

## Актуальні напрями реформування економіки України

### FISCAL DECENTRALIZATION IN UKRAINE: MODERN STATE AND CHALLENGES

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**Abstract.** Implementation of the Budget Code provisions (2001) has not improved situation in public sector as concerns fiscal decentralization; an opposite trend has prevailed which contributed to aggravation of the country's fiscal problems.

**Keywords:** fiscal decentralization, public finance, fiscal equalization.

**Анотація.** Запровадження положень Бюджетного кодексу (2001) не поліпшило ситуації у державному секторі стосовно фіскальної децентралізації; переважав протилежний тренд, який сприяв посиленню фінансових проблем країни.

**Ключові слова:** фіскальна децентралізація, суспільні фінанси, фінансове вирівнювання.

Fiscal decentralization is a policy and process aiming to endow local democracy institutes (bodies of self-government) with fiscal resources and responsibilities.

The scale and intensity of fiscal decentralization is preconditioned by peculiarities of the country's intergovernmental fiscal relations, assignment of governmental functions and revenues within its system. Thus, it also depends on a variety of institutional, political, and economic factors which shape the specific public administration sector. Ukraine as a transition country which gained independence after the disintegration of the Soviet Union in 1991 has inherited some issues from the soviet past that have an impact on its public finance. Even now the remnants of a socialist past, when there was no place for subnational fiscal autonomy and sound fiscal management, are still at play.

After gaining independence in 1991, Ukraine, being a unitary state, naturally tended to practice a centralistic model of fiscal federalism<sup>1</sup>; this

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<sup>1</sup> According to Söderström [6], there are three possible models of fiscal federalism: centralistic (often seen in unitary states), fragmented localistic (mostly prevailing in federal states), and pragmatic (Scandinavia).

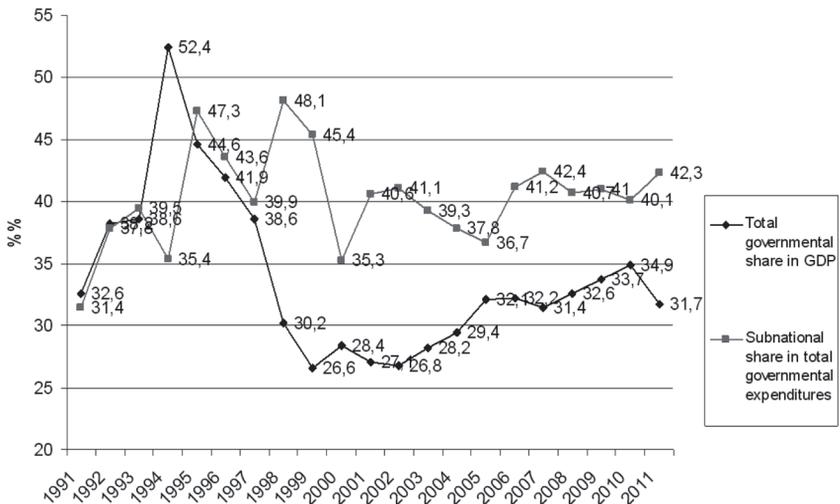
fact does have an impact on the shape of its intergovernmental system in general, and the transfer system in particular. When analyzing the current legal base and actual practice of intergovernmental finance in Ukraine, one will find a kind of duality: on the one hand, some state functions are handed down through the Law on Local Self-Government to bodies of local self-governance of different levels, which corresponds to predictions of fiscal federalism literature. However, on the other hand, actual implementation of these functions is mostly vested onto the national government (further referred to as NG) bodies – district and region state administrations, which are appointed and accountable to the President of Ukraine (a minor exclusion is cities of national and regional importance which comprise only 0,6 % to total number of the territorial units). This means that actually bodies of self-government in Ukraine enjoy a very limited scale of own competence combined with low autonomy for its realization. In the course of the recent Ukrainian revolution 2013–2014, many subnational governments overtook the functions delegated before to the state administrations and began to form own executive bodies. This triggered the state's decentralization efforts, which promise to result in a far-reaching reform of public finance aiming to significantly increase SNGs' economic and fiscal weight at city and village levels.

