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SOVIET UNION AND REPUBLICS: FISCAL DECENTRALIZATION AND THE THEORY OF FISCAL FEDERALISM

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Preface

This paper was prepared while the author was a participant of the "Young Scientist's Summer Program (YSSP)" at the International Institute for Applied Systems Analysis (IIASA) in Laxenburg during the summer of 1991. It was completed just before, on August 19, 1991, conservative forces led by G.Yanaev attempted to oust USSR President M.Gorbachev in a coup.

After the eventual failure of this coup, the political and economic developments in the Soviet Union became even more dynamic: a much faster fiscal disintegration is one of them. In fact, it seems questionable in what sense the Soviet Union is still a fiscal entity, thus justifiably allowing the use of concepts of a Theory of Fiscal Federalism, in which the following analysis is cast: an essential element of any federal system is that a power exists which can effectively limit decision-making power on lower hierarchical government levels. In the case of non-compliance with the rules laid down in the constitution, the former can coerce the latter into adhering to the rules. Certainly after the coup, and probably already before, the central government of the USSR is very much in doubt of representing a political power which could exert the necessary coercion to enforce its rules.

The sequence of reform proposals mirrors the steady loss of power of the federal government in the Soviet Union. From Gorbachev's rejection in the fall 1990 of the so-called "500 Day Plan" prepared by a group of economists around S. Shatalin, partly because it conceded to Union republics alone the authority to tax, the federal government being financed by fixed quotas on the republic's revenues over the agreement on a new draft Union Treaty in April 1991, which was already less biased towards the center, to the latest so-called "Yavlinsky Plan" of September 5, 1991[1]—economic reform proposals made by the Union level systematically lag behind the realities in the Soviet Union. With regard to fiscal matters, the "Yavlinsky Plan" envisages essentially what was the center's main objection to the "500 Day Plan"—giving the right to tax exclusively to Union republics. And, it is doubtful today whether even a federation that loose is possible. If, thus, fiscal-economically the Soviet Union does not exist any more, is it mistaken to interpret developments in the fiscal system there in the light of the Theory of Fiscal Federalism?

The exact characterization of the political system in the former Soviet Union is not the heart of this paper. Rather, this paper singles out some mechanisms which are at work in the devolving fiscal system in the Soviet Union. To assess their relevance now, in post-coup times, one should think of a continuum of possible solutions between a perfectly centralized fiscal system, as had been prevailing until 1987, to a perfectly decentralized fiscal system in which a Soviet fiscal entity has ceased to exist.

Take one example: as discussed below, the fact that, before the coup, Union republics transferred less than 40% of tax revenue in 1991 which was assigned to the central government can be viewed, in terms of the Theory of Fiscal Federalism, as "free-rider" behavior on the republics part. As it turns out, since the failed coup, republican transfers to the center were close to zero.

[1]See Yavlinsky (1991), esp. Article 19–25, p.22f.

Assume it is no longer meaningful to refer to a central government because now its power is perfectly dismantled. Considering the (ex-)republics as independent economies, as long as there are spatial spillovers creating externalities among the (ex-)republics, the issue is now one of "International Policy Coordination", in which a leading issue is again free-rider behavior.

This shows that mechanisms which were fiscally relevant up to August 1991 do not necessarily lose their importance in post-coup times—on the contrary, they might gain importance. If the struggle for fiscal power between the center and the republics is now over in the sense that fiscal power of the center is only what the republics want it to be, problems which relied on that, like the incentive implications for state enterprises which are torn between both subnational and central ministries, will be diminished. By the same token, however, inter-(ex-)republican fiscal relations on the one hand, and intra-republican relations on the other, and their potential inefficiencies (e.g., unstable tax competition between (ex-)republics, or state enterprises now under the sole, but closer surveillance, of subnational fiscal authorities, respectively) gain importance.[2]

Taken together, the analysis of the devolving Soviet fiscal system portrays many elements which are bound to play a major role also for the fiscal relations of politically independent (ex-)republics. Although some aspects will vanish with independent economies, others have emerged already in the transformation of the centralized to a federalistic Soviet fiscal system, which is what this paper is dealing with.

[2]It is worth noting that originally, the Theory of Fiscal Federalism dealt primarily with inefficiencies arising from lower-level behavior, not from competition among national and subnational levels.

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SOVIET UNION AND REPUBLICS: FISCAL DECENTRALIZATION AND THE THEORY OF FISCAL FEDERALISM

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I. INTRODUCTION[3]

The Soviet Union is disintegrating rapidly. Not only the Union republics seek more independence from the center, but also far lower levels of the Soviet state push for it: even some districts of Moscow and Leningrad have declared their "sovereignty".[4]

While nowadays analyses of the Eastern European economies in transition are abundant, comprehensive accounts of the state and the impact of disintegration in some of these economies are rare. So the medium term scenario of the "Study of the Soviet Economy" by the International Monetary Fund (IMF), the World Bank, the Organization for Economic Cooperation and Development (OECD), and the European Bank for Reconstruction and Development (EBRD), (IMF et.al.), published in February 1991, assume that

> the republics of the USSR will maintain an all-union market, including an absence of trade barriers between republics; a common currency and exchange rate, and therefore a common monetary policy; a common external tariff; and an agreed division of responsibilities for taxation and expenditures at different levels of government[5]

which is, already at the time of writing (August 1991), to a varying degree different from what one can see. The intention in this paper, therefore, is to analyze this drive towards decentralization and disintegration. Decentralization is referred to as being a step towards disintegration. On the contrary, the economic theory of integration allows that even very decentralized systems are perfectly integrated since it is factor mobility and the absence of trade distortions that counts. However, the present usage reflects the fact that—as it is the case in the Soviet Union today—often decentralization and disintegration go hand-in-hand.

The analysis is short-run orientated, focuses on the fiscal system, and is motivated by the implications of disintegration for further transition to a market economy: no account of the disintegration in the Soviet economy can ignore its fiscal system, since it is here—especially the question of tax authority—where there are some of the major disagreements

[3]I would like to thank P. Aven, S. Damberger, J. Gacs, A. Illarionov, I. Karimov, M.J. Peck, T. Richardson, C. Schneider and A. Vedev for helpful comments. All remaining errors are the author's.

[4]Alexashenko (1990), p.36.

[5]IMF et.al. (1991), Vol.3, p.344.

between the federal government on the one hand, and the Union republics governments on the other.[6] In fact, problems of tax competence have been the major blocking stone for the Soviet President Gorbachev to present a new *Union Treaty* at the London Summit of the so-called *G-7 countries* in July 1991.

The connection to the transition to a market system stems from the fact that any development leading to a higher budget deficit will postpone, if not bring to a complete standstill, further progress of reform in the Soviet Union: in a market economy, inflationary expectations will prevail—as experiences with hyperinflation in Latin America have shown—as long as the budget deficit in an economy is substantial, since it will eventually be financed by taking resort to the printing press. In a planned economy, with controlled prices, there is also the possibility of a deepening crisis of goods shortages. If it is not possible to stabilize public finances, the USSR will face either accelerating inflation, or more shortages at controlled prices, or a mixture of both. It is impossible to make progress towards a market economy under such conditions.[7]

The analysis is short-run oriented since reference is made to the situation in the Soviet Union before the (eventually failed) military coup of August 19, 1991. The devolving fiscal system of the Soviet Union is the main interest. Perspectives on the likely fiscal performance of fiscally totally independent republics on the area of the (former?) USSR were not central to this investigation, but some of the stylized mechanisms stressed below are prevalent today even more than before August 1991.

To emphasize the fiscal system does not mean to deny the importance of other factors feeding the Soviet deficit which preceded the move towards fiscal decentralization, especially the partial liberalization of state enterprises, with the so-called "Enterprise Self-Management,"[8] and others which are unrelated to it, in particular the system of price subsidies between wholesale and retail prices. Price subsidies accounted 1989 with 97.6 billion rubles for 20% of all budgetary expenditure.[9]

In this paper, however, it is argued that the recent development towards a decentralization of fiscal decision-making power in the Soviet Union is central in explaining the dramatic widening of the budget deficit in the years 1990 and 1991.

The paper is organized as follows.

Section II.A describes the Soviet fiscal system of pre-1987,[10] which serves as a starting point for this analysis. In Section II.B an overview is given of the strong tendency towards fiscal decentralization since then.

In the following Section III, the Theory of Economic Federalism is used as the benchmark of this analysis. Two approaches are distinguished: to begin with, in Section III.B, the normative approach is applied, primarily concerned with questions of the optimal assignment of public functions in a federal system. As a first step the stage is set using mainly concepts of public finance theory. Then the Soviet fiscal decentralization is examined more closely and interpreted in terms of the theory outlined. The bottom line of the argument is the identification of a number of consequences of decentralization just for which the theory calls for centralization.[11]

[6]Most issues concern these two. In some cases we refer to subnational levels which include Union republics, autonomous republics, and local governments, most importantly.

[7]See also IMF, et.al. (1991), Vol.3, p.357f.

[8]See the complementarity of these developments in Sections II.A.1 and III.C.2.3. Discretion, Corruption and Soft-Budget.

[9]Aven (1991), p.12.

[10]Until 1987 the republics remained relatively passive, expecting the reform to come from the center. Also in 1987 falls the "Law on State Enterprises".

[11]More general, it calls for provision at a higher hierarchical level; see footnote 66.

This helps in clarifying the causes of the suboptimal current situation. The second way of analyzing a fiscal system is decidedly positive. Again, the Soviet Union is looked at as a federal system, but this time close attention is paid to the behavior of the economic agents who are representing the government block. Thus, in Section III.C, the focus will be on well-known concepts of public choice theory to single out more consequences, and their impact, of the fiscal decentralization in the Soviet Union. A conclusion summarizes the findings.

II. THE DEVELOPMENT OF THE SOVIET FISCAL SYSTEM

A. The Soviet Fiscal System until 1987[12]

1. The System as a Part of a Centrally Planned Economy

In the Soviet Union the fiscal system differed fundamentally from that of a Western economy. This is because the prime coordination mechanism is the plan, instead of prices.

The main planning tool in the centrally planned system was the national plan, prepared by Gosplan, the central planning agency. Here the allocation of resources was laid down. Starting from the quantity targets of the national plan, the financial plan of the economy had to be made compatible with its input-output system. This was done primarily by the USSR Ministry of Finance, who acted as fiscal agent of the planning agency, mobilizing and transferring financial resources as well as auditing state enterprises to carry out the plan. Coordination among the two was poor, however. And although fiscal tools and the budget were used for purposes of resource allocation, this was done mainly through the actual transfer of resources rather than via monetary signals and levers.

