

OPTIONS OF INTERGOVERNMENTAL FISCAL RELATIONS REFORM IN THE UKRAINE

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Abstract. *Reform of the system of public finance is a key problem in the transformation processes of the Ukraine's economy. Development of efficient methods of financial policy is especially important in the context of strategic challenges of economic growth, the competitiveness of the national economy, and convergence of the level of socio-economic development between different regions of the country. Most elements of the modern system of the Ukraine's public finance were formed as far back as during the Soviet era, under the conditions of command and administrative economy, when neither the state budget, nor the local ones played any active role, but were a mere monetary reflection of the plans of socio-economic development. On the other hand, in market economies, public finance plays an important role in the provision of economic growth and efficient use of national economic resources, as well as in the solution of the problems related to social equity.*

During recent years, the attempt to reform intergovernmental fiscal relations in the Ukraine have failed either to create a well-balanced system for the distribution of powers between central state authorities and local government, or to elaborate adequate and transparent mechanisms for the formation of local budgets. The reason is that most problems of the local budgets are mostly treated by policy makers and local authorities in the context of the need to provide local budgets with "sufficient" financial resources.

We emphasize that creation of an efficient budget system is not limited to a mere re-distribution of revenues between central and local budgets. Investigation of theoretic and methodological foundations of the development of the components of the system of public finance and intergovernmental fiscal relations in the Ukraine let us conclude that such development should be based on the use of economic principles and criteria as to the distribution of powers between the central authorities and local government. Furthermore, a consistent fiscal policy is needed, which would promote not only the convergence between the local budgets' expenditures, but also, and first of all, the regions' socio-economic development.

Key words: *intergovernmental fiscal relations, decentralization, fiscal equalization*

Introduction

Reforming the system of public finance is a key problem in the transformation of the Ukraine's economy, which is due to

the necessity to solve the strategic tasks of economic growth, raising the competitiveness of the national economy and creating favourable conditions for regional socio-economic development.

In recent years, discussions of the guidelines for improving the system of formation of the local budgets and intergovernmental fiscal relations have usually focused on the problems of the revenue part of local budgets and their provision with “sufficient” financial resources. Such formulation of the question does not allow creating a budget system, which would favour responsible execution of the functions of public power, efficient use of resources of the national economy and maximum regard for people’s preferences and interests.

Theoretical bases of the reform

The works by C. Tiebout and P. Samuelson, in which the problems of the provision of public goods are analyzed in the context of economics of regions, initiated the economic theory of budget federalism (Tiebout, 1961, 1956; Samuelson, 1958). Before the 60 of XX century, the term “federalism” had been used to denote a system of public order, and issues of power distribution between levels of government were mainly discussed by specialists in the theory of state law and by political scientists. Meanwhile, within the theory of budget federalism, the question is posed differently, namely, which government functions (no matter if the country is federative or unitarian) are economical when used centrally, and which are economical when used decentrally (Bös, 1971). Initial provisions of this theory are the basis for the solution of economic problems related to the creation of optimal government creation and efficient functioning of multi-level budget systems.

The arguments in favour of power decentralization are, first of all, associated

with the performance of the government’s allocative function, i.e. provision of public goods and services (Olson, 1977). The purpose of that function is to attain optimal distribution of national economic resources, which provides not only for the maximum output of goods and services (with the existing factors of production), but also for the best correspondence of those goods and services to the preferences of economic agents.

It is clear that, in smaller community an individual has better opportunities as to expression of his or her interests and to influence on the supply of budget funded public goods and services, while a centralized supply can only follow the “averaged” interests. In modern democratic societies, decentralization of the power related to the provision of public goods and services allows a due regard for individual preferences.

An argument against the decentralization of powers is connected with “externalities”, causing the goods supplied in one region to affect the well being not only of its residents, but also of those in other regions. In case of “externalities” one can notice a territorial mismatch between the good’s consumers and those bearing costs related to its provision (Olson, 1977). On this basis, each local government should be responsible for such tasks which solution does not affect any territories beyond its jurisdiction.

Besides, in the process of optimization of the provision of such public goods and services, that characterize economies of scale, one should take into account changes in the production costs of such goods in such a way that average production costs are minimal.

