The Dilemmas of Reform in Weak States: The Case of Post-Soviet Fiscal Decentralization

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This article explores the dilemmas of reform in weak states through an examination of efforts to decentralize the fiscal system in post-Soviet Ukraine in the 1990s. Despite increased attention to the state, many reform efforts still ignore the full implications that state weakness has for institutional transformation. Inattention to the problems of institutional capacity has led to a misdiagnosis of the problems facing intergovernmental institutions in post-Soviet Ukraine. Overcentralization and soft budget constraints built into formal institutional design demand an unrecognized degree of institutional capacity that is frequently weak or absent in the post-Soviet context. In addition, reform measures that fail to take into account the problems of weak institutions have inadvertently reduced the authority of already enfeebled state institutions.

It is now widely recognized that robust state institutions are critical for economic and political development. But what do we do in a context in which state institutions are endemically weak?

This article focuses on efforts to reform intergovernmental budgetary institutions in the context of a weak post-Soviet state in the 1990s. I first show how inattention to the problems of institutional capacity led to a misdiagnosis of the problems facing intergovernmental institutions in post-Soviet Ukraine. In the context

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of a weak state, formal rules that would seem to generate negative incentives go unfulfilled. Overcentralization and soft budget constraints built into formal institutional design demand an unrecognized degree of institutional capacity that is frequently weak or absent in the post-Soviet context. Second, I examine the interaction between formal institutional change and existing informal practices. We see how institutional reform, conceived in the context of more stable, efficacious institutional conditions, weakened already weak formal institutions in the post-Soviet context. Efforts in the 1990s to create separate tax bases for central and local governments as part of a general move toward decentralization undermined the formal budget by increasing the degree of central and subnational unilateral control over budgetary implementation. Formal rules are more likely to be followed when control over revenues is fragmented such that neither center nor region has the capacity to unilaterally ignore budgetary laws.

I. WEAK INSTITUTIONS AND POST-COMMUNIST REFORM

Since the mid-1990s, economists and policy makers have almost universally recognized that "development requires an effective state."[1] State institutions are important for providing law and order, public health, and infrastructure. State failure to provide such public goods has clearly disastrous consequences for development.

At the same time, it is not always clear what precisely is meant by "institution building"—the process that is supposed to create a more effective state. Here it is useful to distinguish between two very different traditions of institutional analysis: one tradition (often associated with rational choice) focuses primarily on problems of *institutional design*, and a second tradition focuses on *institutionalization*. The first approach to institution building attempts to draw correlations between sets of institutional rules and political or economic outcomes. Political scientists, for example, have tried to understand the impact of presidential versus parliamentary or proportional versus first-past-the-post electoral systems.[2] In public policy, economists have extensively discussed the relative merits of different types of governance laws, formal levels of decentralization, and tax legislation. The assumption behind many of these analyses is that certain sets of institutional rules create very similar incentive structures across different national contexts. The second approach to institution building, emblematic in the work of Samuel Huntington and many historical institutionalists, examines more fundamentally "the process by which organizations and procedures acquire value and stability".[3] Here, the question is not how institutions are designed but the extent to which government rules and procedures *as such* actually structure behavior. In the world of public policy, attempts to increase institutional authority have included such measures as increasing civil service salaries and training. In sum, the first approach focuses on written rules and procedures while the second approach questions the worth of such rules relative to the paper they are written on.

International lenders and their teams of consultants cannot be faulted for failing to recognize the problems of institutionalization—as the tremendous recent focus on governance and the state attests. Copious research has stressed the extent to which de facto government behavior diverges from formal institutional rules or openly expressed policy intentions.[4] For example, studies of corruption by the World Bank and Transparency International have revealed the staggering extent of bribery among government officials.[5] In addition, recent World Bank discussion of the state has emphasized matching the roles with the capabilities of the state and focusing on reform that complements "what exists." The most recent 2002 World Development report even goes so far as to contend that reform based on Western "best practice" in institutional design can be "flawed."[6] This perspective on international technical assistance is quite remarkable for an organization that has been dedicated for so long to the export of institutional "best practice" into different national contexts.

Despite these genuine efforts, there are several fundamental obstacles facing multilateral efforts to confront problems of institutionalization. Above all, institution building in the Huntingtonian sense is often considered to be the outgrowth of large-scale historical processes such as revolutions, low-level polarization in society, the development of civil society, and a previous history with a strong central administration[7] that economists are not trained to deal with and, even more important, can do little about. In addition, weak institutional capacity has been traced to structural problems such as poverty[8] that are too expensive for donors to cope with. While marginal improvements can always be made, it is often not clear that a change in policies, such as increased civil sector salaries, or new institutional design, can solve the fundamental problems of weak institutional authority plaguing many developing countries.[9] Policy analysts may often loath to directly confront such structural and historically rooted obstacles because doing so would seem to undermine the raison d'être of international agencies. If political and economic institutions are likely to remain weak whatever is done, how is it possible to justify expenditures on foreign technical assistance? Policy makers risk analyzing their way out of a job. Such an approach also risks being misinterpreted or devolving into an unfortunate form of cultural determinism.

A second problem is that designing institutional reform in such weak institutional contexts requires a deep empirical knowledge of how the country's institutions function that international consultants and economists often do not have the time or training to acquire. The weakness of formal rules makes it very difficult to characterize how in fact the systems operate. It is always much easier to focus critiques on formal institutional design rather than on informal practice, which is by definition harder to figure out. Even when the empirical knowledge is there, it may be difficult for staff of international organizations to sell to their supervisors back home any policies that seem to contradict Western "best practice" (despite recent warnings of the flawed nature of "best practice" noted above). Most econo-

mists are much more familiar with how Western institutions function and thus will naturally tend to be more comfortable with proposals consistent with such practice. Finally, when push comes to shove, multilateral actors have been ready to sacrifice institutional authority to short-term policy considerations. Thus in the 1990s, the International Monetary Fund (IMF) actively encouraged many governments to cut budgets unilaterally midyear bypassing the normal budgetary process—thus weakening already weak budgetary systems. The longer-term impact of such actions on the institutional authority of the budget has rarely been considered.

