

# DECENTRALIZATION OF POWER: FINANCIAL PROBLEMS AND PRIORITY DEVELOPMENT DIRECTIONS

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*The author* considers the concept of decentralization of power as a process of state power alienation in favor of the territorial community as well as mechanisms of interaction between public authorities and local governments. The author analyzes the development of creating associations of territorial communities (ATC); substantiates positive results of fiscal decentralization reform; outlines the further directions of the budget decentralization reform in Ukraine. The budget decentralization as a decentralization of financial and material resources was examined. The author formulates advantages and component parts of the budget decentralization; analyzes the changes that took place during the decentralization of power reform, which have affected the processes of budget regulation.

It is proved that reduction of subsidies of local budgets is one of the main indicators, which refers to increasing the financial independence of local governments. It is noted that special attention should be paid to the ecological tax. The author proposes to consider at the governmental level the possibility of keeping the ecological tax in full in the budgets of those settlements, where there is an extremely high level of man-made and anthropogenic load. According to the results of the research, the author proposes the measures aimed at strengthening the financial basis of local governments; reveals the problems of budget decentralization implementation; considers the problems of financial provision of territories development. The author comes to the conclusion that the interrelation of legislative changes in the Tax and Budget Codes has contributed to the transformation of local budgets into effective instrument of socioeconomic development of administrative and territorial units. The author underlines the need of strengthening control and responsibility for compliance with budget legislation on the way to solving financial problems of power decentralization.

**Keywords:** decentralization of power, budget decentralization, interbudgetary relations, local government, association of territorial communities.

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ДЕЦЕНТРАЛІЗАЦІЯ ВЛАДИ: ФІНАНСОВІ ПРОБЛЕМИ ТА ПРІОРИТЕТНІ НАПРЯМИ РОЗВИТКУ

*Розглядається* поняття децентралізації влади як процес відчуження повноважень держави на користь територіальної громади, а також як механізми взаємодії органів державної влади та органів місцевого самоврядування.

Досліджено розвиток процесів утворення об'єднань територіальних громад (ОТГ). Обґрунтовано позитивні результати реформи фіскальної децентралізації. Окреслено подальші напрями реформи бюджетної децентралізації в Україні. Досліджено бюджетну децентралізацію як децентралізацію фінансових та матеріальних ресурсів. Сформульовано переваги та визначено складові бюджетної децентралізації. Проведено аналітичне дослідження змін, котрі відбулись упродовж реформи децентралізації влади, що позначилося на процесах бюджетного регулювання.

Доведено, що зниження дотаційності місцевих бюджетів – один із головних показників, який свідчить про підвищення фінансової незалежності органів місцевого самоврядування. Зазначено, що особливу увагу необхідно приділити екологічному податку. Запропоновано розглянути на урядовому рівні питання щодо можливості залишення екологічного податку в повному обсязі бюджетам тих населених

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пунктів, де є надвисокий рівень техногенного й антропогенного навантаження. За результатами дослідження запропоновано заходи, що спрямовані на зміцнення фінансової основи місцевого самоврядування. Виявлено проблеми реалізації реформи бюджетної децентралізації. Досліджено питання фінансового забезпечення розвитку територій. Встановлено, що взаємозв'язок законодавчих змін у Податковому та Бюджетному кодексах сприяв перетворенню місцевих бюджетів на ефективний інструмент соціально-економічного розвитку адміністративно-територіальних одиниць. Висловлена думка щодо необхідності посилення контролю та відповідальності за дотримання бюджетного законодавства на шляху до вирішення фінансових проблем децентралізації влади.

**Ключові слова:** децентралізація влади, бюджетна децентралізація, міжбюджетні відносини, місцеве самоврядування, об'єднання територіальних громад.

**Formulation of the problem.** Decentralization is a complex concept that can be disclosed through its influence on the administrative-territorial structure of the state, the system of public administration authorities, the division of functions, powers and financial resources among them. The potential of decentralization, as one of the mechanisms of increasing the efficiency of public power functioning, has long been under the attention of domestic scientists and leading specialists. This is due, in particular, to the successful practical implementation of the principles of decentralization among the most of European Union countries. Generally, decentralization of power means such way of defining and demarcating tasks and functions, in which most of them are transferred from the central to a lower level authorities and become their own tasks, powers and responsibilities.

