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DECENTRALIZATION OF BUDGETING PROCESSES: THE CASE OF UKRAINE

Abstract. *The purpose of this research is to enhance the existing experience of budget decentralization with the identification of the practical results of the decentralization reform and its impact on the local territorial communities in Ukraine. The method of research is the case study. The research was conducted in Ukraine. The analysis of secondary sources such as national legislation, reports, draft documentation and international documentation has contributed to the research. The research identifies the results of the first stage of the budget decentralization reform in Ukraine, started in 2015 and reveals its benefits and problematic issues. Through a review of the implementation process and outcomes of the budget decentralization reform in Ukraine, this paper shows that despite many obstacles the first stage of the decentralization reform including budget processes decentralization has been a successful step and has a positive impact on the territorial communities and local self-governments in Ukraine. The paper offers some insights for public authorities and researchers in the frames of decentralization and public management reformation.*

Key words: financial decentralization, fiscal decentralization, decentralization reform, budget, local authorities, self-government, public management, Ukraine.

JEL classification: H70, H72.

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ДЕЦЕНТРАЛІЗАЦІЯ БЮДЖЕТНИХ ПРОЦЕСІВ: ДОСВІД УКРАЇНИ

Анотація. *Розглянуто досвід бюджетної децентралізації в Україні та узагальнено практичні результати реформи децентралізації і її впливу на місцеві територіальні громади протягом 2015–2019 рр. Як метод дослідження застосовано якісний метод кейс-стаді, що ґрунтується на аналізі вторинних джерел, таких як національне законодавство, звіти, проекти документів та міжнародна документація. У дослідженні ідентифіковано підсумки першого етапу реформи бюджетної децентралізації в Україні, розпочатого в 2015 р., та розкрито її здобутки та проблемні питання. З огляду на фактичні результати можна стверджувати, що, незважаючи на багато перешкод, перший етап реформи децентралізації бюджету став успішним кроком і в цілому позитивно вплинув на розвиток територіальних громад та місцеве самоврядування в Україні.*

Ключові слова: фінансова децентралізація, фіскальна децентралізація, реформа децентралізації, бюджет, місцева влада, самоврядування, державне управління, Україна.

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ДЕЦЕНТРАЛИЗАЦИЯ БЮДЖЕТНЫХ ПРОЦЕССОВ: ОПЫТ УКРАИНЫ

Аннотация. Рассмотрен опыт бюджетной децентрализации в Украине и обобщены практические результаты реформы децентрализации в целом и ее влияния на местные территориальные общины в течение 2015–2019 гг. В качестве метода исследования применен качественный метод кейс-стади, основанный на анализе вторичных источников, таких как национальное законодательство, отчеты, проекты документов и международная документация. В исследовании идентифицированы итоги первого этапа реформы бюджетной децентрализации в Украине, начатого в 2015 г., и раскрыто ее достижения и проблемные вопросы. Учитывая фактические результаты, можно утверждать, что, несмотря на многие препятствия, первый этап реформы децентрализации бюджета стал успешным шагом и в целом положительно повлиял на развитие территориальных общин и местное самоуправление в Украине.

Ключевые слова: финансовая децентрализация, фискальная децентрализация, реформа децентрализации, бюджет, местная власть, самоуправление, государственное управление, Украина.

A priority direction for the development of any democratic country today is ensuring the growth of the well-being of each citizen. Achieving this goal is possible only under the conditions of a high-quality state governance, which eliminates inequalities of access to public goods, improves the quality of public services and the standard of living of the nation.

In the context of the introduction of new approaches to the development of regions, the issue of effective implementation of financial decentralization reform is one of the basic conditions in order to gain independent and effective activity of local authorities, increase the financial capacity of regions and communities.

Budget decentralization is a mechanism for the redistribution of functions and powers of a single state power between the relevant state authorities on the one hand, and regional (local) self-government bodies on the other. It is by far the most effective and efficient way of ensuring the financial autonomy and sustainability of local authorities. Moreover, it is considered that financial decentralization makes it possible to balance public service delivery mechanisms with the needs and preferences of local residents.

It is considered, that decentralization reform contributes to the qualitative improvement of the living environment for the residents of the community, creation of real conditions for comprehensive development of territories and human resources, formation of the principles of effective local self-government [1].

The founder of the theory of financial decentralization is the American economist Charles Tiebout. In his writings “The Pure Theory of Local Expenditures” (1956) and “The Economic Theory of Fiscal Decentralization in Public Finance: necessity, sources and use” (1961) he regards municipalities as structures that offer different baskets of goods (municipal services) at different prices (tax rates). Because

municipalities have different needs and different tax options, they will move from one municipality to another in order to maximize the value of the public services they provide, with minimal tax payments [2; 3].

