federation, taxes tend to quite centralized — a feature which may constrain local autonomy.

The state governments provide the main supervision of local governments. The state department responsible for local government is the main general supervisory authority with departments focussing on specific functions (e. g., education, health) monitoring the related local activities under their jurisdiction acted on by local government and notably those delegated to local governments. The federal government has a similar interest in delegated services. With respect to the voluntary undertakings, a county committee comprised of county officials and the county chief executive officer, acts for the state governments to rule on the legality of municipal actions. As for other potential disputes about government action (intergovernmental or otherwise), the courts provide an avenue for resolution.

The intertwining of responsibilities across levels of governments and the interdependence of service delivery requires substantial negotiation and consultation if the federal system is to work smoothly. Intergovernmental consultation and efforts towards consensus building is a characteristic of the German system which can be typified as a form of co-operative federalism. It has been noted that those in the various governments recognize the individual and collective roles of the various levels in providing a comprehensive network of public services. Illustrative of the interrelatedness is the fact that it is not unusual for councillors from local governments to serve as members of the state legislatures. In addition to other services, associations of local governments play an important role as representatives of local governments in addressing intergovernmental concerns. It has been noted that «The system works despite its complexity, but not without a great amount of effort given to consensus formation...» (Norton, 1994, p 255).

Intergovernmental complexity among levels of government is paralleled at the local level itself where local governments have extensive flexibility in the available approaches towards provision of services. Local public services can be provided through government departments, own enterprises, arrangements with private organizations (both profit and nonprofit), and joint authorities. Intergovernmental agreements establishing joint authorities (verband) are widely used. In part, they provided an option to amalgamation when local governments were being consolidated but they grew out of a tradition of intergovernmental co-operation and shared services at the local level which allowed communities to realize enhanced service and cost savings despite small size. Joint authorities are extensively used to supply specific services such as water and sewerage, waste disposal, fire protec-

¹⁷⁶ Local councillors are elected through proportional representation but with considerable personal voter discretion over the composition of the party lists that they ballot. The option of appealing to a referendum is available to council and to the public but with usually only if a relatively large percentage of voters (e.g., 15 percent) petition for it.

tion, schools, hospitals, residential homes, and recreational and cultural facilities. Counties also co-operate or work in conjunction with their member municipalities in providing such services as part of their complementary tasks. In metropolitan areas, regional associations of local governments overlapping counties frequently engage in various forms to create an integrated service network.

Given their freedom of self-administration, local governments have flexibility also in their internal organization. The organization of the executive varies substantially (largely regionally) and committees are largely organized to meet local requirements. Most states require that the local school administrations be autonomous (municipal like) in their organization. Meanwhile, the professional public servants are qualified through a national system of study and examinations. Salaries and benefits are also nationally determined. Local governments have control over appointments and promotion but not over dismissal. Once appointed, these senior officials have tenure.

Local Governments' Expenditures and Revenues

Local government expenditures in Germany are outlined in *Table 13.1*. They were commented on above and there is little to add to that discussion. Recall that most local expenditures are for broad social services (including public housing and housing assistance). Taxation, and the funding side generally, is the more interesting aspect of German local public finance.

Taxes provided 30.6 percent of local government revenues in 1996 (*Table 13.2*). Income and profit taxes account for almost 80 percent of local tax revenues. Those taxes are the constitutionally defined local (municipal) share (15 percent, after the solidarity levy) of the national personal and corporate income taxes that the federal and state governments also share (42.5 percent each). Through legislated arrangements, local governments also receive a small share (2.2 percent) of the VAT. National pensions are allocated 3.64 percent of VAT revenues as well and, after those two assignments, the federal and state governments share the remainder 50.5 and 49.5 percent respectively. Local governments levy a local business tax of which 15 percent is shared with the state governments and 5 percent with the federal governments. By one accounting, revenue from shared taxes accounted for 82.5 percent of local tax revenue in 1996.

The local business tax is the major tax of local (municipal) governments. The base is defined by the state governments and includes operating profit, working capital and (depending upon the state) total wages. Local governments have, within limits, some flexibility in setting the local business tax rates. Eighty percent of the revenue from this tax is retained by the local government and 20 percent is shared with the senior levels. The business tax represents about half of the total shared tax revenue of local governments or about 40 percent of local tax revenue. Not surprisingly, business taxes are a considerably more important revenue source for urban than rural local governments. The importance of this tax on business in local finance has been a lingering concern. In 1969, its role was reduced by about 40 percent in exchange for a one percent increase in the local share of income taxes (from 14 to 15 percent) and proposals to reduce its role further are regularly advanced.¹⁷⁷

Other taxes are relatively minor. The property tax exists but is applied at low rates and accounts for only 6.4 percent of local revenues. For the agriculture and forestry sector, land is taxed but buildings are also taxed on other forms of property. Depending upon the state, various excise taxes (e. g., on beverages, entertainment) may also be levied. Such taxes generate very little revenue.

Nontax revenue, at one-third of the total, is a major source of local funds. Revenue from sales, fees and fines represents most of the nontax revenue and one-quarter of total revenue. There is an expectation that, where feasible and not contrary to social norms, charges will be relied upon. Local governments have discretion in setting fees and charges but they are not to exceed the costs of the service. Some fees, the real estate transfer fee for example, are state government regulated.

The sources of revenue referred to above are primarily municipal revenues. County governments do not share in the income and value added taxes. Their own taxes account for very little (e. g., three percent) of their revenues and they also generate limited fees. Instead, counties levy assessments on the municipalities within their boundaries at a rate (a uniform state approved share) of local taxes. Differences among municipalities in their reliance upon county services and county equalizing support of financially weaker municipalities contribute to some county-municipal controversy over these requisitions; a controversy partly moderated by some degree of cross membership between county and municipal councils. Counties rely heavily as well on grants from federal and state governments and upon compensation negotiated for required and other services.

¹⁷⁷ Spahn and Fottinger in Ter-Minassian (1997, p. 229) refer to the possibility that the tax on working capital (a small part of the total business tax) might have disappeared after 1998 if proposed legislation passes. The revenue loss of municipalities would be offset by an expanded share of the VAT.

Local governments obtain about one-third on their revenues from intergovernmental transfers. Almost all of these grants come from the state governments. The constitution limits direct federal government transfers to local governments to only those in aid of infrastructure. However, federal funds can and do flow to the state governments to assist state support of local operations. The states are responsible for adequate local government funding. The Basic Law requires that the state governments share a percentage of their general tax revenues with their municipalities and counties. The states determine what taxes are to be shared and the percentages. The percentages of state tax revenues shared have been significant, averaging about one-third during the 1970s, with some variation among the states. These funds are used for unconditional grants and are distributed on an equalizing basis. Unconditional funding represented somewhat over one-half (54 percent) of transfers to local governments in 1995. The states take account of revenue generating capacities and fiscal needs in allocating those funds among the local governments.

Conditional or specific purpose grants account for the remaining (almost half) of the transfers. Part of those funds goes to pay for those functions delegated to the local governments by the federal and state governments, part goes to support other activities, and about half may go to aid capital expenditures. Social assistance is a major delegated function which (indirectly via the states) receives federal support. Some insight into the funding and support of specific expenditure areas comes from the appended table (*Table 13.7*). Most, about three-quarters, of Germany's expenditure for education comes from the states with local authorities spending almost one-quarter. Of the local share, about 13 percent was funded by transfers in 1991. Local governments also account for about one-quarter of total transportation expenditures but, in this case, almost one-third of that is funded by transfers. Most of the national health spending is by the federal government (72 percent). Local governments' health expenditures represents 15 percent with very little (3.82 percent) of that funded by transfers. The major financial responsibilities for functions vary among governments and the grant support for the local government share of those expenditures also varies by function.

Denmark¹⁷⁸

Local Governments and Their Relationships with Other Governments

Denmark is not a federal country. It has only the central and local levels of government. There are two levels (perhaps better, two types) of local government in Denmark; counties and the local authorities (municipalities). There are 14 counties and 275 local authorities (including in the latter the two capital metropolitan area jurisdictions of Copenhagen and Frederiksberg which hold the dual status of both county and municipality). Counties and municipalities are equals with different tasks. Counties do not supervise municipalities.

The numbers of local governments were greatly reduced as a result of amalgamations under the Local Government Reform legislation enacted in 1970. Counties were reduced from 25 to 14 and municipalities from 1391 to 275. A major consideration was to consolidate local governments into their respective social and economic communities. An objective was to create municipalities of adequate size to support a primary school of at least 175 students. Approximately 5000 persons was considered a minimum size. Currently, 241 municipalities are in the 5000 to 50,000 population range. Counties were to be of a size to support a modern hospital. Nine counties are in the 200,000 to 400,000 population range with only one smaller. Amalgamation was only one part of the reform. Following the amalgamations, greater responsibilities were placed on Danish local governments during the 1970s and 1980s. The subsidiarity principle was followed in the decentralization — that is, devolve services to the most local level of government capable of providing the service competently. The objective was that the government responsible for a service would be as close to the citizens served as practical.

Local governments in Denmark have substantial responsibilities. Counties are responsible for hospitals, health insurance, upper secondary schools, care and education of the handicapped, intermunicipal transportation (roads and public), environment, planning and business development among other tasks. Municipal responsibilities include primary schools (up to age 16), day care, children's health, recreation and culture, care of the elderly (home care, day facilities, housing, etc.), social assistance to those not covered by unemployment insurance, transportation, environmental protection, water, sewerage and refuse, other public utilities, fire protection (police is a central government function), and planning and business regulation. In addition, the municipal governments activate and administer most social programs even if financed by the central government. For example, old age pensions and child allowances are managed by the municipalities but are centrally funded. Partial central support

¹⁷⁸ Information sources include Hesse (1991), Lotz in Ahmad (1997), Lotz in Rattso (1998), National Association of Local Authorities in Denmark (1999), Nissen in Batley and Stoker (1991), Norton (1994), OECD (1997) and Oulasvirta in Gibson and Batley (1993).

is provided for programs like sick pay and subsidized housing. Social security and welfare spending accounts for more than half (57.5 percent in 1998, *Table 13.1*) of combined local government expenditures.

The magnitude of local responsibilities, particularly with the substantial social programs, means that local government have large expenditures. As noted in *Tables 13.1* and *13.2*, the expenditures and revenues of local government represent just under one-third of GDP and more than half of consolidated government in Denmark. In a country where government is large (total government expenditures were almost 56 percent of GDP in 1998), local government is large as well. The revenues of local government come from central government grants (40 percent), nontax revenue (about 9 percent) and taxes (51 percent). Taxes revenues are almost entirely from locally levied personal income taxes.

The reforms initiated in 1970 were a comprehensive and systematic combination of amalgamations, decentralization of responsibilities, and financial reforms. The plan was to establish viable local governments, transfer responsibilities to them, and see that they had the resources to meet those responsibilities. The shift of responsibilities followed amalgamation. For example, during the 1970s and 1980s, responsibilities for hospitals and upper secondary schooling were shifted to counties and social security responsibilities were turned over to local governments. Local governments already played a major role that was supported in large part by conditional grants. Such specific purpose grants were considered unsuitable for supporting the expanded role of local governments. Consequently, the grant system was reformed with a few block grants replacing a number of specific purpose grants. Also, direct central reimbursements for local expenditures in specific areas declined. Local governments were expected to utilize their tax sources more heavily. Since 1978, the main change in the composition of local finances has been that conditional grants have shrunk while tax revenue has increased (Ahmad, 1997, p. 195). The intention was to expand responsibilities but also to enhance and ensure local accountability for funding and performance. The increased burden largely fell on the local income taxes, taxes which local governments had utilized since 1904. Because local governments' fiscal capacities varied, the increased expenditure and revenue responsibilities would only work effectively and fairly if accompanied by a strong fiscal equalization system. Hence, considerable attention was paid also to equalization among local governments. Regulatory reform designed to afford local government greater flexibility and autonomy in coping with local issues has been part of the reform process.

The authority of Denmark's local governments comes from the country's constitution and dates back to 1849. The constitution recognizes the fundamental right of local governments to manage their own affairs subject to a measure of central supervision. While most powers are statutory, there is also recognition of the general competence of local government to act for the common good within their boundaries beyond the specific powers granted in legislation. Although most (one estimate is 90 percent) of local expenditures may be for services local governments are required to make, local governments are provided considerable freedom in making the arrangements to accomplish their tasks. One form of central supervision is the county supervisory committee which, in each county, consists of the central government's county perfect and four county councillors. This body rules on issues of legality of the actions of local authorities. Perfects are also involved in family law decisions and the county board of appeal that addresses social questions dealt with by local authorities. The Ministry of the Interior provides broader oversight. Providing information on local governments' finances and performance in comparison to that for similar authorities is a means used by the central government to allow local citizens to better assess their own local governments.

Potentially more important than direct supervision is the effort made to coordinate policy making with the central government and to avoid conflict. Annually, the National Association of Local Authorities and the Association of County Councils meet with the central government to negotiate budgets for the next year based upon expected revenues and expenditures of the local governments and the state of the economy and central finance. If the situation of local governments is expected to deteriorate, the central government is expected to provide the additional funds. If local authorities fortunes are expected to improve, the grants to them will diminish accordingly. Similarly, if tasks are transferred from one level to the other, the funds are to follow. For example, if a task were transferred to local government from a central department, the central budget would be reduced by the projected cost and transfers to local government augmented by that amount. Similarly, if central legislation impacts upon local budgets, there is to be compensation under the local budget safeguard rule. That is, for example, there is compensation for mandates but the compensation flows both ways. While the negotiations focus on budget matters, there must be consultation about new or changes to other legislation and there is also discussion about regulations and rules. This exchange provides substantial insight and feedback to all parties and assures much more integrated and coordinated policy and action although the agreements reached are primarily only recommendations to the individual local governments but ones that are intended to be achieved across all such arrangements.

Danish local governments are afforded considerable flexibility in how they accomplish their tasks. Councils can vary considerably in size to suit local requirements and preferences. Councillors are elected by proportional representation of the parties running candidates. Councils may run referendums but they are only advisory except, if one about school closure is defeated by 60 percent or more, it must be honoured by that council. Councils are required to establish a finance committee and a social welfare/services committee but may establish others as required. Counties will typically also have at least a hospital and a technical and environment committee and municipalities a school and a technical and environment committee. Committees have considerable authority delegated to them. The administrative structures of local governments are local decisions. Local governments can supply services through their own departments, operate enterprises, contract out to private firms, to nonprofit agencies or to other governments, enter into intermunicipal agreements for services, or other arrangements as they see fit. Public utilities must be self financing through user charges. Borrowing by local governments has been subject to varying restrictions over the years but is generally permitted for infrastructure needs.

Local Governments' Expenditures and Revenues

The distribution of local government expenditures in Denmark is reported in *Table 13.1*. Social security and welfare outlays account for 57.5 percent of the total. That, combined with 16.2 percent for health and 12.4 percent for education, makes a total of 86.1 percent for social programs and almost 90 percent if recreation and culture were included. Obviously, social spending dominates local spending. Relatively little of local outlay goes toward the «hard» or what are often referred to as property related services; that is, transportation (2.7 percent), economic affairs and services (2.2 percent), and protection (0.3 percent).