**Analysis of recent researches and publications.** Foreign researchers pay attention to the specificity of understanding the essence of decentralization, in particular, in Ukraine. Thus, domestic scientists [1–5] submit it as a redistribution of powers between the center and the regions in favor of the last, one by delegating and sub-delegating the functions and powers to the regions. The creation of local state administrations is also considered as a component of decentralization. Scientific approaches to the definition of "decentralization" include understanding of this process, as weakening or, even, the abolition of centralization; independence in management approach taking into account the diversity of local features while maintaining unity in the essential; transferring part of state administration functions from central executive authorities to local executive authorities and local government authorities, which provides the extension of the powers of the lower authorities at the expense of the higher level authorities; the process of transferring part of functions and powers from higher levels of management to lower.

**The purpose of the article** is to investigate the essence of decentralization of power, the problems of financial provision for development of territories and outline further directions of budget decentralization reform in Ukraine.

**Presentation of the main part.** It is important that decentralization involves the delegation of powers of

the state as a legal entity of public law in favor of another legal entity of public law, a territorial community, which characterizes the content of local government. Decentralization makes possible to simplify the structure of local governance, to ensure close ties with civil society and transparency in decision-making, and also contributes to raising the level of accountability to the territorial community. However, along with this, decentralization is accompanied by the emergence of inconsistencies in strategic goals and areas of development of individual territorial units.

Studying practical experience and generalization of the opinions of domestic and foreign scientists allows to define decentralization as a systemic process containing the following components: the issue of the ability of state authorities to transfer, and local government authorities – to receive and efficiently dispose of powers; definition of the volume and list of powers to be transmitted; administrative – political mechanism of transferring powers; budgetary and market mechanisms of interaction between public authorities and local government authorities; the issue of administrative-territorial reform. That is, decentralization is a specific management method that is important for local democracy and government development.

Budget decentralization represents the decentralization of financial and material resources, which is the basis of the economic independence of certain territories.

Actually all countries in the world faces the problem of financial support for the development some of their territories. In Ukraine, issues of fiscal decentralization are paying particular attention to the fact that decentralization is designed to ensure redistribution of revenue sources, powers between levels of government, maximum financial support for local development projects.

Administrative-territorial entities have different natural – resource and financial potentials, including the tax base, that is, decentralization is intended to increase the efficiency of functioning of the budget system. Transfer of powers to localities and autonomy in decision-making in the formation of incomes and the using of budgetary funds – is the prerogative of fiscal decentralization.

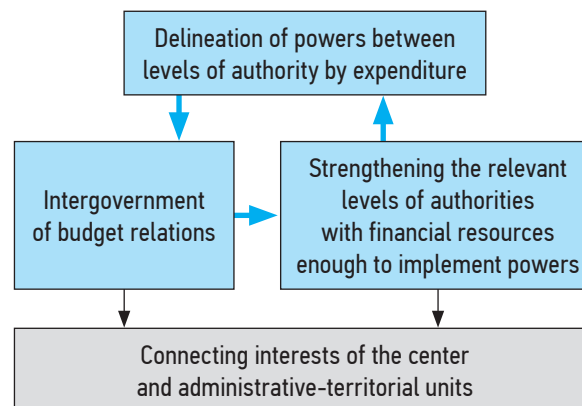
The concept of fiscal decentralization plays a key role in the theory of public finance and is considered an important part of fiscal policy [6–9]. As convinced by the experience of developed countries, the financial problems of the regions are solved by building an optimal mechanism of the system of local budgets and intergovernmental fiscal relations. The advantages of budget decentralization should include:

- the possibility of preserving regional economic stability;
- the possibility of providing a defined level of investment activity;
- rational using of budget funds;
- the proximity of local authorities to the population and the formation of effective channels of communication;
- strengthening of the responsibility of local government authorities to the community, as a consequence – reducing corruption;
- ensuring the financial autonomy of local government authorities in making decisions on the one hand, and transparency of actions of local government authorities on the other hand;
- encouraging local government to increase its own budget (financial) capacity.

Fiscal decentralization allows through relative independence of each budget to combine the fiscal, social and economic interests of the center with the interests of administrative-territorial units (*Fig. 1*).

The transformation of local budgets into an effective instrument of socio-economic development of administrative-territorial units is possible by solving the following tasks: strengthening the financial basis of local government; increasing the efficiency of the process of forming the expenditure part of local budgets and decentralize management of budget funds; improvement of the system of regulation of intergovernmental fiscal relations; introduction of local budget planning for the medium term; strengthening the investment component of local budgets; improving the efficiency of management of local budget funds and strengthening control and responsibility for compliance with budget legislation; ensuring transparency of the process of formation and implementation of local budgets.

