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Financial Foundations of Local Self-government in Russia: Problems and Prospects

Organization of local self-government and problems of current legislation

A single model of local self-government would hardly be equally effective in the whole territory of Russia. One look at the map of the Russian Federation where the settlements with population over one thousand residents (see Figure 1 in Supplement) are marked would be enough to realize that the local self-government in the European part of Russia differs from that in Siberia or Far East while the problems of self-government that are typical of rural areas are different from those of large industrial cities.

The Federal Law On General Principles of Organization of Local Self-government in the Russian Federation adopted in 1995 created conditions for various models of local self-government to emerge in the Russian regions¹. Today, 51 subjects of the Russian Federation² have local governments at the level of cities and raions. Thirteen subjects formed local governments at the sub-raion level, while their raion governments are subdivisions of regional bodies of state power. In 22 regions a two-tier model of local self-government was formed, i.e. at the raion and city level and at the sub-raion (rural settlement) level (it should be noted that not everywhere in these regions rural municipalities have budgets of their own; rather they often but formally approve estimates of revenues and expenditures developed by raion financial bodies.)

In spite of the variety of existing models of local self-government, current legislation (Budget Code) envisages only one level of local budgets. Accordingly, tax legislation (Federal Law on the Tax System) contains only one list of local taxes, while the current version of the Federal Law On General Principles of Organization of Local Self-government in the Russian Federation has only one list of issues of local competence.

In the event that there are two tiers of local governments in the territory of a RF subject, the responsibility for assignment of revenues and expenditures between these tiers falls within the

¹ For more details see Kourliandskaia, G. and Y. Nikolayenko, N. Golovanova, *Local Governments in the Russian Federation in Volume 3 - Developing New Rules in the Old Environment: Local Governments in Eastern Europe, Caucasus and Central Asia*, ed. by I. Munteanu and V. Popa, LGI / OSI, Budapest, 2001 (<http://lgi.osi.hu/publications>)

² *Forming Local Self-governance in the Russian Federation, September 1, 2002*, Goskomstat, Moscow, 2002 (in Russian); results of polls conducted by Center for Fiscal Policy.

competence of the RF subject. However, if there is a one-tier model of local government in cities and rural settlements, both a large industrial centre and a rural settlement would have the same set of responsibilities and the same list of own revenues. Since the tax system in Russia is heavily centralized, own taxes make but an insignificant share of local budgets. Whereas cities with their developed tax base do have some manoeuvring opportunities based on own revenue sources, rural areas are deprived of this possibility in view of the absence of differentiated tax base along with the benefits provided to the agricultural sector by the federal center, the two factors that are responsible for the subsidized nature of almost all the budgets.

Reform of local self-government and assignment of responsibilities

Since current legislation does not take into account the variety of forms of local self-government in Russia it is necessary to improve the pertinent regulatory framework.

The proposed amendments to the Budget Code eliminate the restriction concerning the number of tiers of the budgetary system. The new draft of the law On General Principles of Organization of Local Self-government in the Russian Federation provides for a uniform scheme of organization of local self-government in the whole territory of Russia, three types of local budgets (raion, sub-raion (settlement) and city district), two lists of issues of local competence and two lists of local taxes³ (for settlements and municipal raions). The issues of both lists will be in the jurisdiction of city districts while the latter's budgets will receive all local taxes.

The draft law On General Principles of Organization of Local Self-government in the Russian Federation enables to specify the assignment of expenditure responsibilities between the bodies of state power of the Russian Federation and local governments. Local governments will be relieved of the responsibility to fund inappropriate functions (for example, draft execution) and be able to spend untargeted revenues to finance their own responsibilities.

Unfunded mandates

One of today's major problems of local governments is that of unfunded mandates imposed on them by federal legislation. To address this problem, the draft law On General Principles of Organization of Local Self-government in the Russian Federation stipulates for earmarked financing of mandates through subventions. This provision will undoubtedly impose constraints on the procedure of adopting unsupported expenditure responsibilities.

³ The list of revenue sources of local governments will be determined by the Tax Code.

