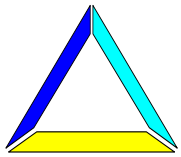
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Setting up a framework for efficient local budget expenditures

Executive Summary

Despite of a large-scaled reform of intergovernmental finance initiated in 2001, a lot of acute problems related to local budgets expenditures remained unsolved, namely excessive centralization of public tasks, unclear division of functions across levels of government, and low administrative and fiscal capacities of local government entities (LGEs) resulting in poor incentives and low accountability of local governments for execution of their tasks.

To overcome these deficiencies we propose the following measures

1. Administrative-territorial reform should be initiated aiming at the establishment of new self-government units (municipalities) that are able to fulfill independently the majority of public tasks on local level. New municipalities in rural areas may encompass the territory of several villages and settlements. Boundaries of municipalities in urban areas should correspond to the boundaries of towns.

2. The number of rayons should be reduced substantially. The size of rayons should be functionally adjusted both to the tasks executed with respect to the regional development, and the tasks executed on behalf of the regional community. Self-government executive bodies should be formed on rayon and oblast level that would replace local state administrations.

3. The crucial part of delegated tasks should be transferred to LGEs as their own responsibilities. Control over execution of delegated tasks should be established. Central government should keep its oversight role in education and health care sectors.

4. Public tasks should be clearly distributed across levels of government. Expenditure assignment by levels should rely on the principles of subsidiarity, territorial equivalency, economy of scale, consideration of externalities. With respect to every function, the responsibilities of levels of government should be specified in 3 dimensions: setting up the standards (quality) for public goods; supply of public goods; financing of public goods supply.

5. Central government regulation of the expenditure patterns for the local budgets should be reduced, and LGEs should be empowered with real fiscal autonomy. LGEs should decide on the amount and structure of their budget expenditures independently including the allocation of funds on execution of their own and delegated responsibilities.

6. As a transitory measure of regulation wages in public sector central government may set up a "basic wage rate" and finance it by conditional grants from the Central budget

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Introduction

Decentralization helps to make governments more accountable, allowing a better matching of public services to local preferences/ needs, and enhances efficiency in public sector introducing competition across jurisdictions[1]. Using advantages of fiscal decentralization requires:

a) sufficient autonomy of local government entities (LGEs) from the center in determining the volume and structure of local budget expenditures,

b) clear division of responsibilities across levels of sub-national government based on economic criteria,

c) sufficient administrative and financial capacity of sub-national governments to fulfill assigned functions and finance expenditures,

d) proper incentives and accountability mechanisms for LGEs ensuring efficient supply of public goods.

A reform of intergovernmental relations in Ukraine that started with the adoption of Constitution and Law on Local Self-Government and proceeded with the implementation of Budget Code (2001), addressed some issues of fiscal decentralisation and made relations between central and sub-national governments more transparent and predictable. However, a lot of fundamental problems remained unsolved.

An overwhelming share of delegated responsibilities in the total amount of public tasks and centralized regulation of the wage rates, employment and material expenses in local budgetary units contradicts the declared autonomy of local self-government. Lack of clear division of functions across levels of government and obsolete system of expenditure financing (based on object subordination) undermines incentives and accountability of LGEs for performing public tasks, incurring efficiency losses. Unreformed administrative-territorial system inherited from former USSR is a serious obstacle for decentralization of public tasks and financial independence of local self-governments.

In our paper, we offer some measures to improve the framework for local budgets expenditures. We start with analysis of current problems – excessive centralization of fiscal decision-making, unclear division of responsibilities across levels of government,

[1] OECD Economic Outlook, 2003, p.143

and deficient administrative-territorial system (Part 1). In Part 2 we discuss the ways of conducting territorial-administrative reform, decentralising local budgets expenditures and redistributing functional and expenditure responsibilities across levels of government (sections 2.2 and 2.3).