Such obstacles have hindered efforts to fully confront problems of institutional authority and the full implications of institutional weakness for reform. When multilateral agencies talk about "building institutions," what they most often mean is "designing" them. The primary task of reform very often continues to be understood in transitional terms as the replacement of institutional incentive structures rather than as a more fundamental problem of institutionalization. Studies of taxation, privatization, fiscal policy, and other areas by multilateral agencies have tended to focus on deficiencies of legal regimes—including inconsistent, or absent, laws or problematic incentive structures created by existing laws. The implication is that if such inconsistencies and problematic incentive structures in the formal laws were corrected, institutional performance would improve significantly. In addition, there is very little discussion of the ways in which problems of institutional weakness affect the "good" as well as the "bad" legislation and what this implies for reform.

The point is not that formal institutional design does not matter (as some have implied) but rather that the impact of formal rules can only be understood once we take into account the full implications of weak institutions and informal practice. The assumption that similar institutional rules create similar sets of incentives and behavior in different national contexts is particularly problematic in contexts where formal rules are often ignored. The outcome of formal institutional reform is very often the product of an interaction or "recombinance" of new formal institutions and preexisting informal practices as Grzymala-Busse and Jones Luong emphasize in their article in this issue. Institutional forms that in a Western context would seem inefficient may serve important governance functions in a weak institutional context. Much more attention needs to be paid to the mechanisms and factors that shape this interaction.

This article examines the problem of institutional capacity in the context of budget implementation and fiscal policy in post-Soviet Ukraine, the second largest country in the former Soviet Union. Fiscal and budgetary institutions are core building blocks of the state.[10] Budgets represent the most public, comprehensive, and explicit statement of the state's commitments and obligations to society. The budget touches on virtually everything that the state does. The state's capacity and willingness to implement formal budgetary law provides a good indication of the

importance of impersonal institutions as well as the degree of accountability and the importance of key participatory institutions such as parliament, which passes the budget each year.

I examine how weak central government institutions affect budget policy and how reform efforts may interact with this system to further weaken such institutions. First, I investigate how weak institutions affect fiscal policy in ways not appreciated by proponents of decentralization. Studies typically concentrate on how weak institutions distort institutional objectives that reformers and policy makers *want*. Yet institutional weakness may also undermine formal rules that would seem to generate *negative* incentives. Specifically, I find that formal institutions that appear to overcentralize fiscal resources, and to generate negative revenue and expenditure incentives, are subject to the same problems of institutional weakness as those that preserve property rights or other reform objectives. Recognizing the potential for informal practices to undercut "antireform" institutions is critical for understanding the actual challenges facing reform.

Second, I examine the interaction between institutional reform and weak formal institutions. I show how reform affects the prevalence of informal practices. I argue that decentralizing institutional reform in the 1990s inadvertently weakened already weak formal budgetary institutions in the post-Soviet Ukrainian context. By reducing the extent to which control over specific revenues is shared simultaneously by center and region, decentralization measures increased the discretion of central and subnational authorities to unilaterally ignore formal budgetary policies that are not benefiting them and to distribute resources on the basis of informal criteria. By contrast, Soviet-era institutional design, by fragmenting control over key revenue sources, generated built-in checks and balances between central and subnational governments that strengthened budgetary rules. Section II explores how formal institutional weakness affects our understanding of the challenges of decentralization. Section III then examines the impact of decentralizing reform in this weak institutional environment.

II. WEAK INSTITUTIONS IN THE CONTEXT OF INTERGOVERNMENTAL FISCAL RELATIONS

While formal institutional design may be highly flawed, the very weakness of formal institutions can undermine negative incentives implicit in the design. In the Ukrainian case, attempts to overcentralize and generate negative incentives have been battered on the shores of institutional weakness as well as fiscal decline. First, I find that key central fiscal agencies, formally controlled by the center alone, can in fact be better described as dually subordinate to both central and subnational authorities. Second, I argue that weak formal institutions as well as extreme fiscal decline have undermined soft budget constraints and formal disincentives for revenue collection.

Table 1
Formal versus De Facto Subordination of Fiscal Agencies

	Formal Subordination	De Facto Subordination
Regional offices of State Tax Administration	Central government	Dual central and subnational subordination
Regional offices of Treasury	Central government	Dual central and subnational subordination
Commercial banks	Central government regulation	Dual central and subnational regulation
Regional offices of Ministry of Finance	Dual central and subnational subordination	Unilateral subnational subordination

Centralization and Weak Formal Institutions

The de facto degree of fiscal decentralization in Ukraine is greater than formal rules would suggest. At the end of the 1990s, the organization of the post-Soviet Ukrainian fiscal system had changed remarkably little since the Soviet era when both expenditures and revenues were strictly controlled by the center. In the face of modest decentralization in the 1990s, control over revenue raising and tax rates has remained highly centralized according to existing regulations and laws. Formally, local taxes and fees accounted for just 3 percent of total subnational revenues in Ukraine in 1998—compared to 46 percent in Russia.[11]

However, strict central control has been undermined by local-level informal networks, which have significantly distorted budget implementation. Formally central institutions responsible for the collection and distribution of tax monies—commercial banks, the State Tax Administration, and the Treasury[12]—are in fact subject to dual central and subnational influence (see Table 1).