Unfortunately, the reverse of earmarked financing of mandates from higher governments will be centralization of budget resources. Is it for better or for worse? - One cannot give an unambiguous answer to this question. On the one hand, if the higher government not only decides to render public services (as is the case now) but also allocates resources for this purpose, this an important step towards creating a transparent system of intergovernmental relations. On the other hand, local governments who earlier had an opportunity not to execute decisions of the federal and regional governments claiming the absence of financing will be deprived of a significant portion of untargeted funds which would be coming back as earmarked subventions. As a result, the volume of budget resources which local governments may spend at their discretion will decrease, while the portion of tightly targeted funds to be spent according to decisions of the federal and regional governments will increase.

Scantiness of local governments' revenue sources

Local revenues are subdivided into own and shared revenues. According to Article 47 of the Budget Code, own revenues (both tax and non-tax) are those that are assigned to the appropriate budgets on the permanent basis⁴. Shared revenues (Article 48 of the Budget Code) are those whose shared rates s are established by the annual law on budget. Also, the current version of the Federal Law On Financial Foundations of Local Self-government in the Russian Federation envisages the requirements to the general (average) sharing rates for allocating tax revenues across the tiers of the budgetary system.

Own revenues of local governments cover about 30% of their total expenditures. However, this is a consolidated indicator achieved basically through the input of industrial cities with advanced tax base and areas with the developed resource-extracting sector.

Own revenues of rural municipalities are hardly enough to cover 10% of their expenditures. Absence of own revenue sources has a negative effect on the initiative of local governments who are not interested in developing their tax base, creating favourable entrepreneurial and investment climate and efficient public spending. This also makes local budgets dependent on higher governments and deprives intergovernmental relations of transparency.

Though the task of step-by-step reduction of shared revenues accompanied with their transformation into own and permanently assigned revenues was set as far back as 2001 in the Program of Fiscal Federalism Development in the Russian Federation up to 2005 (RF government policy document), it is not that easy to implement it. Highly uneven distribution of tax base hinders

⁴ Practically, this means the approval by law, except for the annual Budget law adopted by a higher government.

the assignment of local revenues by federal legislation. Thus, a dilemma arises: to function properly, local governments need own revenues sources. On the other hand, the greater the share of revenues assigned to municipalities, the higher differentiation in own revenue capacity across them and the greater amount of funds is necessary to equalize their fiscal capacities. Since the total volume of tax burden cannot grow for ever, the RF subjects will not have sufficient funds to pursue the equalization policy when consolidated local budgets have a large portion of own taxes.

Selection of revenue sources for local governments

What taxes should the Tax Code assign to local budgets?

The basic criteria for assigning taxes across the tiers of the budgetary system are as follows⁵: revenue stability, economic efficiency, social equity and even distribution of tax base, tax base mobility and the degree of tax burden "exportability" beyond the jurisdiction in question⁶.

Personal income tax

The PIT is distributed rather evenly across municipalities in the RF subjects⁷. In some heavily subsidized RF subjects (Amur Oblast, Koryak AO) the PIT is the most evenly distributed tax at the city and raion level.

Today, the personal income tax is basically paid by enterprises at the place of their registration rather than by taxpayers at the place of their residence. This results in an export of tax burden if the taxpayer resides and receives public services in one municipality and works in another. The amended PIT collection system (transition to collection at place of residence) will make its distribution more even thus benefiting those rural municipalities whose residents are earning in cities.

The personal income tax is a major revenue source for local governments. Today, it makes 34% of tax receipts of consolidated local budgets. In the absence of the real estate tax, the personal income tax is the only tax on resident recipients of public services, and the majority of services (health care, education, housing) are obtained by population precisely from local governments. If local governments do have at their disposal at least one source of revenues whose collections depend directly on the number of residents and the level of their incomes, they will be interested in

⁵ For more details on these criteria see *Explanatory Note to Proposed Assignment of Taxing Powers across Levels of Russian Government in the Concept for Reform of Intergovernmental Fiscal Relations and Subnational Public Finance in 2002-2005* (www.fpcenter.org)

⁶ The more difficult it is to shift the tax burden to taxpayers in other jurisdictions (regions, municipalities), the more suitable for assigning to the jurisdiction in question the relevant tax is.