Further insight into the expenditure pattern is provided by *Table 13.6* which shows the allocation among levels of government and distribution by function for each level for 1994. In financial terms, counties play a smaller role in the local government sector than do municipalities. County expenditures are dominated (about 60 percent) by health followed by that (almost 12 percent each) for education and for social policy. Municipal spending is primarily for old-age pensions (35 percent) which is closely followed by that for social policy (33 percent, largely for care of the elderly and social assistance). Schooling is the next largest item at 12 percent. Note that although unemployment is primarily a central (and a large central) responsibility, it is a recognizable outlay of the municipal governments (4 percent). Copenhagen and Frederiksberg have a combined county and municipality status. A somewhat different accounting for 1994 expenditures in OECD (1997, p. 172) provides further insight into the responsibilities of the county and municipal governments. There, the majority of municipal expenditures are allocated to primary schools (21.2 percent), services to the elderly (19.5 percent), day institutions for children and youth (13.7 percent), social cash payments (13.4 percent) and administration (14.7 percent). The bulk of county outlays are shown as directed to hospitals (48.1 percent), health care (16.0 percent) and upper level schools (13.1 percent). Roads and environment together represented 3.4 percent of municipal and 2.1 percent of county expenditures. While there are some differences in the assignment of expenditures, the alternative perspectives provide insight. Note too that there is also some significant differences in levels of expenditure reported. For 1994, the IMF data (the source for *Table 13.1* and *13.2*) reports total local government expenditures of 314.7 billion kroner while the source for *Table 13.6* reports 291.2 billion and the OECD source reports (revenue) of 267.5 billion. Apparently, although all the data comes from the Ministry of Finance and other government sources, some accounting differences exist; but more of that below.

Table 13.6

Expenditure and Revenue of Denmark's Governments, 1994 (Billions of Kroner)

	Central Gov- ernment	Counties	Municipalities	Copenhagen & Frederiksberg	Total Local Government	General Gov- ernment
<i>Expenditure</i>						
Social Policy	7,8	6,5	65,6	12,8	84,9	92,8
General Old-Age Pensions	-1,8	—	69,3	10,7	80,0	78,2
Unemployment	57,3	0,8	8,2	1,3	10,3	67,7
Health	3,1	34,4	3,0	6,2	43,6	46,7
Education	25,7	6,5	23,3	2,2	32,0	57,7
Interest	62,8	-0,3	0,2	0,5	0,4	63,2
Other	93,0	8,5	26,1	5,2	39,8	132,8

	Central Gov- ernment	Counties	Municipalities	Copenhagen & Frederiksberg	Total Local Government	General Gov- ernment
Total Current and Capital Expenditure	247,9	56,5	195,8	38,9	291,2	539,1
Revenues						
Taxes						
Income Tax	105,1	38,5	79,6	16,7	134,8	239,9
Property Tax	—	3,2	5,1	2,0	10,3	10,4
Value-Added Tax & Excises	141,0	—	—	—	—	141,0
Other Taxes	28,6	0,0	0,8	0,1	0,9	29,5
Total Tax Revenues	274,8	41,8	85,5	18,8	146,1	420,8
General Grants to Local Governments	-34,7	12,3	18,3	4,2	34,8	0,0
Compensation for Old-Age Pension Expenditure	-77,5	—	67,0	10,4	77,4	0,0
Other Specific Grants	-28,9	0,0	25,2	3,6	28,8	0,0
Total Grants	-141,0	12,3	110,6	18,2	141,1	0,0
Fees and Charges	43,1	—	—	0,2	0,2	43,3
Interest	16,7	—	—	—	—	16,7
Borrowing Net	52,8	0,5	1,1	1,9	3,5	56,3
Other Income	1,6	2,1	-1,5	-0,2	0,4	2,0
Total Revenues	247,9	56,5	195,8	38,9	291,2	539,1

Source: Ahmad (1997, p 189)

Total local government revenue sources are reported in *Table 13.2*. That shows half (50.9 percent) coming from local taxes, 40.3 percent from grants and almost 9 percent from other sources. The data in *Table 6*, however, shows grants and taxes each accounting for almost half of total local government revenues. While the amounts of tax and grant funds correspond relatively well with IMF data for 1994, other (essentially the nontax) sources are essentially nil there. While the amount of taxes reported in the OECD (1997, p 171) source approximates that from the other two sources, it accounts for 55.2 percent of revenue with other sources being operating revenues (21.3 percent), general grants (13.6 percent) and refunding (for expenses from the central government, 7.8 percent) and other (2.2 percent). The OECD total revenue is only 267.5 billion kroner for 1994, versus 317.1 in the IMF and 291.2 in *Table 13.6*. These variations illustrate the need for care when using national data and the advantage of have the single consistent accounting across countries such as the IMF data provides.

Local taxes in Denmark are income taxes. In 1998, almost 94 percent of total local government taxes come from income taxes and 98 percent of those are personal income taxes. The local income taxes are locally determined single rate taxes applied on income above a basic personal exemption. The local tax is piggy-backed on the central personal income tax and is applied against the nationally defined taxable income base. In 1996, the average rate for counties was 10.54 percent and for municipalities it was 19.88 percent. In 1994, county rates varied from 8.9 to 10.4 percent and municipal rates from 15.5 to 22.5 percent. Tax revenues go only to the municipality of residence. Municipalities are responsible for personal income and business (but not corporate income) tax assessment following central rules. Numerous, especially small, municipalities have relinquished this responsibility to the central government. A share of corporate income tax and capital gains taxes come to the municipalities but those shared revenues make a very small contribution to revenues and are not regarded positively by central authorities as an alternative to grants.

Property taxes make a small contribution to local revenues. Property taxes in Denmark are on land only. The county rate is set centrally at one percent of the capital value while the municipal rates are permitted to vary between 0.6 and 2.4 percent. The same rates are applied to all properties, both business and residential. Capital value assessments are adjusted annually. Property taxes account for 6.3 percent of taxes, contribute 3.2 percent to revenues and represent one percent of GDP.

Nontax revenues provide 8.1 percent of local government revenues (*Table 13.2*). Most of this (5.8 of the 8.1 percent) comes from fees, sales and fines. Public enterprises and property generate only 1.2 percent. Public

utilities like water and sewerage services, heating, electricity, etc. are required to cover their costs with user charges. Such enterprises are widely operated by local governments under a variety of arrangements.

Table 13.2 shows that about 40 percent of local governments' revenues come from central grants. *Table 13.6* reveals more detail about these transfers. Almost half of total transfers (representing 60 percent of grants to municipalities) is compensation for old-age pensions paid by the municipalities. Old-age pensions outlays (and child allowances) are fully reimbursed by the central government. It is somewhat difficult to regard such transfers as grants and those expenditures as local expenditures when, in effect, the municipal government is simply the agent administering a central program. Other specific purpose transfers exist. Those are for social welfare and employment programs only. They are cost shared or reimbursed 50 percent and provide just under one-quarter of municipal grant revenue. Capital grants, a widely used specific purpose grant in many countries, are very rare in Denmark. General purpose grants represent the remainder (about one-sixth) of municipal grants and all of the transfers to counties. These grants are block grants and, where applicable, equalization grants. Block grants are allocated in recognition of certain broadly defined undertakings and are allocated by formula using objective criteria usually placing considerable weight on demographic factors.

It is useful to reflect briefly on Denmark's equalization system. The objective is to put local governments on equal terms with respect to their citizens' access to local public services. Both tax generating capacity and expenditure need is taken into account. Measuring expenditure needs is the more complex aspect of the process. For the most part, the equalization system is of the relatively unusual Robin-Hood (or fraternal) type. That is, the equalization takes from the «rich» or «have» jurisdictions to fund transfers to the «poor» or «have not» jurisdictions. That is, it equalizes both sides towards the middle. As of the mid-1990s, only the tax based equalization to municipalities was funded by the more common grant or paternal model by which the equalizing transfers to the «poor» jurisdictions is funded by a senior government leaving the well off jurisdictions untouched (and requiring equalization to the top if full equalization is to be achieved). Comparing pre and post equalization per capita tax bases and expenditure needs shows the Danish system to be very effective (Ahmad, 1997, p 199).

Cross-country comparisons with the aid of a conceptual framework

Having outlined the features of local government in five countries, the task is now to compare and assess the often quite different models that have been observed. This analysis is aided by appeal to a conceptual framework that has emerged from the experience of observing and analysing the performance of subnational (and particularly local) governments in many countries by many people; a framework built largely upon the theory of fiscal federalism. There is not space here to develop and rationalize that framework. The principles employed and guidelines being followed will largely have to be accepted. Those principles have been presented and argued elsewhere.¹⁷⁹ The following exercise will briefly sketch the widely accepted criteria applicable to a particular topic (e. g., functions, finances, etc.) and evaluate local government in these five countries to illustrate, demonstrate, and guide policy makers.

The Activities and Expenditures of Local Governments

What local governments do matters for determining intergovernmental fiscal relations. That is, the activities of local governments are critical to the determination of a structure of intergovernmental fiscal relations that will enable local governments to perform their tasks effectively. Indeed, the expenditure assignment, the revenue assignment and the transfers, which together comprise the core of the intergovernmental fiscal arrangements package, are closely integrated.

The responsibilities assigned to local governments vary greatly among countries. *Table 13.1* shows local government expenditures ranging from 2.2 percent of GDP in Australia to 32.6 percent in Denmark. Among advanced economies, local government in Australia is uniquely small being confined essentially to the basic or core activities of local authorities; primarily roads, recreation, waste management, housing, and regulation of local activities. Other than for other Scandinavian countries, local government in Denmark is uniquely large. There local governments have extensive responsibilities for social services (notably social welfare as well a health and education) that are more commonly assigned to central governments or, in federations, possibly to state governments. Interesting to note, however, is that despite the vast differences in the share of local budgets devoted to transportation in the two countries (2.7 versus 27.5 percent), Danish local government spending on transportation is, as a percentage of GDP, larger than that in Australia; 0.9 versus 0.6 percent. Local gov-

¹⁷⁹ The criteria adopted here are outlined and illustrated in McMillan (forthcoming). Those criteria which form the conceptual model employed here emerge from many sources as the numerous references in McMillan (forthcoming) demonstrate. Valuable references include Ahmad (1997), Bird and Vaillancourt (1998) and Ter-Merassian (1997).

ernment in Canada, Germany and the United States are similar in size as a percentage of GDP in the range of 8 to 9 percent. Even here, however, the responsibilities differ. School expenditures account for over 40 percent of local expenditures in Canada and the United States in contrast to 13 percent in Germany. German local governments allocate a much larger portion of outlays to health, social security and housing.

One would be hard pressed to demonstrate that the performance of local governments (or governments more broadly) operating with any one of these distinctly different expenditure assignments is clearly superior or inferior. Indeed, the only safe conclusion is that there is no single best expenditure assignment that can be recommended. What works effectively depends very much upon custom, culture, history, etc. and, importantly, the suitability of the fiscal arrangements.

Clearly there are a set of activities that are best performed by local governments. Beyond that, however, opinions as to the appropriate extent of decentralization or subsidiarity obviously vary. Local responsibility for many services offers the advantages of awareness and responsiveness to local interests but that often needs to be weighed against spillovers, economies of scale and scope, and decision-making costs. Allocative responsibilities (e. g., roads and transport, waste management, drainage, water and sewerage, recreation) — that is, the provision of local services providing distinctly local benefits — are widely regarded as more suitable for local government than those involving significant redistribution and (potentially) significant spillovers such as schooling, health, and particularly social assistance. The countries surveyed illustrate. Local governments in all but (perhaps overlooking public housing) Australia have significant expenditures in at least one social services area but these expenditures are subject to external support. For example, schooling, which is particularly important in local budgets in Canada and the United States has largely been provincialized in Canada and benefits from substantial state equalizing funding in the United States. In Denmark, where social security represents well over half of local expenditures, a large share of those outlays is really made up of centrally designed and funded programs administered by local authorities. Suitably structured intergovernmental relations can make manageable and relatively efficient important spillover generating and redistributive activities left to local governments that can benefit substantially from local management. On the allocative function side, local boundaries (due to obsolescence or for other reasons) need not always match well the effective service areas and communities of interest. Hence, boundaries periodically change, usually at the instigation of a senior government. Major consolidations of local governments have occurred in (at least some areas of) local government in the countries reviewed. To a large extent, these movements were concentrated in the 1950s and 1960s and resulted in considerable reductions in the numbers of local authorities. On the other hand, local governments are not entirely limited by their boundaries. Small jurisdictions especially often see and pursue opportunities for cost saving via shared service arrangements with neighbouring units, contracting with other governments or private firms for service, etc.

Many public services involve a continuum of interests at local, regional and central levels. Consequently, assignment of sole responsibility to a single level can detract from performance. The trick is to unbundle responsibilities for such services so that they will be effectively and responsively provided to citizens' expectations. Because the services and the varying interests can be complex, it is not unreasonable to expect that intergovernmental relations may, in those cases, be somewhat complicated. Various approaches can be found; for example, division of responsibilities for different aspects of the same service (such as health care), cost sharing, joint production. At the extreme are senior governments making local authorities their agents for the provision of some services (e. g., the delegated responsibilities in Germany) and senior governments essentially providing the service (e. g., policing in Australia, Denmark and Germany; fire protection in Australia). The complexity experienced in the recognition of different interests can vary as demonstrated by the Danish and German approaches to (especially) social services. The intertwined interests of the three levels of German government lead to a very complicated system that demands extensive consultation and effort. The Danish structure, despite the greater role of local government, is more clear cut; probably due to arrangements for social assistance and the greater fiscal capacities (taxing powers) of Denmark's local governments. The point is that senior governments may have legitimate interests in services provided by local governments and there are various ways for those to be engaged as seen from the experience of the countries examined. When there is senior government involvement, there need to be mechanisms to provide suitable accountability of local authorities to those governments as well as to their own citizens. In addition, where responsibilities are shared, there needs to be an appropriate assignment of those responsibilities, clarity as to who is responsible for what, and coordination of activities. While various important interests need to be recognized and accommodated, the result should not be confusing even if somewhat complex.

Local responsibilities can be divided among local governments. Local governments can come with varying powers. Counties in Denmark, Germany and the United States overlap and supplement municipalities in the provision of some services. To illustrate, counties in Denmark are responsible for hospitals and upper secondary

schooling, in Germany they have senior schooling and vocational training and health insurance responsibilities, and, in the United States, social welfare is largely a county function. Combining county and municipal powers in a single jurisdiction is widely used in both Germany and the United States to provide local government in urban areas. Canada has some second-tier regional governments in some areas but such authorities are largely missing in Australia. Special purpose local authorities are widespread in Canada, Germany and the United States. Schools, for which there is a large local interest and which require large expenditures, often get special consideration. In Canada and the United States, school districts dominate this class and are a separate form of local government (although as more in Canada lose taxing powers, they increasingly become agents of the provinces). In Germany, the school committees are autonomous and municipal like. Typically less obvious but still important are the host of special purpose and often single authority bodies existing to provide a wide variety of other particular services such as water and sewerage, other utilities, drainage, conservation, fire protection, area wide recreational facilities, transit, health facilities, etc.. These authorities may appeal largely for their ability to realize economies of scale, to better correspond to natural service areas, and/or better match the beneficiaries with those meeting the costs. These special purpose bodies are particularly extensive in Canada, Germany and the United States. The United States has experienced a rapid expansion in the number of these bodies. In Germany, special purpose authorities jointly organized by neighbouring local governments are especially popular and apparently effective and have notable appeal where local governments are small and also in metropolitan areas. Local special purpose bodies are limited in Australia, likely because of the much greater roles of state governments there (e. g., the states provide schooling, fire protection, police services, transit, among others that local governments often engage in elsewhere).