Several institutional legacies of the Soviet era have directly strengthened local-level informal networks. First, in the general absence of a housing market and low population mobility that have characterized the post-Soviet transition,[13] the leadership and staff of both the Treasury and the State Tax Administration have come predominantly from the local population.[14] According to Tax Administration officials, about 80 percent of regional and local leaders are natives of the territory they control. The impact of using local personnel to fill central agencies is further enhanced by the fact that, as Kathryn Stoner Weiss[15] has shown in the case of Russia, governors often have influence over key resources essential to the livelihood of subnational officials, such as access to telephones and housing.[16] Sometimes, local officials even go so far as to contribute directly to the salary of state officials. Local governments have provided additional financing to Treasury offices.[17] Central officials have also relied on local assistance in collecting taxes and auditing firms.

Table 2
Subnational (Local and Regional) Share of Consolidated Government Revenues (Excluding Intergovernmental Transfers), 1994-99 (in percentages)

	Budgeted by Central Government	Actual	Difference between Actual and Budgeted
1994	29	36	+6.5
1995	38	42	+3.8
1996	32	36	+4
1997	32	34	+2.4
1998	31	35	+4.2
1999	31	40	+8.7

Source: Ministry of Finance.

Table 3
Actual Compared to Budgeted (by Center) Revenues, 1998 and 1999

	1998		1999	
	Subnational	Central	Subnational	Central
Tax revenue	146.2	87.8	117.2	88.6
Nontax revenue	92.5	63.2	119.5	55.5
Targeted funds	126.2	69.4	177.1	115
Total (excluding transfer)	141.1	75	122.0	83.9

Source: Ministry of Finance.

Banks are even more susceptible to local influence despite the fact that only the central government formally dictates bank regulation. Formally, the National Bank of Ukraine in Kyiv chooses subnational representatives of the National Bank, which regulates commercial banks. However, observers have argued that the choice of subnational representative is strongly influenced by local actors including the governor as well as commercial banks in the region.[18] In addition, there are many opportunities—through local regulations and extrabudgetary funds—for local governments to pressure local banks.

Local-level informal networks can shape which taxes are collected and which are not.[19] The State Tax Administration may suggest that an enterprise use its limited funds to pay one tax (going to the subnational government) rather than another (assigned to the central level). The impact of such informal decision making is immediately apparent when we compare budgeted and actual revenues of those revenues going to the central government and those going to subnational governments (Table 2). In the mid and late 1990s, the subnational share of revenues collected was consistently greater than that budgeted by the central government. This suggests that tax officials devoted greater effort to collecting taxes and fees that went to subnational governments than those that went to the central government. In 1998 and 1999 (Table 2), we see that tax revenue, nontax revenue, and

targeted funds going to subnational governments were all collected at a higher rate relative to the budget than those going to the central government.[20]

Differential efforts by the State Tax Administration is further suggested by differences in collection of local versus central taxes as well as differences in arrears accumulated for central compared to local taxes in the 1990s. In each of these cases, local governments did better than the center.[21] In effect, this means that while the central government in principle set uniform tax rates, the actual rates were often strongly influenced by local-level interests. A similar, although much less pronounced, pattern of localism was evident in the actual delivery of tax revenues by the commercial banks (until 1997) and the Treasury (after 1997) to the central government. The actual shares delivered were almost always slightly higher in favor of subnational governments.

At the same time, informal local networks were by no means completely undermined central control over revenue policy. Rather, commercial banks, the Treasury, and the State Tax Administration were dually subordinate to subnational and central governments. While these agencies typically put more effort into local collections, they still served the center by sending up tax revenues. In addition, commercial banks, while subject to strong local influences, also could afford to completely alienate central authorities. This is because many banks depended on the right to hold government accounts for their business.[22] The de facto dual subordination of these central fiscal agencies can be contrasted sharply with subnational offices of the Ministry of Finance, which although formally subject to dual subordination, were generally controlled by the subnational administration.[23]

Informal practices, such as local-level networks, need to be incorporated into our understanding of state authority. While comparative analyses have often relied on formal institutional processes, such informal practices complicate how we understand countries such as Ukraine in comparative perspective. For example, "unitary" Ukraine exhibited much of the same informal revenue decentralization as "federal" Russia. While there were other reasons to consider Russia more decentralized, the differences between the two countries were not as stark in the 1990s as a comparison of the formal laws would suggest.[24]

SOFT BUDGET CONSTRAINTS AND REVENUE DISINCENTIVES

In the 1990s, Ukrainian fiscal institutions included a number of rules that would seem to have generated negative incentive structures, including soft budget constraints and disincentives for revenue collection. Yet, such rules were often implemented inconsistently or not executed at all, and as a result these negative incentive structures were weakly manifested or fail to materialize. First, central fiscal institutions retained from the Soviet era would seem to have generated soft budget constraints. Organizations are said to have soft budget constraints when

they expect to be bailed out of financial trouble.[25] Soft budget constraints were core components of the socialist economic system and have been seen as important problems facing local governments in transitional and other countries.[26] Preventing moral hazard associated with implicit bailout guarantees by the central government is considered to be especially difficult.[27] This would seem to have been a particular problem in the Ukrainian context in the 1990s, where according to the formal rules of transfer delivery, higher costs should have translated into higher transfers.[28] Because they can often expect to be bailed out, local governments should have had little incentive to use resources efficiently.