1. Local budgets' expenditures in Ukraine: unsolved problems.

1.1. Centralized regulation of local budgets expenditures

In quantitative terms, the level of decentralisation in Ukraine is quite substantial and comparable to the respective international indicators. In 2002, local budgets expenditures without intergovernmental transfers accounted for 11.2% of Ukrainian GDP (see table 1). For comparison, in OECD countries, on the average, sub-national spending constituted 14.9% of national GDP (Denmark – 31.8% of GDP, Finland – 17%, France – 9.9%, Greece – 2.4%, Italy – 14.2%, Japan – 15.2%, Norway – 22.7%, Portugal – 5.7%, Spain - 13%, United Kingdom – 10.8%).[2]

Table 1: Local and regional budgets expenditures, % of GDP*

	1998	1999	2000	2001	2002
Local budget expenditures without intergovernmental transfers	14.6	12.4	9.2	10.4	11.2
Local budget expenditures with intergovernmental transfers	15.2	12.6	10.0	11.7	12.5

Source: IER calculations, based on the data of State Treasury, Ministry of Finance and State Statistics Committee.
* For data comparability expenditures since 2000 are shown without own funds of budgetary agencies.

The share of regional and local expenditures in consolidated budget in 2002 in Ukraine constituted 44.1% (see table 2) and was higher compared to respective indicators in most of OECD countries (Denmark – 57.8%, Finland – 35.5%, France – 18.6%, Greece - 5%, Italy – 29.7%, Japan – 40.7%, Norway – 38.8%, Portugal – 12.8%, Spain – 32.2% of GDP, United Kingdom – 25.9% of GDP) as well as their average indicator (32.2% of GDP). [3]

Table 2: Share of local and regional budget expenditures in Consolidated Budget, %

	1998	1999	2000	2001	2002
Expenditures without transfers	48.1	45.4	38.6	42.5	44.1
Expenditures including transfers	49.9	46.2	42.0	47.6	49.7

Source: IER calculations, based on the data of State Treasury and Ministry of Finance.

[2] Fiscal Relations across Levels of Government // OECD, 2003.
[3] Fiscal Relations across Levels of Government // OECD, 2003.

Although in Ukraine a significant part of public expenditures is incurred by local governments, a degree of real decentralization of public tasks is quite low. ***Excessive centralization of the Ukrainian fiscal system is reflected in:***

- Domination of the delegated responsibilities in the structure of local budgets expenditures;
- Strict regulation of the local budgets expenditures via central setting of different norms and wage arrangements;
- Weak control over the execution of delegated responsibilities.
- Minor role of LGEs own revenues in financing their expenditures[4].

Domination of delegated responsibilities: Own responsibilities of LGEs are quite limited. In 2004, they are estimated in the amount of 2,24 bn UAH or 8,9% of local budgets expenditures. According to Budget Code, own responsibilities of LGEs encompass the following: local fire-fighting units; extra-curriculum education; local social programs, local programs to support the housing and communal sector; cultural/art programs of local importance; local programs to support development of physical culture and sports; roads construction and maintenance (for the roads of local importance); water-rescue activities.

A dominant part of LGEs' tasks is represented by delegated responsibilities that include expenditures on education, health care, culture and art, sports, public administration, social protection and social security, environment protection.[5]

The scope and mechanism of execution of delegated responsibilities is determined by the central government. Moreover on oblast and rayon level, delegated responsibilities are mainly executed by local state administrations, since oblast and rayon councils do not have executive boards. Thus central government is directly involved both in financing and fulfilment of public tasks assigned to oblast and rayon LGEs. This undermines the autonomy of LGEs in managing public affairs within their localities.

Domination of delegated responsibilities implies that, actually, local budgets serve as an instrument of economic policy for Central Government. This contradicts Ukrainian Constitution and the Law on Local Self-Government that empower LGEs with significant competencies and ensure their full independence. Besides, it is a violation of the spirit of Art. 4 of the European Charter of Local Self-Government (ECLSG), signed by Ukraine, which states that public responsibilities, in general, shall be exercised by those authorities, which are closest to the citizens. Legal authorities of the regional and local governments, related to their expenditures, are strictly prescribed by Ukrainian laws.

Central setting of the norms for local budget expenditures: Central government sets the norms, in terms of wage rates, employment level and some material expenses for budgetary entities. Contrary to quality standards, the norms are rather expenditure-based (i.e. based on ex post input costs) than performance-oriented, i.e. they do not provide incentives for efficient provision of public good.