In this system, the allocative function[13] of public finance is largely redundant since it is the plan which allocates resources between sectors and activities. The government budget is seen merely as a means of exercising financial control, to ensure that physical production targets are met.

The distribution function is also redundant since it is the central planning mechanism which determines wage differentials, and private ownership of wealth is insignificant. The fiscal system has no significant role in the stabilization of the economy either since the objectives of full-employment, price stability, and external balance are all achieved by administrative fiat.

Therefore, the state budget, the tax system and government expenditure are best seen as additional levers to support the planning mechanism and improve control over state enterprises. Consequently, fiscal policy plays a passive role in the sense that government finances are entirely subordinate to the economic plan.

2. Major Budgetary Revenue Sources and Revenue Sharing Arrangements

In a centrally planned economy, the tax collecting mechanism is largely implicit: enterprises are owned and controlled by the central government. Their surpluses are revenue

[12]This very brief overview is based on Alexashenko (1990), Aven/Alexashenko (1991), Bahry (1987), IMF, et.al. (1991), Knight/Waxman (1991), Kopits (1991), McKinnon (1990) and Newcity (1986).

[13]See Musgrave/Musgrave (1973) for the following distinction.

in the fiscal sense. Also in the Soviet Union, the main budget source was enterprise income—rather than taxes, which is what it has been called for simplicity. Explicit tax rates did not exist, but the amount to be transferred for an enterprise was pre-determined by fixing wholesale and retail prices of the goods.

The Soviet state budget relied primarily on five revenue sources. These were transfers from enterprises, turnover taxes, income from foreign trade, taxes on individuals, and other sources. See Table 1.

Table 1: Structure of Revenues of the Soviet State Budget, 1971–1987

Years	1971-1975	1976-1980	1981-1985	1986	1987	1985
Total Revenues (Bln. rubles)	172.6	245.8	336.3	354.5	354.1	362.6
			Percentage of Total Revenue			
Total Revenues	100.0	100.0	100.0	100.0	100.0	100.0
Transfers from Enterprises	36.7	33.4	32.6	34.4	37.4	35.9
Profit Taxes	35.9	32.7	31.9	33.7	36.7	35.1
Income Taxes	0.8	0.7	0.7	0.7	0.7	0.8
Turnover Taxes	34.7	33.5	30.0	27.6	25.8	26.0
Alcohol Tax	n/a	n/a	12.2	11.3	9.0	9.0
Income from Foreign Trade	10.2	15.8	20.2	20.1	18.2	19.1
Taxes on Individuals	9.2	9.0	8.2	8.5	8.8	9.0
Other Sources	9.2	8.4	9.0	9.5	9.8	9.9
Social Insurance Taxes	5.8	5.4	6.6	7.2	7.5	7.7

Source: Gosudarstvennyy byudzhet SSSR, various years; from Ofer (1989), p.125f.

(1) Transfers from State Enterprises

Before 1987, these were individually determined amounts of enterprise income, channelled either directly to the budget or to extrabudgetary centralized funds under the control of industrial branch ministries.

The determination of the exact rate was essentially one of bargaining between the ministry and the enterprise, but in general the system was redistributive, as finance ministries set the fixed payments higher for those enterprises which had a greater surplus.

(2) Turnover Taxes

Turnover taxes are commodity-specific wedges between administratively-fixed retail and wholesale prices, minus notional wholesale and retail margins. Therefore the system does not entail explicit fixed rates and is not comparable to any conventional turnover tax found in a market-oriented economy.[14]

[14]IMF, et.al. (1991), Vol.1, p.248; excise taxes in market economies differ qualitatively, since Soviet turnover taxes are imposed with a far greater degree of discretion—they are commodity and enterprise specific.

(3) Income from Foreign Trade

The difference between the so-called valuta price of a good, i.e., foreign currency prices converted at the official exchange rate, and the domestic wholesale price was largely offset by so called *price equalization taxes* paid by trading enterprises to the budget or subsidies received from the budget.

Part of the difference was also accounted for by customs duties and explicit import taxes levied on a number of consumer goods.[15]

(4) Taxes of Individuals

Taxes on individuals were not a major source of revenue in the Soviet Union, because Communist ideology has frowned upon taxing the population. Therefore, until June 1990, only a very narrow-based income tax existed—practically not more than on wage income. Wages were withheld at moderate average rates, with a top marginal rate of 13% applicable to wages over 100 rubles per month.

(5) Other Sources of Budgetary Income

Apart from social insurance taxes, also loans from the central bank to the budget have supplemented budgetary income. Technically identical to money creation, it was seen as a legitimate budgetary source.[16] In addition, the budget relied on the saving deposits of the population, as well as on, to a small extent, government bonds sold to the public. The various budgetary sources were shared by the government levels differently, see Table 2.

Table 2: Republics Share of Selected Tax Revenues 1950–1980 (Percentage of USSR Total)

Revenue Source	1950	1960	1970	1980
Personal Income Tax	50	49.5	50	54.1
Turnover Tax	12.3	35.3	44.6	57.2
Profit Tax	38.9	65.9	45.1	40.1

Sources: Gosbyudzhet (1962:7–9, 66–69); Gosbyudzhet (1972:11–12, 75–78); Gosbyudzhet (1982:10–11, 46–48); from Bahry (1987), p.58.

Taxes on profits accrued to the level of government where the state enterprises are subordinated, i.e., federal, republic, or local level. The division of turnover tax revenue between the federal and the republican level varied from year to year and also among the republics, since the percentage of turnover tax retained in each region was calculated to cover the gap between the expenditures planned for the republic and the available locally generated sources.

A minimum of 50% of the—relatively minor—revenue from taxes on individuals went to the republican budgets, in the case of extremely poor republics up to 100%. On the other hand, income from foreign trade accrued exclusively to the federal budget, retained by a central institution, Vneshekonombank, and only the federal level could cover its expenditures with central bank loans, via the state bank, Gosbank.

3. The Budget Process and Government Expenditures

Until 1987, the union state budget was an integral part of the consolidated financial plan for the economy. Its preparation, implementation, accounting, reporting, and audit

[15]IMF, et.al. (1991), Vol.1, p.254.

[16]This is still, at least in Moscow, the case. For instance, TASS reported on May 27, 1991 that the USSR Supreme Soviet approved a presidential order for Gosbank to loan 5 billion rubles to the USSR Ministry of Finance. Report on the USSR, June 7, 1991, p.34.

involved a large number of institutions at various levels of government, with the federal Ministry of Finance and Gosplan playing the key roles, see Figure 1.

The structure of the Soviet economy was set up such that the majority of financial resources were gathered in one central budget—the "State Budget of the USSR"—and then allocated to the various lower levels and sectors as the authorities saw fit. Due to the consolidated nature of the state budget, at each level of government two budgets were prepared (with the exception of the lowest one): the budget of that level and the consolidated budget of all lower-level governments.

The revenues of all budgets, except the central budget, were determined according to desired expenditures. Consequently, subnational budgets were strictly non-deficit, and the Soviet deficit was entirely concentrated at the top.

On the expenditure side there is a division of fiscal responsibilities broadly along functional lines: subnational levels being responsible for social expenditures, such as health and education as well as social security benefits, and the union budget for defense, justice, internal security, subsidies to the external sector, and most budgetary investment in the economy. The controlling bodies of government expenditures were primarily branch ministries in Moscow, in particular for the industrial production sector, see Figure 2.

4. The Division of Legislative Power in the Soviet Fiscal System

The 1977 Soviet Constitution, which *de jure* remains in force today, explicitly grants all decision-making power concerning taxes to the federal government of the Soviet Union. And, in fact, a high degree of centralization is evident from the almost complete control that the union authorities have exercised over the imposition of taxes (or requisition of enterprise income) at various levels of government.

The most recent division of tax revenues between the federal and the Union republic level was laid down in the Decree *On Budgetary Law* of 1987. The central government determined the amounts and types of taxes each level of government was to retain, in particular for the major taxes, the turnover tax, and taxes on profits.

To the extent that the Union republics or other local government bodies have exercised any degree of autonomy in determining the tax rates or the collection procedures, they did so only as a matter of discretion, not as an exercise of their sovereign powers.

In budgetary matters, higher state authorities had to approve the main characteristics of the budgets of those below. Gosplan, indicating the degree of centralization, controlled virtually all major budgetary decisions.

In addition to the control over lower-level expenditure behavior by central branch ministries, the center had absolute power to decide which decisions on expenditures had to be centralized—this depended on the importance of a particular program to the federal government. That is, a project connected with national security was funded and managed from the central ministries, whereas a project in the light industry, e.g., might have been under republican or local jurisdiction.[17]

To sum up, despite the formal federal structure of public administration in the Soviet Union, the formulation and execution of fiscal policy has been highly centralized. This was to ensure full conformity with the central national plan.

[17]Knight/Waxman (1991), p.20.