The problem with such analyses is that they fail to take into account the extent to which soft budget constraints demand a certain level of institutional efficacy that is largely absent in the post-Soviet context. The mere promise of subsidies, of course, does not by itself generate bailout expectations that are core to the notion of soft budget constraints. Rather, such expectations are only likely to be created when the central government bails out local governments in a relatively complete, consistent, and predictable manner—a task that demands both administrative and fiscal capacity. In the post-Soviet context, the frequent failure of the central state to honor formal commitments combined with profound fiscal decline has fundamentally undermined this negative incentive structure. Officially budgeted subsidies to subnational governments in the 1990s were often delivered late and sometimes never received. Intergovernmental subsidies to local governments were stunningly unsuccessful at cushioning the hard budget constraint caused by the fiscal collapse of the 1990s in Ukraine. Real local expenditures in Ukraine declined by close to 50 percent in just over five years due to a severe decline in the economy.[29]

The effect of the de facto hard budget constraint is evident from service reduction in a number of key areas. For example, the numbers of preschools in Ukraine (as well as Russia) declined dramatically in the 1990s. Hospitals have had to refrain from the purchase of essential medicines. Secondary schools in many rural areas have had to reduce their hours and fire "nonessential" janitorial staff. Efforts to generate soft budget constraints, embodied in the formal rules governing local government subsidies, have failed to counter the impact of both economic decline and weak budget implementation. It is often the case that local governments (by, for example, spending too much on salaries) do not use resources in an efficient manner according to some criteria. However, outside of energy consumption, there is little evidence that such "inefficient practices" are the result of a soft budget constraint as opposed to other factors such as local-level social pressure.[30]

In addition, formal budget mechanisms were unsuccessful at eliminating the incentives of local governments to increase revenue collection. Budget rules dictated that higher collections one year should result in lower subsidies the following year—a process typically referred to as "claw back." While there was clear evidence of claw back in many instances in the 1990s, local official do not appear

to have made a corresponding effort to reduce tax collection efforts. Instead, as evidenced above, local and regional governments consistently *over*fulfilled the revenue plan set by the central government. This is the opposite of what we would expect if there were "no incentive to increase tax base."[31] Thus, even without the multiyear contracts that exist in China,[32] local officials still had a strong incentive to collect revenues.

Once again, the weakness of formal budgetary institutions undermined the negative revenue incentives present in formal institutional design. The exact impact of increasing revenue collection on future center-subnational subsidies was often uncertain for a particular region and open to negotiation.[33] In addition, the impact of the negative budgetary incentives was most likely to occur in the following fiscal year—an extremely long time relative to more immediate local demands for funds. Faced with immediate social pressures to pay wages, it makes sense that most local governments seemed willing to risk that revenues collected would perhaps be offset by the central government later. Further, as Jones Luong has cogently argued in the case of Kazakhstan, the uncertainty of the negotiation process over budgetary implementation often increases the importance of economic growth in increasing the bargaining power of regions. Economic growth is important to regions both because it adds to their wealth and because it increases their bargaining power with the center.[34]

In sum, standard critiques of the problems facing intergovernmental relations in Ukraine (and other post-Soviet countries) have failed to fully account for the fact that formal rules are often not implemented. First, informal local networks have served to undermine central fiscal control. Second, unpredictable budget implementation combined with severe economic crisis has largely emasculated the budget rules that would seem to generate negative revenue incentives. Rules that are intended to generate soft budget constraints and to discourage revenue collection demand institutional capacity to have an impact just like rules intended to promote efficiency—a fact that has been almost totally forgotten by most analysts.

III. THE IMPACT OF INSTITUTIONAL REFORM IN THE CONTEXT OF WEAK FORMAL INSTITUTIONS: THE CASE OF POST-SOVIET DECENTRALIZATION

What impact does formal institutional change have in a context where informal practices so often diverge from formal policies? The impact of such reform is necessarily ambiguous. Informal practices are often deemed to function relatively independently of formal rules. To the extent that informal and formal systems "run parallel to each other, with no regular crossovers from one to the other,"[35] formal institutional reform should be irrelevant.

Nevertheless, institutional design, by itself, can have an important impact on the size of the gap between codified rules and actual government behavior. To

understand the impact of reform, one needs to take apart the particular mechanisms of interaction between reform and existing informal practices. I show how decentralizing reform in the 1990s that failed to take such mechanisms into account had the unintended consequence of weakening already weak formal institutions. Standard approaches to decentralization, which have emphasized the need to create separate tax bases for central and subnational governments, inadvertently weakened already weak formal budgetary rules in Ukraine by increasing the possibilities for unilateral discretion over budgetary implementation. In this sense, institutional reform that intended only to change incentive structures affected the authority of the institution itself.

Proponents of decentralization have argued for a separation of responsibilities and control over tax bases and expenditures between center and region to increase local autonomy.[36] Increased autonomy over revenues and expenditures, brought about by a separation of control over different tax bases, is predicted to promote both the efficiency and accountability of local governance. Greater reliance on own revenues[37] makes local governments more accountable to the local population in a way that potentially increases efficiency of service delivery, allows greater flexibility in varying service levels to accommodate local preferences,[38] and strengthens the link between services and cost.[39] Local officials, if accountable to local taxpayers, will exercise greater caution in applying a tax and in how they use the revenue.[40] By contrast, dependency on revenues controlled by higher-level governments undermines accountability by giving officials at lower levels of government a convenient scapegoat for shortcomings in their own provision of public services.

Unfortunately, there are several important obstacles to the separation of revenue bases between center and region. First, as in virtually all countries, forcing regions to rely on their own resources may create inequality across regions with different resource capacities. In addition, especially in the underdeveloped economies of the former Soviet Union, there is simply not a wide variety of revenue sources—such as a real estate market—that would allow central and local governments to rely on separate tax bases. In the post-Soviet context, neither the property tax nor the personal income tax (PIT) yields sufficient income to form the primary base of local revenues as in many Western countries.[41] At the same time, the most powerful sources of revenue (the value added tax [VAT][42] and the enterprise profit tax [EPT][43]) are those that public economists argued should be retained by the center.

To deal with these obstacles, public economists working in the former Soviet Union argued that the central government should distribute subsidies or transfers to local governments to cover costs not met by local own revenues. Such centrally distributed explicit transfers were supposed to cover the difference between what can be collected through local taxes such as the PIT and what was needed to cover local expenditures. By contrast, under the old Soviet system of “tax sharing”

retained in Ukraine through the early and mid 1990s, redistribution occurred by sharing a variety of taxes whose rates and bases were formally determined by the central government. Redistribution occurred by giving poorer regions a larger share of central taxes and richer regions a smaller share. Shared revenues were collected locally and "shared up" according to rates set annually in the budget.