[4] The revenue side of local budgets is not discussed in this paper. For discussion see *Openness and Transparency of Public Finance in Ukraine: Analysis and Recommendations*. IER, December 2003 and *Revenue Aspect of Fiscal Federalism in Ukraine*. IER, January 2004.

[5] In Ukraine, LGEs play a dominant role in financing of education, health care, social protection, culture, art and sports, housing and communal amenities, transport and roads, and construction: the respective shares of local budgets expenditures in Consolidated budget 2001 constituted 59.3% 79% 42.5% 80.5%, 75%, 96.4%, 38.2% and 68.2% (data for 2002).



In principle, expenditure norms may and should be used as a tool of expenditure planning and control over financing of ***commissioned*** tasks as it is done in many countries. However, they should not be used in case of own responsibilities of LGEs.

The problem of Ukraine is that **expenditure norms are overwhelming**: they are used for planning and control of all (both delegated and own!) tasks of LGEs. This deprives LGEs of any freedom in budget planning and execution. Besides, earmarked funds calculated on the basis of centrally set norms and used for financing expenditures on delegated responsibilities, can not be redistributed by LGEs in order to meet local needs. Domination of wage bills and social payments in the expenditures of local budgets together with central setting of the norms restricts investment activities of LGEs. Central regulation of local budget expenditures affects LGEs' ability to conduct restructuring of budget sector (e.g. they can not reallocate funds between budget entities even if it economically rational) and does not promote efficient delivery of public goods. Lack of fiscal autonomy also undermines accountability of LGEs to local residents, since it shifts political responsibility for faults in public good provision upwards, i.e. to the Central government. For example, responsibility for the deficit of local budgets or their payment arrears is shifted to Central Government. Any faults in tax or expenditure policy of LGEs are expected to be covered by central budget transfers. This means that incentives for efficient delivery pf public goods are undermined.

Weak control over the execution of delegated responsibilities: Domination of delegated tasks and centralised setting the standards co-exists with a lack of control over its execution. Ukrainian laws envision no regular procedures and mechanisms for control. In relation to this task category, there is only a strict control of direction of spending financial resources by self-governments. Such a strategy results from the fact that the state transfers insufficient funds for financing of delegated tasks. Consequently, if the extent of execution of delegated tasks were controlled, it would be necessary to close a potential gap by increasing the amount of transfers. Due to political reasons, it is more convenient to control just the amount and the direction of spending of transferred funds than the result of spending i.e. the extent and quality of execution of delegated tasks.

1.2. Unclear division of responsibilities across levels of government

Unclear division of responsibilities across levels of sub-national government is one of the most acute problems of Ukrainian fiscal system, which is reflected in

- ignorance of economic criteria in assigning expenditure responsibilities , and
- overlapping of expenditure responsibilities of LGEs of different levels.

Ignorance of economic criteria in assigning expenditure responsibilities:

In order to ensure efficient provision of public goods, expenditure assignments across levels of government have to be based on the following economic criteria:

- subsidiarity - proximity of public goods supply to their consumers,
- territorial equivalency –matching of the LGE's level responsible for public good supply to the area of consumption of this good,
- economies of scale (concentration of service delivery on the upper level if it reduces the costs of supply),
- consideration of externalities (provision of services with territorial spillover effects are to be assigned to upper government level).

In practice, Budget Code regulates expenditure assignments of LGEs of different levels using old "object-based"(or subordination-based) approach to financing inherited from Soviet times. This means that LGE of a certain level finances budget entities, which are subordinated to it. The system of subordination of budgetary units to different levels of government has not been much revised since Soviet times and is not based on the economic criteria described above. Consequently, expenditure assignments across LGEs of different levels are not based on the clear division of functions related to provision public goods.

For example currently, a significant part of professional secondary education is financed via Central Budget, although its benefits are limited by regional boundaries. On the other hand, some social benefits, established by Ukrainian Laws, are financed from rayon and oblast budgets, although redistribution of income and social policy should be a domain of central government. Putting responsibility for financing certain social benefits on LGEs without respective conditional transfers turns into arrears for certain social payments (given the severe restrictions of the local budgets).