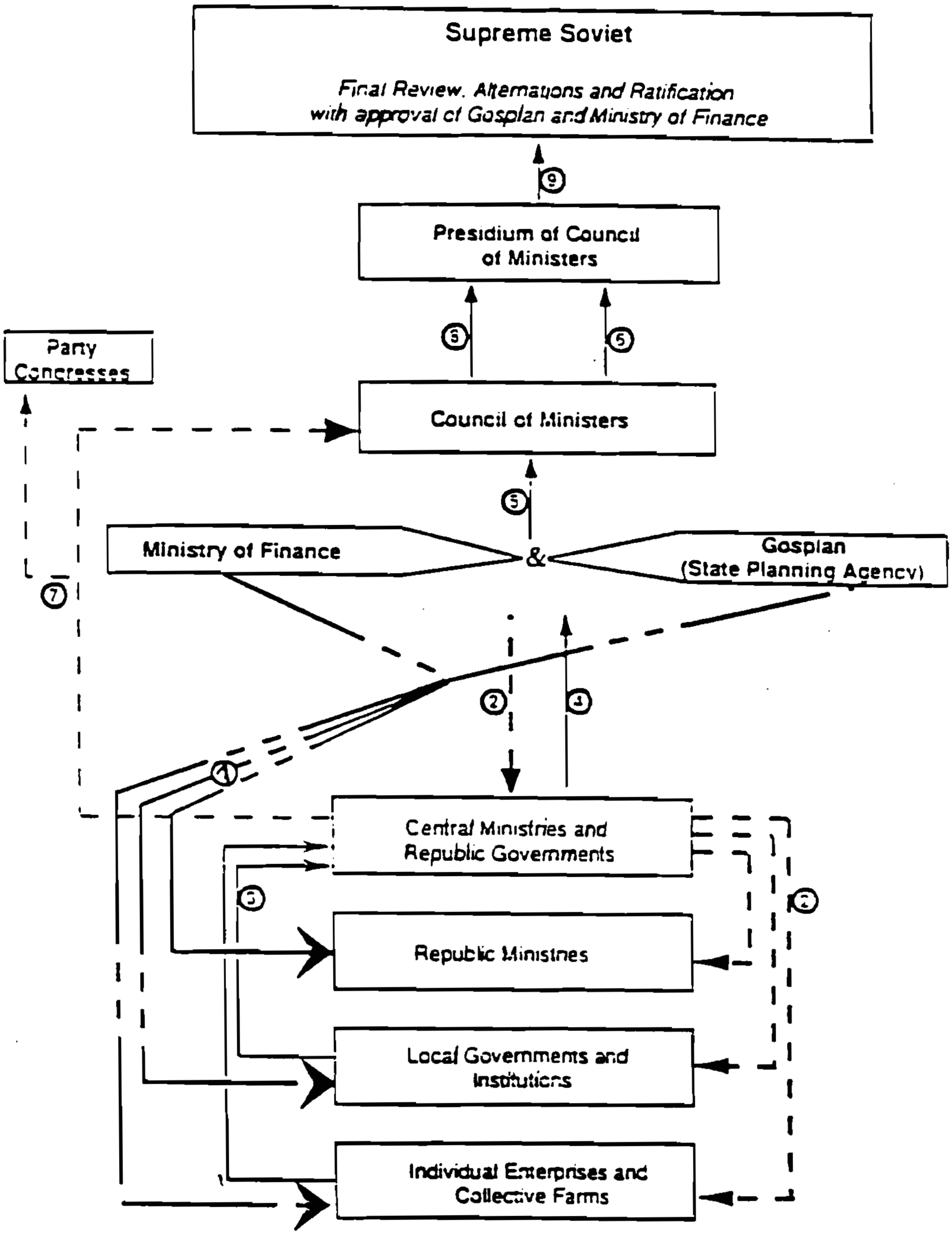

Figure 1: Budget Planning Process

Legend: 1. Guidelines; 2. Financial Resource Assignments; 3. Project and Fund Proposals; 4. Synthesis of higher-level and lower-level proposals; 5. Revised Plan; 6. Amended Plan; 7. Appeals to Budget Plans; 8. Futher Amended Plan; 9. Financed Plan.

Source: Knight/Waxman (1991), p.12.

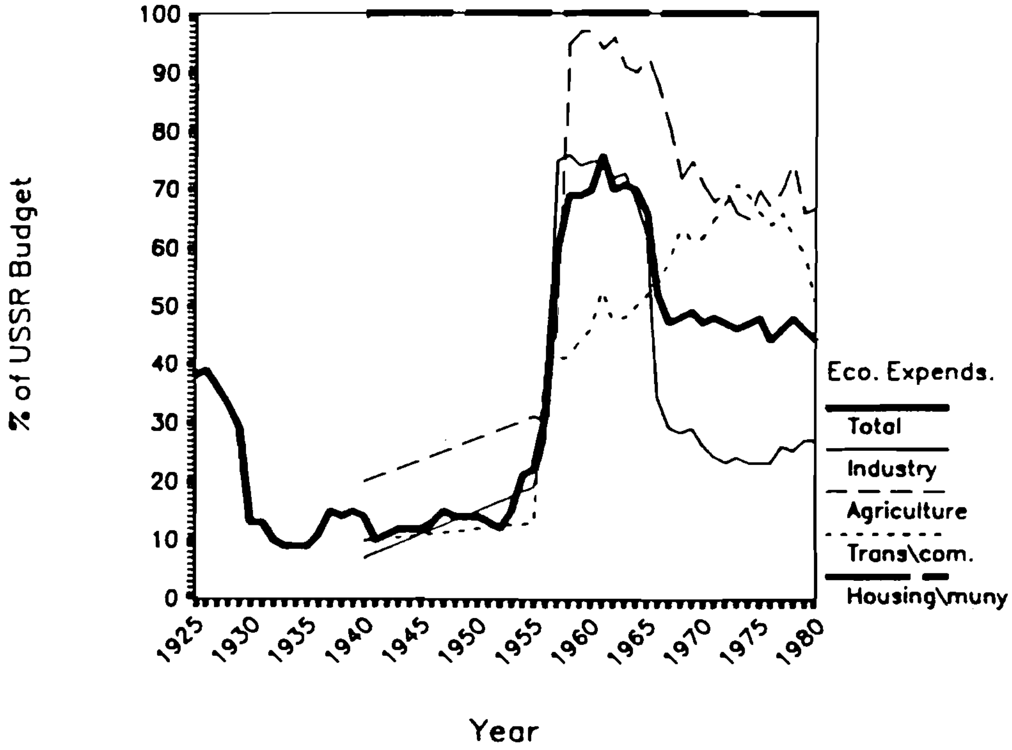

Figure 2: Subnational Share of Soviet Budget, by Type of Expenditure.
Industry includes construction; tans/comm: transport, communications; Housing/muny: municipalities.

Sources: Gosbyudzhet, various issues, Bahry (1987), pp.50, 179–182

B. Decentralization in the Soviet Fiscal System since 1987

In recent years, ethnic, cultural, and political differences in the Soviet Union have led to substantial regional fiscal decentralization.[18] This development is, until now, only partially reflected in newly established fiscal relations between the federal and the republican level, which is, as shown below, an important characteristic of today's Soviet fiscal system. There are no clear rules, but in many cases actions are taken unilaterally and in an ad-hoc fashion.

There are numerous changes, and no attempt is made to provide an exhaustive list in this paper. Instead, at this point a broad overview is given which highlights the relations between the economic restructuring in general, and the decentralization of the fiscal system in the Soviet Union. We will discuss selected developments in a stylized form as we continue to analyze the current Soviet fiscal system using an adequate framework in Section III.

1. The Revenues from State Enterprises

To emphasize that questions of fiscal decentralization in the Soviet Union are intrinsically linked to the overall changing environment, in particular to democratization, liberalization and de-planning, the interrelation of enterprise decontrol and fiscal decentralization is looked at.

(1) Enterprise Decontrol

With the USSR law "On State Enterprises and Amalgations", approved by the Supreme Soviet at the end of 1987, a major change has occurred in the regulations governing the status and activities of state enterprises. In general, the law is designed to liberalize control and transfer more responsibility to enterprise managers:[19] the system under which, since 1987, transfers from state enterprises to the budget and to the extrabudgetary centralized funds have been regulated is called the "System of Enterprise Self-Accounting".[20] In essence, this law means a reduction of plan obligations for enterprises from the center. In particular the investment decisions have been increasingly taken by enterprise managers, and no longer by the central planning agency, Gosplan.

(2) Shift of the Fiscal Responsibility to the Republics

In April 1989, the USSR draft proposal on "Republican Economic Self-Management" was introduced. When it was eventually passed, it put a substantial number of state enterprises formerly belonging to federal jurisdiction under the auspices of the republics.[21] This also means that republican authorities have responsibility for the financial standing of the enterprises.[22]

Here it is important to note that one impact of the just mentioned enterprise decontrol has been a considerable reduction of enterprise profits payments to the consolidated State budget: the percentage share of profit taxes and transfers from enterprises of the total Soviet state budget revenue fell from 34.3% (1987) to 27.1% (1990).[23] Taking the two developments together underlines how the changing economic environment for enterprises

[18]IMF, et.al. (1991), Vol.1, p.241.
[19]Knight/Waxman (1991), p.6.
[20]See IMF, et.al.(1991), Vol.3, p.248ff. for details.
[21]Knight/Waxman (1991), p.18.
[22]Aven/Alexashenko (1991), p.6.
[23]PlanEcon Report (1991), No.11/12, p.18.

Table 3: Revenues Retained by Republics Selected Taxes and Years 1980–1989 (Republic's Percentage Share in USSR Total)

	Years		
	1980	1987	1989
Personal Income Tax	54.1	55.5	61.0
Profit Tax	40.1	34.9	54.0

Sources: 1980 Bahry (1987), p.58; from Gosbyudzhet (1982:10–11, 46–48); 1987 Knight/Waxman (1991), p.17; from Gosudarstvennyi byudzhet SSSR 1988, Moscow, Finansy i statistika pp.5–6, 36–37; 1989 Personal Income Tax IMF et al.(1991), Vol.1, p.280; from USSR Ministry of Finance; Profit Tax Alexashenko (1991b), see Table 6.

has implications which go well beyond a mere fall in overall profit tax revenues: in a federalist economic system this has also distributional consequences which are likely to trigger reactions aggravating any resulting problems.

2. Changes in Tax System, Budget Process and Expenditure Responsibility

Most prevalent is the move towards regional decentralization of the Soviet fiscal system in the area of taxation. For the most important sources the share of subnational governments in total revenues increased substantially, as Tables 3 and 4 indicate. This is true not only for the turnover tax, the main source of republican revenues, but also for the profit tax and the income tax on individuals. The overall share of subnational tax revenue increased during the last three years from an average of 44%–46% (1987) to 49.3% (1990).[24]

The republics are questioning the absolute federal legislative power in tax legislative matters in their strive for greater *independence*. Since 1987 the republics contest the federal's exclusive right to retain taxes on foreign companies. Republics demand the right to receive the foreign trade taxes of transactions in and out of their republic,[25] and they require also a higher share of the personal income tax receipts.

The draft law "On Republic Self-Management" and the June 1989 draft law "On Income Taxes", leading to the new union tax legislation, together with the law "On the Basic Principles of Economic Relations of the USSR and the Union and Autonomous Republics" of middle 1990, confirm and legalize in January 1991 a lot of what the republics had put into effect earlier:

1. Republican budgets are now to receive all state taxes from the reformulated income tax.

2. Republics receive half of the tax receipts—the tax rate being 30%—from firms with a share of foreign capital which exceeds 30%.

3. Republics also retain 70% of a 5%-sales tax on consumer goods and services, with the exception of food.[26]

[24] Izvestia, September 26, 1989; Aven (1990), p.140.

[25] Knight/Waxman (1991), pp.19, 8.

[26] See TASS, December 29, 1990; Report on the USSR, January 11, 1991, p.24f.

