

Microeconomics

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**DECENTRALIZATION OF BUDGET SYSTEM
AS THE ORGANIZATIONAL BASIS
OF THE SYSTEM OF LOCAL SELF-GOVERNMENT**

Abstract

The article analyses the opportunities of budget decentralization in the light of forming and functioning of local self-government system. The author exposes factors, determining a correlation of centralization and decentralization. A great attention is paid to the principles of expenditures responsibilities demarcation, to the problem of taxes` revenues fixing and to variants of regulation of vertical and horizontal inequalities in state budget system. The article exposes the role of local self-government as basis of federal state system. As a result, the author proposes a revenues structure on local and regional level with variant of local taxation system.

Key words:

Federalism, budget decentralization, vertical and horizontal inequalities, budget revenues and expenditures, local self-government, local budget, inter-governmental fiscal relations.

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The essence of the federal structure of the state can be reduced to the opportunities for its subjects to make their own decisions as an independent entity within the framework of a single state. This ensures the achievement and preservation of national unity and the relative independence of the federal subjects with their legal equality in relations with the federal center. The federal government offers the most robust and flexible mechanism for coordinating the interests of the center and the regions, motivating the subjects of the federation for the preservation of national unity.

In a federal system of government activities of regional authorities is built taking into account local conditions of socio-economic development, and accountability to the local population, from which the power is mandated to. This distinguishes it from a unitary system, which is characterized by decision-making at the center without their adaptation to local conditions and regional authorities accountable to central government. The differences in the principles of accountability ensure important background for the organization of a regional control in federal state structure in comparison with unitary system.

Federalism creates prerequisites for the effective organization and functioning of finance at various levels of government, including the budget process. The practice of management of the public finances in a country with few budgetary levels is called fiscal federalism. Its essence lies in the effective functioning of the organization and interaction of the budgets of all levels, providing the interests of all participants in the budget process.

The basis of the existing models in the world practice of fiscal federalism is the principle of decentralization, which is reflected in the form of government; in the structure of the federal, regional and municipal law; in the schemes of distribution of powers between different levels of government and in the construction of uniform, but multilevel fiscal systems.

Decentralization has both advantages and disadvantages, which are identified by comparing of the social costs and benefits. It should be borne in mind that if the decentralization does not affect the costs, the decentralized control is more effective, or at least it is not inferior from the viewpoint of efficiency. Decentralization is effective, if the rise in costs is covered by wins.

Fiscal decentralization is designed to achieve two main objectives: to improve allocative and productive efficiency of the budgetary system. By decentralizing public services can be organized to provide in such a way as to best suit the preferences of local residents, providing an increase in allocative efficiency or quality of the sharing of resources between the directions of their use. Along with this decentralization is accompanied by increased productivity of the budget system, ensuring accountability of local authorities to the population. Also the number of instances, in which solutions have to be coordinated, is reduced, as more powers given to local authorities, which better know the local context and local needs.

Thus, decentralization in its broadest sense involves the transfer of greater powers to local authorities, so that they can make their own decisions on the formation of income, expenses, and legal regulation. Local authorities are closer to the people, know better their needs and thus are able to meet their needs better than the central government. The proximity of the local authorities to the population also contributes to increased civic participation, transparency, and increased government accountability to the public.

Another important argument in favor of decentralization is the fact that the various public goods have unequal coverage. For example, the services of national defense are enjoyed by citizens of the country, and the benefits of inland waterways or the presence of the forest goes only to residents of specific regions. Public services, such as garbage collection and disposal, street lighting, etc., are addressed to residents of specific communities, and the need for them are different in various regions. Since the central government cannot account for such a variety of preferences in each region or country, the production of various public goods should be carried out by the different levels of government. This means that for the lowest level of government should be secured all the tax (revenue) expenditure responsibility and authority for statutory regulation, with the exception of those powers as to which may be presented convincing evidence that fixing them for the lowest level of government is inefficient. Provision of public goods only by institutions under the central government is associated with significant costs for a uniform approach to all areas (on some areas will be an overproduction of public goods, on the other – their underproduction) (Oates, 1972; Tanzi, 1996)

An important advantage of decentralization is the fact that the proximity of the local authorities to the population and the frequent interaction between them allows to create channels of communication through which citizens can express their interests. Moreover, such a regular and active communication increases the accountability of local governments to their citizens. Administrative autonomy creates preconditions for learning, finding new approaches to improve the overall quality of governance. Decentralized systems are able to provide greater stability, as local autonomies limit the ability of the center to conduct fiscal or monetary policy at its discretion. Decentralization contributes to maintaining of markets and

stimulates their development. Finally, the decentralized decision-making process allows to evaluate the different options for solutions, encouraging the spread of best practices. In this case, it is essential that the powers transferred to the level that can really hold any necessary actions and is interested in their results (Khaleghian, 2003; Bahl, 1999).

