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### **FISCAL DECENTRALIZATION OF UKRAINE: SEARCH FOR NEW APPROACHES FOR THE DEVELOPMENT OF LOCAL SELF-GOVERNMENT**

**Abstract.** Specific features of fiscal decentralization as a component of decentralization in Ukraine have been analyzed in this article. It is demonstrated that fiscal decentralization is politically necessary reform for Ukraine, which directly impacts on the formation and implementation of state and regional policy, harmonized actions of central and local authorities, creating a new format of the balance of relationship among the state and local authorities, stabilization and stability of economic processes in Ukraine, efficiency provision of public services, elimination of macroeconomic instability and acceleration of economic growth. The ways of improving this process are outlined. Although the process of fiscal decentralization in Ukraine has not been completed it is concluded about its inefficiency that leads to insufficient effectiveness of reforming the budgetary and tax system, inter-budgetary relations and decorativeness of most measures implemented in the direction of fiscal decentralization. It has been noted that the process of fiscal decentralization in Ukraine should have its implementation strategy, which can determine the main points, can analyze the problems and can search for possible solutions or the ways of mitigation. Key points of such a strategy should be: an adequate political and institutional environment, improvement of the administration quality, close relations of local authorities with the population and formation of effective communication channels; strengthening the responsibility of local self-government agencies to the community (local accountability and transparency, reduction of corruption); fight against corruption, the «horizontal» and «vertical» growth of the budget competition; ensuring the financial independence of local self-government agencies in decision-making; stimulating local self-government agencies to increase their own budget potential, establishing proper access for the development of investment activity. It has been emphasized that the existence of concrete steps of implementing fiscal decentralization in Ukraine will help to strengthen local political and institutional capacities.

**Keywords:** decentralization, fiscal decentralization, local self-government, taxation, budget.

**JEL Classification** H50, H72, H77

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### **ФІСКАЛЬНА ДЕЦЕНТРАЛІЗАЦІЯ В УКРАЇНІ: ПОШУКИ НОВИХ ПІДХОДІВ ДО РОЗВИТКУ МІСЦЕВОГО САМОВРЯДУВАННЯ**

**Анотація.** Проаналізовано особливості фіскальної децентралізації як складової децентралізації в Україні, а також окреслено шляхи удосконалення цього процесу. Доведено, що фіскальна децентралізація є політично необхідною в Україні, безпосередньо впливає на формування та реалізацію державної і регіональної політики, узгодження дій центральних і місцевих органів виконавчої влади, нового формату балансу відносин між органами державної і місцевої влади, стабілізацію і стабільність економічних процесів в Україні, підвищення ефективності надання державних послуг, усунення макроекономічної нестабільності та прискорення процесу економічного зростання. Попри те, що процес фіскальної децентралізації в Україні не завершений, зроблено висновок про його неефективність, що призводить до недостатньої результативності реформування бюджетної і податкової системи, міжбюджетних відносин і декларативності більшості заходів, реалізованих у напрямі фіскальної децентралізації. Зазначено, що процес фіскальної децентралізації в Україні повинен мати свою стратегію впровадження, у якій визначатимуться основні моменти, аналізуватимуться проблеми, що трапляються, і здійснюватиметься пошук можливих способів їх вирішення або пом'якшення. Ключовими моментами такої стратегії повинні бути: адекватне політичне та інституційне середовище, підвищення якості управління, наближеність місцевих органів влади до населення і формування ефективних каналів комунікацій; посилення відповідальності органів місцевого самоврядування перед громадою (місцева підзвітність і прозорість, зниження корупції); боротьба з корупцією, зростання горизонтальної та вертикальної бюджетної конкуренції; забезпечення фінансової самостійності органів місцевого самоврядування в ухваленні рішень; стимулювання органів місцевого самоврядування до нарощування власного бюджетного потенціалу, установа належного доступу на місцях для розвитку інвестиційної активності. Наголошено, що наявність конкретних кроків упровадження фіскальної децентралізації в Україні допоможе наростити місцевий політичний та інституційний потенціал.