At the beginning of the period of intensive nation-building, responsibility for many public expenditures was vested onto SNGs without respective compensation in the form of new revenue sources or intergovernmental money transfers; this made SNGs fully dependent on the NG decisions. As one of the earliest studies of Ukrainian intergovernmental finance stated, public expenditures were assigned mainly in line with the principle of correspondence, but fell short in stability [2, p. 290], though his assignment had no legal base. In 2001, when the Budget Code was adopted, the delineation of responsibilities and revenue sources was done at last. Nevertheless, the analysis of legal rights to execute certain expenditures demonstrates that most public goods delivered by SNGs actually belong to “delegated” responsibilities which are mandated and fiscally supported by the state. Lunina [8] suggested this share of stately mandated functions in terms of expenditures exceeds 90 % of SNGs' expenditure liabilities.

Actually, even after the enactment of the Budget Code in 2001, to date SNGs remain deprived of the ability to manage their finance and assets. In many cases they formally bear responsibility for certain public functions (such as general secondary education or primary health care), but

have no possibility to manage the basic factors affecting their expenditures, such as salaries and wages; they also have no right to hire and fire managers of subordinated public institutions (local state administrations do this), or to set standards of service delivery etc. They even cannot hold accounts in the financial institutions of their choice – only in the State Treasury.

Within this context, it is worth discussing trends in public expenditure assignment in Ukraine, which is conventionally understood as an index of decentralization [1; 3]. Figure 1 demonstrates that a trend to increasing the relative size of public administration sector in GDP generally dominates, being supported by a very slight increase in the relative role of the subnational sector within it. The problem with this index is that GDP expenditure share does not really reflect the real extent of fiscal decentralization. In Ukraine, as shown above, most public expenditures at the subnational level are administered by the state authorities, not by SNGs.



**Figure 1.** Total government share in Ukrainian GDP and subnational share in total government expenditures, %%

As concerns public revenues, the trends here are just the opposite. The data (see Table 1) demonstrates that SNGs' role in redistribution of GDP has constantly diminished through the years. Starting with about 46% at the moment of gaining independence (1991), the total subnational share in public revenues (transfers excluded) has actually halved – it had

dropped to about 23 % by 2012. The NG has gained a much bigger role in subsidizing SNGs and making them more dependent on its decisions concerning the fiscal support granted.

*Table 1. Distribution of revenues among government levels (intergovernmental transfers excluded), %%*

Governmental levels	1991	1995	2000	2005	2010	2011	2012
National	54,1	47,6	70,9	77,3	74,4	78,3	77,4
Total subnational	45,9	52,4	29,1	22,7	25,6	21,7	22,6
Regional	9,8	24,8	12,2	7,3	8,9	7,7	8,6
Cities of regional significance	25,6	17,6	10,2	11,3	11,8	9,4	9,2
Districts	6,3	7,5	4,8	1,8	2,4	2,1	2,1
Total for SNGs of subdistrict level	4,2	2,5	1,9	2,3	2,5	2,5	2,7

*Source:* Own calculations based on MoF data.

While observing two opposing trends (a growing subnational share in expenditures and a diminishing one in revenues) one could draw the conclusion that this will result in a soaring vertical imbalance, which has to be covered by use of vertical intergovernmental transfers. Respectively, the composition of subnational revenues has also changed.

An important component of intergovernmental finance in Ukraine is direct fiscal transfers. As the data in Table 2 demonstrates, the intergovernmental transfer system in Ukraine displays the following trends: (a) growing dependence of SNGs on fiscal transfers, (b) gradual substitution of NG's discretionary transfers (mutual settlements and budgetary loans) for formula transfers (grants) and (c) substitution of general transfers ("grants") for earmarked ones ("subventions").