It should be noted that substantiation of decisions about the decentralization of funds in the budget system requires complete and reliable information about the territorial structure and intensity of financial flows. It comes to developing territorial context of revenues and expenditures of the federal and regional budgets, provide an estimate of «upstream» and «downstream» of funds in the hierarchy of the administrative-territorial system of the country. These data help us to understand how much tax revenue comes from each particular area in the federal, regional and local budgets, and, conversely, how much of this budget is spent on the same site. On the basis of this information one would be able to judge the financial self-sufficiency of each territory and its ability to independently provide its own development. Only these assessments will take solutions for each territory, individual in content, but based on the general rules for the provision or failure of financial support.

Local authorities, having autonomy, on the one hand, get more stimuli to increase revenue within their competence, but they cannot cross certain boundaries of accumulation of resources in view of the openness of the economy. On the other hand, they are spending money more efficiently, because they depend on the taxpayer, and are able to more accurately determine the local needs for public goods and the efficient use of infrastructure capacity gained.

Generally, the effective functioning of fiscal federalism is possible if the decentralized decision-making relates to the delivery of those public goods whose benefits are mainly localized in the area and localization benefits are substantially aligned with the spatial localization costs; also, preferences related to local public goods, mostly differ between regions than within regions.

Of interest is a position, put forward by John Wallace and William Oates about the relation between centralization and decentralization in government, one of the most important levers of which is the budget system. According to the mentioned researchers, the larger the area of the country is, the less centralized, all other things being equal, should be governance (area factor); the more the population of a country is, the less should be centralized governance (population density factor); the higher the proportion of the population is concentrated in urban areas, the less should be centralized state and regional management (social infrastructure factor); the higher the level of per capita income, the more centralized governance and his participation in programs related to the redistribution of income should be (factor of investment depending on the state of the economy); the more diverse is the demand for public services, resulting from the unequal distribution of income across regions, the less centralized, all other things being

equal, should be governance by the state and the regions (the factor of social dependence of the state of the economy) (Wallis, 1988).

In light of this, it can be argued that the impact of fiscal federalism is determined primarily by approaches, used to consolidate expenses, income-fixing and organizing the movement of funds between the various levels.

As the basis of the separation of powers between the expenditure levels of the budget system a set of principles is usually laid:

- territorial Compliance (consolidation of public services for the same level of power, whose jurisdiction covers essentially all consumers of these services);
- subsidiary (as close as possible to those territorial entities that carried budget services in the public interest);
- proportionality (matching of spending authority to financial resources of various levels of the budget system);
- economies of scale (number of costs is much better to carry out by large portions, wherein the provision of public services is assigned to the same level of power that can most effectively ensure the implementation of appropriate services);
- taking into account the external effects (the reasons for the higher centralization are high interest of society as a whole from the proper implementation of the individual regions / municipalities of its obligations and higher overall costs of their possible failure).

Obviously, making decisions on the division of expenditure responsibilities requires a comprehensive approach that addresses all of the following principles.

Of key importance is fixing of revenues (primarily taxes) in accordance with the expenditure side of the budget of a certain level. In general, three options of fixing tax revenues are known (King, 1992; Batkibekov et al., 2000).

In accordance with the first of them a local government gets all the tax revenues generated from the territory under its jurisdiction. In this part of the revenues should be transferred to a higher level of fiscal systems to meet expenditure obligations of the national government.

A weakness of this option is the possibility of reducing the effectiveness of inter-territorial redistribution of income, as well as restrictions to ensure fiscal stability. In addition, it can create inappropriate incentives for local authorities in respect of the financing of national expenditure commitments.

The second version of the distribution of tax revenues in contrast to the first involves the consolidation of all the taxes for the national government with the subsequent transfer of funds to lower authorities by providing grants or other

transfers, either through the establishment of standards for deductions of income for all or certain taxes to the budgets of lower-level.

