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FINANCIAL DECENTRALIZATION AND FISCAL IMBALANCE OF LOCAL BUDGETS IN UKRAINE

The purpose of the article is to identify the correspondence between the revenue and expenditure parts of local budgets, which are responsible for the significant part of state expenditure financing due to financial decentralization reform. The article provides a comparative analysis of decentralization levels of local budgets in Ukraine and European countries by revenues and expenditures, as well as analyzes the structure of revenues and expenditures of the consolidated budget which include state and local budgets. The article notes that over the past ten years, the gap between revenue and expenditure has narrowed due to decentralization reform, but fiscal balance has not been achieved.

The results of the analysis demonstrate the existence of a significant vertical imbalance in the budget system of Ukraine, which consists in the insufficiency of own and fixed financial resources of local authorities to ensure their powers. In terms of income decentralization, Ukraine ranks middle among Eastern European countries, while the level of expenditure decentralization corresponds to the level of Scandinavian countries, where the state plays an active role in income redistribution and has high institutional efficiency and high social standards. The article substantiates that the vertical imbalance exist due to the inefficient structure of local budgets' revenues, in particular the high share of transfer payments from the state budget to local budgets, as well as the low share of own revenues, namely local taxes, in tax revenues. In order to strengthen the revenue side of local budgets and reduce vertical imbalances it is proposed to increase the tax base of local taxes through development of business and welfare in the regions, to increase the share of deductions from corporate tax and personal income tax to local budgets, to improve the control over local budget revenues and to optimize local expenditures, including social protection and social security expenditures. As the practice of foreign countries with decentralized budget systems shows, the elimination of vertical imbalances leads to a significant increase in the fiscal capacity of the regions.

Keywords: financial decentralization, local budget, vertical fiscal imbalance, budget transfers, local taxes, budget revenues, tax revenues, budget expenditures.

JEL classification: E62, H61, H71, H77

Introduction and research problem. Financial decentralization reflects the financial power of regional authorities and is one of the basic conditions for the independence and viability of local authorities: decentralization of decision-making processes increases the capacity of local authorities to participate in the development of their territories; fiscal decentralization contributes to the efficient provision of public services by more closely aligning government spending with the most urgent local needs. A prerequisite for the existence of an effective institution of self-government is the formation of a large part of local budget revenues through local taxes and fees, which are independently set by the self-government bodies. The realization of the legally enshrined right of every administrative-territorial formation to economic independence is impossible without the presence in each authority of its own budget and the right of its preparation, approval and execution without outside interference.

Recent publications analysis. The issue of decentralization and budgetary decentralization, in particular, are covered in the works of many leading western scholars, such as R. Barro, G. Blochliker, J. Buchanan, K. Arrow, J. M. Keynes, D. King, R. Musgrave, W. Oates, A. Pigou, D. Ricardo, C. Thibaut, J. Hicks. Ukrainian scientists, namely O. Sokolova, G. Wozniak, M. Pasichny, A. Stasyshyn, O. Grabchuk, V. Demyanyshyn, V. Zymovets, I. Lunina, V. Oparin, V. Fedosov, S. Yuri emphasized the importance and necessity of initiating such reforms, which would help increase the well-being of the country's population.

Unsolved parts of the problem. Despite the large number of studies on financial decentralization, the issue of the imbalance between budget revenues and expenditures at the regional level remains unresolved. The vast majority of Ukrainian territorial communities, having the right to resolve issues of local importance, are unable to do so due

in the absence of own resources, decline or lack of infrastructure or shortage of qualified personnel. Therefore, many issues of local importance are not resolved: municipal property, territory, landscaping, etc. are not properly maintained. One of the main problems of the national economy development is the scarcity of financial resources on the local level. Solving this problem requires a proper correlation between revenues and expenditures of local budgets.

Research goal and questions. The major objective of this article is to carry out a comparative analysis of the financial decentralization levels in the EU countries and Ukraine, to identify and assess fiscal imbalances in revenues and expenditures of local budgets in Ukraine.

Main findings. The process of decentralization is the restructuring or reorganization of authority, which results in a system of shared responsibility of institutions at all levels of government (central, regional, local) in accordance with the principle of subsidiarity, which increases the quality and efficiency of the governance system and thus provides transparency of the budget system. Budget decentralization is the process of delegating powers (functions, jurisdictions, and amenities) from the central government to local bodies (Sokolova & Kovalchuk, 2016). Financial management is the most difficult issue of fiscal decentralization. Although there is an urgent need to delegate proxies to the lower levels of government, the local authorities normally do not have sufficient means to fulfill its new budgetary powers.