Local government in the five countries have considerable liberty to supply services in the best way that they see fit.¹⁸⁰ In recent years, there has been expanded interest in exposing local government production to market competition, largely through contracting out. The evidence suggests that this can be a valuable approach but it is not a panacea. Appealing to private (or even other government) suppliers requires careful contracting, monitoring and enforcement. Parallel movements have promoted improved efficiency in governments' own operations through programs to measure and reward performance and create better incentives for encouraging productivity. While by no means the only place that (local) public sector efficiency is being promoted, Australia has launched a national program to enhance local government performance.

Local Government Revenue and Own Revenue

Finance follows function. The own-revenue assignment needs to be matched in kind and magnitude to the designated responsibilities. In large part because of external interests in certain local government activities, own revenues are normally less than expenditures with the difference covered by transfers. Not surprisingly, Australian local government, which is small and focussed on local activities, is five-sixths funded from own revenues (and only one-sixth, 16.4 percent, by grants). Grants in Australia contribute half (or less) than grants do in the other four countries. Given the importance of social spending by Denmark's local governments, it is perhaps unexpected that own revenue is not less important there. That feature, however, is likely a product of Denmark's extensive and relatively unique use of local (income) taxes in combination with strong equalization. The composition of own revenues varies considerably among countries.

The benefit principle is fundamental to local government finance. That is, local residents should meet the costs of local public services providing local benefits. There should be a clear benefit-cost (expenditures-revenue) linkage. Local taxes should not be exportable. User or beneficiary charges are a practical way to conform to the benefit principle and to fund a number of local services. Local taxes, charges, fees, etc. should be determined by local governments. The ability to set tax rates (usually not tax bases) is critical. Local taxation contrasts with revenue sharing over which local government have no control and which, therefore, serve as a transfer rather than a tax. Widely accepted criteria for local taxes are that they be locally determined, stable (reliable) or at least predictable, visible (transparent), promote accountability, have low administration and compliance costs, be nondistorting, fair (equitable), and adequate.

Local Taxes

Local tax sources differ considerably among countries. An analysis of OECD countries reveals that many countries (predominately of British heritage) rely heavily upon property taxes, income taxes are the main source in a number of (largely northern European) countries, and in some (mainly southern Europe) a mixture of proper-

¹⁸⁰ In Canada, the extension of natural person powers of local government across more provinces should facilitate and extend local governments' options.

ty, income and consumption taxes prevails (McMillan, 1995/2001). Among the five countries reviewed here, property (and property related) taxes dominate in Australia, Canada and the United States (with modest property taxes found in Denmark and, less so, Germany). Particulars of the property tax bases (land versus land and improvements and capital versus rental value) differ among and within these countries but the tax bases are defined by senior governments. By most of the criteria for local taxes noted above, property taxes are well suited to local governments. The lack of buoyancy (automatic increases in the base, due to inflation for example) has been a criticism but the now widely utilized computer-based mass-assessment methods keep assessments current and diminish that concern. Concentrations of business or industrial property can raise equity issues. Despite their extensive use to fund schooling in Canada and the United States, property taxes are not regarded as an especially successful method to raise revenues to finance social services. High property taxes, such as the levels required to contribute substantially to social programs, meet strong resistance as witnessed in both Canada and the United States where they prompted expanded transfers predominately for schooling.

Denmark and Germany both usually are classified as countries with local governments having a high reliance on local income taxes. Denmark has a true local income tax. The German case, as shall be seen, must be qualified. The Danish local governments receive over 90 percent of their tax revenues and over 45 percent of their total revenues from single rate personal income taxes with the rates set by the individual county and municipal governments. Administration is simplified by piggybacking the tax on the national personal income tax. Because the income tax is seen as better related to ability to pay than the property tax, it is a superior tax for funding social programs that are so large in the Danish local government jurisdiction. Income taxes have a potential disadvantage in that they are less stable than alternatives such as the property tax. In contrast, the local «income taxes» in Germany are actually shared revenues. That is, the municipalities receive a constitutionally specified share (15 percent since 1980) of the national personal and corporate income taxes paid by their local residents. The local governments have no say in these income taxes so they are actually shared revenue, not local taxes, and so rank low when it comes to transparency and accountability. Note that, local (personal) income taxes are relatively common in the United States. While they do not provide a large share of local tax revenue overall (about 6 percent), where utilized, they are a much more important. School districts have access to income taxes in three states. Where not integrated with the state income tax, the administration and fairness is at times subject to some criticism. Canadian local governments had access to local income taxes before World War II.

Business taxes are prominent in Germany. Indeed, the local business tax is (at 40 percent) the major tax source for German local governments. The tax base is operating profit, working capital, and (varying with states) total wages. The local governments have considerable discretion in setting the business tax rate. Forty percent of the revenue is shared with state and federal governments. This tax is widely criticized for its adverse (distorting) effects on business and its lack of transparency and accountability to local residents (e. g., Zimmerman, 1986). Various efforts, some partially successful, have been made to reduce the role of this tax. A variety of local business taxes are levied in most Canadian provinces and they account for about 10 percent of local taxes. At about 40 percent of business property taxes in Canada, they are significant. As in Germany, the Canadian business taxes are subject to criticism for like reasons. Their popularity relates to the perception (at least partially valid overall) that business taxes shift the tax burden beyond the community. Because business taxes are not found to be justified by the cost of services to business property, they undermine the cost-benefit linkage of the local tax-expenditure system.

Among the five countries, local sales taxes are most significant in the United States. Local sales taxes there have been discussed above. Note here that local taxes on goods and services represent 8.1 percent of local government revenue in the United States which far exceeds the contributions from that source in the other four countries where it is almost negligible. Local sales taxes are subject to a number of criticisms. For example, their potential is very uneven among localities, the links to benefits or ability to pay are unclear, avoidance and economic distortions are problems, and multiple levies by overlapping jurisdictions can occur. On the other hand, sales taxes are a popular form of local taxation in the United States (seemingly largely because it is believed to shift some of the tax burden to nonresidents) and they do raise a significant amount of revenue.

A variety of tax sources are found across the five countries but, as is usually the case, a single source dominates in each. With a heavy reliance upon shared taxes (tax-like revenues) and a local business tax, the German system corresponds least well to the criteria for local taxes. Otherwise, while certain criticisms can be aimed at selected revenue sources (especially in Canada and the United States) and there is no shortage of recommendations for improvements, the local tax systems in the other countries fare rather (or, at least, relatively) well. Most assessments rank well designed and implemented property taxes and personal income taxes as attractive for local governments. Indeed, the two in combination would create the potential (with adequate equalization) for local governments to undertake an extensive range of services. Local sales general taxes (and more so local excise tax-

es) score less well by the customary criteria. Local taxes specifically directed at business (i. e., beyond the property tax), and especially local corporate income taxes, fall at the bottom of the list. If sales taxes and business or corporate income taxes are to be directed towards local governments, it is better to use them as a source of contributions to revenue-sharing programs.

Nontax Revenues

Nontax revenues show the most variation of the revenue sources across the five countries. It represents a third of local revenues in Germany and Australia, a quarter in the United States, one-sixth in Canada and one-twelfth in Denmark. Despite its low share of total revenues, as a share of GDP, Denmark's nontax revenue ranks second after Germany and ahead of the United States (with all three in the 2-3 percent of GDP range). In Denmark and Germany, charges are expected to cover the cost of most utility type services. Local governments in Canada have been somewhat «behind» in using charges to cover the costs of many of their utility and utility-like services. In the United States, almost half of the nontax income comes from enterprise profits and property income. In contrast, in Germany and Denmark, charges are not to exceed costs. In general, there has been a widespread movement to increase the use of charges, fees, etc. rather than resort to taxes. User charges meet many of the criteria of good taxes; for example, visible, accountable, fair in that the beneficiaries pay, often easy to collect; plus they both reveal demand and may constrain demand. Where there are not important social reasons otherwise, they are attractive. While distribution and access can be a concern, criticism of charges and fees on distributional grounds often pay insufficient attention to the distributional implications of the alternative funding sources required in their place.

Intergovernmental Transfers

As in other developed countries, transfers in the countries surveyed for this analysis make significant contributions to local governments budgets. The smallest contribution is about 16 percent in Australia, followed by 33 percent in Germany and approximately 40 percent in Canada, Denmark and the United States.

Intergovernmental transfers can be motivated by various economic or other objectives. One of the economic objective for which grants may be employed is to improve efficiency by correcting for interjurisdictional spillovers (externalities) which otherwise cause inefficient levels of output. This case calls for conditional (specific purpose) grants directed to support the externality generating activity yielding positive effects. The problem is that many of the externalities for which corrections are sought are difficult to measure, often because part of the externality has to do with distributional considerations. Closing fiscal gaps because of a mismatch between the expenditure and revenue responsibilities is a second reason. Central to such grants is determining the magnitude of the gap (s) which, ideally, should be based upon estimating the difference between revenue capacity and expenditure need for each local authority. These transfers should be unconditional (general purpose). Also, because they represent a vertical fiscal gap or disparity between levels of government, the funds should come from the senior government (s). Funds designated for revenue-sharing are a potential source. Because local authorities differ in their abilities to meet their fiscal responsibilities a third rationale for grants is horizontal fiscal equalization. Although typically considered as justified on equity grounds, this type of grant can also enhance efficiency. Like the vertical gap-closing grant, these transfers should be based on estimates of differences in fiscal capacity and expenditure need. Consequently, the magnitude and distribution of such grants needs to be over-arching in that consideration is given to other grants. Typically, equalization grants are determined and paid by senior governments but occasionally one finds transfers from rich to poor (i. e., among) local governments themselves; that is fraternal rather than paternal. Political reasons for transfers are numerous and often dominate the economic considerations. In practice, unfortunately, the purpose of grants are often difficult to distinguish as a blend of purposes may underlie the initiative.

As with taxes, intergovernmental transfer programs have criteria against which they can be evaluated. Indeed, there are overlapping criteria. Good grant programs should have a clear purpose, funds be allocated objectively, be non-negotiable, be relatively simple and transparent to all, ensure accountability, provide the autonomy and flexibility necessary for effective utilization, be stable and, as required, be equalizing. Intergovernmental grant systems should be very much about getting the incentives right. With the correct incentives, local government will work better. If they are wrong, they will not help and can detract from performance. There can be significant rewards to getting the fundamentals right.

The diversity in grant practice is reflected in the five countries. The grant programs can be considered broadly under general purpose and specific purpose grant categories. The German revenue-sharing program, the funds of which are (as in the data here) commonly counted under taxes, is actually a gap-reducing transfer that primarily allocates 15 percent of national personal and corporate income taxes to the originating local govern-

ments. The majority of Australia's Commonwealth grants destined for local governments had their origins in revenue sharing. Those transfers are allocated by state grant commissions to local authorities for general purpose use according to clearly defined criteria involving revenue generating capacity and expenditure need. Those funds represent about 40 percent of the total aid to Australian local governments. The German states assign substantial but varying shares of their revenues to local governments, again using equalization formula. Those grants represent about half of the grants to local authorities. Both the Australian and the German state government programs blend fiscal gap-filling with equalization. In Denmark, there is not what might be considered a gap-filling grant program. Rather, there is a strong and effective horizontal equalization program with the fiscally advantaged localities funding (almost entirely) transfers to the fiscally disadvantaged municipalities. Such inter-local transfers are not common. In Canada and the United States, significant gap-filling and equalization transfers are primarily found in school finance where they are quite extensive although with substantial province to province and state to state differences. Municipalities in Canada and the United States, which are similar to but have relatively more responsibilities than their Australian counterparts, receive about 15 percent and 25 percent respectively of their revenues from grants. Among general purpose local authorities, there are no parallels to the national Australian and (constitutionally required) German programs. Again, there are tremendous variations across the provinces and states which are by far the major (almost exclusive) source of support to municipal governments. In Canada and the United States, general purpose grants for general purpose local governments typically are not a priority. In Canada, for example, unconditional support is less than 20 percent of the total and in only three provinces do unconditional transfers exceed conditional. Although general support funds are normally distributed using some, usually rather limited, equalization criteria, past studies suggest that, largely due to lack of adequate funds, the equalization achieved is limited. While there are undoubtedly exceptions among the provinces and states, general purpose local government neither gets the level of total support or the extent of general purpose funding that is found for local governments in Australia, Denmark and Germany.

Specific purpose grant programs are important in all five countries. In Canada and the United States, grants for schooling (to school boards) are multiples of the amounts of total grants to local general purpose governments. Even among grants for the general purpose local authorities, specific purpose grants typically dominate. As in many other countries, reform of the specific purpose grant systems (through a move to block funding) has tended to reduce the number of grants and simplify the conditions making the specific purpose grant system much more tractable. In Australia, about 40 percent of the Commonwealth grant to local authorities is specified as a road grant and that is distributed according to road related criteria but, when distributed, the funds are untied. Meanwhile, the 50 percent of grants to Australian local governments coming from the states are specific purpose; primarily for housing and community amenities and for transportation. In Germany, also about one-half of transfers to local government are designated for specific purposes but much of that goes to compensate for responsibilities delegated by the federal and state governments (as in the social services). Senior governments in the United States and Canada have been much less generous in providing compensation for the functions which they have mandated to local governments. In Denmark, a single transfer dominates the transfer package. Over 60 of total transfers go to reimburse municipalities for outlays under the central old-age security program that local authorities administer. This is not unlike what school transfers in Canada are increasingly becoming. Of the remainder in Denmark, about 40 percent are for other specific purposes.

An anomaly of local public finance is that while transportation (notably roads and streets) is a major expenditure category of local governments, local governments do not (or rarely) have access to motor fuel taxes or license fees that relate to those expenditures. This situation is not surprising because the mobility of purchasers make the application of such user charges (less so for licenses) by individual local authorities problematic. In some cases, the collection of such revenues by state or federal governments may go to fund transportation grants but often there is no direct linkage. This situation makes a good case for revenue sharing of transportation related taxes and charges by central and provincial/state governments with local governments. A share of such funds could be turned over to local governments either as a specific purpose grant or, probably more logically, as an effectively untied grant such as the Australian Commonwealth road grant. In Canada, a few provinces share some motor fuel taxes but with only selected local governments.

Specific purpose transfers have often been in support of capital spending. This has been particularly so in Canada and the United States. In Germany, federal grants to local governments can only be to support infrastructure. In Denmark, however, capital grants are rare. Donors of capital grants have been criticized for providing the upfront or initial cost but ignoring the ongoing operating needs. In addition, capital grants can be distorting by biasing expenditures towards capital versus maintenance.