This option also has some drawbacks, the main one of which is the lack of correlation between levels of government, vested with the adoption of the spending decisions, and the region within which collects certain taxes. This undermines the basis for an effective system of intergovernmental relations. Without establishing such a relationship there is the possibility of excess either finance local expenditure needs either unjustified decline in financial resources transferred to the lower levels of the budget system. Both can lead to the inability to create a stable system of financing public services at the local and / or regional level.

The third version of the distribution of revenue powers gives some of the taxing powers to local and regional authorities, and if necessary, – compensation for the missing revenues either by the share consolidation of regulatory taxes either by transfers by transferring to the local budget.

This option, occupying an intermediate position between the two previous, is largely free from their shortcomings, as it allows to assign to the lower levels of government taxing powers, thus linking the value of the tax burden and expense of the received solutions. However, the local authorities in their actions are guided by considerations of form «cost-benefit», which leads to an increase in economic efficiency. The implementation of this variant of the distribution of income, however, requires a coherent selection of taxes belonging to a local / regional authorities (local / regional taxes), and the share of federal taxes to the regional / local budgets (shared taxes).

The problem of the distribution of tax revenue is not limited to the full consolidation of specific taxes for local, regional or national level of government. Most often preferred is a combination of different schemes of fixing of tax revenues and tax authorities.

Understanding of the different types of government revenues on lower level is given in a table which shows that tax revenues of subnational governments can take many forms: own taxes, which are fully credited to the budget of the relevant authority, which has the right to determine the tax rate, and in some cases – to influence the procedure for calculating the tax base, and «overlapping» taxes, the base of which is determined by federal law for the entire country and subnational authorities shall have the right to set their own tax rates. (Batkibekov et al., 2000)

The issue of fiscal autonomy of subnational governments depends on their expected role in the economic system of the country. If the economic role of the administrative-territorial units is reduced to the practical implementation of the policies formulated at the highest levels of government, there is no need to provide them with a broad fiscal autonomy. If, on the contrary, it is expected that sub-national governments will implement their own spending programs, as well

as the independent determination of the amount and quality of the appropriate level of public services, their inability to change the tax rate, and therefore – the amount of budget revenues, is a serious problem arising from the mismatch of expectations, needs and aspirations of the public authorities of the actual revenue opportunities (Batkibekov et al., 2000).

Table 1

Types of fiscal autonomy of subnational governments

Kind of a lower level of budget revenues	The level of authority to control the view of revenue
own taxes	The power to determine the rate and tax base belong to the authorities of the appropriate level
«Crossed» taxes	The tax base is determined by federal law, the authority to determine the rates belong to the authorities the appropriate level
Regulators (shared) taxes	Rate and the tax base is determined by federal law, but a fixed percentage of tax revenue is credited to the budget authority of the appropriate level (aspect ratio can be calculated both on the basis of the share of tax revenues from the territory under the jurisdiction of the authorities of relevant level, and on the basis of other criteria – population, expenditure needs, revenue potential)
Non-purpose transfers	Share or transfer amount is determined by the central government, but the authorities – the recipients of transfer has the right to determine the direction of spending. In some cases, the amount of transfer tax may depend on the tax efforts of the recipient
targeted transfers	Transfer amount is determined by the central government, authorities – the recipients are required to spend their money on certain programs

Source: (Batkibekov et al., 2000) p. 91.

The use of these schemes of the distribution of tax revenues and spending obligations may lead, however, to the emergence of vertical and / or horizontal imbalances. Vertical imbalance is possible in case of discrepancy between its income and expenditure responsibilities at different levels of the budget system and the horizontal imbalance occurs during the differentiation of its own fiscal ca-

capacity of subnational governments at the same level of the budget system. To eliminate these imbalances a variety of mechanisms of transfer or borrowing are usually used.

The transfer of resources from one level of government to another budget is carried out usually in two ways – through a system of revenue sharing and grants. In this case, revenue sharing can have a number of options such as the division of the tax base or the centralization of tax revenues and their subsequent distribution according to selected criteria.

Allocation of grants may also have two types – non-targeted and targeted transfers, each of which can, in turn, be allocated as a fixed amount or as renewal, be conditional or unconditional, and stand out with co-funding. Selection of a particular allocation mechanism of intergovernmental transfers depends on the objectives of economic and fiscal policy in a given time.