Further development of fiscal decentralization issue was done by the English scientist Wallace Oates. In his work on fiscal decentralization, he argued that if a territorial entity has the capacity to provide the public good and its marginal value is equal to the average cost of its production, then empowering local governments will always be more effective than empowering the central government [4, p. 4–6].

Modern views on the issue of financial decentralization are described in the works of Anwar Shah, Brian Dollery, Jan Werner and other foreign scholars. They mainly explain the potential benefits of decentralization and effectiveness of local self-government, as well as define the main economic functions of the government in the process of decentralization and go into deep research of the specific cases of the budget decentralization in different countries [5–7].

Ukrainian scientists are now also actively involved in the study of decentralization processes. The results of the works of domestic scholars focus on the methodological approaches and the empirics of the implementation of decentralization reform including fiscal and budget issues of decentralization in Ukraine [8–13].

For many years already, the public budget processes and particularly local budgets issues have been the scope of research of professor Inna Lunina [14]. In her works she investigates such specific issues like the effectiveness of the government financing of local authorities in the context of European integration processes and approaches to ensure the development of regional economy, reduce inter-regional imbalances and improve the access of the population to basic social, communal and other services [15].

Igor Lyutyty argues that the evolution of the financial policy is conditioned by the evolution of the forms of state and the democratization processes of the society, the transition from absolutism to a parliamentary republic where the decentralization processes are inevitable [16].

Sergii Gasanov investigates the reasons why structural reforms which are similar by its nature are successfully completed in certain countries, while failed in others [17]. Interesting approaches to the fiscal decentralization are highlighted in works of Olexandr Yastremskyi, who developed a model of fiscal decentralization and combined ideas of general equilibrium and non-cooperative behavior [18].

Considering the obtained valuable research results from foreign and native researchers we *aim* to enhance the existing theoretical framework of the decentralization of budget processes with the identification of the practical results of the decentralization reform and its impact on the local territorial communities particularly in Ukraine.

According to the Ukraine-2020 Sustainable Development Strategy, the goal of decentralization policy is to move away from the centralized model of government in the country, to ensure the capacity of local self-government and to build an effective system of local governance in Ukraine, to implement the provisions of the European Charter of Local Self-Government, the principles of subsidiarity, ubiquity and financial self-sufficiency of local self-government through the creation of a system of ATC [19; 20].

For the last several years Ukraine is focusing its efforts on the implementation of the European integration course, the fulfillment of international legal obligations, including the development of local and regional democracy. That is why the further democratization of society and the simultaneous decentralization of power on the basis of subsidiarity are the priorities of Ukraine [19].

The vector for carrying out decentralization processes in Ukraine was pointed out in the “Concept of reforming local self-government and territorial organization of power” from April 1, 2014. Since one of the main instruments of social and economic policy is the budget, it is the budget policy that should promote sustainable and efficient economic development. Therefore, decentralization of budget processes is the fundamental step in general decentralization [20].

On this basis, the government aims to create a financial system in which the available financial resources are to be used effectively in favor of Ukrainian citizens. Therefore, within the framework of fiscal decentralization, not only power but also obligations of local communities which act in the interests of local residents should increase. Thus, as the integral part the decentralization reform, the process of formation of amalgamated territorial communities (ATC) has been started from 2015.

The goal of local self-government reform is, the first and foremost, to ensure its ability to solve local issues on its own, through its own resources. The main tasks that have been started to be implementing within the framework of financial decentralization reform in Ukraine are the following [21]:

- review and determine the list of delegated and delegated powers;
- expansion of the financial base of local self-government bodies;
- transition to a system of targeted transfers aimed at compensation;
- expenditures of local governments as a result of their delegation functions;
- introduction of the maximum level of transparency of the use of budget funds by local governments.

The main principles of financial decentralization of power in Ukraine are declared as following [21]:

- 1) effective and transparent financial activity of public authorities, local and regional self-government, which eliminates duplication of functions, implementation of ineffective actions, bloating of the bureaucratic apparatus;
- 2) the responsibility of local and regional self-government bodies for the fulfillment of their competence in providing public services should be complete and exclusive;
- 3) maximum transfer of rights, functions and responsibilities for financial activity to local and regional self-government, while maintaining the unity of the country;
- 4) maximum involvement of the population in participation in the decision of local and regional affairs;
- 5) ensuring the standard of living guaranteed by the Constitution of Ukraine in all regions of the country;
- 7) achieving compliance in terms of delegated powers to mobilize and spend the necessary financial resources with covering the needs of citizens;
- 8) the delivery of public services should be transferred to the lowest possible level of government.