Grant systems differ considerably among countries but the basic types of grants are similar. There is sufficient information to make a normative judgement about the unconditional funding provided across these coun-

tries. It would require extensive and detailed study to determine whether specific purpose grants were better designed or implemented in one over another. However, the governments in Canada and the United States seem to place an unnecessarily heavy reliance on specific purpose (versus unconditional or general purpose) transfers to their general purpose local governments. A common problem with grants is that transfers from senior governments are often unstable and unreliable and, with local governments being at the end of the fiscal line, little can be done to moderate the impacts. To illustrate, there was the coming and going of the revenue-sharing program in the United States. In Canada, the fiscal austerity of the 1990s saw grants to municipal governments decline from 23 percent to 15 percent of revenues within a decade.

A Note on Fiscal Imbalance

It is not uncommon to find reference to fiscal imbalance, especially in discussions of local government. In the simplest form, fiscal imbalance refers to situations in which a government's expenditures exceeds the revenue from its own sources. One can refine that definition to relate to the more difficult to measure concepts of expenditure requirements to meet expected services and own revenue generating capacity but the simple expression is adequate here. Fiscal imbalance implies grants, the source of funds covering the deficiency between expenditures and own-source revenues. Often, fiscal imbalance is associated with arguments for need of expanded tax capacity, additional transfers, reduced responsibilities, and may come with negative connotations or a negative spin such as those relating to poor management on one side or unreasonable demands or burdens on the other.

The point to be made here is that fiscal imbalance as expenditures exceeding own revenues is not a meaningful concept. One could have situations in which local governments' own revenues equal expenditures and (despite good management) local public sector needs are attended to poorly. Alternatively, one could have situations where there is a large gap between the two and the local public sector is sufficiently funded and well managed. For example, if local government is responsible for provision of a service having substantial spillovers, balancing expenditures with own revenues will result in inefficiencies and under provision of that service. There is nothing necessarily magical about local own revenues matching expenditures. The question of fiscal (im) balance is more complex.

Rather than raise the spectra of fiscal imbalance, the more relevant approach is to determine the most appropriate fiscal balance in particular circumstances. As noted, finance follows function. If responsibilities are extensive, revenue sources need to match both in terms of providing the capacity for adequate revenue and in terms of providing an appropriate cost-benefit link between taxes and expenditures. Are local authorities provided revenue sources that will allow own revenues to meet expenditures (even if spillovers are not an issue)? It is possible that charges and the property tax, for example, will be insufficient and access to an additional tax source such as a local income tax may need consideration. Alternatively, if other tax sources are deemed inappropriate, a fiscal gap-filling transfer is necessary. The issue then is the suitability of the amount and distribution of the transfer. Similarly, if a local government with little revenue generation capacity and larger expenditure requirements receives equalizations grants, that does not imply a faulty fiscal system that removing the fiscal imbalance would rectify. And again, if important externalities exist, corrective grants are called for. Thus, «fiscal imbalance» (as the deficiency of own revenues to cover expenditures) may exist for legitimate reasons. The valid assessment of fiscal imbalance has to address whether the total fiscal arrangements — expenditure responsibilities, revenue sources, amount, allocation and type of transfers — is appropriately structured to provide local services efficiently and effectively to community expectations. Such assessments must be carefully done and can be complex tasks. It is possible that the outcome might be smaller or larger transfers. Simply noting that transfers exist and their relative magnitude reveals nothing about fiscal (im) balance.

Infrastructure¹⁸¹

Local governments provide a number of capital intensive services. Roads and streets, public transit, water and sewerage systems, and drainage probably dominate the list but capital facilities are also important to recreational and cultural activities, schooling, health care, etc. in which local government is frequently also involved. Overall, local governments typically account for about half of total government capital spending.

Local capital expenditures are usually financed from a combination of own funds, transfers and debt. Own funds are normally reserves that have been accumulated from taxes, charges and other sources of revenue. It is not at all uncommon that many specific purpose grants are designated for specific capital expenditures; for example, roads, public transit facilities, school buildings. Among the countries reviewed, Denmark is relatively unusual in that capital grants are not common. Capital grants may appeal for a variety of reasons — visible, assist

¹⁸¹ For some further discussion specific to local infrastructure finance, see Ter-Minassian and Craig in Ter-Minassian (1997) and von Hagen et al. (2000).

in funding potentially lumpy expenditure demands, aid to localities — but capital spending programs (even at the local level) are often less irregular than suggested; if aid for capital outlays is justified, aid for operations likely has equal merit; aid biased towards capital outlays can discourage maintenance. Infrastructure assistance needs to be thought through carefully. Debt finance can be used to stabilize demands for local funds and is a means of distributing the cost of capital services over its life and onto the beneficiaries as they change over time.

Local government borrowing is almost always restricted to financing for capital facilities. Borrowing to cover unexpected operating or current account deficits normally must be repaid in the next budget year. Local borrowing is monitored in many ways and is rarely left solely to the discipline of the market. In Australia and Germany, local capital requirements are assessed in conjunction with those of the state governments in their negotiations with the federal authorities. Danish local authorities collectively negotiate limits to local borrowing with their central governments. In Canada and the United States, market discipline is a more important determinant of local borrowing but still there are a variety of controls and monitoring by the provinces and states.

Local governments may be able to borrow directly from capital markets but senior governments will typically supervise and in some cases provide support in arranging loans. Some provinces in Canada borrow to lend to their municipal governments through provincial municipal finance corporations. This arrangement affords the province direct supervision and, with the strength of the provincial authorities, enables the municipalities to secure financing at better rates than they could individually in the market. In parts of western Europe, municipal development funds (with central support) have had a long history as financial institutions serving local governments. In many cases, these are evolving into more independent and commercial ventures.

Direct assistance in meeting debt obligations is not unusual. The tax exemption for interest on (state and) local debt in the United States is a large and significant form of aid to (state and) local government. Other forms of assistance to local authorities to meet debt obligations, in the United States and elsewhere, are not uncommon but are typically less systematic and are often occasional. It is important that aid not undermine financial discipline. Good resource use and sound financial management require that local governments not be permitted to borrow and spend indiscriminately in expectation of a bailout from a senior government. Budget constraints must be hard; that is, no bailouts. If some assistance is necessary as a result of a borrower's mistake, it needs to come at a significant price. While exceptions exist, local governments in the five countries use debt responsibly because they are held accountable for their decisions. While accountability promotes responsible use of funds and debt, it is also necessary that local governments have a sufficiently appropriate matching of expenditure responsibilities and revenue sources that they are not pressured towards the use of unsustainable debt.

Accountability

Successful local governments are accountable to their citizens, their senior governments (as needed), and their lenders. Internally, the local public service must be accountable to the local politicians. Accountability requires information. The different lines of accountability require different kinds of information but, generally, information should be accessible to all.

One need of information is for resource management. This aspect is about making the best use of the resources available. Effective resource use has two aspects. One is about allocating resources among programs to best serve the community. In part, this involves forward planning as well as current activities. The other aspect is about making the best use of the resources within each program. The two, of course, are intertwined. Good, but somewhat different, information is essential for both.

Information is necessary for financial management and control. This information is directed at ensuring that resources are used as intended. Avoiding corruption and misappropriation of resources is, of course, important but also important is simply avoiding careless management of funds. Senior governments are interested in assessing the need for their grants and tracking the utilization of those funds, especially conditional transfers. Independent external audits are essential for control but internal control mechanisms are vital as well for an effective system.

Local governments should be making information on their finances and operations public on a regular, timely basis to promote accountability and public awareness. One set of criteria for public disclosure is that it be complete, comprehensible, comparable, verifiable, and public. Senior governments have an interest in and they can do much to promote consistent and reliable local government information systems through combinations of regulations and incentives and they can do much to ensure public disclosure. Senior governments are in a unique position to provide information about local governments on a comparative basis to aid assessment. Australia's initiatives in this direction received special note. In part because of the efforts of senior governments but also partly because of local needs and demands, local governments in the five cases considered above have extensive

and high quality information systems reporting internally, to citizens, to other governments, and to the public generally. Undoubtedly, this exposure contributes to the performance of local governments in those countries.

To perform their tasks effectively, local governments require a civil service that has competence, integrity and motivation. The civil service needs to be accountable to local elected officials. Accountability does not imply political appointees. Rather, the call is for a skilled and trained public administration whose recruitment, advancement and retention is based on their performance in meeting the programs and policies of the council. Germany is somewhat unique among the countries examined in having the more formalized training programs for local bureaucrats but also for permitting the local authorities the least control over that staff in lacking the authority to dismiss.

Local autonomy also contributes to effective performance. Management autonomy or flexibility in the local approaches to problem solving is the main focus here. Generally speaking, local governments among these countries have considerable flexibility in determining how to solve local problems. While many do not have general competence powers, may be bound by the strings of conditional grants in some programs, and may be constrained in their revenue sources, there is still reasonable flexibility, if not autonomy, in addressing issues. This is not to argue that, in cases some relaxation of restrictions might be helpful. Appropriate independence not only enables accommodation to local circumstances but also encourages innovation.

Local governments in the five countries are primarily responsible to their citizen-voters. The organization of elections, councillor representation (e. g., wards versus at large), terms of office, number of representatives, etc. varies substantially and there are wide-ranging views of the pros and cons of the numerous alternatives but the elected representative system is common and vital. Senior governments typically, at least within guidelines, provide the basis for the representative structure. Public participation in local government goes well beyond elections. Hosts of citizen groups and interest groups with varying degrees of formal organization plus concerned individuals serve to monitor, evaluate, advocate, reveal preferences, etc. and, thus provide input into and influence the political processes and decision making. Information is, of course, important to the roles of voters and citizen groups.

Table 13.7

Relative Government Expenditures for Selected Countries, 1993

	Expenditure by Level (%)			Government Expenditure as % of GDP	Local Government Expenditure as % of GDP	Percentage of Local Government Outlay Funded by Transfers
	Central	State / Provincial	Local			
Total General						
Government						
Australia (1993)	51,1	42,6	6,4	41,2	2,6	18,6
Canada (1991)	40,8	40,4	18,9	50,8	9,6	43,3
Denmark (1992)	46,0	—	54,0	60,9	32,9	42,7
France	81,3	—	18,7	53,7	10,1	34,7
Germany (1991)	61,3	21,4	17,4	45,4	7,9	27,0
Netherlands	69,8	—	30,2	57,8	17,5	69,2
United Kingdom	72,6	—	27,4	45,6	12,5	73,2
United States	55,9	19,9	24,2	36,2	8,8	39,3
EU — Average	66,2	21,4	29,5	52,7	16,2	49,4
Average	61,0	31,1	24,7	49,0	12,7	43,5
Education						
Australia (1989)	9,8	90,0	0,2	4,6	0,0	60,6
Canada (1991)	4,4	33,7	61,9	6,3	3,9	67,4
Denmark (1992)	54,1	—	45,9	7,7	3,5	8,8
Germany (1991)	1,9	75,1	23,0	3,2	0,7	13,0
United Kingdom	27,3	—	72,7	5,6	4,1	8,3
United States	4,2	24,1	71,7	5,3	3,8	52,6

	Expenditure by Level (%)			Government Expenditure as % of GDP	Local Government Expenditure as % of GDP	Percentage of Local Government Outlay Funded by Transfers
	Central	State / Provincial	Local			
EU — Average	27,7	75,1	47,2	5,5	2,8	10,0
Average	16,9	55,8	45,9	5,4	2,7	35,1
Health						
Australia (1989)	41,7	57,5	0,9	5,2	0,0	2,5
Canada (1991)	2,0	90,3	7,7	7,2	0,6	46,3
Denmark (1992)	8,1	—	92,0	5,4	5,0	0,6
Germany (1991)	71,8	13,3	14,9	6,9	1,0	3,8
Netherlands	93,6	—	6,4	7,8	0,5	8,3
United Kingdom	100,0	—	0,0	5,8	0,0	—
United States	46,4	40,1	13,6	5,7	0,8	16,9
EU — Average	68,4	13,3	28,3	6,5	1,6	4,2
Average	51,9	50,3	19,3	6,3	1,1	13,1
Transportation & Communication						
Australia (1989)	11,0	61,8	27,2	2,4	0,7	16,4
Canada (1991)	30,2	32,3	37,5	2,7	1,0	24,8
Denmark (1992)	53,7	—	46,3	2,1	1,0	0,3
Germany (1991)	57,2	17,0	25,8	2,0	0,5	32,2
Netherlands	46,4	—	53,6	2,5	1,4	30,0
United Kingdom	38,5	—	61,6	1,2	0,7	0,5
United States	20,9	45,0	34,0	1,6	0,5	25,7
EU — Average	49,0	17,0	46,8	1,9	0,9	15,7
Average	36,8	39,0	40,9	2,1	0,8	18,5

Sources: Government Finance Statistics Yearbook, (Washington, D. C.: International Monetary Fund, 1995).

Notes:

1. Data are for 1993 except for Australia, Canada, Denmark, and Germany, which are 1989, 1991, 1992, and 1991 respectively.
2. Expenditures are net of transfers to other governments.
3. For the Netherlands, the interpretation of education spending is uncertain. In 1993, central education grants exceed provincial and local spending on education. As a result, the data is excluded.
4. For France, transfers to local governments have not been identified by function since 1985.

Lessons and conclusions

This review of local governments focussing on regional-local government fiscal relations affords a number of lessons. The inspection of local government situations in Australia, Canada, the United States, Germany and Denmark is valuable in that there is a great diversity in arrangements but all rank relatively well in terms of performance. This latter comment is not to suggest that there is not potential for improvements for, indeed, most analysts in the field would have suggestions in each instance. Those possibilities, however, help define the lessons. Not surprisingly, the lessons noted here parallel closely what would emerge from the study of many more countries. As is to be expected of a concluding section, the points made here can only highlight major conclusions. The lessons focus upon the results of the comparative analysis.

1. Finance follows function. There is no single best model for the assignment of expenditure responsibilities. Responsibilities can be bundled many potentially workable ways. Hence, there is considerable diversity in the functions and size of local governments. Once the expenditure assignment is made, however, the role of the revenue assignment is to structure a set of revenues that will enable local authorities to meet those duties efficiently and fairly.

2. In some cases, reassigning expenditure responsibilities may be the best way to match (better) finance with function.

3. The imposition of unfunded mandates can create problems for local governments. Quite different approaches are found in the different countries to the financial implications of mandates imposed on local governments. In Denmark and Germany, compensation for costs is given priority.

4. Own revenues (i. e., taxes and charges primarily) are preferred to transfers in the first instance but own revenues may be inadequate or inappropriate for financing some functions. Where taxes or charges are not suitable, transfers are called for but consideration may be given instead to expenditure or revenue reassignment.

5. The benefit principle is particularly important at the local level, and particularly for municipal governments, both across households and across communities.

6. Especially for municipal governments, careful (if not first) consideration should be given to beneficiary (user) charges that could provide a reasonable matching of benefits and costs. Where those are found inadequate or inappropriate, then turn to consider taxes and then transfers.