⁷ The evenness of tax base distribution was estimated by Center for Fiscal Policy (www.fpcenter.org) on the basis of budget revenues data in 23 RF subjects.

promoting comfortable housing and living conditions and paying attention to the demand for local public services. Meanwhile, residents mean spending rather than gaining for local governments.

Generally speaking, the personal income tax has a mobile tax base; in Russia, however, the mobility of population is still insignificant due to the low level of incomes. In the future, when the real estate tax is introduced, when real estate is reassessed at market price and when the tax rate grows, the role of the personal income tax in local governments' revenues may decline. However, this would hardly take place in the nearest future.

Personal property tax

The personal property tax is distributed rather evenly both at the raion (city) and sub-raion (settlement) levels making it a good candidate for a revenue source of sub-raion budgets.

The nature of property taxes makes their revenues only slightly dependent on fluctuations within the framework of business cycles. Such stability is especially important for local governments that are responsible for providing services that are vital to their population whose need in them does not depend on economic downturns or upsurges. Real estate is the major component of the current property tax base. Since it is not easy to hide real estate, one cannot avoid paying the property tax. Presently, the physical person property tax makes only 0.4% of local tax revenue. Such insignificant share is explained by low tax rates as well as by using on inventory rather than market prices for assessing the tax base as is usual in other countries. In the event that the amount of tax due is assessed at the market price of property, only changes in economic or ecological situation would have a major impact on its collections. Local government's infrastructure development efforts can improve the attractiveness of the area to be followed by rising real estate prices.

Real estate does not change its location. A house cannot "move" to another area with lower real estate tax rates. Real estate has a certain address and geographical ties. One can make land use maps and be able to determine the jurisdiction of a land plot with buildings on it, i.e. the municipality entitled to taxation.

Collections from personal property tax can be used to finance real estate related functions covered from the local budget. In this sense, the tax may be considered as charge for a rendered service – at any rate, the experience of countries where this tax is imposed and actively used shows that the volume of rendered municipal services is correlated with the price of real estate located in the jurisdiction where the service is provided. The residents of a jurisdiction who are burdened with the tax have an opportunity to compare the cost of services with their utility.

Enterprise property tax

The enterprise property tax (enterprise assets tax) has all the advantages of real estate taxes, except for one: its distribution across jurisdictions, namely cities, raions and especially settlements is not even thus making it not a very good source of local revenues. Nevertheless, in those regions where this tax is distributed rather evenly part of it can be assigned to municipal raions and city districts on a long-term basis.

Land tax

In terms of tax base even distribution, the land tax is a good candidate to become a revenue source of local budgets. In municipalities of Altai Krai, Republic of Adygeya, Republic of Altai, Novgorod, Ivanovo, Kurgan and Tomsk Oblasts the land tax is the most evenly distributed tax among the rest of revenue sources. Transit to tax base assessment on the basis of market prices will strengthen the revenue base of rural governments having dacha plots in their jurisdiction.

Tax on profits of enterprises and organizations

The profits tax is not a very reliable revenue source for local governments owing to uneven distribution of its receipts. The profits tax to great extent depends on the economic situation in the country, which makes its collections very unstable. For this reason it is not recommended to assign it to the local level. Besides, profit is a parameter that can be easily manipulated with by means of accounting tricks.

The profits tax base has significant mobility, hence, it may be easily exported beyond the bounds of a municipality or a region, and that is the core case against assigning the tax to the local level. The existence of enterprises with many branches complicates determination of a jurisdiction where profit is earned. The legislation that requires payment of tax by branches in proportion to the value of fixed capital is not observed in most cases. In such situation a region is better equipped to overcome the problem than a local government.

Small business taxes

There are two types of small business taxes in Russia: the single tax collected due to application of the simplified system of taxation, accounting and reporting, and the single tax on imputed income from certain kinds of business. Though the share of revenues from these two taxes in the consolidated budget of the Russian Federation is not large, they can become good revenue sources for regional and local budgets in case of small business growth in Russia.