Today, thanks to the decision on financial decentralization in the country adopted in 2014 on the legislative level, we can sum up some results. The result of decentralization is autonomy in approaches to management, taking into account the diversity of local features, while preserving substantial unity in the



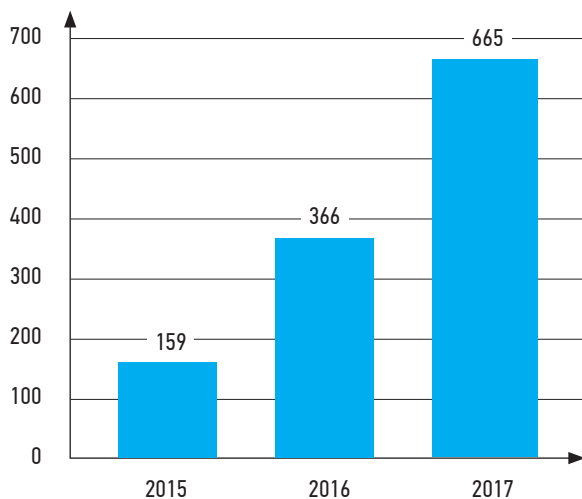
**Fig. 1. The Components and Benefits of Budget Decentralization**

*Origin:* developed by author.

main. Thanks to the legislative changes (introduced in the Tax, Budget Codes and other legislative and regulatory acts), which involve decentralization of tax revenues, local budgets have received more resources for their development.

The process of implementing the reform of decentralization of power went into an active phase with the adoption of the Law of Ukraine «On Voluntary Association of Territorial Communities» of 05.02.2015 [10], which allows to implementation its first basic stage – the formation of associations of territorial communities (hereinafter the ATC) without the introduction of changes to the Constitution of Ukraine. This allowed only in the first year of the adoption of the above Law to create in Ukraine 159 ATC units. Starting from 01.01.2017, 366 ATC units have already been operating in Ukraine, which have switched to direct intergovernmental relations with the State Budget of Ukraine. After the first election on April 30, 2017, 413 ATC units were operating in Ukraine, after the first election on October 29, 2017 – 614 ATC units. On December 24, 2017, the first elections of deputies of village, town councils of the associated territorial communities and corresponding village, town and city mayors in 51 ATC units have already been appointed [11; 12]. This means that by the end of 2017, 665 ATC units will be finally formed in Ukraine (*Fig. 2*).

According to Art. 64, 67 of the Budget Code of Ukraine, the composition of revenues of the general fund of the budgets of the ATC is equated to the budgets of cities of region significance and district budgets, as well as ATC is being granted with the right of transition to direct intergovernmental relations with the state budget of Ukraine only on condition of the formation of ATC in accordance with the law and a with a prospective plan for the formation of ATC [13]. The ATC that went to direct intergovernmental relations with the state budget in 2016–2017 showed a positive dynamics in the growth of their budget revenues. Thus, the own revenues of the



**Fig. 2. The dynamics of the formation of ATC in the process of implementing the decentralization of power reform in Ukraine (units)**

*Origin:* developed by author.

local budgets of 366 ATC in January-September of this year, as compared to the same period last year, increased almost twice (by 182 %) and amounted to UAH 6,25 billion [14].

Top priorities of the introduced changes are the extension of the rights of local government authorities in decision-making and giving them full budgetary autonomy in terms of filling their budgets and exercising their powers in the light of European experience [15–17]. At the same time, it is envisaged to increase the sources of the formation of the revenue base of local budgets by transferring certain revenues from the state budget, expanding the tax base of real estate tax through the introduction of taxation of objects depending on their value, as well as improving

the mechanism for collecting the excise tax on retailing excisable goods.

A new mechanism of budgetary regulation was introduced – the system of total balancing of all local budgets was replaced by a system of horizontal equalization of the capacity of administrative-territorial units depending on the level of income per capita.

