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Policy Brief

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Fiscal Decentralization and Government Subsidies

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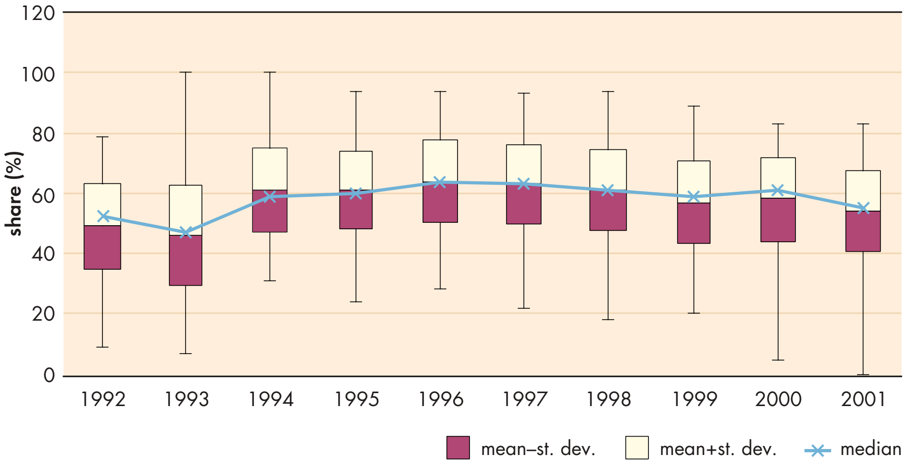
Decentralization of economic activities and decentralization of public administration are two integral parts of transition from a command economy to a free market that cannot be viewed in isolation from one another. A striking example of how decentralization of government can interfere with economic reforms is presented in the Russian experience of reducing budgetary subsidies to enterprises. In Russia, at all levels of government democratic elections replaced the communist party appointees with public officials accountable to the constituency. The newly empowered subnational leaders started to claim their share of what used to be a centralized pool of fiscal resources by capturing local offices of the national revenue service. Trying to balance its fiscal accounts, the central government responded by "off-loading" expenditure responsibilities to the subnational level.

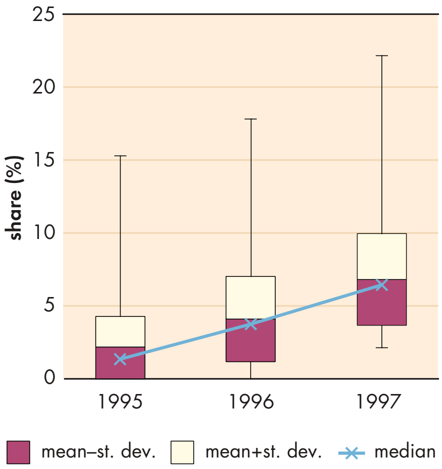
Expenditure items shifted down to subnational governments in 1993 included budgetary subsidies that used to play a key role in bridging centrally set prices with enterprise specific costs. In the course of transition liberalization policies of the central government allowed prices to rise toward market clearing levels thus reducing the extent of subsidization. Yet, in some sectors subsidies associated with price-controls remained due to social and political factors. The central government discontinued providing subsidies from the federal budget while delegating the discretion to regulate prices to subnational governments. Yet, due to their proximity to the constituency, subnational leaders appear to be more sensitive to the political factors of subsidization. Thus, they were quick to fill the gap left by the central government. Hence, the central government solved its short-run fiscal imbalance at the expense of losing control of further price liberalization.

Chart 1. Local Government Share in Consolidated Regional-Local Pre-Transfer Revenues



As federal legislation leaves regional-local relationships completely to the discretion of regional governments, there is a significant variation across regions in the decentralization of both expenditure responsibilities and fiscal resources. In particular, regions differ in the extent of tax revenue retention in local budgets at the point of collection as opposed to receiving intergovernmental grants. Thus in 1997 the mean share of consolidated regional-local tax revenue retained in the local budget at the point of collection was 63 percent with the standard deviation of 13 percentage points (see Chart 1). There are some fluctuations over time but wide variations among regions persisted throughout these years. At the same time the extent of government subsidies to enterprises also varies widely from region to region. Empirically, the degree of subsidization can be measured as a ratio of government subsidies to regional economic product (see Chart 2). As of

Chart 2. Subnational budgetary subsidies as a share of Regional Economic Product



1997 there is a tenfold difference between regions in the degree of subsidization via direct budgetary transfers to enterprises.

Because off-loading of responsibilities for price subsidies trickled down to the local level, these disparities in the extent of subsidization are likely to be determined by differences in financing local government. In our study, we develop a stylized model of local government budget allocation and examine the link between tax revenue retention by local governments and their propensity to give away subsidies. Our theoretical model establishes that for any given local share in total regional-local expenditures, higher rates of tax revenue retention makes local governments reallocate funds from subsidies to more productive uses like public infrastructure. The intuition is that stronger reliance on revenues drawn from the local economic base increases the local government's opportunity costs of unproductive expenditures.

We test this theoretical prediction on a panel of data for Russian regions in 1995–97. The analysis suggests that substituting a share of locally collected taxes for an equivalent amount of grants from the regional government reduces the amount of local subsides. Thus, tax revenue retention appears to be a superior form of financing decentralized expenditures than intergovernmental transfers. Similar results are obtained when the measure of subsidization includes tolerated tax arrears in addition to direct budgetary outlays on subsidies. The robustness of the results is secured by employing different econometric specifications for the region- and time-specific effects. Moreover, explicit treatment for possible endogeneity of decentralization only increases the magnitude of the estimates.

The presented results are highly relevant for the current policy debate on the subnational revenue assignment and delineation of expenditure responsibilities between different levels of government. The findings of our study suggest that decentralization of expenditures can result in more efficient budget allocations only if funded with locally-raised revenue. This contributes to the literature showing that the outcomes of decentralized spending authority depend on the form of financing these expenditures (e.g., Ter-Minassian, 1997). While we do not dispute that tax revenue retention adds little to subnational revenue autonomy, we show it is distinct from other forms of intergovernmental transfers because it creates incentives for local governments to pursue sound economic policies. Thus, under the second best arrangements such as in Russia, our study suggests that tax revenue retention should be promoted rather than discarded as a counter-equalizing—and therefore undesirable—form of intergovernmental transfers. This is especially true given that tax retention often serves as a transition from tax revenue sharing to tax base sharing—that is a piggybacking tax—which would constitute an instrument of genuine tax autonomy for local governments.

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