A clear **division of functions** between centre and LGEs, as well as across levels of sub-national government **is not reflected in Ukrainian legislation**. So, it is not only an implementation gap, but also a legislative deficiency.

Overlapping of expenditure responsibilities of LGEs of different levels: The absence of economic criteria in the background of the division of expenditure responsibilities across levels of government results in overlaps. For example, responsibilities for pre-school and general secondary education are assigned both to towns, villages, and rayons. Primary medical and sanitary aid, out-patient and in-patient aid are defined as functions of towns (villages), rayons and oblasts. Both rayon and oblast LGEs are responsible for the development of the physical culture and sports. An unclear division of functions produces conflicts with respect to the distribution of finance across LGEs of different levels.

Ukrainian legislation does not contain a principle of "presumptive competence of local self-government", which means, that in case of competency disputes between self–government units, the responsibility of handling the task is assigned to the unit of basic level. This complicates the division of responsibilities across levels of government and creates cost-inefficiencies in provision of public goods.

All mentioned above contradicts the spirit of article 4 of European Charter, which underlines that powers given to local authorities shall normally be full and exclusive.

1.3. Low administrative and fiscal capacities of LGEs.

A large quantity of LGEs is a serious obstacle for decentralization of public tasks and financial independence of local self-government.

The borders of current territorial units of Ukraine have been established in socialist times, when no attention has been paid to the ability of the local governments to provide local public goods. A dispersion of local authorities is especially acute, when it concerns the units that are **closest to the citizens** : Presently in Ukraine, there are about 12,1 thousands of local councils (For comparison, in Poland, there are 2.5 thousands of local self–government units – gminas- which still seems to be too many, since some of the village gminas do not have enough potential to carry out their activities). As a rule, numerous village councils do not have sufficient financial and administration resources for executing public tasks. Diffusion of municipalities reduce the scope of public tasks that can be executed on basic level and induce LGEs to

delegate some tasks to the upper level. Such a delegation violates the subsidiarity principle and diminishes the quality of public goods provision.

The quantity of **rayon LGEs** is also too large in the sense that not all of them are able to perform public functions related to supporting regional growth or provision of services beyond the local scope.

Functioning of local self-government at oblast and rayon level is infringed, on the one hand, by the absence of their own executive bodies, and on the other hand, by a lack of clear division of competencies between local self-government and local state administration.

Oblast and rayon councils do not have their own executive boards. They pass execution of some tasks to oblast and rayon administrations. However, oblast and rayon administrations are accountable and subordinated to the state administrations of a higher level, which controls execution of state tasks. So, executive bodies of rayon and oblast level, represented by local state administrations are not accountable to the local community.

The range of tasks that concentrates in the hands of local state administrations is substantial also due to the "delegation from below" mentioned above: LGEs of basic level pass a lot of tasks to the upper level. This contradicts the Constitution and the Law on Local Self-Governance which claim that LGEs are independent, and central government bodies are prohibited to intervene in the activity of LGEs that concerns the fulfilment of their own responsibilities. However, in practice, a significant part of LGEs' functions is implemented by local state administrations, and the major part of local budget expenditures is executed or directly supervised by the state administrations.

Besides, in oblasts and rayons budget planning, execution and reporting is within the competence of local state administrations. This implies that independency of rayon and oblast self-governments with respect to the budget preparation is very limited and reduced to passing the budget bill presented by the local state administration.

The situation, when absent executive bodies of oblast and rayon councils are, practically, substituted by the respective state administration, contradicts the principle of autonomy of LGEs in performing public tasks.

Unreformed administrative-territorial system, inherited from former USSR, is a serious obstacle for financial independence of the local self-government and efficient provision with public goods.

To summarize, the implications of current fiscal arrangements are the following:

Centralized system of intergovernmental relations is backed by the deficient territorial-administrative arrangements that produces multiple LGEs with weak financial and administrative abilities to perform public tasks. Centralized regulation of the local budgets expenditures via domination of delegated tasks and central setting of different norms for local budget expenditures undermines incentives of LGEs to spend funds efficiently and restructure budget sector, since it reduces their accountability to local residents. Lack of incentives co-exists with a lack of control over the execution of delegated tasks. Together with unclear and economically unjustified division of responsibilities across levels of sub-national governments, all above mentioned factors result in poor management of local finance and low efficiency of provision of public goods.