Since the reform has started, the basic powers of local state administrations have been transferred to local self-government bodies. Communities have obtained their own budgets, the ability to attract funding and finance.

From the start, the budgets of the ATC are financed with the funds delegated by the state for their implementation and exercise of self-governing power, namely [11]: maintenance of budget institutions of education, culture, health, sports, social protection and social security. Expenditures of unbudgeted communities are limited mainly to the financing of self-governing expenditures.

The most important issue in stimulating of ATC is state financial support, which is ensured by the State Regional Development Fund for projects aimed at supporting voluntary integration of territorial communities created in accordance with the Budget Code of Ukraine, and state budget funding for the formation of appropriate infrastructure in accordance with strategic programs for the development of territories [22].

Moreover, ATC budgets are involved in horizontal alignment [23]. The equalization is carried out under one tax - the PIT. To increase their fiscal capacity, ATC budgets with revenues below 0.9 average in Ukraine are provided with a state subvention. From the ATC budgets that have revenues above 1.1 average in Ukraine, a reverse subvention is transferred. Non-merged communities' budgets do not participate in horizontal tax equalization and are not provided with state funding.

The active phase of budget decentralization and local self-government reform in Ukraine was started with the approval of amendments to the budget and tax legislation at the end of 2014. This laid the groundwork for the introduction of a new model of financial support for local budgets, the essence of which is to empower local governments, to give them full budgetary autonomy to exercise their powers, while increasing the motivation to increase their profitability.

Amendments to the Budget Code of Ukraine are the basis for stimulating communities to unite and increase their capacity through the mechanism of transition of budgets of the united communities to direct intergovernmental budgetary relations. When united, such communities are empowered as cities of regional importance [22].

According to the amended Budget Code, the following budget transfers are envisaged by the ATC budgets: basic, educational medical and other subventions and funding. The budgets of non-merged communities will not receive intergovernmental budget transfers.

In order to exercise their powers, the ATC's Councils have the right to make local domestic borrowings and local external borrowings (including by obtaining loans from international financial institutions). Thus, the newly created ATC's are provided with a variety of approaches to financing, which, first of all, will allow local communities to use their funds more efficiently.

Amendments to the Tax and Budget Codes have expanded the financial capacity of local self-government, allowing to create economically self-sufficient and capable new communities. The communities have received the full range of powers and financial resources that cities of regional significance already have, including crediting 60% of PIT to their own powers, crediting 10% of corporate income tax, excise tax, single tax (100%), property tax, 80% instead of 35% of environmental

tax to local budgets, direct inter-budgetary relations with the state budget, state subventions. Due to these changes the local budget funds have grown to approximately 40% since 2015.

Legislative changes have given local governments the right to approve local budgets regardless of the annual adoption of the Law on the State Budget.

Along with strengthening the budget capacity, there is an expansion of the overall financial capacity of communities, in particular due to the obtaining of additional powers to implement external borrowing, self-selection of institutions to service local budgets and more.

These achievements in the field of financial decentralization in general not only significantly expand the financial capacity of communities, but also create a strong basis for the regions to achieve their development goals, have economic development benefits, expand and clearly define their long-term prospects and most importantly, enable communities to systematically build their development strategy.

Decentralization in the field of budget relations, which consists, in particular, in strengthening the income capacity of amalgamated territorial communities (ATC), to some extent laid the groundwork for the next stages of decentralization, as since the beginning of the reform in 2015 it affected all (not only united) territorial communities. The budget strength of territorial communities is consistently growing; every year there is an increase in the revenue side of local budgets.

The most significant result of budget decentralization is the increase in the share of local taxes and fees in local budget revenues from 2.5% in 2012-2014 to 30% in 2018, mainly due to the transfer of certain taxes and fees to local budgets, and its growing trend in 2019. The share of local budget revenues in the consolidated budget in 2019 was over 50%, for comparison, in 2014 this share was near 40%. The standard of the ratio of state and local budget revenues of most EU countries – 50:50 – can be considered achieved. Over 15% of GDP is redistributed through local budgets in Ukraine [24].

Now budget equalization is based on an estimate of revenues rather than expenditures of local budgets, which encourages local communities to develop the local economy and business sector.

