CHAPTER 7

TAX SHARING AND SUBVENTIONS

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The system of tax sharing and subventions prevailing in Kazakstan reflects prior Soviet practice. It suffers from a variety of serious defects. Most important, it provides the *oblasts* and *rayons* with virtually no control over taxes levied on economic activity occurring within their boundaries, and thus little control over the level of public expenditures. The rules governing tax sharing are essentially irrelevant ex ante, but ex post they can create problems.

This chapter explains these problems and proposes replacing the current ad hoc system of tax sharing and subventions with a system based on tax assignment and formula-based grants. The first two sections describe the present system and its defects. The third section describes benefits, impediments, and potential problems of tax assignment. The next section presents evidence on potential horizontal fiscal disparities in Kazakstan, and the last section discusses two models of fiscally strong and weak subnational governments.

Sharing rates are only one aspect of tax-sharing arrangements; equally important are the rules dividing revenues to be shared among the *oblasts*. The present rules for dividing tax revenues among *oblasts* cannot provide the basis for a rational system of tax assignment because, except in the case of the individual income tax, they generally assign revenues to the "wrong" *oblasts*. Because these problems are of minimal importance in the present system, but are of vital importance in a system based on tax assignment, their discussion is deferred until the next chapter. Chapter 9 proposes a system of formula-based grants intended to prevent vertical fiscal imbalance and offset the horizontal fiscal disparities that would be created by tax assignment. Chapter 10 discusses the transition to such a system.

As emphasized in Chapter 1, it is useful to begin with a conceptual discussion to elucidate both what is wrong with the current system and the outlines of a better system. With this conceptual picture in mind, it is then possible to proceed to consideration of administrative feasibility and political realities.

THE PRESENT SYSTEM

Central Government/*Oblast* Tax Sharing and Subventions

By law, *oblast* governments have access to certain "local taxes" and charges. All revenues from these taxes flow into local budgets, but local governments have little or no control over the definition of the tax base, determination of the tax rate, or administration of the tax. The list of local taxes (and the tax bases and rates) are specified in the tax code. These are mostly unimportant sources of revenue, especially because the new tax code repeals many small local taxes and converts the individual income tax from a local tax to a national tax.[1] Revenues from local shares of national taxes are subtracted from target expenditures to determine the gap that must be filled by revenues from national "regulating taxes" and subventions from the central government.

There are four main regulating taxes that can be shared in various proportions with the different *oblasts* on a derivation basis to fill (or partially fill) the gap between revenues from local taxes and expenditure targets: the individual income tax, the enterprise profits tax, VAT, and excise taxes. Taxes on natural resources provide important sources of shared revenues in several *oblasts*.[2] All taxes are administered by STC, an agency of the central government. Thus, administrative effort is beyond the control of *oblast* governments, in principle, if not in fact.

Table 7.1 summarizes the sharing rates, by *oblast*, for the main regulating taxes for 1995 and 1996.[3] In 1995, except for four *oblasts* (Almaty City, Atyrau, Mangystau, and Pavlodar), all revenues from

[1] The Budget Law for 1995, as amended by Presidential Decree dated 11 July 1995, continued 100 percent allocation of revenues from the individual income tax to *oblasts* for the remainder of that year. The Budget Law for 1996 utilizes the individual income tax as a regulating tax.

[2] The draft law on taxation of mineral resources would have assigned a minimum of 30 percent of revenues from royalties to subnational governments. This would generate enormous revenues for some *oblasts*, most notably Atyrau.

[3] Almaty City is included in counts of *oblasts*; because of its unique situation, Leninsk City is omitted.

excises were assigned to the budgets of the *oblasts* where they were collected. Twelve of the 20 *oblasts* retained 100 percent of revenues from VAT and the enterprise profits tax. Eleven of these, commonly called "subvention *oblasts*," also received subventions from the central government. The remaining eight *oblasts* ("nonsubvention *oblasts*") retained smaller portions of these taxes.[4]

The Budget Law for 1996 streamlined this process somewhat. Eleven "subvention *oblasts*" retained all of the revenues from VAT and the individual income tax withheld at source. For the nonsubvention *oblasts*, retention rates for VAT ranged from 10 percent in four *oblasts* (Almaty City, Atyrau, Mangystau, and Pavlodar) to 70 percent. For the individual income tax, the range of sharing rates for nonsubvention *oblasts* was 10.1 percent (for Atyrau) to 85.9 percent. With the exception of Almaty City and Mangystau (each of which retained 20 percent), *oblasts* were allowed to retain a uniform 40 percent of enterprise income tax. Similarly, they retained all revenues from excises, except in the case of Almaty City and Pavlodar, which retained 20 percent.