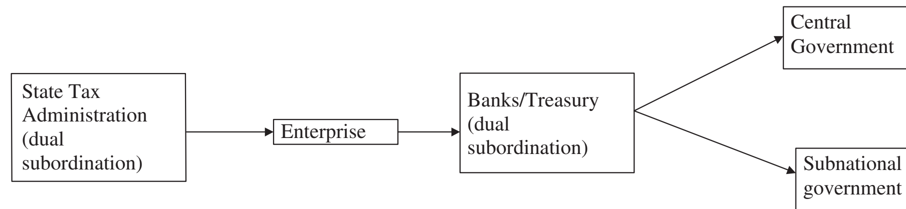
This shift from an older system based on shared taxes to a newer system based on local taxes plus centrally controlled explicit transfers had a direct and negative impact on the degree to which budgets were implemented as written. In principle, the new system should have had no impact on budget implementation. In most Western countries, where formal institutions are strong, the redistribution of funds by officials in the capital would seem relatively unproblematic. Here, third parties such as courts or autonomous bureaucracies diminish the diversion of budgetary funds at the implementation stage. However, in a context such as Ukraine's where formal institutions are weak, it is critical that checks on diversion be directly built into the implementation process. Such checks lay at the heart of the Soviet system of tax sharing.[44] While taxes used for tax sharing were formally in central government hands, informal networks between finance officials and local leaders described above generated a high degree of de facto local influence over nominally central revenues in the 1990s. By contrast the new system, by which the center distributes transfers directly, put much greater discretion in the hands of officials in the capital who are not subject to dual central and local influence. This discretion created opportunities for the central government to unilaterally ignore formal budgetary policies that do not benefit them.

Figure 1 helps explicate how the different systems affect implementation. In the old system of tax sharing (Figure 1A), each stage of the implementation process—(1) tax collection and (2) revenue distribution—was under de facto dual (local and central) control. However, the newer system relying on explicit central transfers for redistribution (Figure 1B) created an additional point of unilateral discretion over revenue distribution by the central government in the capital that is not subject to such dual authority. At point (3) (Figure 1B), the central government has unilateral discretion in deciding whether to retain funds or distribute them to regions. This gives the central government an opportunity to alter the rules midyear through a practice known as "cash rationing" in which payments are unilaterally withheld or delayed to ensure that enough cash is on hand for expenditures that may be politically crucial.[45] As a result of cash rationing, transfers were delivered late and sometimes are never delivered at all. The existence of point (3) in turn affects decision making when taxes are collected (point [1]). If regions know that a certain tax will go entirely to the central government, they will have extra motivation to use their local networks at point (1) to discourage collection of the central in favor of the local tax. In this way, formal institutional reform interacted with the weak formal institutions and robust informal networks to undermine both tax collection and the implementation of the formal budget.

A. Dual control over transfer implementation under Soviet system

(1) Tax collection:
Collect central or local taxes?
dual implementation control

(2) Revenue distribution:
Distribute monies collected in region
to center or locality?
dual implementation control

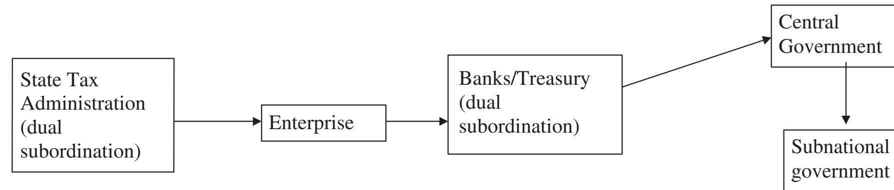


B. New system of explicit central transfers advocated by proponents of decentralization

(1) Tax collection:
Collect central or local taxes?
dual implementation control

(2) Revenue distribution:
Distribute monies collected in region
to center or locality?
dual implementation control

(3) Revenue distribution:
Distribute subsidies to locality
or retain for center?
unilateral implementation control



Unilateral discretion at (3)
(a) makes it easier for center to ignore interests of subnational government even when funds budgeted, which in turn,
(b) motivates subnational governments to increase informal pressure at (1) to manipulate tax collection in their favor.

Figure 1. Old and new transfer systems.

Data on budget implementation of tax sharing and explicit transfers from 1995 to 1999 demonstrates that tax sharing provided a much more predictable source of income relative to the amount centrally budgeted at the beginning of the year than do explicit transfers.[46] On average between 1995 and 1999, actual tax revenues from tax sharing were 2.44 times closer to the amount budgeted at the beginning of the year than were explicit transfers.[47] For example, *actually delivered* explicit transfers relative to *budgeted* explicit transfers to Crimea ranged from 5 percent in 1995 to 463 percent in 1997, while implementation of tax shares and revenues remained relative close to 100 percent in the same period of time.[48]

The negative effects of decentralizing reform are evident in the late 1990s in Ukraine. In 1997, the Ukrainian government attempted to reform the system of tax sharing in line with the recommendations outlined above. In 1997, the VAT, which earlier had been an important component of the tax sharing system, was sent entirely to the central government, while other taxes were given to the local governments. Because of the fact that VAT was given to the central government, poorer rural regions depended to an increasing degree on explicit central transfers. The region's share of the budget that came from explicit transfers almost doubled in 1997.

This reform directly increased the problems created by such ad hoc transfer delivery. Before the reforms, poorer regions had to rely on the whim of central officials for 15 to 25 percent of their income. Suddenly in 1997, they had to rely on the whim of such officials for *half* of their income. After implementation of the reform, poorer regions had a more difficult time fulfilling locally set budgets (see Way "Informal Policymaking and Reform in Weak States"). The reduced capacity of poorer regions to fulfill their budgets means that they are less accountable to the popularly elected legislatures that approved the budgets.