7. Local governments typically rely upon a variety of revenue sources and generate revenue from a number of taxes but, usually, a single tax dominates other tax sources. A tax is a local tax if the local government can set the tax rate (i. e., control the revenue). Local governments need control of their own revenues; that is, the ability to set their tax rates and charges.

8. Different taxes generate different distributions of costs and may be better suited to the finance of different services. Property taxes may correspond well to the benefits of services related to property but a local personal income tax may be better suited for funding services for which ability-to-pay is felt to dominate the benefit criterion or benefits are related to income; for example, hospitals and schooling as in Denmark.

9. Special business taxes (beyond the property tax) have mixed merits. On the one hand they may have the potential to match better taxes with the costs of associated services but, on the other, they appear to be used more often to shift or export the tax burden and mask costs to local residents.

10. Local sales taxes are more common than the survey here suggests but they have problems — for example; border problems, tax exporting problems, uneven tax base problems, and lack of clarity of the benefit-cost linkage.

11. Local taxes should be stable (reliable), visible (transparent), promote accountability, have low administration and compliance costs, be nondistorting, fair (equitable), and adequate.

12. Transfers can have a legitimate purpose. Those roles are to correct economic distortions due to spillovers (externalities), close fiscal gaps, and equalize fiscal capacities. The political role of grants may also be legitimate.

13. Grants should have a clear purpose, be allocated objectively, be non-negotiable, be relatively simple and be transparent (especially in regard to purpose and allocation), ensure accountability to donor and recipient, allow the autonomy and flexibility needed for effective utilization, be stable, be adequate to cover needs, and, when required, be equalizing.

14. Specific purpose grants, which are usually best suited for correcting externalities, are often over or miss used and often could be replaced by less restrictive funding.

15. If grants are for gap closing, the main issues are; what is the gap?, what revenue should be shared?, and how is the revenue to be distributed?

16. Intergovernmental transfers especially, and some would say the whole question of fiscal federalism, is about getting the incentives facing governments right.

17. Often, grants are unreliable and unstable revenue sources which change depending upon the donor's circumstances. Where workable, local taxes may be a more stable alternative.

18. Fiscal imbalance, a measure of the gap between own revenues and expenditures, is itself not a meaningful concept. The problem of fiscal (im) balance is more complex.

19. Local government is responsible for a disproportionate share of infrastructure investment. Funding that investment often requires borrowing. If not for other reasons, borrowing creates the potential for default and that invites supervision by senior governments. Senior governments can aid (especially small) local governments access the capital markets but they should promote responsible borrowing by enforcing hard budget constraints and by not being available for bailouts.

20. Accountability is essential for effective local government. Local governments must be accountable to their citizens, to senior governments (as needed), and to lenders.

21. Accountability requires information if the oversight of citizens, other governments, and lenders is to be effective. Information is also necessary for resource management and financial control.

22. Local governments need a civil service that has competence, integrity and motivation, that is evaluated on merit, and that is accountable to the council for implementing the council's programs and policies.

23. Ongoing and broadly based public participation is required and representatives need to be motivated to be attuned to that by the prospect of electoral defeat.

These lessons emerge primarily from investigation of the assignment problems; that is the assignment of expenditure and revenue responsibilities. Regional (senior) governments play an important role in defining the outcomes to these and a broader set of problems. That is, the regional governments have a major role in creating the institutions in which local governments operate and the development of these institutions is very much what regional-local relations are about. In thinking about these institutions and their development, regional and local governments need to contemplate a broad set of problems. Because arrangements, assignments and institutions themselves evolve from the interaction of many interests, an important consideration and objective is having meaningful intergovernmental relations where views are exchanged and alternatives considered. Other objectives that need be considered are achieving clarity of the mandates of each level of government, provision of adequate resources, allowing sufficient management discretion, and ensuring political accountability. Regional-local relations that pay attention to these matters will go some way towards having institutions and arrangements that will enable local governments to perform effectively.

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Chapter 14. The Role of Federal (Central) Governments in Local Affairs

Introduction

This paper addresses one of the key issues facing local governance in advanced democratic political systems: the role of the central government in local government affairs. At first glance this topic may seem at odds with federal values and the design of federal systems. After all, federalism aims to separate and share power so that local affairs are run by local institutions to meet local needs and preferences. In that sense, discussion of the role of central governments¹⁸² would be pathological: examining how the system has gone wrong, where central governments intervene in local affairs. And one might assert as well that it is the relations between local governments and the intermediate order of government, i.e. states, provinces, regions, etc. that are more vital to local governance. Both of these assertions have much validity. This paper places its discussion of the federal-local role in the context of the more extensive and usually more significant provincial-local relationship.¹⁸³

In this paper, however, the chief assumption is that the exercise of local authority and self-governance depends upon, and is not necessarily diminished by, an effective partnership between the federal government and local governments in a federation. The federal role arises at many natural points. First, federal government operations have inevitably a local presence and effect – for example, military bases have municipal neighbours. Second, federal governments have a direct relationship with their electorates as much as provincial and local governments do, and political representation may reflect local politics as much as national issues. Third, in the age of globalization, policy fields are more naturally concurrent: policy externalities of trade and environment, for example, extend through all the levels of government in a federation –indeed beyond them to international governance institutions. Fourth and finally, federal governments play a key role in economic redistribution and the promotion of national norms in social entitlements. This role in achieving equity in a federation often involves federal governments in local programs, if not always with local governments as such.

To better understand the evolving role of federal governments in local affairs, this paper examines four federations. These are the United States, Australia, Germany and Canada. The paper provides somewhat more detail on Canada, due to the author's more in-depth familiarity and understanding of the Canadian case, as well as better access to research information. Yet the intent is to provide sufficient information on the four federations, presented in a common template of analysis to allow the reader to see the similarity in federal-local relations, and trends in policy and political preoccupations. These four federations are chosen for comparison because they are all well-established, with advanced industrial (and post-industrial) economies and societies. Australia provides an example of relative fiscal and program centralization at both the federal and state levels with a much-reduced role for local government. Germany's federal system is more integrated, through its political party system, interdependent decision-making, and revenue sharing, among other features. The United States has the most competitive system, with a more chaotic system of intergovernmental relations and a highly disaggregated system of local government. Canada's federal system is the most decentralized in fiscal and programmatic terms, as well as having more significant regional and cultural diversity. This paper does not attempt a direct comparison with the Russian Federation, but it is evident that comparing the four systems brings forward important relevant features. These include: territorial scope, regional and cultural diversity, combinations of intensely urban and rural populations, degrees of economic and fiscal disparity, and last but not least, the need for direct involvement of the federal government in many local issues.

The remainder of this paper is organized as follows. The next four sections examine the four federal systems in turn, with discussion within each section of three themes: 1) the federal system and political culture; 2) overview of the federal role in local affairs; and 3) selected federal-local issues (as well as a fourth section of summary comments). The concluding part of the paper draws together comparative analysis covering different models of federal-local relationships and evolving trends in direct federal-local affairs.

United States of America

The Federal System and Political Culture in the United States

The American States invented their original federal constitution in 1789, providing the then unique solution of an independent general government co-existing with state governments, to enable the emerging nation to have democratic rule over a large territory. American federalism today is characterized by continuing competition

¹⁸² From here on we will refer to the central government in federal systems as the “federal” government.

¹⁸³ For further detail on the provincial-municipal relationship as such see the paper prepared for the CEPRA project by Andrew Sancton, “The Legal and Political Setting of Municipalities”.

among governments. Its 50 states interact in a dense geographic pattern, and local government is a dynamic and diverse entity, with many metropolitan areas overwhelming state boundaries. At times there seems more chaos than order in the federation, but the results are creative.

Basic features of the federal constitution and federal system include:

- The strict separation of powers among the executive, legislative and judicial branches of government, at both the state and federal level. Much of American politics is about competition between the three branches of government.
- The distribution of powers between the federal and state legislatures following a pattern of exclusive federal powers, a concurrent list of state and federal powers, and the residual powers held by the states. As a result of the concurrent powers, the federal legislature has occupied much state legislative room over time – i.e., by “pre-empting” state legislation.
- Individual State constitutions provide a further means to promote state autonomy and diversity, including in the structure and functions of local government.
- The federal legislature, Congress, has two houses: the House of Representatives elected on the basis of state population in single member congressional districts, and the Senate originally appointed by the states but now elected, on the basis of equal representation of two seats per state.
- The federal and state Supreme Courts are fully independent under the state and US constitutions. The Supreme Court of the United States is the final court of appeal for constitutional matters.
- The first nine amendments to the US Constitution constitute a Bill of Rights providing a strong protection of individual rights. Combined with the independent judiciary, this has resulted in a political culture that is strongly rights-oriented and litigious, and in which the courts are called upon frequently to settle intergovernmental disputes.

More than other federations the American system depends on intergovernmental relations to make it work. These relations differ substantially from parliamentary federations such as Canada, Australia and Germany. The separation of powers means that the President and the State Governors do not have and cannot deliver a legislative mandate. They must negotiate bills with the legislature, often use the veto power, and can often be in protracted stalemate with legislative leaders. Moreover, the State Governors as a group do not often meet with the US President, certainly not on a regular basis.

Intergovernmental negotiation cannot be monopolized and can occur simultaneously between President and Governors, state and federal legislators, Mayors and the federal Administration, and any other combination of these actors in a complex matrix of relationships. Over the past century state and local governments have cultivated direct, often partisan linkages with Congress – but with the result that they are often perceived as just another interest group.

In the past twenty years, several political trends and developments have shaped federal, state and local intergovernmental relations. Central power declined until the mid-1990s, first in fiscal and later in regulatory terms. In the process the practical autonomy of state and local governments has been partly restored. Since the 1970s state and local governments have collectively improved their administrative capacity, which now matches that of federal agencies. Thus, in many respects, the state and local governments occupy the centre of political gravity in domestic US politics – it is where most domestic policy and programs are devised and delivered (Hanson, 1998). This reality reinforces concerns about finding effective ways to deal with intergovernmental coordination.

Overview of the Federal Role in Local Affairs in the United States

Federalism in the United States did not originally envisage any kind of role for the federal government in local affairs, except as a necessary part of its administrative operations on the ground (e.g. armed forces, post office). That all changed in the 1930s with the New Deal legislation and activist Presidents and Congresses who have used the virtually unfettered federal taxing and spending powers of the federal government to shape policies and programs at the state and local level. Not only does the Constitution provide wide taxing powers to Congress, but also the operation of concurrent powers with the states provides for the supremacy of federal law. This assumes there is political will in Washington to intrude on state and local turf and for state and local governments to comply. For much of the past century that political will has not been lacking.

Thus, the political reality of intergovernmental relations in the USA is that local government actors lobby Congress or the US Administration for funds or programs tailored or directed to their cities or regions. They have done so by working political alliances in the integrated two-party and electoral system. Party slates on election day extend from the office of the President of the United States down to the proverbial local sheriff, and all points in between. Party linkages thus extend through the entire governmental system. So, for example, a Democratic New York mayor is able to obtain favours from a Democratic Congress more effectively than a Republican

governor of the State government in Albany. Local governments also press their case through non-partisan channels, i.e. in their associations based in Washington such as the highly effective National League of Cities.

The federal role in local government and urban issues is exercised by a variety of means -- administrative, legislative and fiscal. First is the policy and administrative focus in the Administration itself, principally the Department of Housing and Urban Development (HUD) and allied agencies. Second, federal legislation of a primarily regulatory character prevails over state and local law. Third federal fiscal instruments, including revenue sharing and conditional and unconditional grants, shape state and local programs.

The federal role in housing began during the Great Depression when the Roosevelt administration established local housing authorities. Funding to these authorities, later coming under the wing of HUD, bypassed state governments. Other Roosevelt-era initiatives however, such as unemployment insurance and training assistance, worked through the state administrations. In any case, HUD became a vital federal presence during the 1960s and '70s, encouraged by Democratic-dominated Congresses with strong support in most major US cities. During this period the federal government took the lead in dealing with urban decay and renewal, but after the mid-1970s its role began to decline and is only now being restored to some degree.

Federal revenue sharing is not a major part of intergovernmental finance. It occurs mainly through the earmarking for state and local governments of taxes on motor fuels and excise tax, and other tax revenues accruing to the Highway Trust Fund. From 1972 to 1986 Congress voted funds with minimal conditions to local governments under the General Revenue Sharing program, which for a time constituted as much as 19 percent of all direct federal funding to local government. Since its demise, there are now no unconditional grant programs to state or local government (Watts, 1999b).

In fact, for most of the last 70 years of US federalism, intergovernmental transfers have been highly conditional and disaggregated. This is a function in part of the process of Congressional lobbying and logrolling by which they were created.¹⁸⁴ As recently as 1993, Congress appropriated funds for over 590 single categories of programs to be delivered by State and local governments. Sometimes funds passed through the states to municipalities, but not before some states imposed additional constraints and conditions (Conlan, 1998). In playing the political redistribution game to meet growing demands for public services, municipal politicians across the United States did not worry unduly about these entanglements and their effect on their autonomy.

These attitudes began to change in the early 1980s, however, when the federal government first began to curtail its program transfers to state and local governments. The result has been the huge movement to "reinvent government" in the US, and to think more creatively about local initiative (Gaebler and Osbourne, 1992). Yet this broader managerial reform brings its own constraints on local government in the form of performance measurement regimes, management processes and other instruments designed to improve accountability and transparency.

In summary, the federal government role in the United States has been changing dramatically in the past decade. It has made major cuts to funding to deal with the federal budgetary deficit and to make room for lower taxes, and it has been reforming regulation to reduce or eliminate the burden on state and local governments. This has included, as part of more general trends in public management, governments entering into contracts, partnerships and alliances with business and non-profit organizations to obtain policy objectives. Overall the federal contribution to local revenues is much smaller, but still significant, and targeted to a renewed urban agenda that includes affordable housing, public transit expansion, demographic changes and the "new economy" (Artibise, 2000) (discussed more fully below).

Selected Federal-Local Issues in the United States

Intergovernmental relations permeate a significant amount of policy-making and political process in the United States. Local government roles are highly influenced not only by relations with state and federal governments but also with other local governments. Here we summarize the key federal-local issues currently at play in the US system.

- *Reform of unfunded mandates:*

Americans have been highly critical of the cumulative effect of directives to state and local governments by the US Congress to achieve a variety of regulatory purposes. Termed "mandates" in the US system, these direc-

¹⁸⁴ The term "log-rolling" is derived from American pioneer life where the job of removing logs from the land required the cooperation of neighbours: "I'll help roll your logs if you help roll mine". Politically it refers to the system of mutual and traded support in the legislature for votes on individual bills, whereby individual members of Congress support another's bill in return for support of theirs, or of some other favoured legislative project. Legislative log-rolling in the Canadian and other parliamentary legislatures is limited by party discipline.

tives were made without sufficient attention to the considerable cost of implementation, indeed usually without provision for financial assistance. A report in 1996 by the Advisory Commission on Intergovernmental Relations estimated that there were 3500 such directives in place, in reference to over 100 federal laws. There is a similar problem at the state level of state governments also imposing unfunded mandates on local government. Following negotiations and representations from state and local government associations, the US Congress began in 1995 a significant reform to reduce the number of mandates overall and to reduce the regulatory burden of the remaining directives. Still, it is a continuing issue as a new wave of directives related to management reform impose costs onto lower levels of government.