In principle, subventions are fixed in nominal terms. Thus, their real value is eroded by inflation occurring during the fiscal year. Moreover, because of its budgetary condition, the central government has recently failed to deliver fully the subventions promised in the budget.

Oblast/Local Tax Sharing and Subventions[5]

The process of formulation and funding of the budgets of local governments is similar to that described above for *oblast* budgets. Local governments derive small amounts of revenues from truly local taxes, and the rest is obtained from the *oblasts* via tax sharing and subventions. Local taxes include those on land, property, and motor vehicles. In the *oblasts* visited (Almaty Oblast,

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[4] One might ask why all revenue from one tax is not allocated to an *oblast* before moving on to the next tax. For example, in Akmola Oblast, 90 percent of enterprise income tax revenues, but only 50 percent of VAT revenues, were allocated to the *oblast* in 1995. MOF apparently believes it important to diversify the revenue sources of *oblasts*, making them less susceptible to economic downturns.

[5] This section describes and analyzes the current practice of intergovernmental relations at the *oblast*/ local level using information gathered from field visits to Almaty Oblast, Taldykorgan, and Karaganda. The first two *oblasts* are relatively poor, as measured, for example, by GDP per capita (about 60 percent of the national average), or the average monthly wage in industry (87 and 70 percent of the national average, respectively [Table 7.2]). Both receive subventions from the central government. Karaganda, being wealthier (with 165 percent of average GDP per capita and 132 percent of the average industrial wage), receives no subvention.

Table 7.1. Tax Sharing Rates, 1995 and 1996
Oblast **Share of Collections of Regulating Taxes**
(percent)

Oblast	VAT 1995	VAT 1996	Excise 1995	Excise 1996	Enterprise Income 1995	Enterprise Income 1996	Individual Income 1995	Individual Income 1996	Subvention
Akmola	50	70	100	100	90.0	40	100	63.7	No
Aktubinsk	50	20	100	100	51.3	40	100	79.6	No
Almaty	100	100	100	100	100.0	40	100	100.0	Yes
Atyrau	10	10	10	100	39.5	40	100	10.1	No
East Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Jambyl	100	100	100	100	100.0	40	100	100.0	Yes
Jezkazgan	100	20	100	100	100.0	40	100	66.2	No
West Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Karaganda	50	50	100	100	54.0	40	100	85.9	No
Kzyl-Orda	100	100	100	100	100.0	40	100	100.0	Yes
Kokshetau	100	100	100	100	100.0	40	100	100.0	Yes
Kostanai	50	50	100	100	29.4	40	100	65.2	No
Mangystau	10	10	10	100	19.7	20	100	36.0	No
Pavlodar	20	10	50	20	26.2	40	100	62.0	No
North Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Semipalatinsk	100	100	100	100	100.0	40	100	100.0	Yes
Taldykorgan	100	100	100	100	100.0	40	100	100.0	Yes
Torgai	100	100	100	100	100.0	40	100	100.0	Yes
South Kazakstan	100	100	100	100	100.0	40	100	100.0	Yes
Almaty City	20	10	20	20	8.9	20	100	31.5	No

Sources: 1995: Amended 1995 Budget (11 July 1995); 1996: Presidential Decree No. 2700, On the Republican 1996 Budget (21 December 1995).

Karaganda, and Taldykorgan), these revenues accounted for 17-20 percent of total expenditures of the *rayons*. As with central government/*oblast* tax sharing, shared tax revenues go to the *rayons* where the revenues were initially collected.

The pattern of tax sharing within *oblasts*, which is determined by the individual *oblasts*, is somewhat more varied than that between *oblasts*. In Almaty Oblast, the local governments are allocated nearly all revenues from the individual income tax, the enterprise income tax, and VAT. The *oblast* share of revenues from excises is fully distributed to the local governments. In short, almost all the revenues the *oblast* receives from shared taxes of the central government are passed through to local governments, with the *oblast* retaining little more than the subvention from the central government for use in financing its own activities.

This pattern is even more exaggerated in Taldykorgan. Only one *rayon*, Taldykorgan City, receives less than 100 percent of the shared revenue from all regulating taxes; it receives approximately 60 percent of such revenues. The other 40 percent of revenues collected in Taldykorgan City support a large portion of the *oblast*-level budget. This is not surprising because Taldykorgan City collects more than twice as much VAT as all the other *rayons* in Taldykorgan Oblast combined.