Reform of the budgetary system intended to increase accountability and stability in the budgetary system had the opposite effect in the context of weak formal institutions. When implementation of transfers was placed entirely in the hands of one level of government, budget implementation suffered. Because of reform, poorer regions were forced to rely on a much less stable source of income, which in turn made it more difficult for them to fulfill their formal obligations.

Reform simultaneously undermined central tax collection. The presence of local networks between tax officials and the local leaders means that taxes going directly to subnational governments have been collected at a greater rate than those going to the central government. As a result, the central government suffered directly as a result of the elimination of tax sharing in the middle of 1997. Ministry of Finance officials had a harder time obtaining VAT than before the reform. As we see below, collection of VAT, which went entirely to the central government after mid-1997, had greater problems in collection relative to the EPT, the PIT, the Stamp Tax, and the Land Tax, which went entirely to the subnational governments after mid-1997 (see Figure 2). In response, the central

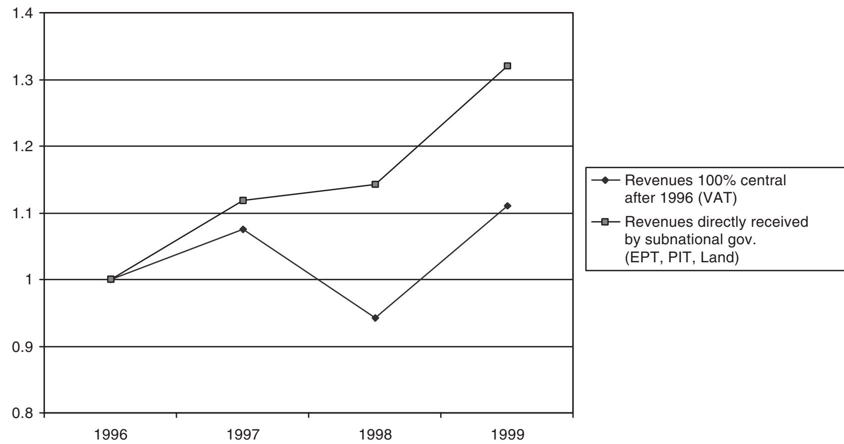


Figure 2. Tax collection and the elimination of tax sharing.
Source: State Tax Administration.
Note: Nominal tax collection as percentage of 1996 level. VAT = value added tax; EPT = enterprise profit tax; PIT = personal income tax.

government introduced various forms of quasi–tax sharing of the VAT in 1999 to tie the distribution of transfers to the collection of central taxes to stimulate the tax collection efforts of these central revenues.[49] Notably, Western advisers responded to these problems by helping the government to introduce this new form of tax sharing. Partly as a result, collection of VAT rose in 1999.

This section has sought to demonstrate how decentralizing reform can interact or "recombine" with weak state institutions and strong informal networks to undermine existing formal institutional capacity. Decentralization measures that focused on creating separate bases of revenue for central and local governments undermined the formal budget by enlarging discretionary power to ignore budgetary rules and by reducing tax collection of certain central revenues.

CONCLUSION

This article has investigated the particular dynamics of 1990s fiscal decentralization reform in a context of weak formal institutions. I have sought to show how weak formal institutions in the post-Soviet context demand a rethinking of the challenges of reform. Fiscal reform, which has most often been conceived in "transition" terms as creating better incentives for efficiency must first be seen in relation to problems of maintaining institutional authority highlighted by Samuel Huntington over thirty years ago. Failure to fully incorporate problems of institution building is problematic for two reasons. First, such failure can lead to a focus on problems that exist only on paper while ignoring real problems that exist in practice. Thus, in contrast to many assessments of post-Soviet Ukrainian fiscal

policy, I found much greater de facto decentralized influence over revenue policy than formal institutions would suggest. In addition, many of the negative incentives that analysts have emphasized as problematic in fact demand a level of formal institutional capacity that is often uncertain in post-Soviet Ukraine. Claims that the soft budget constraint represents an important problem in the post-Soviet context are undermined by well-documented administrative and fiscal weakness. Second, an inattention to issues of formal institutional capacity can lead to reform that inadvertently weakens already weak formal institutions. Because of particular interactions between formal institutions and informal processes, reform intended to increase predictability and accountability of the fiscal system initially had the opposite effect.

The analysis of decentralization reform suggests a possible source of institutional efficacy in otherwise weak states. Institutions that concentrate unilateral discretion in the hands of agencies whose interests do not directly coincide with formal policies are likely to be undermined at the implementation stage. In this context, direct control over implementation needs to be fragmented among agencies with a direct interest in formal policy outcomes. This article provides an example of the ways in which efforts to concentrate too much authority in narrow groups or agencies in the context of weak states may threaten not just democracy but the efficacy of formal institutions. Groups interested in rapid reform in postcommunist countries have often encouraged governments to implement reforms as quickly as possible with or without participation by the parliament or other groups. With regard to the budget, the IMF in Russia and Ukraine has encouraged governments to unilaterally alter the budget midyear to meet fiscal deficit targets. Such efforts threaten not only to undermine democracy but also to weaken institutions more generally by giving too much discretion to too few actors.[50] As in the case of reform of tax sharing described above, such efforts to concentrate authority in relatively few hands have had profound deinstitutionalizing effects on the state.

NOTES

1. See World Bank, *World Development Report 1997: The State in a Changing World* (Washington, DC: World Bank/Oxford University Press, 1997).

2. See Matthew Soberg Shugart and John M. Carey, *Presidents and Assemblies: Constitutional Design and Electoral Dynamics* (Cambridge: Cambridge University Press, 1992).

3. Samuel P. Huntington, "Political Development and Political Decay," *World Politics* 17, no. 3 (April 1965): 394.

4. See World Bank, *The State*, chap. 5.

5. See, for example, Joel Hellman, Geraint Jones, and Daniel Kaufmann, "Seize the State, Seize the Day: State Capture, Corruption, and Influence in Transition," working paper no. 2444, World Bank Policy Research, Washington, DC, September 2000.