*Table 2. Dynamics of different types of fiscal transfers, %%*

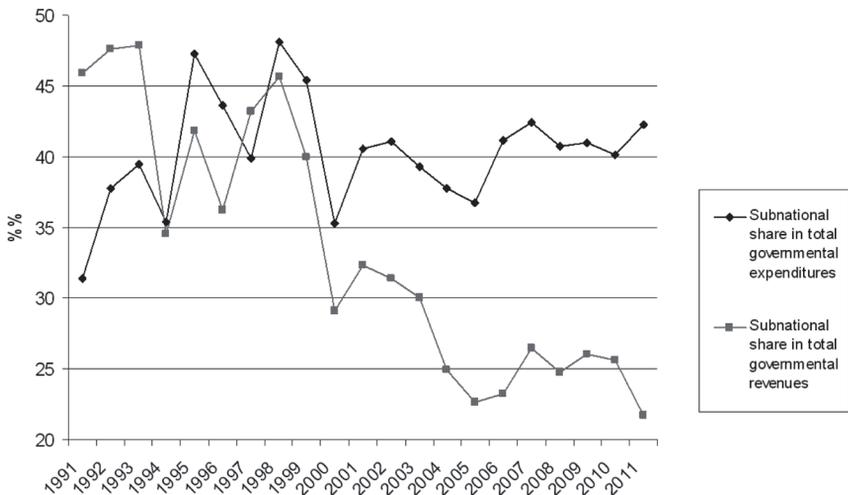
Year	Transfer share in SNG total revenues	Out of total transfer mass:			
		Mutual settlements	Grants	Intergovernmental loans	Subventions
1991	14,4	34,8	55,9	9,2	–
1995	4,9	51,7	40,3	8,0	–
2000	22,9	0,2	96,5	1,9	2,4
2005	43,5	–	61,8	–	38,2
2010	48,8	–	56,8	–	43,1
2011	52,3	–	50,7	–	49,3
2012	55,2	–	48,7	–	51,3

*Note:* Until 1995, grants were referred to as "subventions".

*Source:* Own calculations based on MoF data.

The growing SNG dependence on transfers could signalize a soaring vertical imbalance and diminishing local fiscal autonomy. An elimination of discretionary transfers could be judged as a positive development, since it has made transfer allocation more objective and predictable. Increasing relative importance of earmarked transfers could be hardly judged positively, because earmarking puts additional restrictions on SNGs' fiscal policy and may distort their spending priorities.

Among the different reasons for implementing some kind of intergovernmental transfer policy, bridging the vertical fiscal gap is the less controversial one. A gap between revenue capacity and expenditure liability of governmental levels, "vertical fiscal imbalance" (further referred to here as VFI), is quite big in Ukraine, as in many other transition nations. Conventionally, VFI could be measured as a relation between the revenue and expenditure shares of different governmental tiers.



**Figure 2.** Subnational shares in total government revenues and expenditures (direct fiscal transfers excluded), %%

As shown in Figure 2, during the years 1991-1993 and in 1997, the subnational revenue share exceeded the expenditure share; since 1998, the situation has reversed: a trend towards further VFI increase has dominated. In 1998, VFI was only 2,4 percent points, but it soared by 2011 by almost 10 times (!), reaching 20,6 percent points. The soaring VFI in

Ukraine contributes to the growing need for direct fiscal transfers, and to SNGs' indebtedness.

Besides VFI, significant inter-territorial disparities are present in Ukraine, which could be measured with Gross Regional Product (further referred to here as GRP) and subnational *per capita* revenues.

Table 3 presents data on existing economic differences among macro-regions. In terms of economic development, the Center and the East are significantly ahead of the South and, especially, the West. The former are more specialized in manufacturing and the latter ones in agriculture. Respectively, the economy of Central and Eastern macro-regions attract much more investment (especially DFI<sup>1</sup>), is more export-oriented in comparison to the South and West. As a result, we observe a sizeable gap in terms of total regional production measured by GRP: production in the South and West comprises about half of what is produced in the Center and East.

*Table 3. Economic indicators of macro-regions (in per capita terms), 2012*

Macro-regions	Total annual investments UAH	Industrial production, UAH	Agricultural production, UAH	Export, USD	Cumulative DFI, USD	GRP, UAH
West	3281	11 297	4610	536	371	17 323
Center	9258	33 737	6935	1569	2155	33 956
South	5410	20 219	4221	1086	558	23 310
East	6087	49 223	3222	2402	1131	34 303

*Source:* Own calculations based on data of the State Statistics Service of Ukraine.