**Ключові слова:** децентралізація, фіскальна децентралізація, місцеве самоврядування, оподаткування, бюджет.

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**Introduction.** Fiscal decentralization as part of the process of devolution of power has been undertaken by many developed countries of the world, searching for the correct balance between central government control and decentralized governance. Today Ukraine as most developing countries has embarked in a process of subsequent decentralization. This process combines political, administrative and fiscal aspects. However, fiscal decentralization in any state has its specific characteristics. Fiscal decentralization in Ukraine directly depends on administrative and political decentralization, and the latter, in turn, is a prerequisite for fiscal decentralization. At the same time, the establishment of an effective system of territorial organization of power is impossible without transparency and efficiency of public finances in the state and vice versa, it is impossible to build a new system of financial management in the state without improving the territorial organization of the state.

Fiscal decentralization is politically necessary reform for Ukraine, which directly impacts on the formation and implementation of state and regional policy, harmonized actions of central and local authorities, creating a new format of the balance of relationship among the state and local authorities, stabilization and stability of economic processes in Ukraine, efficiency provision of public services, elimination of macroeconomic instability and acceleration of economic growth.

**Research analysis and problem statement.** The issue of fiscal decentralization and fiscal federalism has been the objective of many theoretical and empirical studies in recent decades. The process of fiscal decentralization has been regarded in developed countries (Oates, 1993 [1] Richard M. Bird, François Vaillancourt, 2008 [2]), and in developing countries (Roy Bahl and Richard M. Bird, 2018) [3]. However, we can currently observe a growing interest in fiscal decentralization in the world. The study of fiscal decentralization has received much attention in the last decades, especially, but not only, its impact on economic growth [4, p. 1095]. Fiscal decentralization is considered in terms of its impact on the economy (Aristovnik, 2012 [5], Neringa Slavinskaitė, 2017 [6], Christopher Dick-Sagoe, 2020 [7], the society (J. Martinez-Vazquez, S. Lago-Peñas, A. Sacchi 2016 [8], Jeffrey Swanson & Namhoon Ki, 2020 [9], politics (Jongmin Shon, Yoon Kyoung Cho, 2020 [10], Francisco Blanco, Francisco J. Delgado, Maria J. Presno, 2020 [11]). Given the fact that fiscal decentralization is a political and economic trend in the development of our state, consideration of the peculiarities of the introduction of this process is of great importance.

The purpose of the article is to research the peculiarities of the introduction of fiscal decentralization in Ukraine and to identify possibilities for improving this process. This objective has been achieved through the task of analysing the current state of fiscal decentralization in Ukraine, highlighting the peculiarities of this process and identifying the ways to improve it.

**The results of research.** There is no doubt that protection of vital interests of a person or a citizen, of society and state, assurance of the stable development of society depends, to the certain extent, on the financial condition of the state and its economic development [12, p. 146].

The effectiveness of the financial management system directly depends on the decentralization of power, which is important for ensuring the stability of the budget system, financial security and sustainable economic development. Decentralization in any country is associated with the process of devolving powers to regional and local governments, where the priority aim is to foster regional development from below by giving subnational governments a greater discretion in determining programmes that are more aspirational to the interests of the community and local and regional development objectives [13, p. 1—3].

Of course, public responsibilities for satisfying the fundamental right and legitimate interests generally must be exercised, in preference, by those authorities, which are closest to the citizen, and transition of any function between local, regional or central authorities should weigh up the extent and nature of the task and requirements of efficiency and economy. Besides, all matters that concern directly the local government, the central or regional authority in the planning and decision-making process should consult with the local authorities as far as possible [14].

Fiscal decentralization is now seen as part of a reform agenda of many nations to strengthen their regional and local governments to meet the challenges of the 21st Century [15, p. 3].