An important part of determining the level of fiscal decentralization is the analysis of

decentralization of expenditures, the essence of which is to assess the ability of local authorities to dispose of their own resources and resources obtained in the state budget, as well as the analysis of decentralization of revenues - the ability of local governments to fill their budget properly both tax and non-tax revenues, and various grants and investments.

The defining characteristics of the system of local budgets in European countries are the level of involvement of residents of territorial communities in the processes of their discussion, formation and implementation, as well as the correspondence of the volume and range of services provided by public institutions to the dynamic structure of public requests and needs. The method of allocation of public finances determines the level of taxpayers' confidence in the fiscal policy pursued both in the country as a whole and in its specific region, generating the phenomenon of tax competition between different jurisdictions and streamlining the movement of resources.

Basics of development of budgetary federalism in European countries was the steady outpacing of expenditure decentralization over the corresponding revenue indicator. With comparable proportions of GDP redistribution through the expenditures and revenues of the local budgets, the recent intergovernmental transfers contributed to the fiscal equalization and elimination of interregional imbalances and the artificial balancing of the system. The average levels of decentralization of the budgetary systems of European countries for the years 2001–2017 are summarized in Fig. 1.

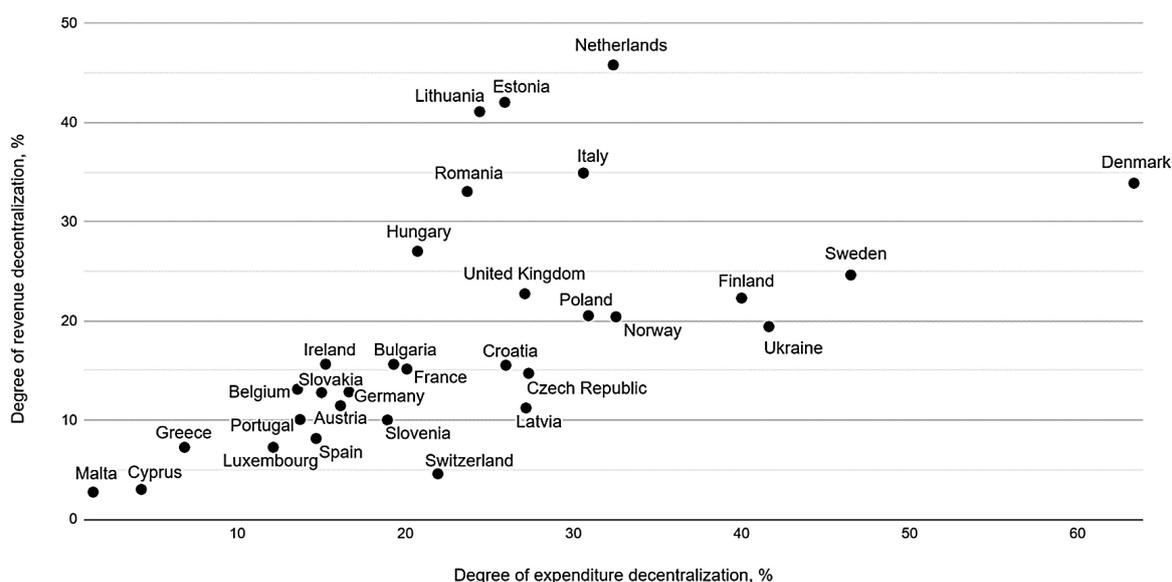


Fig. 1. Budget decentralization by revenue and expenditure in European countries in 2001–2018, %
 Source: by authors based on data from (Eurostat, 2020)

The magnitude of variation in the expenditure indicator is 63.3 pp, for revenue – 45.8 pp. Malta's and Cyprus's relatively low budgetary decentralization parameters can be rationally explained by the specifics of the administrative and territorial structure of the countries. Moderate values of fiscal autonomy were also recorded in Greece (average revenue decentralization at 7.27 % and 6.86 % by expenditures), which is explained mainly by natural geographical conditions and secessionary risks. The country has even implemented a model of state-level direct financial support for local governments based on the Central Autonomous Resources mechanism to support the long-term sustainability of local finances, which is an element of the macroprudential strategic management program. Overall, in 2001–2017, most European countries were characterized by high fiscal decentralization: over 20 % by expenditures and 15 % by revenues.

The highest levels of decentralization are inherent in Fennoscandia countries, whose fiscal space models have been linked to a social-market economy, a stable and high level of development and an adequate standard of living since the mid-twentieth century. The large scale of redistribution of GDP through the public finance system, including its powerful and situationally responsive local segment, is supported in this group of countries by a high level of appropriate institutional support that balances individual and public interests.