Inefficient management of local finance is reflected in selective financing of the expenditure programs, accumulation of budgetary arrears, restricted investment activity of LGEs and poor quality of public services supplied on the local level.

2. Recommendations

Reform of self–government finance system will be a long–lasting process, which can be divided into several stages. First of all, the administrative-territorial reform should be accomplished together with the establishment of executive bodies of LGEs on rayon and oblast level. The next stage should concentrate on ordering tasks and competencies and granting self–government authorities a substantial autonomy in executing public tasks.

2.1. Administrative-territorial reform

Administrative-territorial reform should include the following:

1) creation of new units on the local level (primarily in rural areas);
2) converting present self–government units of villages and settlements into auxiliary units;
3) reducing the number of rayons .

New self-government units (municipalities) should be established that are strong enough in organizational and financial terms to perform the majority of public tasks on the local level: New municipalities in rural areas may encompass the territory of several villages and settlements. Boundaries of municipalities in urban areas, as a rule, should correspond to the boundaries of towns (cities).

The size of the new units should be related to the financial and organizational potential necessary to execute public tasks on the local level. The size should not be too large, so that self–government authorities remain close to the local community[6]. Consequently, we do not recommend transforming rayons into units of basic level, because its primary aim should be executing regional tasks.

At the same time, the creation of units that are too small is also undesirable. This creates a risk of permanent dependency on the transfers from the state budget, which undermines the responsibility for executing the tasks. While determining the right size of the basic units, local communities should be consulted, which is, in fact, required by the ECLSG.

What is the appropriate size of municipality for cost-efficient operation? International experience suggests no standard answer. For example, In Poland gminas encompass, at least, 2000 people. In Bulgaria, only 1,1% of the population live in municipalities with less than 5000 inhabitants which constitute 10,7% of all municipalities.[7] In Ukraine, the minimal size of municipalities in rural areas in terms of population could be chosen in the range of 1500-2500 inhabitants. Administrative reform should be coupled with revenue reform.[8]
Newly created basic units should become legal entities, as it is required by ECLSG regulations. This is in the interest of self–government communities, since without having a status of legal entity self–government units could not run independent activity, and the division of competencies between public state authorities is unclear.

[6] The creation of excessively large units would make it difficult to meet the principle of subsidiary, and therefore, the efficiency of functioning of local authorities would get worse. This is a problem of big cities, where inhabitants have more difficult access to local authorities.
[7] Centre for Tax Policy and Administration. Fiscal Decentralization in EU Applicant States and Selected EU Member States / OECD, 2002.
[8] See IER Policy Paper: Revenue Aspect of Fiscal Federalism in Ukraine.

Newly created units of the basic level should have a right to possess property, which would enable them to execute public tasks on the local level. The state should equip these units with the required property, i.e. land, buildings and other public infrastructure like roads, bridges, tunnels, water–pipes, sewage infrastructure and sewage treatment plants.

The creation of new stronger self–government units in rural areas does not mean that the units operating in villages or settlements are liquidated. These self–governments should be transformed into auxiliary units subordinated to the newly created basic units, and they should execute local tasks delegated by the basic unit. The scope of delegated tasks will depend on the decisions of the authorities of basic unit.

Even after the implementation of the proposed territorial reform some small municipalities might turn to be unable to carry out certain functions on their own. In this case, they might enter into cooperation agreements, setting up "inter-municipal associations", to tackle jointly the issues of common interests.[9]

The number of rayons should be reduced substantially. The size of rayons should be functionally adjusted both to the tasks executed with respect to the regional development, and to the tasks executed for and on behalf of the regional community.

Newly created independent units of basic level will take over some tasks that are presently performed on the rayon level. So, the rayons do not need to remain close to the local communities. Managing extra–local issues, i.e. healthcare system or secondary education, requires the creation of rayons of a bigger organizational and financial potential. Therefore, a reduction in number of rayons seems justified.