Table 4: Share of Turnover Tax Revenue, by Republic (Selected years, 1980–1990)

Union Republic	Total Revenue (1990) Bln.Rbl.	% of Total	Percent Allocation of Turnover Tax 1980	1989	1990
All republics	**248.7**	**100.0**	**58**	**75**	**82**
RSFSR	137.5	55.3	48	71	84
Ukraine	39.5	15.9	55	61	68
Byelorussia	11.8	4.7	64	86	71
Estonia	1.9	0.8	57	84	76
Latvia	3.2	1.3	43	58	57
Lithuania	4.3	1.7	91	78	94
Moldavia	3.4	1.4	54	69	87
Georgia	4.4	1.8	67	100	100
Armenia	3.5	1.4	62	100	77
Azerbaidzhan	4.4	1.8	53	81	75
Kazakhstan	15.2	6.1	100	100	100
Turkmenistan	2.3	0.9	100	100	100
Uzbekistan	11.6	4.7	98	100	100
Tadshikistan	2.7	1.1	91	100	100
Kirgizia	3.0	1.2	100	100	100

Sources: 1980 Bahry (1987), p.56; from "Zakon SSSR o gosudarstvennom biudzhete SSSR na 1980," in Pravda, December 1, 1979, p.2 1989 and 1990 IMF et.al.(1991), Vol.1, p.279; from USSR Ministry of Finance and estimates and own calculations.
Consolidated budget of Union republics and local soviets of people's deputies.
Allocation refers to the proportion of revenue to be retained by Union republic from revenue collected within the republic. First row figures are weighted averages of Union republic amounts.

In the extreme republican leaders argue that all the taxes collected in the republic must go into its own coffers.[27] The question of legislative power in fiscal matters is important in view of the high subnational share which had already been reached in the 1960's.[28] Furthermore, the overall subnational's share of revenues is partly the result of a complex system of intergovernmental transfers.[29] This time the law "On Basic Principles" entrusts the Union republics and Autonomous republics with the fiscal responsibilities within their territory, subject to compliance, however, with USSR legislation.[30]

The law "On Basic Principles" also had an important influence on the budgetary process of the Soviet Union, since from 1991 on there will be entirely independent federal, republican, and local budgets.[31] For 1991, the Federal Ministry of Finance has been responsible for the preparation of the draft budget, while the Ministries of Finance of each republic assumed responsibility for preparing their respective draft budgets for legislative action at the republican level.[32] Another implication is that the Soviet budget deficit is not exclusively located on the federal level anymore, but on republican and local levels.

For the expenditure side the fiscal decentralization movement in the Soviet Union manifested also in the "Basic Principles"-Law: the approval and execution of the republic budgets now lies within the competence of each republic, conditional on its conformity with the federal laws.

Summing up, in the last three years a crucial degree of fiscal decentralization has emerged in the Soviet Union. This is evidenced by the increased share of subnational levels in major taxes and by current union legislation, most importantly the Law "On Basic Principles" and the tax legislation effective as of January 1991.

Nevertheless, in some cases, Soviet reality today already goes beyond this, and subnational levels are, if anything, likely to gain even more power: for instance, the union tax legislation of January 1991 still assigns the taxes on foreign trade to the federal level, whereas *de facto* in a number of republics has set up their own customs.[33]

III. FISCAL DECENTRALIZATION AND THE THEORY OF ECONOMIC FEDERALISM

A. Overview[34]

It is argued that today's fiscal stance of the Soviet economy is closely connected with an overall change in the intergovernmental relations in the Soviet Union. While so far the fiscal relations were dominated by the center, now, as shown in Section II.B, a substantial amount of fiscal decision-making power has been passed on to subnational levels. This warrants a new look on the Soviet fiscal system in terms of a theory which emphasizes especially the structure of the underlying government: this is what the Theory of Economic Federalism does. A federal economic system is one in which public functions are provided

[27]See Alexashenko (1990), p.8.

[28]See Bahry (1987); Table 2, profit tax share in 1960.

[29]For this, see Knight/Waxman (1991).

[30]The exact meaning of this qualifier is still to be seen.

[31]Alexashenko (1990), p.20; on March 29, 1991, the Chairman of the Lithuanian standing budget commission, A.Rudis, told TASS that Lithuania's budget was now completely separate from the USSR's. Report on the USSR, April 5, 1991, p.35f.

[32]IMF, et.al.(1991), Vol.1, p.259.

[33]This is, i.e., the case in Ukraine and Byelorussia, see IMF, et.al.(1991), Vol.1, p.257.

[34]See also van Rompuy/Abraham/Heremans (1990).

for by a multi-level public sector which consists of the federal, state (or republic), and local government.

This paper is primarily concerned with demand management and fiscal stability, thus, according to the Musgravian classification the stabilization *branch* of the government has been reached. Although recent work has dealt with questions of stabilization policy in a federalist economy using this approach,[35] instead, "fiscal stability" is often thought to be a good produced by the public sector. This leads back from the stabilization to the allocative *branch*. As it turns out, this interpretation is particularly revealing for additional problems of achieving fiscal stability in a multi-level government.

The approaches which have been taken can be divided into an essentially normative one which concentrates on the optimal assignment of these functions to the different levels of government—an "optimal" allocation of public functions would satisfy an efficiency criterion like Pareto-optimality and guarantees the highest overall welfare of its constituents. In the more recent positive contributions, governments are no longer treated as monolithic blocks maximizing a given social welfare function, the "benevolent dictator assumption," but politicians maximize their own welfare, properly defined, and more generally, the government is a playing field of various interest groups and bureaucrats, each of which is also aiming at its own welfare. The resulting division and performance of public functions will, in general, not be optimal in the efficiency sense. In the following, the current situation in the Soviet Union is first analyzed in terms of the normative concept, before the assumption of the *benevolent dictator* is withdrawn in part two.

B. The Normative Theory of Economic Federalism

In this part, the normative theory of fiscal federalism is outlined. General concepts are introduced for the decision on which public function optimally—bearing in mind the special interest in the production of "fiscal stability"—to assign on which government level. It should be emphasized at the outset that there is no suggestion that any decision-maker in the Soviet Union today thinks in terms of the theory, nor that its assumptions are true in the descriptive sense.[36] But to see how and why a federal fiscal system is constructed optimally in a certain way helps to understand exactly from where the problems in the Soviet system stem. It is exactly those mechanisms for which the theory suggests the fiscal stabilization function to be highly centralized that are causing losses in the decentralized Soviet system today.

1. Outline of the Theory

The allocation of public functions to various members of the federation is a fundamental issue. In order to assign expenditure responsibilities, Oates (1972) advanced the so-called "decentralization theorem" which states that each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the costs and benefits of such provision.

This gives a strong *a priori* argument for decentralization. Local provision allows governments to cater better to the preferences of local residents, whereas central provision often results in more uniform provision. Also, decision making is closer to the people for whom the services are intended. This induces more responsiveness to local concerns as

[35]See Ter-Minassian (1991).

[36]That the assumptions do not hold is exactly why inefficiencies arise; see esp. pp.14ff.

well as more fiscal responsibility and efficiency of provision, especially where financing of services is decentralized as well.[37] Given the vast area and regional diversity of the Soviet Union, these considerations of differences in tastes and needs are particularly important. Under quite restrictive assumptions,[38] then, the so-called "Tiebout-Solution" applies: the production of private and public goods takes place at some given points in space and consumers will move in order to find the package of goods that suits them best. Preferences for public goods are revealed by consumers who move around, "voting with their feet".

In the case of spatial externalities, when costs and/or benefits of public services are realized by non-residents of that jurisdiction (spill-overs), Coase (1960) argues that these will be internalized via bargaining among the involved jurisdictions. This is the essence of the so-called "Coase Theorem". The ideal world sketched above is, however, far from any real economic environment. Several things need to be taken into account:

1. Firstly, mobility is less than perfect and involves private and, in some cases, social costs due to externalities.

2. More fundamentally,[39] jurisdictions which want to enter into bargaining face the problem of imperfect information and transaction costs. The requirements for efficient bargains are indeed high:

   (i) All parties should have perfect knowledge about each other's preferences and endowments.

   (ii) Strategic behavior, which leads to hiding one's true preferences, should not occur.

   (iii) In order not to have insuperably high transaction costs, the number of parties should be sufficiently small.

   If these conditions do not prevail, the bargaining process might break down. In this case, efficiency can be restored by establishing a central institution, government, or a constitutional court that acts as a coordinator between parties and enforces the agreements.

3. There is a third reason for provision at a higher level when production entails lower costs than on lower hierarchical levels, for instance due to increasing returns to scale.

Summarizing, the blueprint for a federal economy according to the Theory of Federalism displays strong tendencies of decentralization. There are only three motives for assigning government functions to a hierarchically higher level: decreasing costs of provision, externalities and failure to reach agreements between competitive lower-level governments. These elements will be identified in today's Soviet fiscal system.

[37] Shah (1991), p.2.

[38] See Rubinfeld (1987).

[39] This is more fundamental since externalities of the above mentioned type could, in principle, be cured by an agreement between jurisdictions. But the fact that often the externality is not subject to bargaining then is usually explained by a transaction costs-argument.

2. Consequences of Fiscal Decentralization in the Soviet Union

2.1 Cost Considerations

2.1.1 The Problem Awareness on Lower Government Levels

Due to the minor role of public finance in a centrally planned economy, financial considerations did not have high priority even after the introduction of the new leadership of Gorbachev in 1985. The budget deficit was not published until October 1988.[40] Observers in the Soviet Union find that the republics are even less aware of the destructive forces of mismanaged public finances in an economy.[41] While this can not be generalized to all subnational governments—certainly not to the Baltic Republics—it might well hold as an overall judgement, since awareness of the role of public finance could not easily develop in the republics in times of strict federal control and dependence on the center. Evidence provides the fact that until the middle of February 1991 each third republic and a lot of regions had no current and up-to-date budget.[42] This increased unawareness on fiscal questions works like a mark-up on the costs of achieving fiscal stability.

2.1.2 Administrative and Compliance Costs

While in terms of Fiscal Federalism Theory it is generally agreed that a centralized system leads to lower administrative and compliance costs,[43] in January 1990 the USSR Council of Ministers created the State Tax Service, which encompasses republic and local tax offices.[44] Its structure is complicated enough to require an additional coordinating and managing department in the USSR Ministry of Finance, the Main State Tax Inspectorate. The State Tax Service is not organized along functional lines, but according to the taxes that are assigned to a particular unit, and this structure is replicated on all levels of the organization. It is conducive to duplication of work, poor coordination, and higher costs.