Thus, according to the provisions of the theory of public finance, the basis of the distribution of costs between the government levels is the criterion of access to public goods, i.e. it depends on whether the funds are spent on “public goods and services” available for use by the population of the whole country or of a particular region (oblast’, administrative region, town/city, village etc). In case when consumption of a certain public good is limited to the population of one community, it is economically advisable to endow the local government with power to take corresponding decisions (on the volumes of provision and funding of the given good). The powers should be transferred to upper level either when the consumers of those goods reside in different communities or when it is possible to reduce unit costs by expanding the supply of public goods. However, in this case one should be sure that efficiency losses due to additional costs (for example, on transportation and data collection) will be lower than the economies of scale.

Besides, based on Knut Wicksell’s ideas as to taking decisions on public expenditures, one can say that efficient performance of government functions requires that, within a multilevel budget system (with autonomous local budgets), the conditions of institutional symmetry be strictly met. According to modern public finance theory, the prerequisites of institutional symmetry require simultaneous observance of the three following principles (Blankart, 1994):

- Principle of fiscal equivalence implying that the consumers of public goods should incur the corresponding costs themselves;

- Principle of correspondence between functional authorities (those related to decision-making on the provision of public goods) and expenditure liabilities (correspondence between expenditure item and authority);
- Principle of autonomy, i.e. independent decision-making, by a certain level of government, on expenditures and revenues of the corresponding budget.

Under such conditions, taxes practically perform the function of prices for public goods, i.e. higher provision of public goods requires higher expenditures and hence higher taxation of individuals.

Thus, a real decentralization of the budget system requires solution of various strategic issues related to decentralization of the system of state management and creation of entities, which would ensure efficient organization of the system of national public power. To sum it up, in a transition economy, the tasks of reforming the intergovernmental fiscal relations are not limited to a mere redistribution of government’s financial resources between budget levels, but should also include creation of necessary economic conditions for levels of government to efficiently perform their functional authorities within the fund limits of their corresponding budgets and as a result promoting a proper increase of the social well being.

In the context of creating conditions for the national economic development, it is important that the capacity of local expenditure increasing depend on the increase of their revenues. That condition can be met only if the size of territorial communities

corresponds to the powers imposed on the corresponding local government, and the territorial accessibility of the public goods and dwelling area of the persons financing their provision maximum coincide so that no intention should arise to shift off the burden of funding public goods on third persons. Thus, from the economic point of view, and hence from the point of view of the creation of real bases for the solution of the country's medium- and long-run social issues, one should speak not about the maximum expansion of powers (and hence the duties) of local government and unconditioned increase in the revenues of local budgets, but rather about the correspondence of those authorities to the possibilities of local communities to raise the revenues for covering the corresponding expenditures.

Situation in the Ukraine

Quite a few elements of the Ukraine's current system of public finance were formed during the period of centrally planned economy when neither central nor local budgets played any active role. The bulk of budget revenues used to come to at the disposal of the central government, while every local budget obtained funds necessary to finance the measures included in the national economic plan. Annual correction of the conditions of formation of the local revenues allowed to coordinate their amount with the planned expenditures. Thus, the independence of local budget was rather formal. In such a system, there was no problem with connection among the authorities of local government, local expenditures and regional tax revenues.

During recent years series of steps have been made towards reforming the budget

system as a whole and intergovernmental fiscal relations in particular. Those steps were reflected in the Constitution of the Ukraine, the Law of the Ukraine "On Local Self-Government in the Ukraine", and in the Budget Code of the Ukraine.

According to the Constitution of the Ukraine, local self-government is the right of the village residents (or residents of several villages), residents of settlement, or town/city to independently manage the issues of local importance (with the limits of the Ukraine's Constitution and laws). The organs of local self-government are village, settlement, and town-city councils and their executive bodies. Regional and oblast councils are defined as bodies representing common interests of territorial communities of villages, settlements and towns/cities. Each of the above mentioned local governments approves the programs of socio-economic development of the corresponding territorial communities and their budgets.

The Law of the Ukraine "On Local Self-Government" specifies the main provisions of the Constitution. According to Article 61, interference of the central government in the process of formulation, approval and enforcement of local budgets is prohibited. independence of the local budgets is «guaranteed by their own taxes and share of general government taxes, as well as by their right to independently and legally define the guidelines of use of the funds of local budgets».