A special attention will need rayons that are situated close to the cities. The areas around the large cities do not have either sufficient infrastructure or financial and organizational potential to be able to complete their tasks. It is better to create rayons that include city agglomerates together with the nearby areas. (One good reason for this is sub-urban transport and commuting systems, usually financed by areas around the city but, of course, with enormous spill-over effects to the city).

Self–government executive bodies should be formed on rayon and oblast level. Such executive bodies subordinated to the councils of specific units would replace current local state administration.

Having their own administration enables self–governments to take over responsibility for executing tasks of extra–local and regional character. Local self-government bodies will be concentrated on executing the priorities of the local communities rather than those of the state.

The tasks of a nation–wide character delegated to rayons and oblasts will be executed by the state administration that is separated from the regional authorities and organized vertically (subordinated exclusively to appropriate ministries). This solution works well in Poland, where police and some of the inspections that execute tasks of national importance, were separated from the territorial administration. They function exclusively vertically as state administration units and are subordinated to appropriate ministries.

2.2. Decentralisation of the local budgets expenditures.

[9] Centre for Tax Policy and Administration. Fiscal Decentralization in EU Applicant States and Selected EU Member States / OECD, 2002.

Clear division of competences across levels of government is indispensable for economic efficiency.

The crucial part of delegated tasks should be transferred to self–governments as their own responsibilities.

The state should decide, which of the tasks delegated so far to LGEs should remain within the competencies of state administration, and which one should be transferred to self–governments as their own tasks. In the long run, delegated tasks should be abolished completely.

Responsibilities assigned to LGEs of the basic level should have limited territorial spillover effects and offer little arguments of economies of scale. Subsidiarity principle imply, that supply of certain public goods may be assigned to the upper level of government only in case of externalities, which spill over local boundaries and in case of more efficient supply at the upper level due to economy on scale.

The scope of tasks transferred to self–governments should be vast enough so that self–governments can manage a substantial share of public affairs under their own responsibility and in the interests of the local population.

Own responsibilities of LGEs should include pre-school and general school education, primary health care, culture, sports, housing and communal amenities, road construction and maintenance, transports services, etc. So the scope of delegated responsibilities would decrease substantially.

Control over delegated tasks' performance should be established: The transfer of major part of delegated tasks into own responsibilities of self–government cannot be done over night. For some time, delegated tasks will continue to exist (at least in a reduced amount). Consequently, the issue of controlling their execution will remain on the agenda.

Ukraine can use Polish experience in order to implement ECLSG standards of controlling the execution of delegated tasks. This implies the following:

- The funds transferred from the state budget to self–government become own funds of the latter, which can manage them independently. This provides local self-government an incentive to spend resources efficiently.
- In return, self–governments are obliged to execute delegated tasks on the full scale. If they fail to do it, then the part of the funds proportional to the size of unexecuted tasks should be returned back.
- Savings (at least, the major part) on the delegated tasks can be used for co–financing of own tasks (conditional to full execution of delegated tasks)

Transformation of delegated tasks into own tasks of LGEs unambiguously implies more freedom of LGEs in managing their expenditures. Another step in the same direction is related to a ***reduction of central regulation of the expenditure patterns of local budgets***. LGEs should decide on the size and structure of their budgets independently[10] and have a right to allocate funds between the expenditures on their own and delegated responsibilities***.*** This implies a gradual abolishment of the expenditure norms. Firstly, the application of expenditure norms to financing of own responsibilities of LGEs should be stopped. Then, along with a gradual diminishing of delegated responsibilities, using of expenditure norms will also go down.

[10] Within certain fiscal rules.

Increasing fiscal autonomy of LGEs does not exclude that execution of some tasks of national importance will require a certain degree of central control. This concerns ***education and health care sector***, ***where we recommend to preserve the oversight role of central government.*** Economic rationale behind it is that investment in human capital is an important determinant of economic growth on the national level. The level of intervention (in terms of both expenditure and norms setting) has to be identified carefully.