Organizational failures in the course of fiscal decentralization are exacerbated by the fact that the technical capacities of republican and local bodies are lower than in the center. In the Soviet Union tax administration has been weakening over time, because under central planning most revenues were transferred to the budget through debiting of a relatively small number of large state enterprise accounts at Gosbank (or its branches). Sophisticated ways of tax evasion and other problems of enforcement are therefore largely unknown. The destruction of the tax administration system culminated in the 1960's with its complete dismantling. Since then these functions have been performed by the Ministries of Finance on various levels.[45]

With the arrival of the mass income tax system, the privatization of state enterprises, the development of a large number of small- to medium-sized enterprises and the increase in foreign direct investment, new ways of tax evasion and avoidance will be found. Since most of the subnational bodies lack the knowledge, staff, and technological means to fulfill

[40] Aslund (1991), p.3.

[41] Alexashenko (1990), p.25.

[42] Alexashenko (1991a), p.5f.

[43] Shah (1991), p.2; in the United States the administrative costs of the federal individual income tax amount to only about 0.5% of revenues. In contrast, at the state level these costs for income taxation are roughly 1% to 2% of tax receipts, Oates (1977), p.15.

[44] See the chart in IMF, et.al.(1991), Vol.1, p.295.

[45] See IMF, et.al.(1991), Vol.1, p.256.

many of the basic tasks which have been or will be assigned to them,[46] tax revenues will fall.

On the other hand, it can be expected that tax morality is higher if taxes collected and spent for republican purposes, which might counteract the loss of revenues due to the lack of trained personnel on lower levels, at least in some republics. However far this motive takes, in the disintegrating Soviet Union the lack of trained staff will reduce tax morality even there, and might well be self-defeating: the not to-be-prevented increase in tax evasion and avoidance in the beginning might undermine the taxpayer's perception of the fairness of the system and therefore their willingness to comply voluntarily with the tax legislation in future.[47]

2.2 Externalities due to Fiscal Decentralization

2.2.1 Moral Hazard on Lower Government Levels

The concept of "moral hazard" was introduced in the area of economics recently, where one party in a relation may undertake certain actions that:

(a) affect the other party's valuation of the action, but that

(b) the second party cannot monitor and enforce perfectly.

A classic example is fire insurance, where the insuree may or may not exhibit sufficient care while storing flammable materials. In this setting the outcome depends on whether the insurance company, sometimes called the "principal", can give incentives to the insuree, called the "agent", such that the latter behaves in a way which is preferred by the former.

We will apply this concept in a generalized form to the Soviet Union. The devolving fiscal system suggests an analysis in the principal–agent framework, since the center can not perfectly observe the behavior of subnational levels, and to which extent they are abusing their newly gained *de facto* and/or *de jure* power in fiscal matters.

The externality, then, lies in the fact that despite transferring tax revenues and expenditure authority to lower level governments, there is a probability greater than zero that the federal level acts as a lender of last resort in the case of credit default on the part of lower level governments—it will bail them out.

This will give certain disincentives to republics, as will be discussed in turn. The negative externality could be internalized only if the federal level would abstain consistently from any financial rescue operation, or if the center could perfectly monitor financially weak lower-level behavior. The notion that the center might have perfect control can be rejected: many of the lower-level governments themselves[48] can only guess their fiscal stance, and even more than before the center must expect to receive biased information from the republics.

The reason why there is a positive bail-out probability in the Soviet Union is historical: past attempts to decentralize failed for a number of reasons. Most importantly, there are inflexibilities inherent in the existing system that tend to make the economy return to its original shape.[49] Therefore it resembles fully rational economic behavior for financially weak republics to attach a non-zero probability to an eventual bail-out by the federal level.

[46] See IMF, et.al. (1991), Vol.2, p.239; Alexashenko (1990), p.23.

[47] Owens (1990), p.14.

[48] See Alexashenko (1991a), p.5f.

[49] See Knight/Waxman (1991), p.25 on this.

a. Spending Behavior of the Republics

As international evidence shows, lower-level governments tend to overspend in this situation. Particularly the recent experience of the fiscal decentralization in Brazil in the 1980's has confirmed the view that all newly assigned revenue inflows to subnational levels are promptly spent, whereas the corresponding responsibilities for formerly federal programs are in general not taken up. Also large parts of the external debt of subnational governments were shifted in large scale bail-out operations to the federal government.[50] Over the last ten years Union republics doubled spending while they increased their revenue only by 50%,[51] and to some respect, the former system with only one budget deficit at the union level can be seen as a bail-out mechanism by design. However, the important difference is that now the control of central levers is much less effective.

Indeed, given the prevalent uncertainty about the irreversibility of the decentralization movement, and the difficulties for the center to monitor subnational's behavior, let alone enforce their new responsibilities, all levels of government want to just maximize their expenditure.[52]

b. Regulating the Access to Regional Central Banks

A second major issue in this context is the extent to which lower level governments are restricted in their refinancing decisions. On the one hand, there is the question to what extent subnational governments have access to the domestic and foreign capital markets.[53] On the other, whether they can refinance themselves directly at the domestic central bank. The latter gains special importance in the Soviet Union since the banking system is under reform. With the *Central Banking Law,* finally approved in December 1990, a Union Reserve System has been created, consisting of Gosbank in Moscow and republican central banks.

The new law allows for bank financing of the union and republic budgets up to the limits established by the Supreme Soviet. However, under exceptional circumstances, which are not specified by the law, the President of the USSR can authorize short-term credits in "limited" amounts in excess of the approved amounts.[54] Even this arrangement will most likely not hold water: in the Soviet Union, Union republic governments are increasingly claiming their right to use the state banks as sources of financing.[55]

Again, one can learn from recent Brazilian and Italian experience, but especially from Yugoslavia that such transactions are bound to require subsequent bail-out operations, either by the budget of the national government or the union central bank.[56]

This is so in the case in the Soviet Union: it seems the less a republic restricts its expenditures, the more it will claim to have its deficit covered by forcible selling of obligations to central banks.[57] And a lesson drawn from Soviet history would tell that credits from the central bank are indeed a legitimate source of filling government coffers.

[50]Oliveira/Velloso (1991), p.24f., p.32.

[51]Aven/Alexashenko (1991), p.2.

[52]See Alexashenko (1991a), p.4.

[53]See IMF, et.al.(1991), Vol.1, p.247 on this.

[54]See IMF, et.al.(1991), Vol.1, p.371.

[55]The Moldavian President Snegur issued a decree founding a Moldavian National Bank by means of what, in effect, amounted to a takeover of the Moldavian branch of USSR Gosbank. While it is due to become operational by December 1991, there is no indication of a change of policy relative to Gosbank's. Report on the USSR, June 14, 1991, p.34; also the Georgian parliament decided to take over the Gosbank's branch on its territory and create a central bank; TASS, August 16,1991, from Neue Zurcher Zeitung, August 18/19, 1991, p.13.

[56]See Ter-Minassian (1991), p.4.

[57]Alexashenko (1990), p.19.

Table 5: Personal Income Taxation as of January 1991 (In rubles)

Union Legislation		Russian (RSFSR) Legislation	
Income (I) per Month	Magnitude of Payment	Income (I) per Month	Magnitude of Payment
Less than 160	0	Less than 200	0
161–1000	0.13×(I–160)	201–1000	20 +0.13×(I–200)
1001–1500	109.2 +0.30×(I–1000)	1001–1200	124 +0.15×(I–1000)
1501–2000	259.2 +0.35×(I–1500)	1201–1400	154 +0.20×(I–1200)
2001–2500	434.2 +0.40×(I–2000)	1401–1600	194 +0.30×(I–1400)
2501–3000	634.2 +0.45×(I–2500)	1601–3000	254 +0.40×(I–1600)
More than 3000	859.2 +0.50×(I–3000)	More than 3000	814 +0.50×(I–3000)

Sources: Union legislation from Aven/Alexashenko (1991), p.14; tax on income from *principal* occupation; RSFSR legislation from official register, December 1990.

Although moral hazard behavior on the part of the republics is central to the negotiations among republican central banks[58] and the union central bank, objective and transparent rules for permissible subnational financial operations and their outright barring from borrowing from the banking system are not in sight. The only exception is Russia (RSFSR), which legislated the 1991 limit for its deficit at 5% of total republican revenue.[59] However, this limit was not obeyed: during the first quarter of 1991 the Russian budget was in deficit at an annual rate of 120 billion rubles,[60] which is around 40% of Russian tax revenue.

2.2.2 Tax Base Erosion due to Interjurisdictional Tax Competition

Another externality stems from the ongoing so-called "War of Laws" in the Soviet Union. This refers to the fact that in the Soviet Union there are currently different fiscal-legislative regulations existing parallel to each other. It is particularly important in the area of taxation: despite the most recent tax reform efforts of 1991, contradictions between the Union and republican legislations prevail.

The legislation of the Russian republic fixed the tax on so-called *excessive* profits at the single rate of 75%, whereas the rate is 80%–90% according to the Union legislation. Also Russia's personal income tax scheme differs from that of the federal level, see Table 5.

Estonia introduced a progressive tax scale on enterprise profits, whereas the union legislation set a flat rate of, at the time of writing, 35%. Also personal income taxation differs there from the union legislation. And the republics in general require to receive 75% of the revenues of the consumption expenditure tax and the capital gains tax, instead of 50% according to the federal law.[61] Differing tax legislation across space is no argument for re-centralization *per se*. On the contrary, as mentioned above, the competitive behavior of subnational jurisdiction is an essential ingredient of a Tiebout-type process, and consequentially, a Pareto optimal outcome. However, the current situation in the

[58]Alexashenko (1990), p.19.

[59]Alexashenko (1990), p.15.

[60]Khanin (1991); Report on the USSR, July 19, 1991, p.2.

[61]See Aven/Alexashenko (1991) for details.

Soviet Union is very different from the setting which would assure the Tiebout-consistent solution,[62] and therefore losses emerge because of decentralization.

Two important violations are: firstly, as was experienced in market economies, primarily less developed jurisdictions—which suffer the most acute revenue need—are engaged in tax competition, seeking to attract any investment inflow possible by offering tax holidays, reduced tax rates, etc. In Western market economies these countries are usually liquidity constrained—as is, by any measures, the central government in the Soviet Union—thereby preventing a Pareto optimal outcome.[63] The argument holds especially in the Soviet economy, since financial markets are barely existing at all. Secondly, the Tiebout outcome requires that consumer's mobility is costless and responsive only to fiscal conditions. But in the Soviet Union today tax legislative acts are following so close to one another that migration flows are hardly observed. Without this a Tiebout-like sorting process can not work, but instead, the system will be dynamically unstable: both the republics and the central government introduce tax legislations to capture tax revenue at the source, which simply leads to tax base erosion and, *ceteris paribus,* to a higher overall deficit.