PROBLEMS WITH THE PRESENT SYSTEM

The system of tax sharing and subventions used to fund expenditures of *oblast* and local governments in Kazakstan can be presented in the following schematic terms:

Target *oblast* (local) budget[6]

Less: estimated revenues from *oblast* (local) taxes

Equals: amount to be financed from regulating taxes and subventions

Less: estimated revenues from *oblast* (local) share of regulating taxes

Equals: subventions required for budgetary balance

The fact that the total budgetary allocation to an *oblast* (from local taxes, shared taxes, and subventions) is independent of the amount of taxes expected to be collected in the *oblast* has several important implications. These statements are equally applicable to budget allocations and revenue sources of local governments.

[6] In principle, expenditure norms are used to calculate the target *oblast* or local budget. In fact, target budgets are calculated by scaling up prior approved budgets to adjust for inflation; also see Chapter 6.

Lack of Fiscal Choice

Ex ante (that is, during the budget process), the *oblasts* do not determine the level of revenues they receive from taxes and subventions, except to the extent they can negotiate larger total target budgets. Thus, tax revenues are inframarginal to the budgetary decision-making process. This has fundamental implications for the functioning of the system. It is impossible for subnational governments to affect the level of revenues they receive by changing tax rates to affect the split between public and private sector spending.

From an ex post point of view (during the course of the year, once sharing rates and subventions have been set), subnational taxation including subnational shares in regulatory taxes may provide a marginal source of revenue in the sense that subnational governments get more or less revenue, depending on the actual performance of tax collections, unless the central government fills in revenue shortfalls or "claws back" revenues in excess of what was expected. But subnational governments generally cannot control whether they get more or less revenue, unless they resort to "backdoor" sources of revenue, such as extrabudgetary funds discussed in the previous chapter. A subnational government may also exert influence over the efficiency of tax administration within its jurisdiction, if there is a system of dual subordination (to the subnational authorities, as well as to STC). If so, it can exert some control over total revenues and thus the level of expenditures. It is claimed that dual subordination is not important in Kazakstan. Also, because sharing rates are adjusted each year, based in part on how much revenue was collected in the *oblast* in the previous year, there is relatively little incentive in this system for the *oblasts* to insist on more efficient revenue collection, even if dual subordination exists.

Some of the ex post effects of the current system are undesirable. If, for example, capital goods or intermediate goods are imported from outside the CIS through one *oblast* for use in another, VAT is collected in (and shared with) the *oblast* of importation, but a credit for tax on the purchase is allowed (and perhaps refunded) in the *oblast* where the entity importing the goods is registered and pays VAT. Above-budget revenues from excises would be shared with the *oblasts* where production or importation occurs, instead of with the *oblasts* where consumption occurs, as would be more appropriate. (See also the discussion of tax assignment in the next chapter.)

Irrelevance of Tax Sharing

The division of tax revenues between levels of government (the distinction between local taxes and regulating taxes of the central government) and between governments at a given level is essentially irrelevant ex ante. A different division would be offset by differences in sharing rates and subventions. For example, the seemingly improper assignment of revenues from excise to the *oblast* where production or importation occurs is rendered largely irrelevant in the case of Almaty City and Pavlodar (the only *oblasts* that did not receive all revenues from excises collected on their territory in 1996) by the relatively low (20 percent) sharing rates assigned to these two *oblasts*.

Figure 1.1 helps show that tax assignment is essentially irrelevant in the current system and that local taxes do not provide a marginal source of revenue. If local taxes were expected to be higher or lower, the amount of shared taxes would be adjusted to keep total revenues expected from all sources equal to target revenues. If shared revenues would not be adequate to fill the gap, even with 100 percent sharing rates for all taxes, subventions would be provided. If revenues to be shared were expected to be different, sharing rates or subventions would be adjusted to take up the (positive or negative) slack. If, in fact (ex post), either local taxes or shared taxes were to differ from budgeted amounts, the *oblast* would have more or less revenues than expected (unless the central government made up any shortfall or clawed back any excess), but this would not affect budgeting.

Equivalence to Subventions

All things considered, it is more accurate and more useful to think of the existing system of tax sharing as a form of grant—as part of the subvention system, rather than as a form of tax assignment. Contrary to the situation under tax assignment, subnational governments have no legal control over any aspect of the determination of the revenues they receive; they are not allowed to choose the taxes, define the tax base, set the tax rate, or administer the tax.[7]

Another way to think of this is to delve more deeply into the distinction between subvention and nonsubvention *oblasts*. The

[7] For the opinion that tax sharing generally should be viewed as a form of grant, instead of a method of tax assignment, see Bahl and Linn (1992, Chapter 13).

terminology currently employed in Kazakstan focuses on the *administrative* source of revenues: entirely from within the *oblast* (in the case of nonsubvention *oblasts*) or partially from outside the *oblast* (for subvention *oblasts*). A more useful distinction is the *political* source of revenues: marginal sources of revenues over which the *oblast* has control (none, for any *oblast*), versus those over which it has no control (all, for all *oblasts*). If the problem is framed in this way, it is readily apparent that all *oblasts* are subvention *oblasts* in the latter sense.[8] The central government could achieve the same budget allocations by eliminating all local taxes, setting all sharing rates equal to zero, and using only subventions to provide the target budgets. This study recommends that Kazakstan switch to a system that relies more heavily on grants, with surcharges covering marginal spending. It may be objected that this would convert all *oblasts* to subvention *oblasts.* In fact, all *oblasts* are already subvention *oblasts.* Such a switch would not alter reality; it would only bring appearance into conformity with reality — an important plus in a democratic system — while giving *oblasts* control over marginal sources of revenue — another important plus.