- *Welfare reform*

Several US federal governments have sought to reform the centrally controlled US welfare programs and to provide more leeway for the State and local governments that administered them. The Clinton administration achieved significant reform in 1995-97, especially in programs of aid to needy families and health insurance schemes aimed at children. These programs are now essentially devolved to the states, most of which have in turn provided considerable flexibility to local governments to design and run their own programs. The federal role is now confined to block grants (no longer tied to actual state and local program expenditures) and to certain continuing national mandates. The sub-national governments are able to design, fund and deliver their own programs, which now differ substantially from state to state. Controversy continues over remaining federal directives covering such issues as information technology and data, and some remaining national standards such as in children's health.

- *Transportation Infrastructure*

Federal legislation in the late 1990s (*Transportation Equity Act of the 21st Century*) provides five years of new funding (1998-2003) for a variety of types of state and local infrastructure programs, in addition to continuing federal funding in areas such as highways and public transit. The funding programs include: a new comprehensive surface transportation program at \$ 33 billion; a separate bridge replacement and rehabilitation program at \$20 billion; and a separate, continuing public transit program at \$41 billion, among others. (FCM, 2001)

- *New Federal Urban Agenda*

The US federal department of Housing and Urban Development leads a team of US agencies pursuing a renewed urban agenda focussing on such issues as the "crisis" in the availability of affordable housing; demographic change in cities (e.g. more culturally diverse, aging); and strategies for more controlled and sustainable urban growth. (Artibise, 2000). It is not clear that this agenda is being pursued as aggressively under the Bush administration, but the focus in US policy is shifting.

Summary Comments

It is important to emphasize the political context in which these and other issues are raised and resolved. Despite its subordinate legal status, local government is more of an equal partner in political terms with the state and federal governments. In an electoral system based on territorial districts for both the state and federal legislatures, local governments have a lot of influence on the political agenda. Indeed, federal policy is often only a set of brokered deals with sub-national and local interests. This is especially true of decision-making for capital projects such as infrastructure. Also, in a country as large and diverse as the United States there is a strong impulse to achieve efficiency without centralization, through shared or decentralized programming and through contracting out or partnerships with the private and not-for-profit sectors. Locally based interest groups also play an important role in financing political campaigns and lobbying state and national governments to achieve collectively what they cannot do alone.

Australia

The Federal System and Political Culture in Australia

Six self-governing British colonies joined in 1901 to form the Commonwealth of Australia. To the six states are added two territories, the Australian Capital Territory and the Northern Territory; the total national population is currently 19 million. Over its first century the federation has continued a nation-building process with a strong central government and a political culture that values uniformity, equity and national standards. The population is increasingly urban, with most states dominated by the single capital city. Yet there is a growing tension between urban and "regional" (i.e. smaller cities, towns and outback) Australia. Little room is left for local governments, but their relative position appears to be stable, due in part to federal government support.

Basic Features of the federal constitution and federal system include:

- British-type parliamentary institutions that combine the executive and legislature at both the federal and state level. The state parliaments have all adopted state constitutions, and all states but Queensland have an upper house.
- No explicit constitutional bill of rights.
- A distribution of powers modelled on the US Constitution with enumerated federal powers, some concurrent with the states, and the residual power to the states. The Australian High Court has interpreted federal powers widely, granting the federal parliament authority to occupy any area of previous state jurisdiction providing the federal legislation covers the field. The federal legislature also monopolizes most major tax fields.
- A Commonwealth (federal) parliament with two houses; the lower House of Representatives is elected by 148 constituencies on a single transferable vote electoral system; the upper house, the Senate is elected on state-wide constituencies with equal representation (12 per state). Party discipline rather than state loyalties have tended to determine Senate proceedings.
- A seven-member High Court appointed by the federal government with full authority for constitutional judicial review.
- Intergovernmental relations with a strong executive dominance and an extensive network of premiers, ministerial and officials meetings. While not constitutionally entrenched, reforms in the 1990s provided a significantly upgraded and rationalized intergovernmental decision-making process.

Compared with the three other federal systems covered in this paper, Australia is significantly more centralized in legislative, financial and programmatic terms. The Commonwealth (federal) government has a very dominant fiscal position and many of its transfers to the States are highly conditional. It is responsible directly for social programs that elsewhere would be designed and delivered by the provinces or states, e.g. medical care insurance and social assistance (welfare). The federal government also makes direct transfers to the local governments. The state governments in turn dominate regional finances and functions, undertaking directly roles which elsewhere would be devolved to local government, such as policing, education, social and community services, land-use planning and public transportation. In some policy fields local governments act as agents of the state governments.

Nonetheless, in Australia federalism as a political value remains strong, particularly in the more recent context of political and economic liberalization, as many have perceived the public sphere as being overly centralized and interventionist. Local government, while relatively stable in fiscal and functional terms, continue to be subordinate. They are vulnerable to attacks on their democratic integrity and autonomy from the federal and (especially) state governments (Kiss, 2001).

Overview of the Federal Role in Local Affairs in Australia

The Commonwealth government takes a strong interest in both urban and rural development. This interest goes back to 1920s programs for roads, but the most activist federal government since the federation was founded in 1901 was the Labor Party government in power in the early 1970s. In this era the federal government tried to outflank the states by appealing directly to local government and by creating a regional administrative structure of its own. This reflected the traditionally hostile position of the Australian Labor Party to federalism (Galligan, 1995; Mathews and Grewal, 1997). In this period the federal government introduced general purpose payments to local governments aimed at promoting greater equity in local services. It also began to spend heavily in state-local programs such as housing, urban social services, public transport and recreation. A new federal Department of Urban and Regional Development undertook a wide array of direct federal programs as well, for "growth centres, land acquisition and development, area improvement and a national sewerage program" (Mathews and Grewal, 1997).

The Conservative coalition government in power from 1975 to 1983 retreated from such programming, and ended overtly hostile moves towards the states. It continued the basic, general purpose financial support to local government, but made the payments "through" the States on the condition that the States establish State Grants Commissions to allocate the funds at arm's length from the Commonwealth and State governments. The return of the Labor party to power in 1983 to 1996 saw a more balanced approach. It inherited large economic and fiscal problems, but accomplished a significant amount of microeconomic, fiscal and intergovernmental reform. Its incursions into urban and local affairs were selective but important. The federal government continued a strong presence in housing programs (delivered generally by the state governments, not the local) and the "Building Better Cities" program, again with a strong intergovernmental component of capital grants for social and physical infrastructure. On the broader intergovernmental front, the federal government initiated a series of Special Prem-

iers Conferences in 1991, ultimately leading to the creation of the Council of Australian Governments (COAG) in 1992.

COAG includes the first ministers (premiers) of the federal, State and Territorial governments as well as the President of the Australian Local Government Association (ALGA). Particularly in 1992-95, COAG directed a highly coordinated and integrated set of economic and public sector reform processes, to which numerous federal-state ministerial councils reported. The ALGA is a federation of the associations of municipalities of every state and the Northern Territory. These associations are composed in turn of elected officials (e.g. Mayors or councillors) from each of the 750 municipalities in Australia. Thus the President and other senior executives of the ALGA are all also elected officials from one or other of these local governments. However, the President of the ALGA cannot speak authoritatively for local governments in the same way as the premiers can speak for their governments. While most of the specific COAG commitments and undertakings do not apply directly to local government, some very important ones do. For example, the microeconomic reform agenda is being extended to them, both on their own initiative and through conditions placed on funding, and in some states, by political directive. The rigour by which this reform is being applied varies among the states, for example from a soft approach in Queensland to a much harder line in Victoria.

Since the national peak organization (ALGA) took a seat at COAG in 1995, it has also been represented at the Ministerial Council of Ministers of Local Government. This body is supported by the National Office of Local Government, part of the federal Department of Transport and Regional Services. In addition, this federal agency convenes an annual meeting of the state grant commissions.

While the current conservative coalition government in office since 1996 maintains these intergovernmental mechanisms, it tends to take a more stand-off attitude to local government. Yet on rural issues in particular the government is under some pressure from the minority party in the two-party parliamentary coalition to reverse the economic decline of "regional" Australia. The federal government did propose to roll the general purpose payments to local government into overall state funding, but relented in the face of widespread local government outcry. In summary, the position of the federal government towards local government still exhibits large swings in emphasis depending on the partisan label of the government in power in Canberra. Yet the trend in Australia, as in other federations, is for a somewhat more arm's length relationship, with the exception of some important specific policy fields.

Selected Federal-Local Issues in Australia

The following summarizes the major current intergovernmental issues involving the federal government directly with local governments.

- *Microeconomic reform agenda*

Since the late 1980s Australian governments have undertaken a wide-ranging agenda of microeconomic reform to increase the size and competitiveness of the national economic union, mainly to improve international competitiveness. The objective has to increase competition in labour markets, agricultural and other inputs to industry and in the provision of public goods and services. The agenda has included much privatization, deregulation and provision of national infrastructure. Since 1995 the agenda has been gradually expanded to include the local government sector. Initiatives being pursued by local governments, with varying degrees of intensity and success depending on the State, include contracting out services, financial management reforms, commercialization of functions, the enforcement of competitive bidding on the procurement of goods and services, and the adoption of standardized performance measurement.

- *Renewal of urban infrastructure*

While the direct federal role in the provision of urban infrastructure has declined over the past three decades, targeted federal initiatives continue to be negotiated and implemented. The Labor federal government in office until 1996 had initiated the Better Cities Program, with specific purpose, conditional grant funding to both state governments and, through the States to local governments, covering a variety of housing, recreation, cultural and related programs. These programs have been maintained in general terms through specific purpose payments through the state governments. The current federal government's newer initiatives tend to be targeted to "regional", i.e. non-urban, Australia (see below).

- *Declining public and private service levels in regional Australia*

A major issue has emerged in recent years over the level and quality of services to "regional" Australia – i.e. the smaller cities and towns, remote resource and farming communities and the "outback" in general. This has occurred as the Australian population becomes increasingly urban, and as the role of the State has declined, both in the direct provision of goods and services –e.g. through state-owned monopolies for air and rail transport, electricity and telecommunications, -- and in the regulatory structure of private markets. A political coalition of rural

municipalities, resource industries and the National party (the later being the minor partner in the current government coalition in the federal Parliament) has emerged to fight back for “regional” services. It has pushed for concessions in the federal privatization process to find separate federal funds or otherwise require private service providers to retain what are termed “community service obligations”. A prime example has been ongoing debate over the conditions to be placed on the final privatization of the once wholly publicly owned telephone utility, Telstra.

Summary Comments

Intergovernmental issues affecting the three levels of government are less extensive in Australia than for example in the USA. This is due in part to the narrower range of functions performed by local government, and the conversely broader range of state government functions. Also, intergovernmental bargaining is more effectively monopolized by the cabinets of the two levels of senior government and their senior officials. Formal and direct relations with local government are in general dominated by the States. Direct political linkages between local council politicians and the federal government tend to be less formal and more ad-hoc. Local mayors and councils are generally not elected on a party basis.

As noted, Australia has an extensive network of intergovernmental relations with an impressive recent track record of substantive co-decision (Galligan, 1995; Brown, 2002A). Local governments are represented at the peak of that network and in the Local Government Ministers Council, but there are no signs of integrating them fully into a trilateral process.

Nonetheless, public policy solutions in Australia continue to take on a flavour of uniformity, stressing equitable national standards. The same public sector values extend through all three spheres of government. Federal funding is strongly conditional and programmatic, or where it is meant for general purposes, comes with conditions as to equitable redistribution. An important example is the application of the fiscal equalization process not only to the states' shares of local government transfers but to their allocation within a state.

Germany

The Federal System and Political Culture in Germany

West Germany officially became a federal system of government in 1949, and expanded in 1956-58 to include the Saar region, and in 1990 to include “east” Germany in the Treaty of Unification. Thus, to the ten western Länder (i.e., provinces) have been added six eastern Länder including a united east and west Berlin, for a total of sixteen constituent governments. Three of the Länder are essentially city-states with little or no non-urban territory: Berlin, Bremen and Hamburg. Otherwise Germany has an extensive system of thousands of local governments – cities, towns, counties and sub-county regions – that are provided general constitutional protection but are under the legislative jurisdiction of the Länder.

Basic features of the federal constitution and federal system include:

- The predominance of “administrative federalism” whereby the federal legislature passes laws for which the administration is delegated to the Länder or the local governments. As a result, the federal government as such administers few of its own laws directly and has a relatively small public service. A similar structural relationship exists between the Land governments and local governments.
- Federalism in Germany adheres generally to the principle of “subsidiarity” whereby government roles and particularly the delivery of services should be devolved to the lowest level possible – an increasingly important consideration given the wide range of European Union competences (i.e. power to issue directives) and the potential for centralization several steps removed from citizens.
- The formal distribution of power between the federal and Land governments consists of a list of exclusive federal powers, a short list of exclusive Land powers and an extensive concurrent list. The federal parliament also has power (article 75, *Basic Law*) to legislate framework provisions in areas touching on regional and local matters including land and regional planning and coastal zone management. There are also a set of constitutionally mandated “joint tasks” to be undertaken by the federal and Land governments, in particular to provide education and health infrastructure and regional economic development (article 91, *Basic Law*). This form of power sharing has led to a heavily interlocked governmental system, requiring strong consensus norms to be workable (Scharpf, 1988).
- There is a federal parliament with two houses: the lower house, Bundestag is elected on the basis of population. The upper house, or Bundesrat, consists of delegates of the Land governments, with representation weighted to provide the larger Länder more votes. The Bundesrat has an absolute veto over laws affecting the Länder, which in practice is about half of all bills in the federal parliamentary process.

- The Bundesrat provides for direct representation of the Länder in federal policy-making, including in the ratification and negotiation of any European Union treaty or policy affecting directly the powers of the Land governments (article 23 *Basic Law* amended in 1992). Voting patterns in the Bundesrat are affected by party alliances with federal parties in the lower house. Therefore Länder elections, held separately and at different times than the federal elections, can affect the balance of power in the parliament as a whole.
- The role of the Länder in the Bundesrat allows “administrative federalism” to work by giving the states a role in the process of making laws that they will be responsible for implementing. However, there is no automatic provision for federal funds to match any specific legislative mandate for administration.
- On the social, cultural and economic plane, the German federation is much more homogenous than many other federations –especially so before the unification in 1990. Since then the economic and social disparities east-west have been difficult to bridge, as has been integrating the political culture and expectations of the eastern Länder with the capitalist values and structures of the west.

Overview of the Federal Role in Local Affairs in Germany

The federal government’s jurisdiction intersects with local issues in a variety of ways, including specific constitutional provisions, the mandating of policy frameworks through federal legislation, direct fiscal arrangements for local government, and engaging local governments as “agents” for administering federal programs. As noted above, the federal parliament has concurrent jurisdiction over real estate and land use matters, and housing and settlement issues – jurisdiction it has used extensively during centralizing periods, particularly in the 1960s and ‘70s (Johnson, 1983). The framework legislation powers of the federal government also extend to land and regional planning and coastal zone management. In addition, the “joint tasks” assigned by the constitution to the Länder and federal governments deal with a potentially large set of infrastructure and regional economic development issues.