Inside the regions, the single tax on imputed income is distributed more evenly than the single tax collected due to application of the simplified system of the taxation. In some regions (Vladimir, Saratov, Volgograd Oblasts and Khanty-Mansi AO) the tax on imputed income has the most even distribution

Proposals of the Government of the Russian Federation on formation of revenue sources of local governments

Given the huge size and heterogeneity of Russia, one probably will not be able to find the only right solution to the problem involving selection of local taxes. Whatever the decision, it cannot be simultaneously in the interests of both “wealthy” and “poor” municipalities as well as in the interests of municipalities and the regions.

The high degree of unevenness of tax bases makes it impossible to assign significant own revenue sources to local governments, since the greater the share of revenues assigned to them, the stronger the differentiation of per capita fiscal capacity. Revenue assignment to local governments leads to growing independence of municipalities with advanced tax base (mainly, city districts); at the same time, however, the possibilities of regional governments to allocate transfers to equalize municipal fiscal capacities will decline.

The Government of the Russian Federation proposed to assign part of personal income tax, single tax collected due to the application of simplified system of taxation, single tax on imputed income from certain kinds of business, single agricultural tax, land tax, tax on property of physical persons and advertising tax (see Table 1) to local governments as their revenue sources. These are the taxes that best of all meet the assignment criteria of revenue sources, although they cannot cover municipal expenditure needs in full. Only the personal income tax contributes substantially to local governments' revenues and, despite the mobility of its tax base, it remains the main revenue source of local budgets.

Nevertheless, 30% of PIT collections, 60% of small business taxes, 100% of land tax and 100% of tax on property of physical persons will provide more revenue to local budgets than 2% of profits tax, 50% of enterprise property tax, 50% of land tax and the rest of local and assigned taxes as envisaged by current legislation. Such assignment pattern would increase revenue capacity of rural budgets since tax bases of the profits tax and enterprise property tax are concentrated mainly in the cities and natural resource-extracting areas and tax bases of the personal income tax and small business tax are rather evenly distributed in the whole territory of Russia.

Specific features of local self-government in rural Russia

In addition to the problems typical of all local governments in Russia, rural governments have their own specific difficulties namely the absence of developed tax base.

Any model of expenditure responsibilities and revenue sources assignment will not be able to solve the problem of rural budgets if there is no tax base. In terms of intergovernmental fiscal relations, the assignment of the personal property tax to rural settlements is a right step. However, the tax's low rates and evaluation of its tax base at the book value would not allow it to become a significant revenue source for rural budgets. Even the right to change the tax rate would not be of great help, since personal incomes in rural areas are not that high and the possibilities to pay this tax are limited. In this situation only per capita redistribution of the personal income tax collected in the territory of a region would ensure, on the one hand, local governments' revenues and, on the other hand, would support governments' wish to attract residents into their jurisdictions. However, since the given source of revenue does not relate directly to the incomes of the residents of a municipality, they would hardly be interested in the control over the efficiency of rendered services and effective public spending. Only the personal income tax paid by the residents of a municipality formation directly at the place of residence together with the tax on imputed income can involve rural communities into active participation in the budget process and responsible approach to the elections to local administration. The taxes imposed on small business in the situation when agriculture is unprofitable are not stable revenue sources although the fact that they are collected into local budgets induces local authorities to reduce administrative barriers in order to develop small business in their jurisdictions.

In case local budgets in rural jurisdictions are supported only by transfers, the institution of local self-government will not work because in the absence of own municipal revenues the interdependence between public services rendering and paying for them by means of taxes is broken. Only gradual development of tax base in rural areas and interest of communities and local administrations in own tax base growth will promote the stability of financial foundations of local self-government, communities interest in control over their jurisdictions and, as a consequence, the progress of democracy and civil society.