The character of intergovernmental fiscal relations are defined by the Budget Code of the Ukraine, in accordance with which, from 2002 onwards, direct financial relationship was introduced between the central budget, on the one side, and, on the other side, the budget of the Autonomous Republic of the

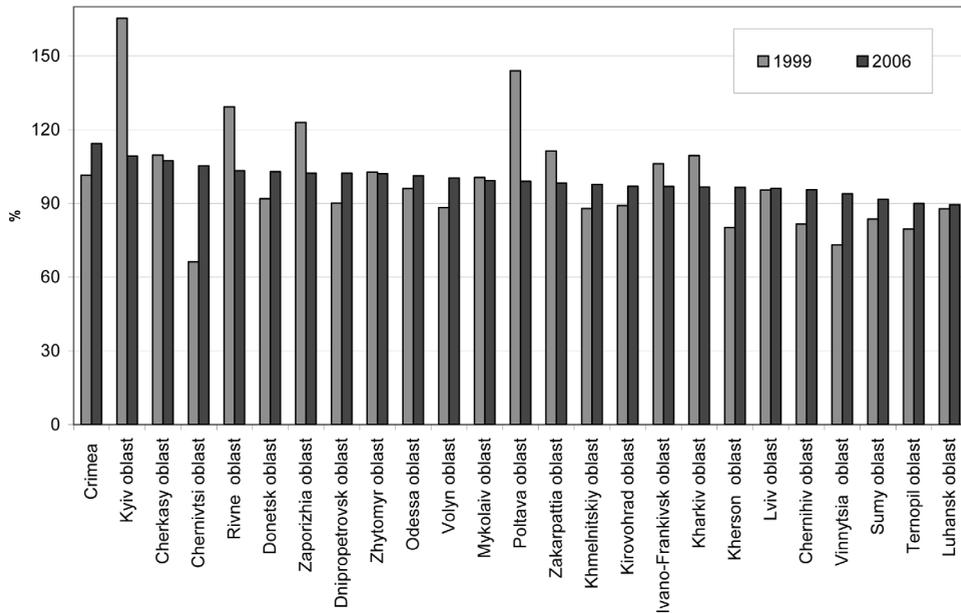


Figure 1. Local expenditures in the Ukraine: 1999–2006, percentage of average in the Ukrainian oblasts

Source: Author's estimates based on the data of the Ministry of Finance of the Ukraine

Crimea, 24 oblast budgets, and the budgets of the cities of Kyiv and Sevastopol, 175 budgets of republican (of the Autonomous Republic of the Crimea) and oblast jurisdiction, as well as 488 regional budgets totaling 690 local budgets. Equalisation transfers are calculated by a special formula.

The provisions of the Budget Code of the Ukraine formally establish very strict rules of the formation of local revenues, including transfers. At the same time, the existing system of intergovernmental fiscal relations still has several serious problems.

In recent years, in defining the parameters of intergovernmental relations, priority has been given to equalization the financial capacity of the local budgets. Thus, while in 1999, the minimal level of expenditures by local budgets (at the oblast level) differed from the average value almost by 35%, and

the coefficient of interregional expenditures variation was 22%, after the Budget Code of the Ukraine came in force, all the oblasts' were granted no less than 89% of average expenditures, and the variation coefficient was reduced to 7%. A similarly high degree of equalization has been reached in the expenditures of budgets of the towns/cities of oblast jurisdiction and regions.

In 2002–2006, the difference between the minimum and maximum level of budget expenditures in per capita terms amounted to about 40%, while in 1999, the maximum level was two and a half times as high as the minimum. In 2004–2006, the expenditures of local budgets of most oblasts were higher than 92% of the average of the Ukraine's oblasts, and only in Sumy, Ternopil and Luhansk oblasts they were 89–91%. (Figure 1).

A certain equalization of the financial capacity of local budgets is undoubtedly necessary both to fulfill the state's social obligations, and from the economic point of view (in order to avoid inefficient inter-regional allocation of capital, labor and other factors of production). However, high level of equalization of local expenditures has a negative impact in the context of regional development and expansion of their tax base.

Thus, in 2004–2005, at the expense of the transfers from the central budget (in the form of equalization transfers and output-oriented subventions on the solution of urgent problems of particular oblasts) the local expenditures of 13 Ukrainian oblasts were higher than the total amount of all taxes collected on their territory. In 2006 the number of such oblasts increased up to 15 compared to 5 in 1999. During 1999–2006, nominal amount of the transfers granted to local budgets grew almost ten-fold, while total revenues of the Ukraine's consolidated budget increased only 5.2 times.