Considering the fact that fiscal decentralization is primarily concerned with the creation of opportunities for the financing of supported functions or subsidized, it is closely linked to political and administrative decentralization. Political and administrative decentralization is aimed at giving citizens more power in public decision-making. This supports democratization, where citizens have more influence and their representatives in government and transfer of institutional authority in the establishment and functioning of institutions for the performance of local functions and the provision of services [16, p. 104—109].

Fiscal decentralization aims to distribute financial resources between different levels of government so that the regions and the government should have a strong financial base for their activities and the state makes transfers to local budgets not because they can finance their minimum needs, but only for delegated functions. Fiscal decentralization aims to increase the financial capacity of local authorities. This financial capacity of local authorities is based on the ability to attract existing and potential financial resources from this territory to finance economic, social and environmental needs, establish rational and efficient directions for their distribution and use. Fiscal decentralization balances the public services with the needs and preferences of local communities and citizens, increases the responsibility of local authorities for their respective functions and the efficiency of the public sector in the whole due to the introduction of competition elements.

The demand for decentralization has increased with widespread political devolution because it is thought to be a more efficient and accountable form of government. The decentralized system is closer to its citizens and responds to them more effectively [10, p. 1]. Decentralizing governance can restore confidence in public policies and provide a basis for broader policy consensus, decentralized fiscal systems offer a greater potential for improved macroeconomic governance than centralized fiscal regimes [8; 17].

Unitary and federal countries have different opportunities for fiscal decentralization. Unitary countries do not have sub-national governments that are constitutionally empowered to make decisions over a specified range of government functions and services, they have multiple subordinate levels of the same government. Federal countries have constitutionally protected sub-national governments and thus, the possibilities for independent decision-making are clearly stronger under these systems [18].

The desire to achieve the transformed system of government and transition to decentralized financial management has led to reforms in Ukraine. However, fiscal decentralization in Ukraine has its peculiarities.

First, public administration reforms and decentralization in Ukraine are based on purist principles and borrowed approaches from other countries, without assessing the wider international experience or in-depth diagnosis of the country's political and institutional context and its implications. Fiscal decentralization in Ukraine is carried out without assessing the possibilities of reforming the existing system of public administration or the need to create a fundamentally new system. Of course, each decentralization process may be regarded as unique and only be explained through the specific context (political, historical, economic and cultural), where it takes place [19].

Second, the reason of the introduction of fiscal decentralization in Ukraine is the current model of local government, enshrined in the Constitution of Ukraine, that preserves the level of excessive centralization of power, violates the principles of competence, autonomy, organizational independence, material, and financial capacity. As a result, de facto local governments are being replaced by a centralized mechanism of public administration through local state administrations.

It destabilizes the situation in the regions and harms their socio-economic situation. District councils represent the common interests of territorial communities of villages, settlements, cities, and district budgets are intended to finance joint socio-economic and cultural programs. However, district councils are not legally the primary subjects of local self-government. Thus, there is a contradiction between the constitutional status of the authorities and their budgetary rights.

Third, fiscal decentralization in Ukraine is being carried out in particularly difficult conditions, which gives rise to a large number of challenges, in particular: exacerbation of the domestic political crisis, critical inhibition of Ukraine's economic development, which leads to

reduced economic activity and its shadowing, budget shortfalls, and increased public debt, the welfare of the population, rising unemployment, high levels of corruption and its entrenchment into all spheres of public administration, the economic inability of most local self-governments to exercise their own and delegated powers, limited resources in local budgets for regional development, public distrust and alienation of local authorities and their closeness, lack of local authorities transparency, non-use of resource potential of regions for local development.