The average degree of expenditure decentralization over the analyzed period in the countries of Europe was 22.9 %. The national indicators that are closest to it are recorded in countries with markedly different economic development parameters and indistinguishable institutional traditions of fiscal autonomy. Among the group, the highest levels of public well-being are in the UK (+4.2 pp), as well as Switzerland (-1.0 pp) and France (-2.9 pp). Another group is made up of some post-socialist countries, including Bulgaria (-3.7 pp), Croatia (+3.0 pp), Hungary (-2.2 pp), and Romania (+0.7 pp) and the Baltic States (+2.9 pp on average), which achieved notable results through strategic progress in the fiscal area. The average degree of revenue decentralization by local budgets is 18.7 %. Indicators as close as possible were recorded in Norway (+1.8 pp), Ireland (-3.0 pp) and Poland (+1.9 pp) (Davymuka, Kuybida & Fedulova, 2019).

As we see, Ukraine has transferred a large number of spending powers to the local level, which corresponds to the level of local spending in the Scandinavian countries. However, the total share of own and assigned revenues of local budgets is lower than the corresponding indicators of Poland, Romania, Hungary, Lithuania and Estonia, which have a much lower level of decentralization by expenditure.

However, if Sweden and Finland can allow imbalance between revenues and expenditures in their stage of growth, such a difference can significantly affect the development of regions in Ukraine, while expenditures exceed revenues by about two times.

The results of the analysis allow us to conclude that the level of financial decentralization of revenues in Ukraine remains low, as local budgets finance expenditures that are not supported by appropriate financial resources.

The large part of the budget system of Ukraine consists of local budgets. The number of local budgets in Ukraine as of 21.08.2019 is 9139 (Ministry of Finance of Ukraine, 2020). Quantity of local budgets has decreased over the last 5 years as territorial communities become larger in the process of decentralization, and the amount of funds that was redistributed through local budgets has increased as a result of the extension of powers of local bodies.

The dynamics of allocation of budget resources in the consolidated budget of Ukraine (Fig. 2) shows that today there is a neutral-positive tendency of a moderate increase in the share of revenues that flew

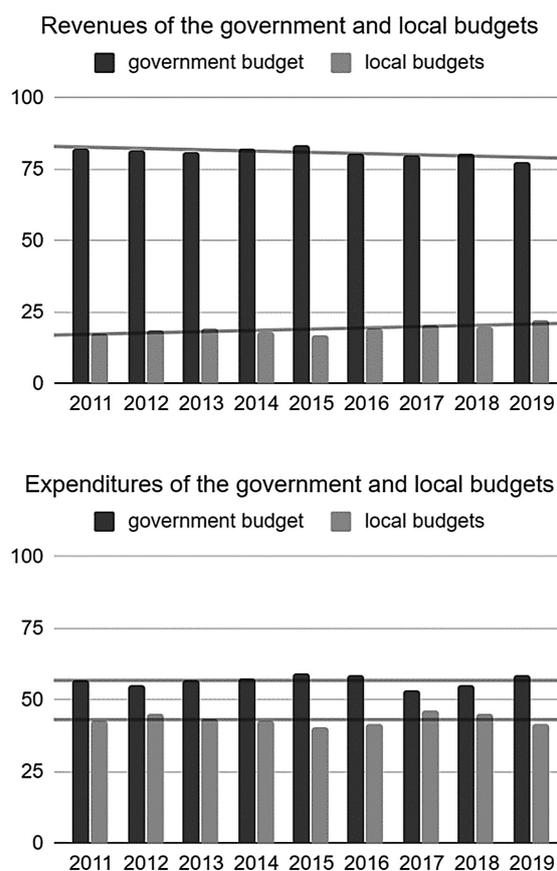


Fig. 2. Revenues (without transfers) and expenditures (with transfers) of the government and local budgets of Ukraine in 2011–2019, % of the consolidated budget
Source: by authors based on data from (Ministry of Finance of Ukraine, 2020)

to local budgets. Since the government approved the main conceptual document on decentralization – the Concept of reforming local self-government and territorial organization of government in April 2014, the percentage of local budget revenues in the consolidated budget decreased from 19.11 % in 2013 to the lowest value in 10 years – 16.72 % in 2015. However, as a result of the decentralization reform, the ratio of local budget revenues to the state revenues has gradually increased: for the last reporting calendar year, the share of local community revenues was 22.35 % in the consolidated budget.