A clear example of this: in January 1991, the new federal tax legislation set the tax rate for *ordinary,* i.e., those which do not allow the enterprise to exceed given limits of return fixed by the Parliament *(de jure)* or by the central government *(de facto),* operational profits at 45%, from which 22% should go to the union budget, and up to 23% to the republic. The Russian government, in turn, fixed the profit tax rate for the majority of enterprises under its subordination at 38%.[64] But on March 23, 1991 Gorbachev released a Presidential Decree which set the tax rate again lower than the Russian government, from 45% to 35%.[65] This rate is still to be approved by the Parliament, and is unlikely to be the last word in the competitive but self-destructive tax revenue seeking until all sides agree on clear and enforceable sharing arrangements.

2.3. Coordination Failures and Free Riding

As noted in Section III.B.1, a third reason for provision on a higher hierarchical level according to the Theory of Fiscal Federalism are obstacles which prevent governments from reaching a bargaining solution on the underlying externalities.[66]

The most obvious point is that institutions which have a coordinating function to overcome this do not exist (any more).

2.3.1 A Lack of Coordinating Institutions[67]

During the last three years the Soviet Union has witnessed a considerable amount of destruction of the former policy-making bodies, primarily the Central Committee apparatus and the Council of Ministers, without any new institutional framework set in their place. Although it is a common presumption that the dissolution of these old institutions is a

[62] See Rubinfeld (1987), pp.575,591.

[63] See Atkinson/Stiglitz (1980), p.150.

[64] In addition, this was to give an incentive for state enterprises to switch from federal to Russian subordination.

[65] TASS on March 23, 1991; the 35% are to be shared, with 17% to the federal level, and 18% to the republics. Report on the USSR, April 5, 1991, p.22.

[66] In the case of the Soviet Union today, most externalities emerge among the center and republics, not among republics. The basic concepts, however, carry over, if one thinks of the *higher hierarchical level* as a constitution, or, in fact, *Union Treaty,* which is binding for republics and center.

[67] See Aslund (1991), IMF, et.al.(1991), Vol.1, pp.242,274.

necessary condition for further progress to a market economy, this imposes at the same time a high cost upon the Soviet Union.

For now, functioning institutions are often simply not available: from a mechanism to negotiate the controversial issue of tax-legislative competition to an institution which is capable of dealing with technical questions of budget preparation; in many areas the developments of fiscal decentralization are ahead of newly needed institution-building.

Recognizing that fact, the Presidential Guidelines of October 1990 envisage the creation of an Interrepublic Economic Committee, composed of plenipotentiary representatives of the republics, under the Federation Council, to coordinate measures introduced by all republics. In turn, the members of the Federation Council are the deputy prime ministers of the republics, chaired by the President of the Soviet Union. But even after the executive powers of the Council have been strengthened substantially following the session of the USSR Supreme Soviet held on November 17, 1990, the lack of bodies that can coordinate economic policies is still a major shortcoming of the situation in the Soviet Union today.[68]

2.3.2 Coordination Failures

It is argued above that there is a case for centralized provision of a public service if the costs of bargaining between subnational governments is excessively high. In economics, quite distinct approaches are applying their concepts in the case that there are obstacles of bargaining on externalities: property rights theorists refer to high transaction costs of the agreement, game theorists stress the agents strategic behavior and worse-than-possible deadlock situations, Prisoner's Dilemmata, and public finance economists speak of the free-rider problem and argue the service to be provided is a public one.

They share the idea that the interaction of economic agents (here, the national and subnational governments), simply left by themselves, will not lead to the first-best, Pareto-optimal outcome. As the concepts are not mutually exclusive, they are linked in the following eclectically to observed behavior in the Soviet Union.

a. High Transaction Costs

The fiscal decentralization allows, since 1990, for budget deficits also on subnational levels. Though it is true that also in other countries the possibility of subnational deficits exists, in the Soviet Union this immediately has intensified the haggle over tax revenues among jurisdictions. The reason is obvious: since the federal level can not enforce its laws, noncompliance is an option; when Estonia could not balance its budget in 1990, it simply reduced its contribution to the union budget.[69]

In addition, devolving greater responsibility to subnational levels is often accompanied by increased localism and politically based ideas of self-sufficiency, as had been seen in China and Yugoslavia.[70] In the Soviet Union today, each republic wants to decide individually on its level of participation in each federal spending program.[71] These changed priorities raise transaction costs, too.

Does fiscal decentralization mean increased inequality of wealth across Soviet Union republics? The complex tax/transfer system in the Soviet Union can not be analyzed

[68]However, according to TASS of June 7, 1991, the Commission rejected a proposal to divide republics in those willing to sign a *Union Treaty* and those which are not, and kept the option of cooperation open. On the other hand, Lithuania and Estonia are only participating in the Commission as observers. Report on the USSR, June 14, 1991, p.38.

[69]See Alexashenko (1990), p.10.

[70]See Blejer/Szapary (1989), Knight/Waxman (1991), p.25.

[71]See Alexashenko (1990), p.10.

here, in trying to find an answer to the often-posed question "Who feeds whom?". But it is widely agreed that in a decentralized Soviet system poor regions are falling further behind.[72] This means that over time the costs of reaching an agreement on interrepublican redistribution are rising.

b. Noncooperative Behavior

In game theoretic terms, we consider Union republics on the one hand, and the national government on the other, as two players who attempt to find their dominant strategy, i.e., which is optimal regardless of what the other player is doing. Observing Soviet players, one has the impression that they completely neglect mutually advantageous actions by trying to shift the financial burdens to the opponent. This is the familiar "Prisoner's Dilemma": distributional conflicts prevent the players to reach the first-best, cooperative solution. The outcome is one of collective irresponsibility:

(1) The upward revenue sharing scheme, which Russia and the Ukraine favor in the ongoing negotiations on a new "Union Treaty", is *de facto* already in use for some time. Also its unpromising experience in Spain and Yugoslavia—the transfer amounts are subject to annual negotiations, no effective enforcement of one republic's contribution—has been confirmed in the Soviet Union recently: several republics have retained already in 1990, and more so in 1991, a higher share of tax revenue than allocated.[73] Although this is, at least by now, an open secret, the national level does not reduce its spending activities correspondingly: in the first quarter of 1991 the central budget spent more than two and a half times of what has been transferred from the republics.[74]

(2) Similar in spirit is the recent move of some republics, under which are Ukraine and Byelorussia, to set up own customs,[75] and, consequently, to withhold revenue the union tax legislation of 1991 still assigns to the center.

(3) In the late 1980s, Moscow has promised an increase in social programs for the people in recent years, to compensate for the neglect of past years and current economic hardships. Now these programs are handed over to subnational levels, who are, for lack of funds, not keen to take them.[76]

(4) Subnational governments have also learned that the increased number of state enterprises under their subordination is more a burden than an asset: still on June 8,

[72] See Knight/Waxman (1991), p.25.

[73] On January 5, 1991, the Chairman of the RSFSR Supreme Soviet Yeltsin told reporters that the RSFSR had agreed to contribute about 78 billion rubles, 27 billion short of the center's demand. Report on the USSR, January 18, 1991, p.31; On March 29, 1991, USSR Finance Minister V.Orlov told Pravda that seven republics, the RSFSR, Ukraine, Georgia, Moldavia, and the Baltic republics, had failed to transfer tax revenue to the central budget, Russia alone 66 billion rubles. Report on the USSR, April 5, 1991, p.35; On April 4, the USSR Supreme Soviet sent an appeal to the legislatures of the fifteen union republics asking them to make their full contributions to the central government's budget, TASS reported. Report on the USSR, April 12, 1991, p.31f. On April 10, 1991, A.Orlov, deputy chairman of the USSR Supreme Soviet Committee on Planning and Finance told "Rabochaya tribuna" that the RSFSR had withheld all of the (then, W.K.) 45% corporation tax (tax on profits, W.K.) and the 5% sales tax levied since January, 1. Report on the USSR, April 19, 1991, p.20f. According to Latvian Prime Minister I.Godmanis, the central government and Latvia agreed on 350 million rubles, not 4.2 billion, as the center had demanded, as the Latvian contribution to the central budget in 1991—this is 8.3%. (Radio Moscow, April 27, 1991); Report on the USSR, May 10, 1991, p.27.

[74] Aven (1991), p.20.

[75] See IMF, et.al.(1991), Vol.1, p.257.

[76] See Knight/Waxman (1991), p.21; Alexashenko (1990). p.12.

1991, the Ukrainian Prime Minister V.Fokin told parliament that the republic must take control over all Soviet enterprises in the republic.

A week later, on June 16, 1991, he said in an interview with *Vremya* on the contrary that the Ukrainian government had no intention of owning such enterprises. He claimed that his government had had a bad experience with the transfer of the coal industry to republican ownership, and it now realized that it simply could not afford to own all of the industries on Ukrainian soil.[77]

(5) Short-term goals clearly dominate tax legislation in the Soviet Union today. This is evidenced by the new 5% sales tax, introduced by the union legislation in January 1991. The tax was a desperate, and unsuccessful,[78] attempt of the center to acquire new sources of revenues: already on May 21, 1991 the USSR central government repealed the 5% sales tax selectively. This decision was a consequence of a joint declaration by Gorbachev and the leaders of nine union republics on April 23, 1991, which led to new optimism in the center concerning cooperation with the republics.[79]

c. Financial Stability as a Public Good: The Case of the "Stabilization Funds"[80]

In the end of 1990, the central budget as well as the republican budgets has been divided into the actual budget and essentially extrabudgetary so-called stabilization funds: the idea of the union tax legislation of January 1991 was to collect 37% of the enterprises wage funds as social insurance payments. Although resistance of the enterprises forced the rate down to 26%, the union insisted nevertheless on collecting 37%, with 11% assigned to the stabilization funds.[81] The purpose was intended to be support for privatization, infrastructure investment, and enterprise restructuring, and they were said to function only temporarily.

International experience suggests that extrabudgetary funds are bound to weaken budgetary control as in Poland 1990, where they became simply a part of the state budget. In the Soviet Union, both the federal and subnational levels have participated in obscuring the fiscal stance: the federal government delegated the deficit both to the republics and to the stabilization funds, and the republics in turn delegated their deficits to their stabilization funds. In addition, the Baltic republics refused to contribute to the funds any longer after the center financed its share with a 5 billion central bank loan approved by the USSR Supreme Soviet on May 27, 1991.[82]

Finally, the balance of the stabilization funds has apparently not been made public.[83] The example shows clearly the public good-character of "fiscal stability"; due to the at least partial non-excludability, every level has an incentive to act as a free rider if others start to produce the good "fiscal stability". This leads to an underprovision since no level

[77]TASS, Izvestia, June 8, 1991, and Vremya, June 16, 1991; Report on the USSR, June 14, 1991, p.38 and Report on the USSR, June 28, 1991, p.31f., respectively.