TAX ASSIGNMENT ALTERNATIVE

In the literature on fiscal federalism, it is customary to speak of subnational fiscal autonomy. Because Kazakstan has a unitary form of government, subnational autonomy is inevitably limited. Yet, one of the primary objectives of decentralization of government is to give subnational governments a greater voice in their level of spending.

If subnational governments are to exercise control over their level of spending, they must have both the capacity and the incentive to raise the revenues needed to finance their activities, at the margin. Otherwise they will be totally dependent on grants and transfers from higher levels of government, they will not enjoy control over the level of public spending, and they may not exercise economy in the use of public funds.

In some countries of the West, subnational governments are granted the power to choose the taxes they levy, define tax bases, set tax rates, and administer the taxes. The US, where the states have all these powers, subject only to very general constitutional

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[8] Moreover, the present distinction between subvention *oblasts* and others rests, in part, on administrative distributions of revenues among *oblasts* that have little to recommend them; see Chapter 8.

limitations, is the extreme example (Duncan and McLure, 1997). In most other countries, the fiscal powers of subnational governments are more limited. Such systems, based on independent subnational legislation and administration, clearly provide substantial fiscal autonomy to subnational governments.

While a system of independent legislation and administration has clear benefits, it also faces impediments and creates problems. Moreover, it is not appropriate for a country that has a unitary government, such as Kazakstan has. This section describes in general terms some of the benefits, impediments, and potential problems of tax assignment.

Objective of Tax Assignment: Marginal Sources of Own Revenue

For a government to control its level of spending and to be held accountable, it is not necessary that it raise all the funds it spends, or even the majority of them. What is essential is that it must have control over marginal or incremental sources of funds. Thus, for example, a subnational government would enjoy considerable fiscal discretion, even if it received grants per capita from a higher-level government that financed much of its budget, as long as it could supplement the grant funds with revenues from important taxes under its control.

An important question is the degree of control over tax policy needed to assure subnational fiscal discretion. The answer is inherent in the concept of marginal revenues — revenues that can be increased or decreased, depending on whether citizens want more or less public services. Clearly it is not adequate to have total control over sources of revenue that are inevitably unimportant, as that would not provide marginal revenues. Nor should an *oblast* be forced to levy higher taxes than its residents want to pay for the public services they get, even if the *oblast* gets all the revenue. What is required is the legal capacity to choose and the administrative capacity to implement the level of taxes that residents of the *oblast* are willing to pay to finance the services they want. The next chapter argues that subnational governments should have the capacity to levy (but not administer) surcharges on some of the important taxes levied by the central government.

It might be objected that no subnational government can truly control its own fiscal fate if it survives primarily on grants, even if it raises marginal revenues from taxes it controls. There is an important element of truth in this observation; governments that depend on grants are often at the mercy of higher levels of government, as in Kazakstan today. But it is important to distinguish, for example, between grants that are constitutionally guaranteed, those that are provided by generally respected laws of long standing, those that are legislated annually (for example, in annual budget laws), and those that are provided on a discretionary and ad hoc basis, perhaps after the fact. It is difficult for subnational governments to exercise fiscal control if they must rely on grants falling in the last two categories (grants provided annually or with discretion), because they do not know in advance — indeed cannot predict — how much revenue they will have. By comparison, there is evidence from international experience that if properly structured, constitutional grants and grants specified by laws of long standing can provide substantial certainty.

Grants provided by constitutions or legislation of long standing ordinarily do not and should not specify monetary amounts; if they do, the amounts are likely to become inappropriate or meaningless during a time of high inflation. Rather, such grants are likely to be based on formulas. (Such formulas may, for example, call for a given percentage of revenues of the central government to be divided among subnational governments on the basis of population, perhaps with adjustments for the *oblast's* per capita income, relative to the national average.) In that case, the certainty of revenues is limited by the precision with which the components of the formula can be predicted, especially the predictability of tax revenues of the central government. In this respect, grant funds may be similar to tax revenues, which are also dependent upon the state of the economy.[9] This type of (economic) uncertainty is different in kind from the (political) uncertainty inherent in grants determined annually or with discretion by the political process.