The reform resulted in increased interest of local governments in increasing revenues to local budgets, finding reserves to fill them, improving the efficiency of administration of taxes and fees. United communities show high and dynamic growth in their own revenue. In terms of the use of funds, the emphasis is on the need to formulate the most optimal structure of budget expenditures, to create an effective management bodies, to carry out analysis of spending of budget funds and to prevent cases of their irrational spending [23].

For instance, of the 28 united communities of the Rivne region, 25 are in direct intergovernmental relations. This gives them the right and opportunity to fully experience the benefits of decentralization, including those defined by the Budget Code of Ukraine. Hence, since 2018, all the district heating companies in this region have been exceeding the planned revenues [25].

It is important that since the merger, the size of the ATC budgets has increased significantly, not only through transfers from the state budget, but also from own revenues. For example, the own revenues of a relatively small Mylyats'ka ATC

exceed UAH 9.7 million which is a large amount of money comparatively to the times before the reform. Although, before the reform, these funds would go not always for the benefit of the community and its taxpayers, which, in fact, might have the right to use these funds.

There are claims that the revenue does not cover all needed costs and that the village councils that decide to unite will not be able to service their selves. From the other hand, before the unification process, a careful assessment of the financial capacity of the potential community is made. It includes up to 34 specific indicators. Moreover, the experience of ATC shows that, after unification, the community, when carefully analyzing their expenditures, has the potential to significantly optimize them. State support in the form of subsidies for infrastructure development is very helpful in this process. This is funding that goes into community development projects and back after its completed formation.

When it comes to state support for ATCs, we traditionally mean a subsidy for infrastructure development, although this does not limit the community support. This includes additional subsidies and subsidies for the development of rural medicine, educational and medical subventions, funds from the State Regional Development Fund. This funding is targeted, and it comes to development, the infrastructure subvention is solely intended for the development and cannot be spent on other projects. During the reform the state has increased the amount of financial support to local authorities for infrastructure development. The Ministry of Regional Development has already approved 48 projects of our communities. It is important to note, that the funding is allocated according the principle “the first come the first served”. The analysis of the funds received by communities since the beginning of the reform shows following approximate amounts: almost 1 000 000 UAH per thousand rural population in 2016; 600,000 UAH per thousand population in 2017; 450,000 UAH in 2018. In fact, amount of funding is increasing every year, but it is distributed among all existing and newly created ATCs. So, those who united earlier got the most support [26]. The communities could spend the funding for roads to be repaired, street lighting, buildings repairs, equipment for public utilities, equipment and furniture for kindergartens and schools, etc.

The main source of budgeting at different levels is the distribution of state taxes and fees. This not only ensures the independence of budgets, but also intensifies their role in the conduct of public policy, enables local governments without the intervention of the central authorities to form their own financial resources and make long-term prospects for social and economic development of territorial communities.

The united communities have received a considerable range of powers, the financial resources are managed by cities of regional significance. It is envisaged that the local councils are obliged to establish a single tax and decide on the establishment of a property tax (in the part of the real estate tax other than land) and a fee for parking spaces, tourist tax [21].

Since the beginning of financial decentralization, local budget revenues have been growing rapidly: if they amounted to UAH 68.6 billion in 2014, then in five years, they are increased almost four times and to reach UAH 267 billion in 2019.

Table

Revenues of the local budgets, billion UAH

Year	Tota	Growth
2014	68,6	+29,6 (42%)
2015	98,2	+48,4 (49%)
2016	146,6	+46,0 (31%)
2017	192,7	+41,4 (21,5%)
2018	234,1	+32,9 (14%)
2019	267,0	–

Source: [26].

The dynamics of revenue of ATC budgets outpace the growth rate of income at other levels of local budgets.

Experts believe that such results have been made possible by expanding powers and increasing the interest of local governments in increasing revenues to local budgets, implementing measures to attract reserves to fill them and improving the efficiency of administering taxes and fees (Table).

The largest share of own revenues of the general fund of local budgets is formed with the revenue from personal income tax - about 60% of the total amount of own revenues of local budgets. The share of local taxes and fees in the structure accounts for approximately 26% of all local budgets of Ukraine.

It should be noted that the budget execution indicators reflect the general social and economic condition of the local region and its potential for further development. The availability of sufficient resources in local budgets is an indicator that the territorial community is able to provide better and more diverse services to its residents, implement social and infrastructure projects, create conditions for entrepreneurship and investment attraction, develop local development programs and fund other comprehensive activities improving the living conditions of community residents [19].