In return for increasing federal encroachment into Länder affairs, the latter governments were increasingly brought into the web of federal decision-making, formally through the Bundesrat, but also through the extensive network of administrative intergovernmental relations. Local government is sometimes a partner but not a full and equal one in this interlocking set of intergovernmental relationships. Similarly it is integrated in the local and regional institutions of corporatist (i.e. government/ business/ labour) consensus-building that mark economic decision-making in Germany. In some cases, however, individual cities, individual political leaders of cities, and associations of municipalities exercise strong political influence by virtue of influence in their party or other qualities of leadership. (Local government leaders may also hold office simultaneously in the Land or federal parliament.)

National organizations representing various types of local government are also important, particularly the Deutsche Städtetag representing all the major cities. And in all of these relations one must consider the special role of Land governments that are essentially city-states such as Bremen and Berlin – where local matters become automatically Land matters.

Since the mid-1980s the federal government’s political appetite and fiscal ability to intervene and influence local affairs has fallen considerably, as it has in other federal systems (Klatt, 1999). Part of this is a public management reform reaction to the “joint decision trap” of overly coordinated and complex intergovernmental decision-making – which has served less to eliminate traditional patterns of intergovernmental collaboration as to prevent their proliferation (Scharpf, 1988; Benz, 1999). Disentanglement has been a popular theme as well in education, public health and housing policy. In recent years, however, considerable conflict has emerged as new federal legislation on social security and kindergarten reforms, among others, have produced added costs for local government without providing increased transfer funding.

Selected Federal-Local Issues in Germany

The following summarizes the key, current intergovernmental issues involving the federal government directly with local governments.

- With the unification of east and west, local government capacity in the eastern Länder became one of the most important administrative challenges in the federation (under Communist rule, autonomous, effective and accountable local government was nonexistent). The federal government has undertaken a major program to increase local government capacity using its transfer and discretionary funding to the new Länder (Goetz, 1998). Unification has also brought the federal government

back into a more direct relationship with urban and local affairs, through the issues of migrant settlement and public housing, among others.

- The issue of “offloading” to Land and local governments has arisen as a major fiscal strain especially given the huge and unexpected fiscal burden of unification. The Land and local governments are constitutionally obligated to administer federal laws with no guarantees that they would have the fiscal capacity to execute them faithfully (e.g. housing, public transportation, public health, aspects of education, etc.). Complicating these issues are major realignments in fiscal equalization by which the poorer western Länder now find themselves considered to be rich by eastern Länder standards, and therefore less entitled to receive redistribution.
- European integration continues to affect a wide swath of Land and local government responsibilities, from environment to migration to justice, not to mention the changing economic context of integration favouring some urban areas over others. European structural funds are available to some cities and other local governments for economic and social development purposes. These funds apply primarily to cities and smaller municipalities in the five new German Länder (not including Berlin). The federal government plays an important role in the negotiation and allocation of these funds. Also, the local governments’ views are directly represented to the European Union through their membership in the European Committee of Regions, which has specific legal status and a significant if limited role in EU decision-making.

Summary Comments

The German federal system provides many avenues for the resolution of intergovernmental issues, embedded in a political culture that values consensus, cooperation and coordination. This compares sharply with the degree of competition and conflict tolerated and even welcomed in North America. The chief means of dispute resolution for federal-local disputes are (1) the indirect role of the Länder in the federal legislative process, as well as their diplomatic presence in the European Union; (2) the integrated party system that reaches from national to local governments; (3) the role of the constitutional court where even municipalities are granted standing; and (4) the role of associations of municipalities to lobby collectively for their interests, in the Land capitals, in Berlin and in Brussels.

Canada

The Federal System and Political Culture in Canada

Canada has one of the oldest federal systems of government, founded in 1867. The initial union (termed “confederation”) brought together the self-governing British provinces of Canada, Nova Scotia and New Brunswick, under a new central legislature and government, while retaining some powers to be exercised by provincial governments. The former United Province of Canada became two new provinces: Quebec with a French-speaking majority, and Ontario. To these four provinces were later added six others, some original colonies, others new provinces created out of former British territory. In northern Canada there are still three territories that, while lacking the full constitutional status of provinces and thinly populated, exercise a nearly provincial degree of autonomy.

Canada as a society is also strongly federal with multilingual and multicultural features. This includes the large French-speaking population of about 25 percent of the total, concentrated in Quebec, and numerous Aboriginal nations. Of the federations compared in this study, Canada has the greatest degree of cultural and linguistic diversity, reflected in its political culture and many constitutional provisions.

Basic features of the constitution and federal system include:

- The first federation to combine a federal division of powers with a parliamentary form of government. The legislature and executive branches are not formally separated as in the US system, but remain essentially fused, with the executive drawn from and responsible to the legislature, while performing different functions.
- Legislative power is distributed between the federal and provincial governments in a scheme of exclusive powers for each order of government, and a small list of matters of concurrent jurisdiction. The courts have interpreted broadly the provincial powers, protecting provincial autonomy from federal legislative incursion. The relative lack of concurrent powers leaves the federal parliament with less room to occupy policy fields compared with the United States and Australia. And unlike Germany, federal law is administered directly by federal departments and agencies (with the important exception of criminal law).
- There is a federal legislature with two houses. The House of Commons is elected on the basis of population in single member electoral districts. The Senate is appointed directly by the federal cab-

inet and is perceived as lacking in democratic legitimacy, unlike the upper houses in the three other federations reviewed here.

- Most provinces have not adopted separate constitutions, although there is nothing to prevent them from doing so. Local government is not a recognized order of government. Rather, exclusive legislative jurisdiction over municipal government is vested in the provinces. No province has constitutionally entrenched the role of local government.¹⁸⁵
- Aboriginal Peoples have constitutionally recognised treaty and other rights, which they are exercising to varying degrees for local and regional self-government.
- Constitutional amendments in 1982 added a *Charter of Rights and Freedoms*, which constrains the actions of all legislatures and shapes the administrative decision-making of all levels of government. The Charter and other constitutional provisions are interpreted by an integrated system of provincial and federal courts, with the Supreme Court of Canada being the final court of appeal for constitutional and other disputes.
- An extensive network of intergovernmental relations is dominated by the executive branch (First Ministers, ministers and senior officials) who mediate conflict, enter into cooperative planning, policy-making and programs, and negotiate fiscal and other arrangements between governments. This system does not normally include local government, whose relations tend to be confined within each province.

Canada is seen by some observers as among the most decentralized federations in the world (for discussion see Watts, 1999a). Decentralization arises from the natural regional diversity of Canadian geography, and the inherited cultural and political diversity of the “founding nations” – notably the consistent preference by French-speaking Quebecers for strong provincial autonomy and, increasingly, for national self-determination. The courts have generally upheld the provincial powers, including taxing powers. The system of intergovernmental fiscal transfers reinforces the overall preference for strong provinces. Thus Canada is more decentralized in jurisdictional, fiscal and program terms than the US, Australian and German federal systems. The provinces have more direct power than the states or Länder in the other systems, but have less influence over decisions made in the central government than in the USA or Germany.

In the federal system as a whole, local government remains strongly subordinated to the provincial governments, even as urban issues have become more important to Canadian economic and social development. The capital cities do not dominate the provinces as strongly as in Australia (although Winnipeg in Manitoba would come close). However, with one exception (Ottawa-Hull) metropolitan areas do not overlap provincial boundaries – unlike several metro areas in the USA and Germany.

Over the past decade, and in particular in the wake of strong local opposition to municipal amalgamations in Ontario and Quebec, the governments of the larger cities have begun a campaign aimed at achieving greater fiscal and legal autonomy. At the least these city governments want more room provided in the statutory authority granted them by the provincial legislatures – akin to the “home rule” status afforded to municipal governments in the USA. At the most, they want as a longer-term goal to attain constitutional recognition as a separate, independent order of government in the federation -- on the same footing as the federal and provincial orders of government. While some provinces are proceeding with a degree of reform to increase local government autonomy, municipalities are no closer to their goal as constitutional equals in the federation (see the Toronto Charter, 2000; for discussion, Sancton, 2001).

Overview of the Federal Role in Local Affairs in Canada

The federal government’s most direct legislative role in local government is its important jurisdiction over Aboriginal Peoples. Through the *Indian Act*, the federal government establishes and regulates “Indian” (or as they prefer to be called, “first nations”) band council government – similar in scale if not always in function to rural and village municipal government as regulated by the provinces. These governments have a strong fiscal dependency on the federal government. Moreover, inter-municipal and municipal-provincial relations involve Canada’s aboriginal community governments in many ways, often drawing in the federal department of Indian and Northern Affairs. In addition, as many as one-half of the aboriginal population lives off-reserve or away from their traditional communities, many concentrated in larger cities such as Vancouver, Regina, Winnipeg and Toronto. Federal responsibility for this population is more limited, although its extent is in dispute. Canada’s abo-

¹⁸⁵ British Columbia has its *Constitution Act, 1996* but it does not mention local government. Other constitutional instruments that form part of the provincial constitutions include the Terms of Union of some provinces, the *Manitoba Act*, and relevant parts of the *Constitution Acts* of Canada.

iginal population is growing much faster than the non-aboriginal population, and as aboriginal communities gain in fiscal, economic and political influence, the complex matrix of aboriginal-municipal-provincial-federal relationships will also grow in significance.

Apart from the aboriginal communities, the federal Parliament has no direct regulatory role in local government as such. However, several aspects of federal jurisdiction have strong local impacts e.g. airports, ports and railways, defence establishments, immigration, and all manner of federal spending programs including health and post-secondary education, job training, community, regional and industrial development and housing. Yet in most cases where municipal and other local government authorities are involved, the federal government treads carefully, and has more than once been warned off by provincial governments.

Nonetheless, the federal parliament with its single-member constituencies often takes a keen interest in local issues. Individual Members of Parliament or deputies (MPs) are often frustrated by constitutional constraints and in a competitive political environment may seek to outflank provincial governments, especially those governed by a competing political party, to appeal to rural and urban voters on local matters of interest. Still, compared with individual Congress representatives in the USA, individual Canadian MPs have much less power in the legislative process. Also, the system of political parties as a whole is not as integrated in Canada as in the other federations. Canada has differing mixes of parties in differing provinces, and federal and provincial branches of the same party that keep their distance. In addition, with some exceptions local government elections are not contested on a party basis. This lack of a fully integrated party system from the federal to the local level means that political relationships in Canada are much less systematic than in the USA or Germany.

Even with these constitutional, institutional and political constraints, the federal government has played historically important roles in local and urban issues. With strong direct representation from Canadian municipalities during the Great Depression, the federal government introduced spending programs for public works – funding directly local governments. After the Second World War the federal government introduced other locally-oriented programs such as agricultural and regional development, loans for sewage treatment works, and make-work projects, among others. The most important and sustained federal effort from the 1940s to the late 1970s came through the Central Mortgage and Housing Corporation (CMHC) and its important role in developing housing standards, funding public housing, and promoting community planning (Artibise, 2001). Many of these programs were delivered by intergovernmental agreement with the provinces, allowing funds to pass through to local authorities.

Ottawa signalled a more comprehensive federal role in the establishment of the Ministry of State for Urban Affairs in 1971 with a mandate to co-ordinate a variety of federal economic and social programs important to urban development. By 1979 the Ministry was disbanded, a victim of the growing fiscal problems of the federal government, and in the face of stronger provincial administrations and more aggressive defence of provincial jurisdictions through the 1970s and into the 1980s.¹⁸⁶ As with other federal systems, Canadian governments are less entangled now, particularly in welfare-state programs. Fiscal and program decentralization in general has led to a reduced federal role.

Thus since 1979 federal involvement in local government programs has declined in both intensity and dollar terms. Its direct relations now confined to a few issues and programs (discussed below). The common thread in all of these initiatives is their temporary and ad-hoc nature. The federal government, under severe fiscal constraint through most of the 1990s, has been in no position to enter into big new, multi-year funding programs. The exception that proves the rule is the infrastructure program, seen from the federal government perspective as a means to create thousands of short-term jobs and thus speed economic recovery, as promised by the Liberal leader Jean Chrétien in the election campaign of 1993. While it seems to have been a model of intergovernmental cooperation, ultimately it is hard to replicate in other areas without trading more firmly on provincial turf (Andrew and Morrison, 1995).

Finally, from the perspective of local economic development, the most important federal role is the effect of national economic and social programs delivered directly by the federal government. Three major policy areas where such programs are prominent are in the promotion of economic development, in particular for the high-technology oriented “new economy”; in job training and other labour market issues; and in “social cohesion”

¹⁸⁶ The most dramatic example of a defensive provincial posture occurred in Quebec in 1983. In the midst of growing federal-provincial tensions, Ottawa had announced its intention to by-pass the province and provide direct job-creation funding to Quebec municipalities. Quebec responded by introducing bill 38 in the National Assembly, “Loi sur la participation gouvernementale du financement des municipalités”, which would have had the effect of preventing municipalities from accepting funds from any government except the Government of Quebec. After protest from the official opposition in the National Assembly and the Quebec association of municipalities, the provincial government did not proceed with the bill. Ultimately federal-provincial relations improved and apparently the issue of legislation has not returned (Baccigalupo, 1990).

issues such as dealing with child poverty or immigration settlement. In all these policy fields the federal government deals directly with voluntary organizations and local groups of all kinds. This includes local government agencies, even if not as part of an intergovernmental program as such.

One does not see in these diverse programs a common federal vision of urban policy. But clearly there are the seeds – and the tools – for such a vision if the federal government wished to pursue one. This may be the objective of a special task force of the federal Liberal caucus in Parliament (consisting of 13 Members from the House of Commons and Senate) appointed in early 2001 by Prime Minister Chrétien. Its focus is to explore how the Government of Canada, within its jurisdiction, can help to strengthen the quality of life in Canada's urban centres. In its interim report, the task force called for an explicit federal urban strategy that would enable the government to put an "urban lens" on the policy-making process, and to address new, collaborative initiatives in priority areas such as housing, transportation and other infrastructure. The federal government has also undertaken recently an interdepartmental exercise in horizontal policy coordination on urban issues.

Parts of a renewed federal vision could be built on clear federal responsibilities that cut across provinces and governments: the issues of social cohesion, promotion of the new economy and, as noted above, aboriginal peoples. The question remains about how and whether local government entities as such could be full partners in that process.

Selected Federal-Local Issues in Canada

The following summarizes the key, current intergovernmental issues involving the federal government directly with local governments.

◆ *National tri-level infrastructure programs*

The federal government is now in its third national infrastructure program. Together they have spent over \$6 billion in federal funds for infrastructure projects. The first one initiated in 1994 is said to have leveraged \$8.3 billion for 17,000 projects across Canada (FCM, 2001), the second started in 1998 has had a similar effect. In the two previous programs the federal government put up one-third of the cost of capital projects in municipal and other local infrastructure; the participating provincial government and the municipal government (or in some cases, private partners) contributed the other two-thirds. (For more details see Appendix 1). In 2001 the federal government reoriented the program to the Canada Strategic Infrastructure Fund.