Under the existing conditions, local expenditures may grow without any increase in the corresponding tax revenues. In each Ukrainian oblast one can find many examples when local budgets have approximately equal average per capita expenditures, while their revenues (less transfers) vary two-fold and more.

At the same time, local governments always may justify insufficient funding of certain expenditures by allegedly insufficient regard of local differences in the course of transfers calculation (90% expenditures of the general fund of local budgets are the costs taken into account in transfers calculation).

The high level of equalization of the financial possibilities of local budgets practically acts as an anti-incentive for the expansion of tax base, in the first place in the economically weaker oblasts, because increase in tax revenues resulting from the local government's successful economic policy would only lead to reduced transfers from the central budget. That also encourages the lobbying of tax exemptions and write-offs of tax indebtedness aggravating not only the condition of local budgets, but also that of the central budget. To sum it up, current system of local budget formation in the Ukraine do not comply with the principle of fiscal equivalence, therefore it reduces efficiency of budget system of the Ukraine and has a negative impact on regional economic development.

In the formation of the local budgets, no attention is paid to the fact that the level of budget expenditures and, correspondingly, the amount of financial resources necessary for the solution of particular tasks depend on different factors. Equal level of local public goods provision (for example, local transport) is possible with different volumes of budget appropriations as the participation of the private sector in service provision is possible. It also depends on tariff policy, regional differences in price levels, and the availability of the local governments' incentives for rational use of budget funds.

Even now the Ukraine lacks a clear-cut legal distribution of the powers between the central and local governments, which would be based on economic criteria. The performance of certain functions may be financed not only from the local budget, but also from the central one, which de-

depends on the jurisdiction of education establishments, health care, physical education and sports, and such a practice is fixed in the provisions of the Budget Code of the Ukraine. Thus, specialized schools, general hospitals, and polyclinics may be financed not only by the sub-national budgets, but also by the central one. Vocational schools, post-graduate and high education institutions, sanatoriums for tuberculosis and young-age patients may be financed by the oblast and central budgets. And that happens when the current distribution of the facilities in the central and local governments' property between government levels does not always correspond to the economically advisable distribution of authorities. Such state of things reflects not only economic, but also political unsolvability of the problem of authority distribution between central and local governments.

Thus, the Ukraine's current system of the formation of local budgets and inter-governmental fiscal relations is oriented to high degree of expenditure equalization and practical conservation of the current highly centralized pattern of budget decision-making. At the same time, it does not create any incentives for the local government to raise the level of budget revenues, or to increase the efficiency of the operating system of budget expenditures and search for its more rational patterns.

It should be also pointed out that in the Ukraine in recent years hundreds of small territorial communities have been created so that one rural community includes on average less than three rural settlements with a population of 1,5 ths, while in 1971 it included 3,6 rural settlements with a

population of 2,5 ths. Small communities also exist in other countries (for example, in France, Czech Republic, and Hungary), but only in the Ukraine and in Hungary small communities have very excessive responsibilities in comparison with their size and, correspondingly, financial capacity (Table 1).

The limited pool of local budgets of small territorial communities leads to limited sources for financing investment expenditures or even to a complete absence of such sources, while modern technologies used in the provision of public goods require considerable budget investments.

Besides, small communities face the problem of ensuring competition between the producers of local public services. For example, in rural areas, the selection of primary and secondary schools is very limited or even absent. Under such conditions, a wide range of self-government of villages creates certain risks as to the provision of the population with the appropriate budget funded services, and thus can not be considered as an efficient measure to improve the public sector (Hemmings, P., Turner D., Parviainen, S. 2003, p. 28). Taking into account above mentioned, international experts consider it advisable, for example, for Hungary, to specify the potential role of «areas» (which is the traditional intermediate level between central and local government), whose efficient functioning could reduce costs (due to economies of scale) and raise the quality of the local public services (Cekota, J., Gönenç, R., Yoo, K.-Y., 2002, p. 26). Lithuania (in 1995) has already cancelled the lowest level of local government and organized municipalities at the region level.