6. World Bank, *The State;* and World Bank, *World Development Report 2002: Building Institutions for Markets* (Washington, DC: World Bank/Oxford University Press), 4.

7. Anna Grzymala-Busse and Pauline Jones Luong, "Reconceptualizing the State: Lessons from Post-Communism," *Politics & Society* 30 (2002): 527-54.

8. Thus, Caiden and Wildavsky argue that erratic and unpredictable budgetary implementation in developing countries is a politically expedient way of coping with perennial revenue shortfalls endemic in poor countries. See Naomi Caiden and Aaron Wildavsky, *Planning and Budgeting in Poor Countries* (New York: Wiley, 1974).

9. Along these lines, investigations into the roots of growth in the postcommunist countries have often emphasized structural over other factors. For example, Falcetti et al., who argue that the importance of initial conditions is weakening, concede that "over the first decade, on average, differences in starting points have been far more important than reform commitment" (p. 2). See Elisabetta Falcetti, Martin Raiser, and Peter Sanfey, "Defying the Odds: Initial Conditions, Reforms and Growth in the First Decade of Transition," working paper no. 5, European Bank for Reconstruction and Development, London, 2001.

10. Joseph Schumpeter, "The Crisis of the Tax State," *International Economic Papers* (1954); and Margaret Levi, *Of Rule and Revenue* (Berkeley: University of California Press, 1988).

11. Era-Dabla Norris, Jorge Martinez-Vasquez, and John Norregaard, "Making Decentralization Work: The Case of Russia, Ukraine, and Kazakhstan." Conference on Fiscal Decentralization sponsored by the IMF Fiscal Affairs Department (FAD) IMF Headquarters, Washington, D.C., November 20-21, 2000. Available from *http://www.imf.org/external/pubs/ft/seminar/2000/fiscal/norris.pdf*.

12. The State Tax Administration is responsible for assessing and enforcing tax payment from enterprises and taxpayers. Since 1997, the Treasury has responsible for the physical transfer of funds to the central government as well as the division of funds between central and subnational governments via tax sharing. Prior to 1997, this was undertaken by commercial banks, which automatically transferred funds according to tax sharing rates when taxes were paid.

13. Stephen Collier, "Post-Socialist Cities: The Government of Society in Neo-Liberal Times" (Ph.D. diss., Department of Anthropology, University of California, Berkeley, 2002).

14. Treasury interview, Kyiv, April 2000; State Tax Administration interview, Kyiv, April 2000.

15. Kathryn Stoner-Weiss, "W(h)ither the Central State? The Regional Sources of Russia's Stalled Reforms" (unpublished manuscript, 2001).

16. Lucan Way, "Bureaucracy by Default: State Capacity and Budgetary Politics in Post-Soviet Ukraine" (Ph.D. diss., Department of Political Science, University of California, Berkeley, 2001).

17. Interview former Treasury official, Kyiv, March 2001.

18. Sean O'Connell, consultant on Ukrainian banking issues, interview, March 2002.

19. Representative of State Tax Administration, Donetsk oblast, interview, June 1996.

20. It is unlikely that factors other than differential effort can account for the patterns shown above. First, after 1994, both sets of taxes have generally touched on the same tax bases. Second, the central government, which determines the revenue plans, would seem to have every reason to exaggerate subnational revenue forecasts insofar as such forecasts shape the level of transfers sent to lower-level governments. Thus, if anything, we would expect subnational revenue collection to be *lower* rather than *higher* relative to the central government's budgeted forecast.

21. Lucan Way, "Informal Policymaking and Reform in Weak States: The Case of Post-Soviet Intergovernmental Fiscal Policy" (paper presented at the conference on State-

Building in Post-Communist States: Toward Comparative Analysis, Yale University, New Haven, CT, 27-28 April 2001).

22. Thus, one Donetsk bank, Donugolkombank, went bankrupt when deprived of the right to distribute government pension funds (O'Connell interview).

23. Way, "Informal Policymaking."

24. In Russia as in Ukraine, tax arrears are much higher for those revenues going to the central level than for those going to the subnational level. See Daniel Treisman, "Russia's Tax Crisis: Explaining Falling Revenues in a Transitional Economy," *Economics and Politics*, 11, no. 2 (July 1999): 145-69.

25. Janos Kornai, "The Soft Budget Constraint," *KYKLOS* 39, no. 1 (1986): 3-30.

26. Giuseppe Pisauro, "Intergovernmental Relations and Fiscal Discipline: Between Commons and Soft Budget Constraints," working paper WP/01/65, International Monetary Fund (IMF), Washington, DC, 2001; Jonathan Rodden, Gunnar S. Eskeland, and Jennie Litvack, *Decentralization and Fiscal Discipline* (Washington, DC: World Bank, 2000).

27. Pisauro, "Intergovernmental Relations and Fiscal Discipline," 10.

28. In the 1990s, the formal system of determining center-subnational transfers in Ukraine as well as other post-Soviet countries relied on a "gap-filling" method in which transfers were formally determined by the gap between expected costs (calculated on the basis of previous year's expenditures) and expected revenues (calculated on the basis of previous year's revenue collection). The situation is different today.

29. Nina Bubnova and Lucan Way, *Trends in Financing Regional Expenditures in Transition Economies: The Case of Ukraine* (Washington, DC: World Bank, 1998).

30. For an extension of this argument to Kazakhstan and Russia, see Pauline Jones Luong and Lucan Way, "Getting a Second Opinion: Is Market Preserving Federalism the Right Diagnosis for what Ails the Post-Soviet Economy?" manuscript, 2001. It is true that the prevalence of energy arrears and the difficulties of shutting off energy to nonpayers have created a situation in which budgetary organizations have less incentive to use energy resources in an efficient manner. Yet energy represents only a limited portion of the costs facing local governments in Ukraine—ranging from 10 to 30 percent of subnational expenditures.