The reform resulted in increased interest of local governments in increasing revenues to local budgets, finding reserves to fill them, improving the efficiency of administration of taxes and fees. The amalgamated communities show high and dynamic growth in their own revenue [11]. With regard to the use of funds, attention is focused on the need to formulate the most optimal structure of budget expenditures, the creation of an effective not too numerous management apparatus, the constant analysis of spending of budget funds and the prevention of cases of their irrational spending

Local budget performance indicators reflect the overall social and economic status of the area and its potential for sustainable development. The availability of sufficient resources in local budgets is a guarantee that the territorial community is able to provide better and more diverse services to its residents, implement social and infrastructure projects, create conditions for entrepreneurship development, attract investment capital, develop local development programs and finance other activities for comprehensive improvement of community living conditions [27].

As a result of successful implementation of the first stage of the reform, in the beginning of the 2019 the Cabinet of Ministers of Ukraine initiated the transition

to a second stage of decentralization reform, which envisages consolidation of the already created ATCs, change of territorial structure at the level of districts and communities, clear delineation of powers and functions of control on different levels of public management, as well as further development of local governance democracy [28].

Hence, regular local elections in the fall of 2020 must take place on a new organizational basis for communities. Powers between levels of government should be differentiated on the principle of subsidiarity. Community residents should be provided with mechanisms and tools to influence local government and participate in decision-making [19].

However, there has been a number of obstacles on the way of full implementation of budget decentralization, which reduce the positive impact of the reform in general in Ukraine. For instance, the Transcarpathian region, one of the most considerable and prospective regions in Ukraine, confirms that the process of budgetary decentralization may not be so successful and easy to implement.

The study of the implementation of budget and fiscal decentralization in the Transcarpathian region has revealed the existence of several problematic issues which could be important to analyze.

The Transcarpathian region is the one in Ukraine where the creation of ATCs has the slowest rate. This has created some legal conflicts with existing Law "On Voluntary Association of Territorial Communities", the Government's Methodology for its implementation, as well as with the laws regulating the financing of ATC and direct intergovernmental relations with the state.

It is claimed that the slow process of formation of ATCs in Transcarpathia is mainly due to the reluctance of the regional authorities to release certain territories of the region from their influence [29]. Since, after the creation of the ATC, they would cooperate directly with the state budget, and obtain the right to make independent decisions. Another reason is the reluctance of individual village heads to give power to one community head. After all, after the creation of the ATC, all candidates have to be elected and risk to lose their positions.

An important specific factor is that a significant number of Transcarpathian self-sufficient communities are concentrated in the specific natural and climatic zone, where the communities of the mountainous regions are almost all subsidized and are afraid of risks associated with taking the independent path of development. Hence, the indifference and resistance to create ATC is evident [10].

Another important factor is the multinationality of the region, which creates some problems in the formation of the ATCs. This is especially felt in places of compact residence of Hungarians and Romanians, where the share of such ethnic groups is significant. State and local governments have an obligation to take into account their interests and vision for implementing the principles of decentralization [29].

In addition, Transcarpathian have problems with public information and therefore, united communities do not fully understand the essence of the reform, do not see its ultimate purpose and, as a consequence, are in no hurry to take any steps.

Thus, the process of implementing decentralization reform in Transcarpathia may be a valuable experience showing that the approach to some territorial communities must be individual and only an ongoing dialogue with people and

communities, communication with local governments and municipalities, training and education will solve the problem.

Conclusion. It is generally considered that budget decentralization is the most effective and efficient way of ensuring financial autonomy and resilience of local authorities by transferring to their management budget sources, which were previously assigned to the central government, and expanding the power rights of administrative and territorial units. Decentralization also means the introduction of a new model of financial support for local budgets by the central government. Decentralization of state power and financial sources in favor of local self-government has been one of the most successful reforms since Ukraine's independence.

Since the beginning of 2015, a new budgetary model has actually been introduced in Ukraine, aimed at ensuring financial decentralization, namely increasing the amount of financial resources at the disposal of local authority's self-government, formation of financially independent territorial communities. The processes of decentralization in Ukraine has been accompanied by the transfer of not only significant powers but also considerable financial resources to newly created communities.

If we consider all the pros and cons, which have been fully felt by the communities that have decided to unite in Ukraine, we can conclude that budget decentralization is one of the keys to the well-being of each individual territory in particular and an instrument of regional development, decentralization of power and an effective system of governance in general. It stimulates the regions to financial autonomy, search for additional resources, activates the internal potential of the region, which balances its needs and opportunities. Thus, the reform of budget decentralization makes it possible to improve management decisions about local finances. The case of Ukraine shows that the administrative and territorial structure of the country should be built in a way to simultaneously take into account the interests of local residents and to ensure local budget incomes within the particular community.

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