It is likely that grant policy will change over the next few years, as both experience and data are accumulated. It is important that Kazakstan find a way to provide flexibility, without sacrificing certainty. Because of the need for flexibility, grant formulas should not be prescribed in the constitution, though their objectives might be specified there. It might be appropriate to specify the grant formula, but not the amount of grants to be made, two years in advance.

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[9] *Oblast* revenues from shared (regulating) taxes of the central government depend on the performance of revenues, and thus on economic conditions and the quality of tax administration.

Impediments to Tax Assignment

Subnational governments, taken together, often have difficulty in raising enough revenue from taxes assigned to them. Administrative impediments often underlie such vertical fiscal imbalance. Even where there is no overall problem of vertical imbalance, there may be important horizontal fiscal disparities, or differences in the fiscal capacity of *oblasts*. The potential for creating, aggravating, or offsetting vertical fiscal imbalance and horizontal fiscal disparities must be considered in determining tax assignments and in designing grant systems. Moreover, it is generally appropriate that subnational governments only be assigned taxes that are not exported to nonresidents in significant amounts.

Administrative Impediments

As in other countries in transition from socialism, the skills needed for tax administration and compliance are extremely scarce in Kazakstan. Thus, some solutions that might be attractive, in principle, may not be available in practice, at least for the foreseeable future. Independent subnational administration of most important taxes is likely to be infeasible. Surcharges on taxes administered by the central government are the most likely vehicle of tax assignment. Whereas surcharges on the individual income tax should be quite feasible, consumption-based subnational surcharges on excises may not be. In addition, some alternatives are inherently difficult, even in countries with an abundance of administrative talent; subnational surcharges on VAT is the best example of this type of problem. These problems are described in detail in the next chapter.

Dual subordination can also complicate or even undermine the use of surcharges, as it does tax sharing. Most obviously, STC and *oblast* governments may have very different views on the assignment of administrative resources between taxes subject to high surcharge rates and those subject to low surcharge rates. Dual subordination to subnational officials might lead to overemphasis on the former (for a given amount of equally likely potential revenue), while STC might prefer to concentrate too much on the latter. It is important that STC assign equal weight to revenues of the central and *oblast* governments and that individual *oblasts* not be allowed to exercise dual subordination, although they might, as a group, participate in oversight of STC.

There have been cases in Kazakstan in which an *oblast* government has induced the local tax administrator to allocate tax payments to its account, instead of to the central government's account. (Enterprise managers can generally be expected to cooperate in such a scheme, to help their home *oblast*.) In part, for this reason, tax arrears of the central government are proportionately greater than those of the *oblasts*. The prohibition of local subordination of STC should be enforced. (Local subordination has already been abolished.) There should be clear rules for priority over payments that are inadequate to discharge liabilities to all levels of government, with punishment for violation of such rules, and even for aiding and abetting such violations. Shift of responsibility for collection of taxes to NBK should significantly reduce this problem.

Vertical Fiscal Imbalance

A common phenomenon in many multitiered systems of government, be they federations or unitary systems with devolution of powers to subnational government, is the existence of vertical fiscal imbalance—the inability of one or more levels of government (ordinarily the subnational ones) to finance the services that are assigned to them, using the revenue sources at their disposal. One can identify at least two sources of such a problem. First, for administrative reasons, it may not be possible to raise the revenues subnational governments need to finance the public services people want them to provide; this seemingly anomalous result can occur because it is generally possible to enjoy such services without paying taxes.

Second, a higher level government may mandate services levels without providing the funds needed to finance them. In some parts of the FSU, vertical fiscal imbalance has been aggravated by the shift of expenditure responsibilities to subnational governments, without a corresponding shift of revenues. While "unfunded mandates" may produce the appearance of budgetary balance at the central level, "shifting the deficit down" generally accomplishes little, because the central government is ultimately responsible for the deficits of the *oblasts*. A further source of vertical fiscal imbalance is the shift of responsibility for expenditures on social services from enterprises to subnational governments, not matched by increased subnational revenues.

It is sometimes said that vertical fiscal imbalance cannot exist in a system such as that currently used in Kazakstan because the targets for expenditures and revenues are determined simultaneously in the budget process. Be that as it may, the switch to a system that combines subnational discretion in budgeting with tax assignment may create vertical fiscal imbalance.

The problem of vertical fiscal imbalance is ordinarily addressed through grants from other (usually higher) levels of government. Chapter 9 discusses this issue further. An important objective to be addressed is that of providing grants to subnational governments in a way that reduces or eliminates vertical fiscal imbalance and horizontal disparities without destroying incentives for subnational governments to raise revenues at the margin.