Having in mind such significant economic differences, one should assume that a situation of this type must call for a massive use of equalization transfers because differences in per capita GRP would be reflected in big differentials as concerns per capita revenues and expenditures. In a unitary state like Ukraine, this situation would be considered as unfair. Inter-regional fairness should be manifested in redistribution from the urbanized industrial Center and East in favor of the rural agricultural South and West [4]. As the data in Table 4 demonstrates, these expectations are not fully realized. SNGs in the Center, South and East actually had the same level of per capita revenues at the intermediate equalization stage in 2012 (see Table 4 below), and only the West demonstrates a significant deficiency as concerns revenue collection. It is no surprise that SNGs in

<sup>1</sup> DFI stands here for “direct foreign investments”.

the West received also the highest revenue support in comparison to the other macro-regions<sup>1</sup>.

Table 4. *Per capita* subnational revenues in macro-regions, 2012

Macro-regions	Total subnational revenues, transfers excluded, UAH	Total subnational revenues, transfers included, UAH	Total subnational revenues, transfers included, to total revenues without transfers
West	1,405	4,675	3,3
Center	2,414	5,320	2,2
South	2,271	4,754	2,1
East	2,534	4,840	1,9

Source: Own calculations based on data of MoF.

A more interesting observation is the fact that SNGs virtually in all regions receive fiscal support from the NG that at least doubles their revenues. This means that fiscal equalization in Ukraine occurs with intensive NG intervention, unlike in the models analyzed by R. Musgrave [5] where the NG does not intervene into inter-territorial redistribution and only intermediates equalization by redistributing the funds.

The growing extent of NG intervention into subnational finance is objectively motivated by the substantial economic differentiation among the regions, and could be measured by *per capita* GRP, calculated in Ukraine since 1995. GRP is the most suitable tool for measuring interregional differentials, as it is more strongly related to regional economic capacity than *per capita* revenues, which include net transfers. Table 5 shows the growing economic inequality among the regions. In 1995, the GRP maximum/minimum ratio was 2,7 to 1, but in the middle of the first decade of the 2000s it exceeded 6 to 1, and has remained this high. As a result, differences in social development across the regions became more visible, too, triggering inter-regional and international migration of production factors. In addition, it generated significant differences in fiscal endowment of SNGs, as data in Table 4 suggested, which required equalization measures from the NG's side.

<sup>1</sup> It should be mentioned here that, in the long run, scale of the fiscal flows in favor of specific regions has changed. Data series since independence show that some shifts in economic development have really occurred: the South and West have demonstrated higher economic growth and better demographic trends in comparison to the Center and East. But this outdistancing is not big enough to consider the possibility of the two former overtaking the latter within the foreseeable future [7].

*Table 5. Regional differentiation of per capita GRP in Ukraine (UAH)*

Year	Average value	Variation coefficient	Minimum	Maximum	Maximum to minimum
1995	970	0,232	507	1368	2,7 / 1
2000	2788	0,340	1411	5965	4,2 / 1
2005	9373	0,486	4603	28 780	6,25 / 1
2010	23 600	0,486	10 939	70 424	6,44 / 1

*Source:* own calculations based on MoF data.

Our analysis showed that Ukraine since independence had not taken definite steps in direction of real fiscal decentralization. Implementation of the Budget Code provisions has not reversed a general trend to fiscal centralization which is just opposite to the world-wide developments vector. Fiscal centralization, in its turn, called for paternalistic policy of the state towards regions which has its manifestations in growing scale of redistribution among subnational governments of different levels. The opportunity cost of intensive fiscal equalization includes significantly increased transfer dependence of subnational governments and, as theory predicts, diminishing incentives for regional and local authorities in making efforts towards generating sufficient revenue flows and better expenditure management.

Now we have a good chance to step a path of modern development in public finance by assigning subnational governments important public functions and granting them sufficient fiscal endowment. But this will be not enough in order to achieve publicly desirable results. Some institutional changes like vesting local governments with majority of powers executed at the moment by the local state administrations, instituting executive bodies formed by respective local governments at district and region levels, granting local governments a full right to run locally provided public services in education, security, culture and healthcare spheres. And of course, a very important prerequisite for successful decentralization should be accountability of local government in order to minimize corruption and secure maximal community involvement into decision making.

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