[78]See footnote 73.

[79]TASS, May 21, 1991; Report on the USSR, May 31, 1991, p.31.

[80]On December 29, 1990, President Gorbachev announced its creation, operating effectively on January 1, 1991 (TASS); Report on the USSR, January 11, 1991, p.24f; see also Aslund (1991); Aven/Alexashenko (1991); IMF, et.al.(1991).

[81]Another source was, according to USSR Finance Minister V.Pavlov, taxes on proceeds from the privatization of state property. Central Television, December 29, 1990. Report on the USSR, January 11, 1991, p.24f.

[82]TASS, May 27, 1991; Report on the USSR, June 7, 1991, p.34.

[83]Aslund (1991), p.16.

has an incentive to keep public finances under control as long as there is no guarantee that others also do so.

This is just another case of a coordination failure among agents. To summarize, in a number of ways both republics and the federal level have acted in their perceived short-term interest, thereby adding to the Soviet economic difficulties. Not only time has been wasted before deeply rooted systemic changes are implemented, but at the same time this has caused a further deterioration of the Soviet fiscal stance.

C. The Positive Theory of Economic Federalism

1. Outline of the Theory

As mentioned above, the positive approach to economic federalism is closely related to the analysis of the government. To this end, most of the concepts are discussed in the so-called Theory of Public Choice. This line of thinking is therefore introduced in turn.

1.1 Definition

Public Choice[84] can be defined as the economic study of nonmarket decision-making. The major contribution of Public Choice has been that of endogenizing political decision-making: the state, far from being a "benevolent dictator" maximizing a social welfare function, is at least partially endogenous, and the policies it institutes reflect vested interests in society. The theory applies standard neo-classical economic theory to Political Science. Thus, the approach is one of methodological individualism: the tools of optimization are applied to actors in the government field, in particular politicians, voters, bureaucrats and interest groups (lobbies). Public Choice models building on such characteristics are to some political scientists all but a naive caricature of political behavior. But public choice theorists point to the positive research agenda and argue that these models are justified if they out-perform the competing models in explaining political behavior.

There is no consensus reached on this issue: the theoretical basis of Public Choice models is still often considered to be to a substantial degree ad hoc, without convincing behavioral assumptions. Also testing proved relatively difficult, since most of the relevant variables are not observable. Nevertheless, the concepts have increasingly and fruitfully been applied to a number of areas.[85] We also see a role in explaining the current situation in the Soviet Union.

A large part of Public Choice theory is devoted to inefficiencies due to the agent's behavior, be it the politician, the bureaucrat, etc., relative to the first-best world, where a market failure is promptly cured by political action. Analogously, these inefficiencies are referred to as government failures. Public Choice theorists point out that these may be substantial, and in cases even higher than the losses due to the market failure in the first place.

Indeed, consensus is widespread that a market failure is only a necessary, not a sufficient condition for government intervention. In many cases these inefficiencies rely on high costs of monitoring and controlling the agent's behavior. Due to informational constraints for voters, taxpayers and consumers, politicians and bureaucrats can exercise a considerable degree of discretion and pursue their individual goals of being in office, such

[84]See Mueller (1978) on the following.

[85]See, e.g., Roubini/Sachs (1989), Alesina/Tabellini (1988).

as[86] power, prestige, income, perquisites which generally do not coincide with society's overall welfare. We interpret this political leeway as budgetary means for discretionary use.

1.2 Implications of Decentralization: The Views of Brennan/Buchanan and Moesen/van Rompuy[87]

In which sense is the move towards decentralization in the Soviet Union important for Public Choice considerations, then? The relevant difference lies primarily in the fact that the number of agents involved has increased and/or their function has changed: now there are more subnational bureaucrats and politicians. One might, therefore, expect Public Choice theory predicting higher inefficiencies with a decentralized system.

However, the "decentralization-hypothesis" proposed by Brennan and Buchanan contends that fiscal federalism can serve, on the contrary, as a constraint on the expansion of government. They argue that "total government intrusion in the economy should be smaller, *ceteris paribus,* the greater the extent to which taxes and expenditures are decentralized" (p.185). The main argument is based on a greater political competition between the various fiscal jurisdictions. In a centralized setting the monopoly power to extract resources through tax legislation is less challenged than with a decentralized multi-layer government. Here citizens have access to comparative political shopping which introduces a dimension of contestability on the political markets.

Moesen/van Rompuy argue, in addition, that there is a relation between the fiscal outcome of the political decision process and the status of the budget constraint. Under a soft budget constraint it is expected that the political decision-makers will give in more easily to the demands of interest groups and bureaucrats, as only a part of the tax bill has to be presented to the taxpayer-voters.

They find the demand management function in most countries assigned to the central level, hence there is the possibility of incurring deficits pursuing Keynesian *deficit spending* policies, whereas subnational levels often face harder budget constraints, they argue: public borrowing is often restricted on the domestic as well as the international capital markets, and in any case, subnational levels are not entitled to money creation and the associated seigniorage. Two things can be observed:

(1) Normative and Positive Theory of Economic Federalism are thus far highly complementary. The dissolution of the government block does not give any insights which would run counter to the previous analysis, the only change being that now one does not only think of the republic's consumer-taxpayers, but realize that the republic's rational behavior is formulated, channelled and executed by selfish bureaucrats and politicians whose personal gain is linked to the republics' welfare.

(2) The arguments advanced by Brennan/Buchanan and Moesen/van Rompuy do not contradict the presented analysis at all—rather, they confirm it. This is so because there is no functioning tax competition between jurisdictions in the Soviet Union today, but destabilizing tax base erosion (see III.B.2.2.2), and there are no restrictions on subnational financial operations, but Union republics are even about to gain access to regional central banks (see III.B.2.2.1.b), etc.

[86]Niskanen, in Mueller (1978), p.185.

[87]Brennan/Buchanan (1980); Moesen/van Rompuy (1990).

However, Public Choice theory developed other arguments which should be elements of the positive Theory of Fiscal Federalism in the Soviet Union today.

2. Fiscal Decentralization in the Soviet Union: Public Choice Mechanisms at Work

2.1 The Behavior of Bureaucrats in a Devolving System

The study of the behavior of bureaucracies is a central element of Public Choice theory. The standard model is that of the budget-maximizing bureaucrat in a bilateral monopoly setting between administration and sponsor, due to Niskanen.[88] Because of the unobservability of the true costs of the bureaucracy's service to the sponsor, the bureaucracy succeeds in extending its output beyond the social optimum, where marginal public benefits equal public costs.

In a devolving fiscal system the tax administration on subnational levels will increasingly try to capture some of rents of the center bureaucracy, thereby also maximize its budget, given that many discretionary goals are positively correlated to the budget size.

On the other hand, as a reaction federal bureaucracies will attempt to slow down the devolutionary process. Ukrainian Prime Minister V.Fokin told the Ukrainian parliament on June 7, 1991 that some USSR ministries had been creating joint-stock companies out of their enterprises in Ukraine only for the purpose of preventing these properties from being transferred to republican ownership.

In general, this leads to superposition and duplication of public functions, and its fiscal impact is an increase of the size of the public sector and of its deficit, as the recent Brazilian experience confirmed, too.[89]

2.2 Mounting Social Expenditure

Populist Pressure and Competing Politicians

Pioneers in analyzing politician and voter behavior in representative democratic systems are A. Downs and W. Nordhaus.[90] Politicians are, in principle, seen as political entrepreneurs—maximizing votes—but also here costly and therefore imperfect surveillance through the voters leaves the politician room to pursue his own goals (Downs). And a successful strategy to gain popular support and win the next elections is to increase shortly before social expenditure, but taxes only afterwards (Nordhaus).

A key element of the Nordhaus theory—the politician's possibility to build on the myopia of the voters who discount future tax payments too much—received considerable attention recently in explaining populist behavior of South American governments.[91] The same considerations are relevant for the Soviet Union today, since "glasnost" and the transformation away from an authoritarian system raised expectations, and lowered the voter's time preference rate. This gives a bias towards short-term policies.

In the Soviet Union, drastically increased social expenditures is the main expenditure item preventing budgetary balance.[92] The figures are impressive: average annual expenditure for new social programs in 1985–89 totalled about 3 billion rubles. In 1990 it

[88]See Mueller (1978), Ch.8 for discussion of Niskanen's 1971 model.
[89]See Oliveira/Velloso (1991), p.25.
[90]See Mueller (1978), Ch.6.
[91]See Dornbusch/Edwards (1990).
[92]See Ofer (1990), p.311.

climbed up to 16 billion rubles, and for 1991 more than 90 billion rubles are envisaged,[93] on the federal level alone 65 billion.[94] The upsurge of popular demands in the social area is a common feature in the transition from an authoritarian to a democratic regime.[95] Furthermore, they have to be seen in perspective: soviet pensions and other social benefits were small before "perestroika", and most of the new benefits seem reasonable in a Western economy at a similar level of development. Given the acute crisis in the Soviet economy, however, they are out of touch with economic reality.

The situation is greatly aggravated by the struggle between jurisdictions for recognition from the constituents. Union republics and the center keep on promising more and more generous social programs and end up outstripping the current financial possibilities of the Soviet Union by far. One example for that is the Pension Law legislation: in May 1990, the federal level enacted a pension reform law which provides a considerable expansion of benefits, including indexation, and without tightening eligibility requirements. Although this program was already beyond the financial means of the country, in September 1990 the Russian parliament started discussing a republican law on pensions, and in the heat of political rivalry Russia picked up the glove and announced a still more ambitious program which increased expenditure on pensions by an additional 15 billion rubles.[96]

2.3 Decentralization, Discretion, and Soft-Budget Constraints

2.3.1 Economic Incentives and Decentralization

So far we have primarily been dealing with interactions within the government block. This section addresses the question of incentive effects of the Soviet fiscal system on individual economic behavior, which is also of prime importance, especially in the context of an economy in transition from a planned to a market system. To this end, the Soviet fiscal decentralization is analyzed using the concepts of credibility and rules versus discretion.

The notion of credibility is directly related to the long-term incentive effect of a system. The idea is applied by a number of theories which look at the interaction of policymakers and private agents. The basic setting is that the behavior of rational, forward-looking agents depends on expected policy actions. This implies that decisions taken by the policy-maker have an influence, positive or negative, on private efforts. This consideration gains importance if policy-makers have the possibility to make discretionary decisions due to informational/observance inefficiencies which are at the heart of the positive theory of fiscal federalism. With forward looking agents, the policy-maker will optimally try to enact a policy program which does not frustrate the private agent's incentives, neither today nor in the long-run. The crucial question is under what circumstances will the private agents believe what the policy-maker announces as his future policy? That is, when is his announcement credible? Private agents will only believe a time-consistent announcement, i.e., they do not have reason to assume that the policy-maker will, contrary to his earlier announcement, deviate from the announced policy later. If the announced policy is time-inconsistent, private agents will not believe it, and any stimulus on private incentives which has been intended by the policy announcement will not materialize.