Horizontal Fiscal Disparities

If taxes are assigned to subnational governments, it is virtually certain that some jurisdictions will have inadequate fiscal capacity. Horizontal fiscal disparities are commonly caused primarily by geographic differences in the levels of economic activity. No matter whether the tax base is related to production or to consumption, rich areas can be expected to have greater fiscal capacity than poor ones. Horizontal fiscal disparities can sometimes be traced to extreme differences in endowments of important natural resources; this issue is important enough in Kazakstan to receive special attention in the next chapter.

Tax Exporting

Taxes are sometimes paid by those who do not live in the jurisdiction that levies the tax. Such tax exporting is generally condemned because it is unfair and it may cause the jurisdiction that is able to export its tax burden to over expand provision of public services. There is an important exception to this general observation. If taxes are closely related to the provision of public services to the taxpayer, tax exporting is not inappropriate because it is, by assumption, matched by exporting of public services. Indeed, it would not be fair or economically neutral if taxes were not exported under those circumstances. In the remainder of this book, references to tax exporting will be limited to instances where the exported taxes are not matched by benefits to the taxpayer. Whereas significant tax exporting may be quite common in a system of tax assignment based on independent legislation and administration, it is easily avoided in a system of surcharges on taxes selected by the central level of a unitary government. See Box 8.1 for a discussion of tax exporting in the US.

Macroeconomic Inflexibility

A central government is arguably less able to maintain control over macroeconomic policy in a system based on tax assignment than in one based on subventions, including a system such as that in Kazakstan, where tax sharing is best seen as a special form of subvention. Thus, there may appear to be a potential conflict between the goals of decentralization of fiscal authority and macroeconomic stability, both of which are important to the transition to a market economy.

In principle, macroeconomic stability can be maintained in a system that includes tax assignment. Some of the countries with the greatest macroeconomic stability are strong federations, such as Switzerland. In other federations that suffer from instability, the problem cannot properly be traced to tax assignment. For example, in Argentina the states have been allowed to borrow from banks they own; this is a manifestation of defective banking laws, and not an inherent problem of decentralization. For political reasons—an impasse over budget policy—the US has a budget problem at the federal level, despite the presence of technically adequate tools to deal with it; the states are not the source of fiscal imbalance. Tax assignment is necessary to give subnational governments control over the level of public spending. It is not inherently incompatible with macroeconomic stability.

Political Immaturity

The theory of fiscal decentralization underlying this study assumes that a democratic system functions at all levels of government. If this assumption is invalid, a variety of problems can occur. On the one hand, tax rates may be set so high that savings, investment, entrepreneurship, and work effort suffer. Limiting surcharges to the individual income tax (and perhaps excises), and allowing subnational governments to impose only flat rate surcharges reduces vulnerability to this threat. Because expatriate workers bulk large in some areas, it may, however, be desirable to place an upper bound on the allowable surcharge rate, to prevent exploitation of such workers in an effort to export the tax.

Equally risky is the possibility that *oblasts* will choose surcharge rates so low that they cannot cover their expenses and, thus, incur deficits. The ultimate solution here is to harden the budget constraint facing *oblast* governments. In the short run it might be appropriate to phase in reliance on surcharges, making additional access to surcharges available only to *oblasts* that exercise fiscal responsibility, once there is evidence that budgetary processes are adequate to prevent abuse (see Chapter 10).

POTENTIAL HORIZONTAL FISCAL DISPARITIES

Potential Inter-*oblast* Disparities

Table 7.2 provides several rough measures of potential horizontal fiscal disparities among *oblasts* in Kazakstan. The first two pairs of columns present figures on GDP per capita and average industrial wage rates in the various *oblasts*, and the next two present per capita figures on individual income tax collections and total tax collections (before sharing with the central government), by *oblasts*. The second column in each pair expresses these per capita figures as percentages of the national average.

Several *oblasts* have substantially higher GDP per capita than the average *oblast*. This represents a relatively high concentration of industrial production in these *oblasts*. Whereas GDP per capita is twice the national average in Mangystau, it is barely half the national average in Almaty Oblast and Kzyl-Orda.[10]

In most of the *oblasts* with higher than average GDP per capita, other indicators of fiscal capacity are also at or above the national average. Average industrial wage rates show somewhat less variation than GDP per capita, but still provide evidence of potentially substantial horizontal fiscal disparities. Two *oblasts* have average wage rates slightly in excess of 170 percent of the national average, while two have average wage rates of less than 65 percent of the average.