31. Ekaterina V. Zhuravskaya, "Incentives to Provide Local Public Goods: Fiscal Federalism Russian Style," *Journal of Public Economics* 76 (2000): 337-68.

32. See Susan Whiting, *Power and Wealth in Rural China* (Cambridge: Cambridge University Press, 2001), chap. 3.

33. See Jones Luong and Way, "Getting a Second Opinion: Is Market Preserving Federalism the Right Diagnosis for what Ails the Post-Soviet Economy?" manuscript, 2001.

34. Pauline Jones Luong, "Economic Decentralization in Kazakhstan: Causes and Consequences," In *Reconceptualizing Central Asia: States and Societies in Formation*, edited by Pauline Jones Luong (forthcoming).

35. Katharina Pistor, "Demand for Law, " *East European Constitutional Review* (Fall 1999), 8: 4. Available from *http://www.law.nyu.edu/eecr/vol8num4/feature/supply.html*.

36. Andrei Shleifer and Daniel Treisman, *Without a Map: Political Tactics and Economic Reform in Russia* (Cambridge, MA: MIT Press, 2000), 156-57.

37. By which I mean revenues over which local governments control the base, rate, and collection of taxes.

38. It thereby increases opportunity to strengthen efficiency by adapting local supply levels to local demand.

39. E. Emiliani, S. Lugaresi, and E. Ruggiero, "Italy," in *Fiscal Federalism in Theory and Practice*, edited by T. Ter-Minassian (Washington, DC: IMF, 1997).

40. Richard M. Bird and Francois Vaillancourt, *Fiscal Decentralization in Developing Countries: An Overview and Perspective* (Toronto, Canada: International Centre for Tax Studies, Faculty of Management, University of Toronto, 1997).

41. In many Anglican countries, local governments rely on property taxes for the substantial portion of their income. In Scandinavian countries, the income tax is used.

42. Bahl and Wallich have argued that the value added tax (VAT) is not a good tax to be shared since they claim it benefits industrial provinces and port cities while handicapping regions that sell to foreign markets. See Roy Bahl and Christine Wallich, "Intergovernmental Fiscal Relations in the Russian Federation," in Bird, Ebel, and Wallich, *Decentralization of the Socialist State*. In addition, J. Martinez, C. McLure, and S. Wallace, "Subnational Fiscal Decentralization in Ukraine," in *Decentralization of the Socialist State: Intergovernmental Finance in Transition Economies*, edited by R. M. Bird, R. D. Ebel, and C. I. Wallich (Washington, DC: The World Bank, 1995), 321-378, suggest that trade between regions complicates the use of the VAT for tax sharing on a derivation. This creates problems with credits on interjurisdictional sales. The argument is that a firm that purchased supplies from another oblast would find that the oblast in which it filed VAT would be reluctant to give refunds for tax collected in another oblast.

43. The enterprise profit tax (EPT) has also been considered an inappropriate local tax because it is said to lead to tax competition (Martinez et al. 1995, 305). In addition, EPT is an improper local tax because it is particularly susceptible to regional economic swings, with which the national level is better able to cope. Wallich et al. among others also argues against a tax sharing of the EPT because it can lead to tax exporting. See Cristine Wallich, ed., *Russia and the Challenge of Fiscal Federalism* (Washington, DC: World Bank, 1994, 133-34). Residents of regions that buy goods produced in one region must pay the taxes on those goods that benefit only the producing region.

44. Initially in the 1920s and early 1930s, all tax revenues of Soviet local governments were sent directly to the center and only later returned to the subnational government in the form of transfers. Yet according to Davies, the central government felt that revenue collection was low because local governments did not benefit directly from higher revenue collection in their territories. As a result, a system of tax sharing was introduced whereby local governments directly benefited from the higher collection of key central taxes by receiving a portion of those taxes collected in the territory. See Robert Davies, *The Development of the Soviet Budgetary System* (Cambridge: Cambridge University Press, 1958). Local officials like the system because they do not have to rely directly on central officials to distribute funds.

45. For a description of this practice in developing countries, see Naomi Caiden and Aaron Wildavsky, *Planning and Budgeting in Poor Countries* (New York: Wiley, 1974). The same applies for wealthy donor regions that are expected to send explicit transfers to the central government.

46. Under the older system dominated by tax sharing, explicit transfers were still used for a small amount of redistribution not accomplished through tax sharing. Later, tax sharing was mostly abandoned and replaced by a system relying mostly on explicit central transfers of funds.

47. The budget is determined by the central government, which has a strong reason to exaggerate expected revenues at the local level because doing so reduces the transfers that must be passed down by the central government. I measured budget implementation by comparing the actual amount delivered with the amount budgeted by the central government. Divergence from the budget is equal to the absolute value of the percentage difference between the amount of money budgeted at the beginning of the year and the amount

actually received by the end of the year. The average was calculated for all regions in 1995, 1996, 1997, and 1999 together (in 1998 there was no tax sharing).

48. In addition, budget implementation across different regions in any given year has much less variable (as measured by the coefficient of variation) for tax sharing and revenue collection than it has for explicit transfers. For example, in 1996, explicit transfers were implemented for some regions at –18 percent of budget as opposed to 248 percent of budget for other regions. By contrast, budget implementation of local tax revenues ranged from 88 to 114 percent.

49. Thus in 1999, the delivery of explicit transfers to oblasts was tied directly to the success at collecting total daily tax revenue relative to the plan.

50. The argument made here is similar to that made by David Stark and Laszlo Bruszt regarding the importance of "extended accountability" in *Postsocialist Pathways: Transforming Politics and Property in East Central Europe* (Cambridge: Cambridge University Press, 1998), 188-92.