◆ *Housing and homelessness*

After more than a decade of decline and indeed the abandonment of a federal presence in housing programs, the federal government in 2001 began a limited return to the field. It reached a \$680 million agreement with the provinces to support affordable rental housing as well as a \$750 million "National Homelessness Initiative" aimed at reducing the numbers of homeless vagrants particularly in the larger cities. In both these programs, delivery is devolved for the most part to local authorities as well as to not-for-profit organizations, whose representatives played an important role in advocating and negotiating the federal spending initiatives.

◆ *Transportation coordination and redevelopment*

The federal government continues to be involved on a trilateral basis with some Canadian provincial governments and their largest cities, on issues related to the redevelopment of transportation infrastructure, particularly of ports and adjacent lands (e.g. Vancouver, Toronto, Montreal, Halifax). This is in the context of substantial devolution of port and airport facilities to local corporations.

Summary Comments

The intergovernmental system in Canada in which these issues is played out is profoundly divided into two separate sub-systems, which only rarely intersect. First is the world of federal-provincial "executive federalism". It is characterized by relations between first ministers, other cabinet ministers and their senior officials. This set of relationships remains largely informal, and while an enormous amount of day-to-day contact takes place, the frequency of meetings, the agenda and the nature of decision-making is highly dependent on political leadership, particularly from the federal government. The informality extends to the decision-making process, for example, intergovernmental agreements are not normally enforceable by law. Final decision-making most often takes place within individual governments following the intergovernmental meeting. Governments retain a broad range of choice as to when, how and under what conditions they will pursue cooperative solutions.

The second sub-system is the provincial-local one. In it the municipalities have less formal status than even the smallest province in the first sub-system, because their position is not entrenched in the federal constitution. The provinces tend to treat the municipalities as just another interest group or as an administrative arm of the provincial government. Even less than federal-provincial relations, there is no formalized process by which the two levels of government reach joint decisions. The larger cities obviously have more ready access to senior pro-

vincial officials and politicians, but the provincial municipal associations have shown considerable effectiveness in collective representation as well.

These two systems – federal-provincial and provincial-municipal/ inter-municipal – rarely intersect. Unlike Australia, there is no formalized intergovernmental council in which the local governments are represented, even indirectly. Unlike the USA, there are few opportunities for local governments to represent their views directly to federal legislators, let alone to negotiate specific deals. Unlike the party system in the USA and Germany, local politicians do not have the partisan linkages that might make intergovernmental consensus easier, regardless of jurisdictional niceties.

If all three levels of government are to be involved in Canada, negotiations typically take two stages – first federal-provincial, then provincial-municipal. Even in the Canada Infrastructure Program, the nature and extent of municipal involvement in the identification and management of projects varied by province. Each provincial government essentially determined the municipal role. The chief exceptions to this lack of genuine tri-level relations have been in specific urban settings involving one province only. Prime examples are the Winnipeg Core Initiative or the Halifax gateway transportation planning initiative (Graham et al, 1998). A more integrated tri-level relationship across the whole federation would be unwieldy at best and might only magnify the existing weaknesses of executive federalism. Canada's significant regional diversity means that local problems need local solutions better found in their specific regional context. Still, problems will arise if the federal role in local matters is continually confined to ad-hoc, bilateral and issue-oriented settings. In sum, the Canadian federation is not conducive to the national definition and mobilization of consent for broader public policy objectives dealing with local issues. However, concerns persist that dealing with only a city here or there without a comprehensive federal approach may lead to regional antagonisms and injustices. A more comprehensive federal approach on urban issues would be possible, if pursued sensitively with the provinces and flexibly in each urban area with the relevant local governments.

Conclusions

From the separate discussion of the four federations, one can now conclude with a more expressly comparative illustration and commentary. Here we concentrate on two major themes: comparing models of federal-local relationships; and comparing the direct roles of the federal government in local affairs.

Comparing Models of Federal-Local Relationships

Table 14.1 presents a comparison of the federal-state-local relationship according to three criteria: (1) the basic type or main characteristics of the prevailing model in each system; (2) the key institutions and processes involved; and (3) the means for resolving conflicts or building consensus in the intergovernmental system.

From these comparisons, one can conclude the following:

1. Parliamentary federations are alike in the tendency to executive dominance in intergovernmental relations (i.e. by the first ministers, other cabinet ministers and senior executive officials – not by ordinary legislators). As noted above, the separation of powers in the US system means that ordinary legislators there have more power and more of a role in a multidirectional intergovernmental system. Canadian party discipline is especially strong among the Westminster parliamentary systems, both in the federal and provincial legislatures. If this were relaxed to provide a greater role for committees and individual members, the role of the legislatures in intergovernmental relations – including those with local governments -- might also increase.

Table 14.1

Comparing Federal-State-Local Relationships

	USA	Australia	Germany	Canada
Basic type/ characteristics	<p>Informal relations among and between legislatures and executive at both state and federal levels, and with local governments.</p> <p>Highly competitive at interstate and local level.</p> <p>Take-it or leave it cooperation from feds.</p> <p>No attempt to rationalize responsibilities among governments.</p>	<p>Formalized executive federalism.</p> <p>Strong cooperative and rationalization ethos, but room for competition.</p>	<p>Formally integrated federalism.</p> <p>High value on cooperation and consensus.</p>	<p>Informal executive federalism.</p> <p>Strong fed-prov and interprov competition; some inter-local competition.</p> <p>Some attempt to rationalize roles.</p> <p>Take it or leave it cooperation in prov-local relations.</p>
Key Institutions and processes	<p>Lobbying Congress (by both state and local governments).</p> <p>State-wide and national associations of local governments.</p>	<p>Council of Australian Governments and related Ministerial Councils (includes local government reps).</p> <p>State-wide and national associations of local governments.</p>	<p>Bundesrat.</p> <p>Other ministerial councils.</p> <p>State-wide and national associations of local governments.</p>	<p>First Ministers forums; Other ministerial councils.</p> <p>Provincial and national municipal associations.</p>
Means for Resolving Conflicts / Building Consensus	<p>Courts play major role.</p> <p>Partisan connections and lobbying.</p> <p>Specific mechanisms in inter-municipal and partnership agreements.</p>	<p>State government bullying of local govts.</p> <p>Major upgrade in capacity for intergovernmental co-decision (small role for local government)</p>	<p>Strong intergovernmental consensus institutions including Bundesrat.</p> <p>Use of courts.</p> <p>Partisan connections Lobby in EU.</p>	<p>Intergovernmental consensus mechanisms (such as conferences of ministers).</p> <p>Low level use of courts.</p> <p>Low level use of partisan connections.</p> <p>Prov-local appeal bodies.</p> <p>Intermunicipal agreements.</p>

- Germany's Bundesrat is the most integrated and formalized model of intergovernmental structures. It provides an automatic process for the interests of the Länder (provinces) as governments to be heard and weighed in the federal legislature. Even with this institution, German governments have also found the need to maintain an extensive network of intergovernmental councils and committees to deal with administrative matters.
- Australia has an elected Senate, but also needs extensive "executive federalism". It has gone much farther than Canada in formalizing its federal-state-territorial intergovernmental mechanisms and improving its capacity for co-decision. It does so through a formalized Council of Australian Governments (COAG), a rationalized set of ministerial councils (some with binding decision rules and regulatory mandates) and several new, arm's length intergovernmental agencies. The Australian Local Government Association is represented on COAG, but local government is not fully integrated into the system as a whole.
- In all federations intergovernmental relations are bifurcated: two separate systems, federal-state and state-local. The US does the best job at integrating the two. The other systems, including Canada, will have to find new ways to do so if they seek to pursue more coordinated tri-level relationships.
- There is no magic bullet for conflict resolution. It is messy and political everywhere, although the US stands out as using the courts more readily. Canada's less formal institutions compared with Australia and Germany means less ability to reach substantive, binding decisions by intergovernmental means. Long-standing pro-

vincial institutions provide for arbitration or appeals on boundary issues among municipalities. Intermunicipal agreements and regional governance agencies often encompass dispute settlement procedures.

The Direct Role of the Federal Government in Local Affairs

Table 14.2 presents a comparison of the roles of the federal government in local affairs according to two criteria: (1) the relative roles of each level of government in the important area of economic development; and (2) illustrative issues of a direct federal role, or of tri-level cooperation.

Table 14.2

Comparing the Roles of the Federal Government in Local Affairs

	USA	Australia	Germany	Canada
Overall roles in economic development	<p>Decentralized state and local economic development programs.</p> <p>Strong capacity for inter-municipal and private-public partnerships.</p> <p>Flexibility for brokering financial deals (F/S/L).</p> <p>Competition among state and local governments for people and investment.</p>	<p>Federal government still takes a leading role in economic development.</p> <p>Public-private partnerships are mainly State-led and initiated.</p> <p>Little competition among local governments, some among states.</p>	<p>Interlocking fed-state-local roles in economic development</p> <p>Ongoing intensive tripartite mechanisms (govt/business/Labour)</p> <p>Competition among state and local governments not overt</p>	<p>Strong provincial role; Selective federal role.</p> <p>Some intergovernmental partnerships; many public-private partnerships.</p> <p>Still strong effects of disruptive fiscal off-loading.</p> <p>Moderate degree of competition among local and provincial governments.</p>
Issues of Direct federal role and/or Trilevel cooperation	<p>Strong fed regulatory presence (but declining).</p> <p>Major federal administration presence (HUD).</p> <p>Current federal emphasis: Controlled Urban Growth; Housing; Community development; Public transport; Other infrastructure (including Environment).</p>	<p>Indirect federal role (but major funding to local governments).</p> <p>A modest federal ministerial function.</p> <p>Current federal emphasis: National micro-economic reform (competition policy, tax reform, etc. applied to local govts); Infrastructure: roads, electronic highway.</p>	<p>Direct role via assigned tasks to local governments.</p> <p>Involvement of local govt in Fed-Land "Joint Tasks" (eg regional planning).</p> <p>Current federal emphasis: Migrant housing (east-west); Capacity-building for local governments in East; Use of EU funds at local level; Social cohesion issues in cities.</p>	<p>Mainly indirect federal role, with ad-hoc direct programs.</p> <p>No coordinated administrative focus.</p> <p>Current federal emphasis: Infrastructure including "electronic highway"; Homeless and related housing initiative; Aboriginal Peoples.</p>

From these comparisons one can conclude the following:

1. Competition among municipalities -- i.e. the operation of a market among communities by which they attract mobile capital and labour -- thrives in the US context. It is also significant in parts of Canada, and may be an important underlying factor in competitiveness.
2. Since the 1980s the lead role for economic development has settled at the regional government (i.e. state or province) level. Even the federal governments in Germany and Canada, which at one time

had major economic development programming, have largely retreated from the field. The federal government in Australia continues to retain a leading role in this field.

3. The USA has the most flexible arrangements for institutional, financial, and program cooperation over economic development involving inter-local, state-local and trilevel partnerships. Germany's consensus and integrated intergovernmental system is comprehensive, but probably less flexible.
4. Federal governments in all four countries since the mid-1990s have begun a selective re-engagement in local issues with a strong emphasis in two areas: 1) significant social cohesion issues such as housing, immigration and minorities; and 2) infrastructure broadly defined to include both conventional and electronic highways, public transit, and the environment. The US government, for example, has recently re-launched major programs for the direct funding to local authorities for community development and urban mass transit. The German federal government is heavily involved in infrastructure and capacity building in municipalities in the eastern Länder, as well as direct funding of housing and other needs for migrants and refugees. Australia's better cities program provides significant infrastructure funding, in addition to the Commonwealth government's longstanding programs of support of housing.
5. Canada's federal government has a much smaller direct role in local affairs than the other federal governments compared here. It is much more reticent to get involved in direct agreements and funding relationships with local government on a national basis. The Canada Infrastructure agreement is an exception, but one in which the federal government played mainly a paymaster role. Tri-level cooperative arrangements are somewhat more common on a province-by province basis. Despite its retreat from much of the economic development field in the past decade, the Canadian federal government continues to have a policy focus on human capital development and industrial adjustment to the new economy. It delivers these programs in part through local civil society organizations.

From these conclusions, a final point emerges, that is the growing significance of cities to national and international economies. In all four federations examined in this paper there is a general recognition that urban economies are driving global competitiveness. Cities are especially dominant in the "new" economy of telecomputational and information technologies. There remains some debate, nonetheless, about the importance of city government as such to urban economic development.¹⁸⁷ City or municipal governments may not in fact be as important as the federal and provincial governments in determining the conditions for local success, but they are by no means unimportant. In any case, federal or central governments in federations wish increasingly to ensure that their policies and actions contribute to, rather than impede, urban-led competitiveness. This only reinforces our finding that a direct, pragmatic and proactive relationship between federal governments and individual local governments is likely to remain an important ingredient in promoting competitiveness in the global economy.

¹⁸⁷ For further discussion, see my paper prepared for CEPRA in July 2002, entitled "Local Government and Federalism: Canada in Comparative Perspective".

Annex.

Federal-Provincial-Municipal Infrastructure Programs in Canada

Overview: These programs to cost-share strategic investments in local, public infrastructure, are one of the few examples of genuine tripartite intergovernmental co-operation involving municipal government, as well as being a regionally decentralized approach to economic development.

Structure: With a general political mandate from First Ministers, meeting first in December 1993, the infrastructure program has proceeded on the basis of a general national approach, with provincially specific implementation. In the 2000 Budget, the federal government announced a third generation of funding totalling \$2.65 billion over 6 years. On behalf of the federal government, the President of the Treasury Board negotiates a bilateral agreement on infrastructure priorities with the relevant Minister in each province and territory. The overall federal contribution is meant to be one-third, with the provinces and municipalities providing one-third each, although in some cases public funding has also leveraged private capital contributions. The allocation of federal funding to the provinces and territories follows a formula whereby each province's share is determined 50 percent by its share of the national population and 50 percent by its share of national unemployment. Each bilateral agreement is overseen by a management committee of senior officials, with federal and provincial co-chairs, whose role is to review, select and evaluate projects for funding. Individual municipalities are not represented on the MCs, but local government organizations are represented in advisory boards. Nonetheless, specific funding proposals can only be made by the municipalities. An exception is that some of the federal funds are earmarked for spending by aboriginal governments, through Indian and Northern Affairs.

Mandate and Workplans: The program allows the federal government to spend on local infrastructure needs and induce job creation in an area of provincial jurisdiction and municipal responsibility. Delivery is in the hands of local government, while the senior governments help set priorities and provide their share of the costs. Considerable diversity occurs across provinces and territories in terms of the type of projects funded, reflecting differing urban/rural population structures, growth patterns, state of infrastructure stock, and provincial priorities for economic and social development.

Assessment: This model is essentially the old Economic and Regional Development Agreement (ERDA) format, extended to municipal infrastructure. It is very effective in both administrative and political terms, as a means of meeting general national objectives through a regionally diverse delivery system. The program provides the federal government with a modest political relationship with national municipal organizations as well as local visibility in individual municipalities.

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