Supplement

Figure 1. Russian Federation: settlements with population over 1000 residents

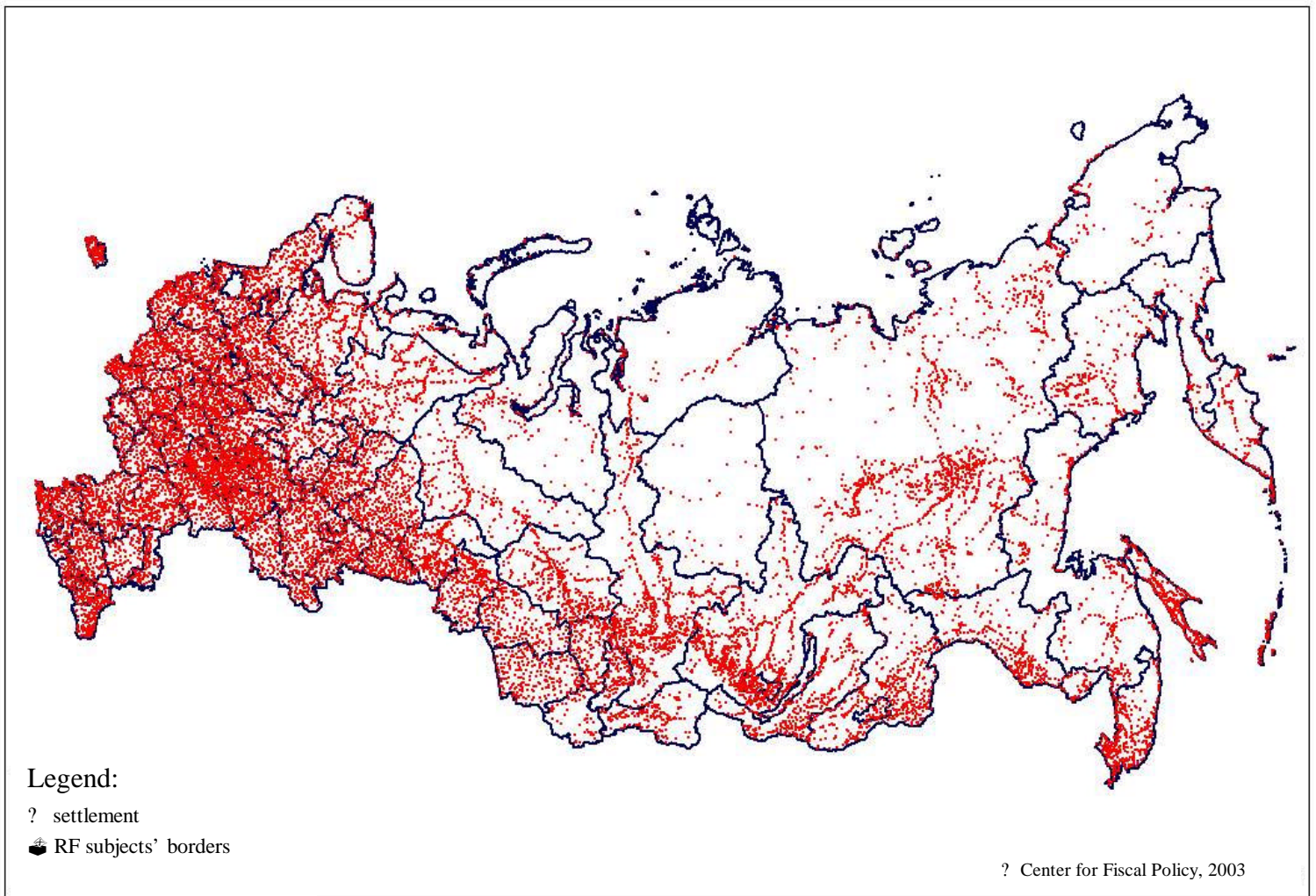


Table 1. Proposed tax revenue sources of local budgets

Revenue source	Consolidated budget of RF subject	Including		
		Local budgets	Of which	
			Budgets of municipal raions	Budgets of settlements
Personal income tax	100%	30%	15%	15%
<i>Including redistribution from regional to local budgets</i>		20%		
Single tax collected due to application of simplified system of taxation	90%	60%	30%	30%
Single tax on imputed income from certain kinds of business	90%	60%	30%	30%
Single agricultural tax	90%	60%	30%	30%
Land tax	100%	100%		100%
Personal property tax	100%	100%		100%
Advertising tax	100%	100%	100%	

Source: RF Government Documents