Expenditures of local budgets including transfers during the researched period fluctuate within 40–45 %, that is twice more than revenues without transfers to local governments. The imbalance between revenues and expenditures indicates the insufficiency of the revenue base of local budgets to ensure the performance of functions entrusted to local self-government.

The transfer of tasks and competencies to local authorities without the provision of adequate sources of revenue contradicts the idea and role of territorial self-government. The revenue base of local budgets is the basis of regional financial regulation. Various targeted programs, and above all social ones, are financed through local government funds. The local budget can also be considered as the main financial plan for the development of territorial communities.

Local tax revenues are an important source of local budgets revenues, affecting the economic development of a particular region. The main payments to the local budgets are personal income tax, corporate income tax, excise tax on excise goods produced in Ukraine, land value tax, local taxes and fees, other payments.

The personal income tax, as a basis for filling the local budgets of Ukraine, is a fairly stable source of

local budgets (more than 50 % of revenues). However, its high share in a particular community indicates a strong dependence of its budget revenues on the availability of business structures and official employment.

According to the State Treasury of Ukraine, local taxes and fees are the second largest source of local budgets, the share of which increased 2.5-3 times after 2014, reaching as much as 28.8 % in 2016 in the total structure of local budget revenues. For comparison, their share in 2014 was 8.1 % of total local budget revenues. This increase in 2016 can be explained by the attribution of property taxes, including land payments, to local taxes and fees. Anyway, the share of local taxes and fees decreased in 2019 to 26.5 %, which is explained by the underdevelopment of business and property institutions in the regions, as well as the lack of an effective legal framework governing liability for tax evasion (Bui, 2018).

Local expenditures in the consolidated budget are about 40–45 %. The largest share in expenditures is occupied by education, medicine and social protection (which amount to 60–70 % of all local budgets expenditures). Local expenditures for education, social protection, medicine, transport, culture and sports, utilities and other sectors of the economy take up a large share in the consolidated budget (more than 50 % in 2019). Thus, it is possible to conclude the existence of the so-called vertical fiscal imbalance, which usually arises from the distribution of tax revenues between central and local governments.

However, the positive trend is the outstripping growth of local budget revenues compared to local budget expenditures in the last decade. In 2010–2019 the local budgets revenues to GDP ratio grew from 6.6 % to 8.2 %, at the same time the local expenditures to GDP ratio grew from 14.1 to 15.2 % (Fig. 3).

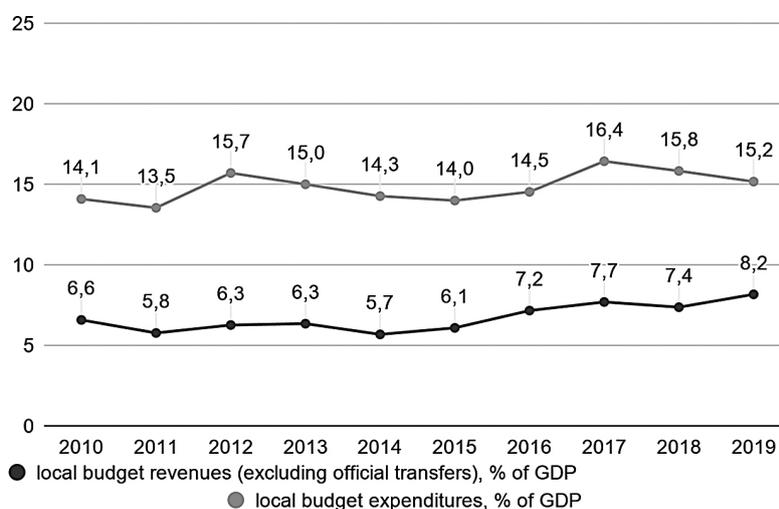


Fig. 3. Local budgets own revenues and expenditures in Ukraine, % of GDP
Source: by authors based on data from (Ministry of Finance of Ukraine, 2020)

Given that official transfers from the state budget are decreasing every year and local taxes and fees are increasing, the positive dynamics in the growth of local budget revenues to GDP are being traced. The gap between expenditures and revenues has been constantly fluctuating for 10 years, but only within 1 % difference, which again confirms that the regions do not have enough resources. Expenditures of local budgets to GDP have been steadily increasing since 2014, which to some extent demonstrates the efficiency of optimizing the expenditure part.

The theory of fiscal decentralization states that the gap between the level of income and the level and structure of expenditures has negative consequences. Excessive financial transfers to local budgets and insufficient use of direct taxation at the local level lead to the rupture of the relationship between the assigned functions and the ability to perform them. Transfers from state to local budgets may not be fully integrated into population income, and the income distribution process provides an opportunity to expand public services that would not be possible under other conditions.