Both individual income tax collections and total tax collections, per capita, differ widely by *oblast*. Individual income tax collections per capita show more dispersion than either GDP per capita or average industrial wages, ranging from less than 40 percent of the national average in three *oblasts* to 170 percent or more of the national average in four *oblasts*. Mangystau has individual income tax collections per capita of 281 percent of the average. It is difficult to explain these differences without more detailed information, but it is likely that they can be explained by differences in economic activity in various parts of the country, combined with structural

[10] The figure for GDP per capita in Almaty City, 60 percent of the national average, seems suspect, especially in light of the other figures in the table. Perhaps these calculations were based on net material product (which would assign no production to the government sector), instead of GDP.

Table 7.2. Alternative Indicators of Horizontal Fiscal Disparities among *Oblasts*

Oblast	GDP Per Capita (rubles 000)	Percent of National Average	Average Monthly Industrial Wage (tenge)	Percent of National Average	Individual Income Tax Revenue Per Capita (tenge)	Percent of National Average	Total Tax Collections Per Capita (tenge)	Percent of National Average
Akmola	136.38	102.91	148.00	92.77	1,061	78.07	5,882	130.81
Aktubinsk	136.54	103.03	144.60	90.64	1,801	132.47	6,762	150.38
Almaty	73.94	55.79	138.60	86.88	676	49.71	1,548	34.43
Atyrau	170.20	128.42	184.50	115.65	2,310	169.88	9,809	218.15
East Kazakstan	197.19	148.79	147.50	92.46	1,521	111.84	4,461	99.22
Jambyl	94.53	71.33	117.60	73.72	522	38.40	1,759	39.12
Jezkazgan	229.43	173.12	254.20	159.34	2,691	197.92	4,559	101.39
West Kazakstan	82.01	61.88	134.70	84.44	1,114	81.97	3,407	75.77
Karaganda	218.77	165.07	211.30	132.45	1,972	145.05	5,944	132.19
Kzyl-Orda	70.26	53.02	100.90	63.25	575	42.33	1,851	41.18
Kokshetau	121.35	91.57	132.70	83.18	810	59.58	2,872	63.88
Kostanai	152.06	114.73	158.40	99.29	1,645	120.96	5,949	132.30
Mangystau	269.13	203.07	272.90	171.07	3,823	281.19	8,621	191.73
Pavlodar	245.68	185.38	274.00	171.76	2,155	158.53	6,408	142.52
North Kazakstan	121.17	91.43	123.90	77.67	933	68.61	2,769	61.58
Semipalatinsk	89.01	67.17	147.50	92.46	685	50.39	2,633	58.57
Taldykorgan	80.36	60.64	111.00	69.58	456	33.55	980	21.80
Torgai	125.80	94.92	177.60	111.33	796	58.55	1,947	43.31
South Kazakstan	88.82	67.02	103.60	64.94	488	35.88	2,776	61.74
Almaty City	80.48	60.73	178.40	111.83	2,517	185.11	13,487	299.95
Leninsk	0.00	0.00	88.20	55.29	0	0.00	0	0.00

Sources: Revenue by *Oblast*, USAID-Barents Group; Population, 1994 *Statistical Yearbook* (population, 1994, GDP, 1992, wages, 1993, figures).

features of the income tax, such as preferential treatment of farming and progressive rates.

Total tax collections per capita are also quite unevenly distributed, with Almaty City having three times the national average and nearby Taldykorgan having barely 20 percent of average collections. Part of this dispersion reflects the fact that, as explained more fully in the next chapter, the rules for sharing revenues from the enterprise income tax, VAT, and excises are questionable. (The first two are shared on the basis of registration of enterprises, and excises, plus VAT on imports, are shared with *oblasts* where production or importation occurs). Under more conventional sharing rules, the fiscal capacity of Almaty City and other producing *oblasts* would be much less, and the fiscal capacity of consuming *oblasts* would be greater.

Some of these potential horizontal disparities are alarming. As discussed in the next two chapters, some of them can be effectively addressed through more rational systems of tax assignment and a formula-based system of intergovernmental transfers. Even so, short of complete equalization of fiscal capacities, some *oblasts* will remain fiscally weaker than others.

Potential Intra-*oblast* Disparities

Data needed to analyze potential horizontal disparities at the *rayon* level are not readily available. The Mission obtained the appropriate data only for Almaty Oblast. As can be seen from Table 7.3, there is significant variation in revenue collections per capita among *rayons* in Almaty Oblast. Kapchagai City collects T4,528 per person from VAT, excises, and individual and enterprise income taxes, while the Rajinbek region collects only T297. Thus, Kapchagai collects over 15 times per capita what Rajinbek does. (For further discussion, see Chapter 9.)