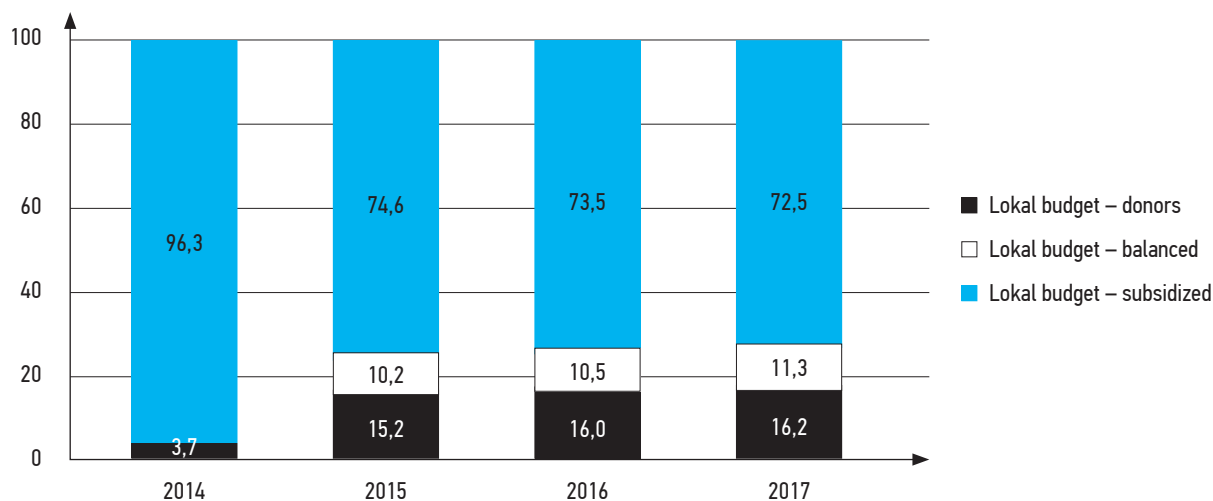
Reduction of dependence on subsidies for local budgets from state is one of the main indicators, which testifies increasing of financial autonomy of local government authorities. By 2014, the percentage of subsidies among local budgets was 96,3 %, and donors were 3,7 % of local budgets. From 2014, if compared with 2017, the number of subsidy budgets decreased by 23,8 percentage points to 72,5 %. In turn, the volume of donor budgets is currently 16,2 %, that is, their growth was 12,5 p. p. (Fig. 3). Due to the introduction of financial decentralization, the level of subsidies to local budgets decreased by 23,8 p. p. from 2014 to 2017.

Also, the structure of expenditures of local budgets has changed. The share of expenditures for government powers has increased, which indicates an increase in the autonomy of local budgets and the efficiency of using budget funds at the local level.

At the same time, financial resources now match the real needs of local budgets in spending on state-authorized powers.

Another positive result of fiscal decentralization reform is the increase of investment resources of local budgets.

In general, the availability of sufficient financial resources at the disposal of local governments allowed them within a 2016, except in rare cases, not to



**Fig. 3. Dynamics of the structure of local budgets as a result of fiscal decentralization reform, %**

*Origin:* developed by author.

apply to the authorities of the State Treasury for short-term loans. The associated territorial communities fulfilled their spending powers completely and accumulated on treasury accounts the balance of funds, which as of January 1, 2017 (fund) amounted to 1,1 billion UAH. This is almost 4 times more than in the beginning of 2016 (UAH 0,3 billion).

The balance of funds of general fund of all local budgets of Ukraine (on treasury accounts) as of January 1, 2017 amounted to UAH 33,6 billion.

In January–May 2017, the general fund of local budgets received UAH 72,3 billion, which is 44,5 % of the annual plan allocations approved by local councils. The increase in revenues to the corresponding period of last year was 34,3 % or UAH 18,5 billion. At the same time, the growth rate of income growth above the average in Ukraine is ensured in 19 regions.

In our opinion, it is expedient to carry out calculations of intergovernmental transfers on the basis of consolidated budgets of regions, transferring responsibility for further redistribution of budget funds to regional state administrations. To do this, it is necessary to strengthen the financial basis of local government by implementing the following measures:

- increasing local government's interest in raising their own revenues by stimulating an increase in production volumes, gross value added, investment volume and income level according to the innovative direction of economic development of the territory;
- annual increasing of the share of the general fund of local budgets in the consolidated budget of Ukraine;
- increasing the level of self-sufficiency of local budgets by further improving tax legislation in line with the directions of reforming the tax system, in particular the system of local taxes and fees;
- further optimization of distribution of taxes and duties (mandatory payments) between state and local budgets, transfer of separate sources of income to local budgets;
- redistribution of revenues between local budgets and revision of revenues, which are taken into account and not taken into account in determining the amount of intergovernmental transfers.