For the efficiency of exercising all the powers of local authorities, namely providing public services to the population, it is necessary that the majority of revenues to local budgets come from the tax and non-tax revenues of local communities, and not through the state budget of Ukraine. It is more effective for local authorities to provide social and economic benefits to citizens through their own finances, rather than provide them through transfers received.

Conclusions and further research proposals.

Establishing an effective system of local self-government, as international experience shows, is possible if decentralization methods are taken into account, which will ensure better performance of the functions of the state with more efficient provision of public goods and services. It is clear that the main directions of local self-government

reform are formulated on the best traditions of foreign experience, such as empowering local authorities and granting budgetary autonomy; expansion of sources of filling of local budgets; establishment of uniform rates of deductions of national taxes; introduction of a mechanism of budgetary regulation and alignment; implementation of sectoral transfer policy.

The current state of the local government system in Ukraine does not meet the needs of society. Territorial communities do not have sufficient resources to create and sustain an adequate living environment. Therefore, there are no high-quality administrative, social and other necessary services for the full development of the person in the respective territories.

In the process of decentralization of local budgets, it is important for central governments to ensure the autonomy of local authorities to fulfill their powers, functions and tasks, taking into account the needs and interests of the united territorial communities, using budget resources effectively.

To improve financial decentralization in the regions of Ukraine, several ways to solve urgent problems can be proposed: to identify areas of responsibility at central and local levels, to enable to supplement own revenues at the expense of their own sources, to increase the role of local taxes and fees and to rise their share in local budgets' own revenues, to establish additional incentives, such as tax breaks, subsidies, transfers, to integrate interests on the goals of regional development, to strengthen links between national and regional industries and to introduce modern information technologies in the field of regional development process management. The problem of revenue-expenditure imbalance can be partly solved by increasing the rate of deductions from personal income tax, as well as by improving the system of property tax administration and the institution of local borrowings.

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ФІНАНСОВА ДЕЦЕНТРАЛІЗАЦІЯ І ФІСКАЛЬНІ ДИСБАЛАНСИ МІСЦЕВИХ БЮДЖЕТІВ В УКРАЇНІ

Метою статті є виявлення відповідності між дохідною та видатковою частинами місцевих бюджетів, яким у процесі фінансової децентралізації було передано значні повноваження на виконання загальнодержавних функцій. Проведено порівняльний аналіз рівнів децентралізації за доходами та видатками місцевих бюджетів в Україні та країнах Європи, а також проаналізовано структуру доходів і видатків зведеного бюджету в розрізі державного та місцевого рівнів. Зазначено, що протягом останніх десяти років розрив між дохідною та видатковою частинами скоротився завдяки реформі децентралізації, проте фіскального балансу досягнуто не було.

Результати аналізу демонструють наявність значного вертикального дисбалансу в бюджетній системі України, який полягає в недостатності власних та закріплених фінансових ресурсів місцевої влади для забезпечення покладених на них повноважень. За рівнем децентралізації доходів Україна посідає середню позицію поміж країн Східної Європи, тоді як рівень децентралізації за видатками відповідає рівню країн Скандинавії, в яких держава відіграє активну роль у перерозподілі доходів і має високу інституційну ефективність та високі соціальні стандарти. У статті обґрунтовано, що вертикальна диспропорція зумовлена неефективною структурою надходжень до місцевих бюджетів, зокрема надто високою часткою трансфертних платежів із державного бюджету до місцевих бюджетів, а також надто низькою часткою власних доходів, зокрема місцевих податків, у податкових надходженнях. Для зміцнення дохідної частини місцевих бюджетів та зменшення вертикального дисбалансу запропоновано збільшити податкову базу місцевих податків шляхом розвитку бізнесу та зростання добробуту в регіонах, підвищити частку відрахувань від податку на прибуток і податку на доходи фізичних осіб до місцевих бюджетів, підвищити ефективність контролю за надходженнями до місцевих бюджетів та оптимізувати місцеві видатки, зокрема видатки на соціальний захист і соціальне забезпечення. Як свідчить практика зарубіжних країн із децентралізованими бюджетними системами, усунення вертикального дисбалансу сприяє значному підвищенню фіскальної спроможності регіонів.

Ключові слова: фінансова децентралізація, місцевий бюджет, вертикальний фіскальний дисбаланс, міжбюджетні трансферти, місцеві податки, бюджетні доходи, податки, бюджетні видатки.

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