In general, there are three possibilities of the state policy in the field of intergovernmental transfers to align the vertical and horizontal imbalances (Bat-kibekov et al., 2000):

1) The use of separate mechanisms aligns the vertical and horizontal imbalances. Subnational budget deficit alignment is performed by dividing the tax revenue and allocation of transfers from the national budget, while the alignment of fiscal potential is produced by the horizontal payments from regions with high budget level to the regions with low incomes. A similar system is used in the Federal Republic of Germany.

2) The complex system of equalization transfers. Both vertical and horizontal imbalances are aligned with a unified system of equalization transfers and special grants. A similar approach is used in budget systems in Australia and Canada.

3) Only the vertical alignment of the imbalance of the budget system. As with the first version of the budget policy, subnational deficits are aligned with the fixing of regulatory taxes and equalization transfers, but there are no specific measures to equalize the horizontal imbalance. In this case, the movement of capital and labor arises as a result of the difference in incomes in sub-national entities, as well as the net fiscal benefit to the regions (the net benefit of public expenditures and taxes paid). Under this option, fiscal policy may allocate special grants that, among other purposes, can be horizontal leveling effect. This approach is widely used in the USA.

In addition to establishing a relationship between the objectives of the horizontal and vertical alignment of imbalances in the design of the transfer system it is also required to determine the relationship between the types of transfers. The latter, as mentioned, can be either conditional or unconditional or targeted and untargeted transfers. Conditional transfers are grants, provided on the conditions of co-financing, the simple purpose transfers and block grants, each of

these types of transfers, in turn, can be allocated as a fixed amount, and with the possibility of extension. Unconditional transfers are allocated in the form of deductions from income tax in the sub-national budgets or in the form of direct transfers in a fixed volume or to be extended.

The practice of construction and functioning of budgetary systems in the federal structure of the state shows that the distribution system transfers must meet the following criteria (Batkibekov et al., 2000):

First, you need to avoid a situation where equalization transfers just cover the gap between revenues and expenditures of sub-national budgets. The distribution system of transfers should be built in such a way that sub-national authorities have not been able to influence the size of the transfer by its solutions in the area of expenditure policy, tax policy and tax administration.

Second, the application of the system of equalization transfers should not be accompanied by significant costs for the collection and processing of the initial information.

Third, the development of methods of distribution of transfers is necessary to involve representatives of the regional government to reach a political consensus in this area, in the absence of which the system will be ineffective. As a result, there can be a step change in the principles of horizontal and vertical alignment in order to avoid sharp fluctuations in the fiscal situation in the regions.

As a result, there should be incentives to conduct rational and responsible fiscal policy, to expand its own revenue base and for efficient use of public funds for the benefit of the local population.

The establishment and operation of an effective system of intergovernmental relations is ultimately aimed at:

- 1) improving the standard of living, social security and ensuring equal access of the population to the public (budget) services and social guarantees throughout the country;
- 2) ensuring the sustainable economic development with the optimal use of fiscal and resource potential of certain areas and the country in general;
- 3) strengthening of government and territorial integrity of the country, preventing the emergence of centrifugal tendencies and conflicts between different levels of government over the allocation and use of resources of the national budget system, the creation of conditions for the development of civil society.

Thus, the purpose of intergovernmental relations is to ensure consistency between income and expenditure in the budgets of different levels in cases when its income is insufficient to cover the necessary budgetary expenditure.

In all countries, using the principles of fiscal federalism, the scope of fiscal relations is the subject of a thorough legal study. The development of an appro-

appropriate legal framework lies in the direction of detail and comprehensive coverage of the legislative distinction between different levels of government expenditure and revenue responsibilities, as well as about the use of budgetary procedures alignment.

An essential element of social structure in many countries is the local government. Its circle of competence usually includes the implementation of the main share of social functions of the state, public safety, land improvement, promotion of entrepreneurship, etc. In recent years, local authorities received a significant level of autonomy [European Charter of Local Self-Government, etc.], and in some cases, local authorities are independent from the institutions of government.