Minimal standards for public goods provision should be established in education and health care sector (In many countries, central government sets special standards in education and health care sector, although subnational jurisdictions are important providers of medical and educational services[11]). Local governments will be required to fulfill these standards and attain specific performance criteria. The state should ensure (via transfers if necessary) that in the spheres of national importance local budget expenditures are consistent with minimal standards. LGEs will be free to spend more than implied by minimal standards, but they would not be entitled to spend less.[12]

In terms of replacing input-related norms by performance criteria, minimal standards may be related both to quantity and quality of public goods. Minimal standards will replace current expenditure norms. This will improve performing of public tasks by LGEs and ensure access to the essential public goods (at least, on the minimal level) for the residents of different areas.

At the moment, majority of expenditure norms are related to setting employment level and wages and salaries in budgetary entities, since wage bills preoccupy a dominant part of local budgets expenditures. This problem needs careful treatment. Before a higher degree of fiscal decentralization is achieved, we recommend to use the following transitory measures:

- Central government should set up a "basic wage rate" and finance it by conditional grants from the Central budget .
- "basic wage rate" represents the minimum wage which is expected to be paid by LGEs to employees of local budgetary units; the maximum boundaries of wages are not set, so actual wages correspond to the policy priorities of LGEs and their tax collections efforts[13].
- The role of "basic wage rate" will be diminishing with the proceeding of decentralization process. .

Beyond education and health care sector, control of the central government over LGEs should be limited to the issues of law compliance. The state administration is entitled to interfere in the self–government activities only if the law has been breached. The intervention should be limited to restoring of law compliance. All disputes between self–governments and state administration in regard to the legality of LGEs' transactions should be decided only by special courts whose only function would be settling the disputes between the state and self–government entities.

2.3. Clear division of competencies across levels of government

Responsibilities of every government level should be clearly specified.

[11] Fiscal Relations across Levels of Government // OECD, 2003.
[12] W. Thirsk. The Road to Intergovernmental Fiscal Reform in Ukraine // Ukraine Under Transition, 1998.
[13] This measure, of course, require a workable fiscal equalization procedures.



Certain tasks should be clearly assigned to the specific government levels. Ukrainian laws should strictly specify the division of functions and expenditure responsibilities across the tiers of government. Neither state administration nor self–government units of a higher level should decide on the revenues and expenditures of the units of basic level[14]. Subordination of budgetary entities should be based on economically justified division of functions across levels of government.

LGEs of basic level should be responsible for the local public goods supply – preschool education, roads repair, water supply, provision with accommodation, etc. Local public goods have limited externalities (consumed mainly by local residents) and can be efficiently produced in small scales

LGEs of rayon and oblast level should be responsible for the regional public goods supply – roads construction, investment in human capital, etc. These goods have the territorial spillover effects and can be efficiently produced only by government units with substantial organizational and financial potential.

Expenditure responsibility for social protection should be shifted from LGEs to central government. Redistribution of income is the domain of central government. Assignment of social expenditures to the local governments causes inequality in provision of public services and growing income disparities across the regions. Expenditures on social benefits are to be incurred by Central government in the form of direct expenditures or conditional grants to local budgets[15].

List of expenditures incurred by the different levels of local budgets should be based on effective budget classification including all levels of detalization.

With respect to every function, the responsibility of levels of government should be specified in 3 dimensions: 1) setting up the standards (quality) for public goods; 2) supply of public goods; 3) financing the supply of public goods.[16] These specifications should be a part of legislation that regulates specific area of activities (Law "On Education", "On Health Care", "On Culture", etc.) and appear in Budget Code in general form.

The principle of presumptive competency of the territorial self-government (that works well in Poland) should be considered for implementation in Ukraine.

Strict division of functions across the levels of government and appropriate assignments with expenditure responsibilities are indispensable for fiscal autonomy of LGEs and their accountability to local residents.

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[14] It will be impossible to define a clear competency system in Ukraine before rayon councils stop handling the distribution of funds for self–government units of the basic level.

[15] Currently the coverage of social programs funded by conditional grants and Central budget expenditures is not full and some of them are imposed on the local budgets.

[16] А. Лавров. Стратегия и тактика реформы межбюджетных отношений в Российской Федерации. / Совершенствование межбюджетных отношений в России. – Москва: Институт экономики переходного периода, 2000.