Fourth, the implementation of fiscal decentralization policy in Ukraine has several weaknesses related to ensuring the financial independence of local self-governments and strategic goals of regional development. Fiscal decentralization has not produced an adequate level of revenue for local budgets to enable them to be financially independent of the State budget and to enable them to carry out their functions independently of the transfers listed, sufficient for the normal functioning of the territorial communities. In particular, according to the Ministry of Finance of Ukraine, the general fund of local budgets received only 262 095,3 million hryvnias for 11 months of 2020: actual receipts of the real estate tax made 5 477,2 million hryvnias, receipts of the uniform tax made 36 018, 3 million hryvnias. Also, the Cabinet of Ministers of Ukraine, following the budget legislation, for 11 months of 2020 provided the transfer of intergovernmental transfers to local budgets for 145,386.8 million hryvnias, which is 97.2% of the planned appropriations for January — November 2020, in particular: basic subvention was transferred for 12,175.5 million hryvnias or 100.0% of the appropriations; the medical subvention was transferred for 14,582.8 million hryvnias or 100.0% of the appropriations, the educational subvention was transferred for 73,265,9 million hryvnias or 99.8% of the appropriations [20].

Fifth, today local authorities are unable to pursue an active economic policy, including in the search for and attraction of investors, and contribute to both the prosperity of the regions and the high economic dynamics of the state in the whole. Thus, despite the announced course of decentralization of public finances, Ukraine is strengthening the centralization of state power; budget and tax reforms do not contribute to the introduction of financial independence of local authorities from central government. And both Ukraine's fiscal balance and public debt continue to deteriorate, accompanied by volatile growth, high gross external debt, inadequate financial regulation, low incomes, and history of sovereign default. The exchange-rate policy is becoming increasingly politicised, and the currency is starting to look overvalued [21]. Moreover, these negative trends lead to Ukraine's low ratings in the world. In particular, Ukraine is currently ranked in the sixty-fourth position among 190 countries of «Doing Business-2020» data of the World Bank [22], while it is ranked in the eighty-fifth position among 141 countries of the Global Competitiveness Index [23].

The experience of developed countries and developing countries that have undergone fiscal decentralization confirms the fact that fiscal decentralization is an indispensable step towards the establishment of a legal, social, democratic state, combating corruption and improving the efficiency of the authorities. In this process country's economic development level is an important factor when introducing reform of fiscal decentralization [6; 24].

Fiscal decentralization is the key point for determining territorial autonomy and the performance of regional authorities. Fiscal decentralization can improve the efficiency of public service delivery through preference matching and allocative efficiency, by fostering stronger accountability [25, p. 3]. A process of fiscal decentralization, accompanied by measures to improve the quality of government, would be an effective strategy for reducing regional inequalities [26, p. 951—954].

However, it remains important to determine the best distribution of roles and responsibilities for the formation and distribution of financial resources between different levels of government in the process of fiscal decentralization. The question of the extent of centralization and decentralization is critical in addressing interstate funding. What level of management will be responsible for providing specific services? How will these services be financed?

First of all, in seeking answers to these questions, it is worth focusing on understanding the context, where government reforms and fiscal decentralization management were initiated. Fiscal

decentralization can be implemented when: 1) there is a credible financial management system but is not being used properly, or 2) there are some elements of a quality financial management system, but others need to be developed. In other cases, the current system may be dysfunctional, nontransparent and politically captured, and reformers face the challenge of building an entirely new system [27, p. 363—372].

There are three main reasons for fiscal decentralization in any country, including Ukraine:

1. Central governments increasingly are finding that it is impossible for them to meet all of the competing needs of their various constituencies, and are attempting to build local capacity by delegating responsibilities downward to their regional governments.

2. Central governments are looking to local and regional governments to assist them on national economic development strategies.

3. Regional and local political leaders are demanding more autonomy and want the taxation powers that go along with their expenditure responsibility [15, p. 3—4].