Table 1. Service responsibilities of local governments

	North Europe	South Europe	Hungary	Ukraine
Nursery schools	X		X ²	X
Primary education	X		X ²	X
Secondary education	X		X ²	X ³
Day-time baby sitting	X		X ²	X
Health care	X		X ²	X ⁴
Social protection	X		X ²	X ⁵
Social security	X		X ²	
Illumination	X		X ²	X
Roads	X	X	X ²	X
Water supply	X	X	X ²	X
Sewage system	X	X	X ²	X
Garbage disposal	X	X	X ²	X
Fire service	X		X ²	X
Cemeteries	X		X ²	X
Housing	X	X	X ²	X

1. For communities with a population less than 5000

2. Compulsory

3. Except for central government institutions

4. Except for institutions included in the corresponding list of the Cabinet of Ministers of the Ukraine

5. Local programs for women, children, young people and family

Source: Cekota, J., Gönenç, R., Yoo, K.-Y. (2002). Strengthening the Management of Public Spending in Hungary. *OECD, working papers*, № 336, p. 26; data on the Ukraine have been compiled by the author based on the Budget Code of the Ukraine.

From early 50s to mid 70s, in many North European countries an enlargement of rural communities was implemented in order to bring the minimum number of population in the communities to 8–10 ths (Boex, J., Martinez-Vasquez, J., Timofeev, A., 2004). At the same time, one should pay attention to the fact that in North European countries the population did not agree with the communities enlargement, and so the issue of raising the efficiency of their activities has been solved by way of cooperation between different municipalities in the provision of certain services

or partial transfer of the responsibilities of local government to higher levels. In some South European countries, in particular, in France, Greece, Italy, and Spain, in practice, there is a mixed hierachal system of fiscal relations among central and local governments, in which many local services are often provided by central government.

Very common for many unitarian European countries is coordination of actions between local governments and their cooperation with the central government (Boex, J., Martinez-Vasquez, J., Timofeev, A., 2004, p.30). Thus, in Italy the Law on

Local Government requires mutually coordinated actions. In France communities must unite for the realization of certain objectives. Even in North European countries characterized by a high level of tax revenues (from 9% of GDP in Finland to 16% of GDP in Denmark and Sweden), local governments successfully cooperate with each other and with other organizations in the provision of budget funded services to their population. Among the post-socialist countries, one should point out Slovenia, where municipal councils of each of the 58 administrative units appoint their representatives to an advisory committee, which ensures coordination of budget decisions between local governments and state administrations.

Thus, based on the quite contrasting experience of different countries in defining the size of territorial communities and ways to increase the efficiency of expenditures of the local budgets, one can conclude that solution of similar issues in the Ukraine would require a broad discussion in order to take into account the country's issues and possible negative reaction of the population to the reorganization of territorial communities.

Conclusions

Theoretical provisions and practice of the construction of multi-level budget systems in different countries allow a conclusion that elaboration of a concept of the formation of local budgets in the Ukraine directed to consolidation of financial bases of the local government should include a clear-cut distribution of authorities related to the provision of public goods and services between the central and local govern-

ments. The powers related to the solution of particular tasks and expenditure responsibility should belong to the same government level.

The result of the decentralization of the Ukraine's budget system should become a creation of such system of formation of local budgets and intergovernmental fiscal relations, which would ensure fulfillment of the conditions of institutional symmetry. It assumes the coincidence of economic agents using certain public goods, those who bear the burden of their financing (by paying the taxes), and those taking independent decisions on their provision (in the person of executive bodies or local government representing the interests of economic agents as residents of a particular community). Reforming the local government (and local budgets) in the European transition economies is now progressing mainly towards ensuring this very responsibility.

Expansion of financial autonomy of the local governments should take place in parallel with the expansion of their responsibilities before the taxpayers. Taking over a sufficient number of tax sources, local governments, at the same time, should, with the emergence of any need of additional expenditures, provide their residents with the account specifying which additional revenues should be raised for that purpose, i.e. what additional taxes they will have to pay.

As the differences in tax burden will affect the differences in the use of budget-funded goods provided within the basic-level communities, the list of functions of the basic-level communities, under the present Ukraine's conditions, should not be

too extended. But those functions should be a sphere of their exclusive authorities, which will be used by them under their own responsibility and will be financed from their own revenues.

Further reform of the Ukraine's local budgets (including intergovernmental fiscal relations) and this country's administrative and territorial pattern should ensure a gradual attaining (on a wide range of powers) of a territorial correspondence between the local governments' authorities, revenues granted to their disposal

and expenditures the corresponding budgets. That should be a step-by-step process coordinated with the country's economic development (and taking into account the stages of this development), increase in the government's revenues, improvement of the state legal control, and the stage of formation of the institutions of civil society, which should ensure the people's control over budget decisions taken by local governments and the latter's responsibility before their voters.

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