The system of local self-governance as a fundamental element of a federal state structure is designed to provide a combination of national interests and the interests of each individual territory. Therefore developed and effectively organized local government is an essential element of the state government, allowing the latter to concentrate on solving national problems, thereby optimizing the entire system of government. Local governments carry out the implementation of local issues and the creation of conditions for the daily needs of the population. Obviously, for the effective implementation of their functions and powers the local authorities should have sufficient economic and financial base.

In modern conditions, Russia (since the late 90's. to Present) has been increasing centralization of control, including in the area of fiscal policy and the overall state of regional policy. To a certain extent it was justified in solving the most acute crisis and conduct basic market reforms. However, the current centralized model has exhausted its constructive possibilities and becomes a brake of territorial development. Preservation of this trend in the future is fraught with further intensification of existing problems in regional development. One of the most actual ways to overcome these problems is the decentralization of the budget system, including the decentralization of resources and authority, autonomy in decision-making, competition and strategic marketing.

In accordance with the above proposed we can focus on the formation of the following structure of income sources at the level of regional and local budgets (Sumskaya, 2010):

- 1) taxes, the proceeds of which are sharply reduced during periods of economic downturn and rising in the economic recovery (for example, the corporate income tax), should be assigned to the regional budget and local budgets should get the most stable tax sources;
- 2) taxes, the base of which are distributed unequally (taxes on some natural resources, etc.), should be fixed in the regional budget;
- 3) taxes, the base of which can easily be moved to another municipality (by re-registering the parent company, etc.) or the burden of which can be

passed on to the population of another municipality (excise on vodka imposed on the manufacturer and the like), it is necessary to centralize into the regional budget;

4) taxes on immobile bases, must be attached to local budgets (property taxes);

5) tax revenues that directly depend on the well-being of taxpayers registered, or living in the area (income tax, sales tax on consumer goods, etc.) should be attached to local budgets;

6) fees for budget services (fees, administrative fees) are due to the budget authority providing these services.

In summary, we can state the following provisions on which to build a system of local taxation:

1. Tax revenues should primarily cover the needs of the local budget. If local autonomy is an economic and political purpose, the local authority should not, if possible, be dependent on subsidies of higher authorities. Taxes collected by the local authorities, are more reliable base of long-term planning and development, particularly in respect of costs. The system of local taxation should not be the only source of local budget. There are many unusual costs, especially in the municipalities performing the functions of regional centers, which should be compensated by subsidies for general use.

2. Local authorities should have the right to set the rates of one or two major taxes. This enables local authorities to determine their expenditure program in accordance with the desire of the population to pay taxes. The financial autonomy of local governments has the advantage that taxpayers may authorize the local authority action by voting in elections and to control the decisions and activities of the local elected officials and administrative offices.

3. Taxes should be transparent and understandable to citizens and businesses, which bear the tax burden. This transparency is a prerequisite for the efficient allocation of resources according to individual requirements. Ultimately, it allows people to «vote with their feet» by taking the decision to move on the basis of differences in local taxation, which is characteristic of highly developed countries.

4. Providing income growth and thus satisfaction of its growing needs is impossible without establishing correspondence between economic development and income from local taxes. In addition, tax revenues should not be directly linked to the cyclical nature of business activity in the territory. From a formal point of view, the elasticity of tax revenue must be equal to one. The reason for this requirement is that the ratio of costs and revenues of local authorities should be stable over time. Stabilization policy is the responsibility of the central government because of its external action and requirements for flexibility in spending

and income. If there is a need to promote the stabilization policy of the local authorities, it is desirable to encourage them with grants for special purposes. Positive attitude of citizens and businesses to local authorities influences the distribution of the tax burden between the local population and the business sector, although the fear of environmental pollution often makes the local authorities to act against the creation of new industries. However, the system of local taxation should be neutral without any «drag» of the population and businesses. This rule has been called «the principle of equalization of interests.»

5. The establishment and a balance between the consumption of local services in the territory and the distribution of the tax burden are required. This equilibrium is not only has a positive effect on the distribution of resources, but also accompanied by political advantages, because the obligation to distribute the tax burden among all consumers of public services does not allow the use of certain groups through political decisions.

6. In the municipalities, roughly equal in size, the difference between the proceeds from local taxes per capita should not be significant. Otherwise, you need an active implementation of measures aimed at balancing between local authorities with a view to preventing violations of their financial autonomy. Since differences in the tax revenue are often associated with inequality of regions, the non-observance of the principle of building a system of taxation aggravates it even more.

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