To assess the effectiveness of decentralization of power, more than 25 decentralization indexes are being used worldwide today, namely: the definition of territorial autonomy including fiscal autonomy (the local autonomy Index), determination of indicators of activity of regional authorities (the regional authority Index), intergovernmental grants, and revenue and spending shares by the level of government, the kind of units of analysis, the number of cases, the nature of variables, the timescale, the measurement frequency, the scoring, the sources, the validity and reliability assessment and the transparency of the data production process [4, p. 3—4; 28, p. 3].

Unfortunately, it is difficult to assess the effectiveness of fiscal decentralization in Ukraine, since the process of reforming state executive agencies and local authorities has not been completed yet. However, it can already be stated that fiscal decentralization is inefficiently implemented in Ukraine, as a result of which the reform of the budget and tax system, inter-budgetary relations, and decorativeness of most measures implemented in the direction of fiscal decentralization is insufficient.

Reforms in Ukraine in recent years, including budget reform, have partially delegated the right to spend on public services at the local level. However, this reform has not been completed yet, since there is no clear division of powers and responsibilities between the state and local authorities.

For example, some types of expenditures in the Budget Code of Ukraine are financed from both the local and state budgets, depending on the subordination of educational institutions, health care, but the responsibility for the quality of services provided is not assigned to any level of government. As a result, it is impossible to establish who is responsible for low-quality public services, because the allocation of expenditure obligations is based not on functional powers, but on an object-by-object approach, depending on the subordination.

The main factors justifying the need for effective fiscal decentralization in Ukraine include the increase of economic efficiency through providing of better services, the competitiveness and mobility of the population in local governments for the provision of public services.

In our opinion, fiscal decentralization in Ukraine should be based on the principle of subsidiarity, which is not only one of the main mechanisms to curb excessive centralization, but also a method of determining the scope of powers of local authorities. Today, the principle of subsidiarity is the basis for the operation of the budgetary system in Ukraine. This principle is to distribute the types of expenditures between the state budget and local budgets, as well as between local budgets in such a way as to bring the provision of public services as close as possible to their direct consumer [29].

Central and regional authorities should intervene in the activities of local authorities only to the extent and within the limits beyond which the territorial community cannot meet its diverse needs. This means that the relationship between central and local authorities should be based on a balance between financial sovereignty of local budgets and the state budget. It is the principle of subsidiarity that should become the basis for the functioning of the budget system of Ukraine and the urgent task of reforming inter-budgetary relations in our country [30].

The definition of the functions of each level of government and the model of the relationship between central and local authorities is the significant step in fiscal decentralization. Constitutional protection, territorial quality, and strength of self-rule is important during this process, as well as legal, functional, financial, organizational, and vertical aspect of autonomy of equal importance [31].

Typically, the centre should be responsible only for functions that affect all lower levels of government (defence and monetary policy), lower levels should be responsible for all other functions especially related to service delivery.

The development of regions is possible only with stable financial incomes. This makes it possible to plan the development of social infrastructure and to introduce economic incentives for business development. Therefore, fiscal decentralization is effective only when local authorities can independently provide their territory with revenues to the local budget. In this aspect, a degree of autonomy of local authorities over revenues and expenditures is important for fiscal decentralization. Fiscal autonomy can ensure the realization of objectives without the need for permission or acceptance from another public authority. The degree of autonomy of local authorities over income should be measured by two criteria: the freedom to determine the tax base and the tax rate.

Based on the classification of own and joint incomes developed by the OECD according to the degree of autonomy of local incomes, there are several indicators of autonomy of the territory: 1) when local authorities control both the tax rate and the tax base; 2) when local authorities set the tax rate; 3) when local authorities establish the tax base; 4) when local authorities determine the distribution of income [32, p. 10].

Since local taxes are usually the largest source of autonomous income for local governments, the ability to influence the tax base, tax rate or revenue collected is a significant condition. Local authorities can adapt the level of services to their financial circumstances with this opportunity.