TWO MODELS OF INTERGOVERNMENTAL FISCAL RELATIONS

Box 7.1 describes two models of intergovernmental fiscal relations that Kazakstan might consider: "strong" subnational government, based on surcharges on taxes of the central government, plus equalization grants; and "weak" subnational government, based more heavily on continued reliance on subventions from the central government.

The two models share common features. In both models, a system of grants would be established to underpin subnational

Table 7.3. Horizontal Fiscal Disparities among Rayons Almaty Oblast, 1995

(tenge)

Rayon	Collections Per Capita	Retentions Per Capita	Subventions Per Capita	Retentions Per Capita Plus Subventions Per Capita
Balkhas	592	592	2,963	3,555
Jambyl	716	716	2,029	2,744
Ikiy	2,630	1,552	305	1,857
Kaskeleu	2,059	1,261	500	1,761
Kengen	1,212	1,212	7,202	8,414
Kurtin	662	662	2,820	3,482
Rajinbek	297	297	2,302	2,599
Talgar	1,645	1,645	661	2,306
Urgur	449	449	2,701	3,150
Chilik	710	710	1,973	2,683
Enbekshikza	1,385	1,385	1,077	2,463
Kapchagai	4,528	2,914	1,138	4,051

Note: All revenue figures are for VAT, excises, individual income tax, and enterprise income tax only.

Source: Almaty 1995 Budget.

expenditures and eliminate (or substantially reduce) vertical fiscal imbalance and horizontal fiscal disparities. In both models, subnational governments would be allowed to derive significant amounts of marginal revenue from sources under their control.

In the model of weak subnational governments, own-revenues would come from relatively few small taxes, plus surcharges on the individual income tax, and perhaps surcharges on excises. Thus, while the ability to raise marginal revenues would exist, it would be relatively limited, and perhaps inadequate. In the model of strong subnational government, much greater use would be made of surcharges, especially on the enterprise income tax. Thus, subnational control over marginal revenues would be substantially greater.

Though pictured as alternatives, these models might better be seen as two points on a spectrum of subnational fiscal control joined together by an optional evolutionary process. In the short run, the model of weak subnational governments is probably the only realistic one. For reasons explained in the next chapter, the ability to implement subnational surcharges on some taxes is likely to be quite limited in the short run. While continued subnational access to the individual income tax seems quite feasible, surcharges on excises seem generally infeasible for now; formula-based surcharges on the enterprise income tax may be feasible, but they have definite disadvantages, to be noted in the next chapter.

Box 7.1. Models of Revenue Assignment

It is possible to identify two prototypical models of revenue assignment, along with their strengths and weaknesses.

- *Fiscally "Strong" Subnational Government*. The provinces of Canada and the states in the US are fiscally quite strong. This is achieved in the US, and to a considerable degree in Canada, through independent legislation and administration of subnational taxes. In both countries intermediate governments levy retail sales taxes—a fact that has impeded imposition of VAT at the central level in the US because of the difficulties of meshing the two taxes (explained in the next chapter). Most states in the US also levy income taxes on individuals and corporations. The largest and most economically powerful Canadian provinces levy their own income taxes, but the others rely on surcharges on the national taxes.
- *Fiscally "Weak" Subnational Government*. The Australian states are fiscally weak, because they have few revenues

from own-sources. Because overly restrictive interpretations of the constitution prevent their imposing either income taxes or a general sales tax, they rely heavily on grants from the central government. Subnational governments account for half of public spending in Australia, but raise only 25 percent of revenues. In this respect Australian states resemble the *oblasts* of Kazakstan.

- *Kazakstan's Options*. For political and administrative reasons stated in the next chapter, tax assignment based on independent legislation and administration of taxes is not appropriate for Kazakstan. This does not mean that fiscally strong subnational government is not possible. Surcharges could provide subnational governments with latitude to set tax rates applied to economic activity occurring within their boundaries, without the complexity and duplication of effort inherent in independent legislation and administration. Equalization grants can be used to overcome vertical fiscal imbalance and horizontal fiscal disparities, while providing fiscal control at the margin, as explained in Chapter 9.

  Having a unitary form of government, Kazakstan might well choose, for political reasons, to remain at the "weak" end of the spectrum, even in the long run, as Australia has. Or it might choose to move toward the model of strong subnational government as the capacity to impose subnational surcharges increases.
- *Setting Grant Policy*. In Australia, grants are determined by a semi-independent Grants Commission, instead of through a budgetary process like that in Kazakstan. In South Africa, another country in transition that is facing many of the same issues as Kazakstan, a constitutionally established Financial and Fiscal Commission is charged with developing formulas for recommendations to the Parliament for its use in making grants from the central government to the provinces, as well as the design of surcharges. See Box 9.1 for a description of the FFC's initial recommendations in this area.