Special attention should be paid to environmental taxes. In accordance with the Law of Ukraine «On the State Budget for 2017» and the Budget Code, the amount of environmental taxes distributed between the state and local budgets, but it should be noted that its greater share, and this is 80 %, goes to local budgets. But even under such conditions, it should

be proposed to consider at the governmental level the possibility of keeping the ecological tax in full in budgets of those settlements where there is a super-high level of man-made and anthropogenic loading, while additional revenues should be directed exclusively at environmental measures and environmental protection. We consider such step as a logical development of the processes of budgetary and financial decentralization in the country.

An important step towards addressing the financial problems of decentralization of power is to increase the efficiency of management of local budget funds and to increase control and accountability for compliance with budget legislation, which requires: providing local government with methodological and advisory assistance on local budget reform; improvement of the procedure of financial control over observance of the budget legislation at all stages of the budget process by its participants in accordance with the powers determined by the legislation, ensuring economical and efficient management of budget funds in accordance with the established directions of their use; improvement of the procedure of financial and administrative responsibility for violations of the requirements of budget legislation by local government authorities; introduction of a mechanism for monitoring and evaluating the effectiveness of the implementation of their powers by local government authorities, increasing responsibility for the exercise of such powers; developing a system for monitoring the results of the work of local self-government authorities in the context of reforming local budgets; introduction of the system of annual rating assessment of the results of the work of local government authorities in managing budget funds; improvement of the procedure for the implementation of internal financial control in budgetary institutions.

According to A. Shah, the advantages of budget decentralization are that local governments are put in «tight budgetary frameworks». This circumstance urges regional authorities to optimize revenue sources and improve tax administration [8]. A rational approach to spending budget funds leads to a minimization of the budget deficit.

Well performed budget decentralization helps to increase the financial potential of the territory, intensify investment activity, stimulate entrepreneurial activity, which in the end strengthens economic potential and provides a «ground» for growth and development. Therefore, it is extremely important to further develop the procedure of financial and administrative responsibility for violations of requirements of budget legislation by local government authorities.

The first steps of regional state administrations on the way to solving the urgent problems of implementing the budget decentralization reform should be:

- optimization of the network of budget institutions in the context of sectoral decentralization, which will enable to increase the efficiency of planning and using of budgetary funds of budgets of all levels;
- ensuring the process of verification of recipients of social benefits, which will enable to optimize and increase the efficiency of budget expenditures, which are directed to budget support of vulnerable population groups;
- increasing the transparency of the budget process at the local level through the active implementation of public monitoring and tools such as budgets of participation/public budgets (allocation of part of the budget funds for financing public initiatives (projects), co-financing of community projects selected on a competitive basis, allocation of financial resources from the regional budget for co-financing of grant projects funded by international institutions and international donor assistance.
- submission to the highest level executive authorities of financial indicators and proposals to the draft State Budget of Ukraine, proposals on the amount of funds of the State Budget of Ukraine for their distribution among the territorial communities, the sizes of dotations and subventions, data on changes in the composition of objects subject to budget financing, balance of financial resources to account for them in determining the size of subventions, as well as for budget equalization on the basis of ensuring the minimum social needs in the context of the implementation of the decentralization reform and taking into account the results of the association of territorial communities;
- elaboration of proposals for activating the «points of growth» of the economic sphere of administrative-territorial units taking into account the budgetary and socio-economic results of the association of territorial communities.

**Conclusions and directions of further research.** It is necessary to increase the transparency of the budget process at the local level through the active implementation of public monitoring and such instruments as participation budgets/public budgets (in particular, the application of the program-target method and medium-term budget planning at the local level); co-financing of community projects selected on a competitive basis; allocation of financial resources from the regional budget to co-finance grant projects funded by international institutions and international donor assistance.

It is also important to make adjustments to regional strategies in the context of promoting the growth of the internal social and economic potential of territories in accordance with the goals of the State Strategy for Regional Development by 2020, as well as ensuring the effective functioning of the system of

provision of administrative services to the population in order to prevent their deterioration in the process of community association and improving the quality of medical, educational, administrative and other services.

Thus, fiscal decentralization is a guarantee of decentralization of power, the establishment of an effective system of local finance, and most importantly, an instrument for regulating regional development. Budgetary decentralization that involves encouraging regions to become financial autonomy, finding additional own resources, and enhancing their internal development potential allows to balance the needs and capabilities of the regions.

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