Unfortunately, today local authorities in Ukraine are not in a position to mobilize financial resources. The current system of revenue generation in local government budgets does not ensure their financial self-sufficiency: it depends on transfers from the State budget and is characterized by a gradual decline in the share of its revenues. The financial resources of local authorities are limited, and as a result, there is a need to deepen the study of the structure and trends of local budget revenues, to develop practical recommendations for finding reserves for budget revenues in terms of decentralization.

To define the level of financial autonomy, it is necessary to compare the financial resources and the tasks to be performed by the local authority. Thus, the analysis of both revenue and expenditure by the local authorities plays an important role here, as well as the availability of decision-making powers that local authorities can apply to different types of revenue sources.

A principled and transparent division of powers becomes crucial for public administration and ensuring the effectiveness and accountability of citizens, monitoring and effectiveness of policies, service delivery. A well-defined model of the relationship between central and local authorities can provide the basis for giving local authorities discretion within a certain framework of authority and responsibility.

There are several drawbacks to fiscal decentralization besides benefits [11, p. 226—249]. Given that decentralization gives local bureaucrats greater discretionary power in implementing policies and allocating fiscal resources, leads central governments to weaken monitoring, controls, and audits, which creates [10, p. 187—188], global experience has displayed that fiscal decentralization is inexpedient in the face of high levels of corruption. Fiscal decentralization contributes to corruption, if political competition at the local level is limited, minimizes the effectiveness of central government control over the budgetary process at the local level, deepens the differentiation in the levels of regional development.

Being ranked one hundred and twenty-sixth in the Corruption Perception Index issued by Transparency International, Ukraine faces the fact that the development of decentralization policy is particularly difficult, because institutions, information and capacity are all very weak. The cross-

cutting nature of decentralization, the importance of local institutions in influencing the impact of decentralization and the limited empirical evidence on what works and what does not make the design and implementation of decentralization a considerable challenge (for example, matching expenditures and revenues at each level of government, providing a regulatory framework that imposes a hard budget constraint on subnational governments, and incorporating local participation and accountability in decentralization) [33, p. 141].

The process of fiscal decentralization in Ukraine should have its implementation strategy, which identifies the main key points, analyzes challenges and searches for possible solutions. In our opinion, adequate political and institutional environment, improve the quality of government, the proximity of local authorities to the population and the formation of effective communication channels; strengthening the responsibility of the local government to the community (local accountability and transparency, reducing corruption); fight against corruption, the «horizontal» and «vertical» growth of the budget competition, ensuring the financial independence of local authorities in decision-making; stimulating local authorities to increase their budget, reduce regional tensions, establishing proper access on the ground for the development of investment activity should be the key points of such strategy. The existence of concrete steps to implement fiscal decentralization in Ukraine will help to build local political and institutional capacities.

**Conclusions.** The process of fiscal decentralization, that has begun in Ukraine, is being implemented inefficiently and is characterized by several peculiarities. Such peculiarities should include borrowing approaches from other countries, without assessing the wider international experience and in-depth diagnosis of the country's political and institutional context and its implications; without removing contradictions at the legislative level the status accorded to authorities and their fiscal rights and obligations; implementing the reform in particularly difficult conditions with a large number of challenges and weaknesses related to ensuring the financial independence of local governments and strategic goals of regional development.

The improvement of the process of fiscal decentralization in Ukraine requires creation of a strategy for its implementation, which can identify the main key points, can analyze challenges and search for possible solutions. An adequate political and institutional environment, improvement of the quality of government, close relations of local authorities with the population and the formation of effective communication channels; strengthening the responsibility of the local self-government agencies to the community (local accountability and transparency, reduction of corruption); fight against corruption, the «horizontal» and «vertical» growth of the budget competition, ensuring the financial independence of local authorities in decision-making; stimulating local authorities to increase their own budget, reduction of regional tensions, establishing proper access for the development of investment activity should be the key points of such strategy. The existence of concrete steps to implement fiscal decentralization in Ukraine will help to build local political and institutional capacities.

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