[93]Gaidar (1991), p.12f.

[94]Alexashenko (1991a), p.3.

[95]See the Brazilian experience, Oliveira/Velloso (1991).

[96]As one observer, Gaidar (1991), p.24, put it.

The problem of time inconsistency arises because the policy-maker can not precommit himself to carry out the promised policy action. Thus, there is an advantage of policy rules over discretion: a precommitted policy-maker, such as one following policy rules, will carry out the policy that is optimal given that it is expected. A policy-maker with discretion may under rational expectations be expected to make the short-run optimal decisions every time he can. Therefore he gains nothing from his opportunism and on average produces a worse outcome than would a policy-maker able to tie his hands.[97] On the other hand, instruments at the discretion of the policy-maker are most desirable from the standpoint of facilitating central macroeconomic management, as their impact on demand can be most easily predicted by the federal authorities and their level and timing can be adjusted to conjunctural requirements. In particular fiscal instruments should be flexible in the sense that authorities have to possess the ability to adapt and change the rules in a timely manner in response to evolving circumstances.

A trade-off exists between the two considerations. Here long-term aspects of incentive compatibility of government policy are emphasized, implying them to be the more fundamental in the emerging Soviet market economy.

2.3.2 Rules and Discretion in Taxation

One "policy rule" which is of prime importance for private incentives is the effective tax rate: Litwack (1991) argues that a critical element of the current Soviet dilemma is the absence of a dynamic tax scheme which is supported by a long-run commitment, since the tax scheme for tomorrow is, in general, at the discretion of some politician. There is considerable consensus that a major weakness of tax systems in planned economies is their lack of stability and certainty,[98] thus, they are entailing a high degree of discretion. Until very recently, it was not justified at all to speak of a taxation system in the Soviet Union, rather than a transfer system (see II.A.2). An argument could even be made that the former practice of the common-pocket of state enterprises and government rendered credibility and commitment issues pointless since the institutional setting was such that in no way government announcements of "norms" could be credible.[99] In itself, the move towards a market economy should undermine the Soviet government's implicit tax collecting ability, and reduce thereby problems of discretion.

Nevertheless, Litwack sees both less administrative planning and more serious problems of commitment leading to an increased budget deficit.[100] His argument is primarily based on the fact that the rate of which one piece of legislation supplants the next has greatly increased, pointing at the huge number of laws, decrees and regulations which have been enacted during the last three years. But it is not obvious how even this partly deregulated economy facing many tax legislative acts could possibly do worse, from an incentive point of view, than the former *common pocket* practice.

To the extent the fall in tax revenues is simply due to less central power to squeeze out enterprises, the picture of the "bargaining economy" (Aven 1991), instead of long-run incentive questions, seems more applicable. Despite this, Litwack's point that a high frequency of ad hoc changes in tax rules can disrupt credibility, and therefore has long-run incentive effects is relevant with respect to the emerging private sector (cooperatives).[101]

[97] Blanchard/Fischer (1989), Ch.11.4; see also here for a more complete discussion.

[98] Owens (1990), p.8.

[99] Litwack (1991), p.262, wonders, however, why in the "stable" Brezhnev era long-run commitments were not credible.

[100] Litwack (1991), p.259.

[101] Litwack (1991), p.267.

Apart from that an argument of increased discretion has to rely instead on the increased number of involved politicians and bureaucrats on different government levels: the fiscal decentralization has led to more, not less administrative planning, thereby partly offsetting the reduced problem of discretion due to the emergence of a market economy.

2.3.3 Discretion, Corruption and Soft-Budget Constraints

We argue that fiscal decentralization has led to an aggravated discretion problem. This is not the same as suggesting that the fiscal legislation of the republics is intentionally less transparent and objective than the federal—which does, at least as a general statement, not hold.[102]

Instead, the argument is based on the influence of subnational bureaucrats and politicians: often these agents realize that they have nothing to gain from a shift to a market economy, thus they are simply trying to put their control in place of Moscow's.[103] This has happened in the case of the income tax legislation of 1991: the Executive Committee of Regional and Local Soviets may grant partial or complete exemption for a certain type of income or class of taxpayers, and even to a particular taxpayer.[104] Overall corruption has increased a lot since the controlling function of subnational parliaments is still in its infancy.[105]

But given that state enterprises are still the main source of tax revenue for all government levels, the influence of fiscal decentralization in this area is decisive. There are two important mechanisms of how bureaucratic discretion works here:

(1) The amount of tax transferred to the budget is determined after observing the performance of the enterprise. But enterprises do not at all benefit from fiscal decentralization, because now they are tied to both the industrial branch (central ministry) and the territory (local government and party organs) and depend on both to one degree or another.[106] In some cases, control and surveillance has increased due to subnational competence to an degree such that protection for enterprises against despotic behavior of subnational politicians has been called for.[107]

    Furthermore, the recent experience in China showed that fiscal decentralization can significantly increase the problems of discretion and corruption.[108] Local governments gave a very generous tax treatment to enterprises within their jurisdiction—which reduced tax revenue which was subject to sharing arrangements with the center—but relied increasingly on case-by-case negotiated *voluntary* contributions by the enterprises for local projects.

(2) Poorly performing enterprises are typically bailed-out. Therefore, in order to conserve and use its discretionary powers, bureaucracies must keep the budget constraints of enterprises soft. In some cases, the obstacles of creating hard-budget constraints have increased after subnational bureaucracies collude with central bureaucracies: in the Soviet Union, both federal and Russian authorities insist on the

[102]For instance, the tax system of Estonia is much more explicit than the current union legislation, distinguishing gross and net household income. Also, the RSFSR has only one rate on return on expenditure, not a multiplicity, as the union legislation; Kommersant, February 1991.

[103]See Alexashenko (1990), p.36.

[104]IMF, et.al.(1991), Vol.1, p.251.

[105]See Knight/Waxman (1991), p.25.

[106]Litwack (1991), p.272f.

[107]See Alexashenko (1990), p.24.

[108]See Blejer/Szapary (1989), p.20f.

Table 6: The Soviet State Budget, 1987–1991 (In billion rubles)

	1987	1988	1989	1990	1990[a]	1991[b]
Total Revenue	360.1	365.1	384.9	452.0	n/a	300.0
(Percent of GDP)	(43.6)	(41.7)	(41.0)	(47.2)		(31.1)
Total Expenditure	429.3	445.9	465.1	510.1	n/a	580.0
(Percent of GDP)	(52.0)	(51.0)	(49.5)	(53.2)	n/a	(60.1)
Total Deficit	69.2	80.8	80.2	58.1	80.0	280.0
(Percent of GDP)	(8.4)	(9.2)	(8.5)	(6.1)	(8.0)	(29.0)

Sources: For 1987–1989 Official Data from USSR Ministry of Finance, Goskomstat, and estimates; IMF et.al.(1991), Vol.1, p.54f.; For 1990 Goskomstat, USSR State Committee Press Release No.155, May 22, 1991;

[a]Estimates by Aslund (1991), p.34; based on Yasin, Y., and Alexashenko, S., "Drama byudzheta," Izvestia, December 30, 1990;

[b]Own estimates, based PlanEcon Report (1991), No.17, May 16, 1991; Soviet press releases until August 1991, Report on the USSR (1991).

creation of a special bank which function it is to give soft credits to enterprises, thereby preserving their soft-budget constraint.[109]

Thus, evidence collected so far indicates that for Public Choice reasons decentralization might well be detrimental to the creation of a non-discretionary Soviet fiscal system.

IV. CONCLUSION

The analysis of the Soviet Fiscal Federalism, both in normative and positive terms, suggests the move towards decentralization to be accompanied with less fiscal stability. Indeed, over the last few months the Soviet fiscal stance worsened dramatically, see Table 6.

The figure of 280 billion rubles (nominal prices) presented for 1991 is a prediction based on current trends in GDP, tax revenue and spending in the Soviet Union. USSR Minister of Finance V.Orlov expected that the total budget deficit could rise to 280–300 billion rubles by the end of the year, which is about 30% of GDP.[110] By any measure, the budget deficit in the Soviet Union is huge. But how can one argue that the decentralization of fiscal decision-making power to the Union republics aggravated the Soviet fiscal stance when most impulses to further reform to a market system come increasingly from the republican side, not from the federal level?

Three things must be noted: firstly, the general development of disintegration in the Soviet economy has to be taken into account: The republics are, at least partially, pursuing their goal of economic and political independence with the use of fiscal policies. This has clearly led to a certain degree of *Overshooting,* as, for instance, happened in the case of tax-legislative competition with the federal level. Secondly, our discussion above showed that the most important effects stem from the fact that the current fiscal system is a *non-system*, i.e., it still lacks objective, stable and enforcable rules for intergovernmental relations. Therefore, any impact of fiscally independent Union republics which

[109]Alexashenko (1990), p.20f.

[110]Radio Mayak, July 4, 1991; Report on the USSR, July 12, 1991, p.32; Khanin (1991) guesstimates a total deficit of 328 billion rubles for 1991, see Hanson (1991), p.2.

would—presumably at least partially—follow a fiscal policy more conducive to stability is still dominated by the chaos in the current fiscal system. In Brazil, the same transitional situation has led the head of the International Monetary Fund's advising delegation, Fajgenbaum, to call even for changes in the constitution to clarify responsibilities.[111] Today's situation is, due to uncertainties about rules and lack of coordination, likely to be more detrimental to fiscal stability than the former centralized system or fiscally independent Union republics, which would mainly have to deal with coordination questions. Thirdly, as especially the positive approach points out, it is necessary to distinguish between intended fiscal policies and the actual outcome in the Union republics: for this year one estimate attributes about 62% of the total budget deficit to the republics, 37% to the Russian republic alone.[112] Also, the joint effect of disintegration and step-by-step enterprise liberalization and reform requires future research, given that most enterprises are still state owned. This factor is a central one in assessing the future course of transition to a market economy when the Union republics will be reforming their economies individually.

[111]The Guardian, July 24, 1991, p.11; Neue Zurcher Zeitung, July 26, 1991, p.10; Der Standard (Wien), July 23, 1991, p.16.
[112]203 and 120 billion rubles, resp. in absolute terms, Khanin (1991).

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