

DOI: 10.46340/eujem.2021.7.1.5

**Yaroslav Pylypenko**

ORCID ID: <https://orcid.org/0000-0003-4149-2008>

*Taras Shevchenko National University of Kyiv, Ukraine*

## **INSTITUTIONAL FRAMEWORK FOR STRENGTHENING THE FINANCIAL AUTONOMY OF LOCAL SELF-GOVERNMENT BODIES IN UKRAINE IN DECENTRALIZATION PROCESS**

The article examines the impact of administrative and financial decentralization processes on the local financial system of Ukraine. It defines the main transformational changes in the local financial system because of the implementation of the restructuring measures. It identifies the risks that affect the financial autonomy of local self-government bodies, and, in particular, the formation of local budget revenues under decentralization: formation of local budget revenues from personal income tax; reduction of income of certain territorial communities as a result of cancellation of the gasoline excise duty income to local budgets; insignificant or missing tax revenues from public utilities. There are the measures suggested to minimize these risks. In particular, it is necessary to: change the procedure for personal income tax charge (at the place of residence of the natural person); ensure the charge of a part of the deductions from the income tax of private enterprises to the budgets of communities; enhance the control over the effective use of funds by the public utilities; take stock of all real estate property as well as make changes to the process of immovable property tax administration other than land tax, in particular, in the taxable base (establishment of the taxable base in terms of market or estimated value of real estate property). Institutional restructuring of the national system of local taxes and fees under decentralization should be considered in the context of building the model of local taxation, in terms of which the powers of local self-government bodies will include the right to introduce a list of local taxes and fees, and tax rates in accordance with the limits established by the law. At the same time, stimulation of economic development of territories (attracting investments, supporting entrepreneurs, developing specific industries) will increase the revenues of local budgets and, as a result, improve the quality of public goods and services to population.

**Key words:** decentralization, local self-government bodies, local financial industry, local budget, united territorial community, financial autonomy.

**Problem statement.** Administrative and financial decentralization, which has been taking place in Ukraine in recent years and is recognized as one of the most successful reforms, is a complex and a priori ambiguous process for the development of the socio-economic system of any country. This is confirmed by the experience of states that have implemented such reforms, and domestic practice. Of course, not all results of the first stage of decentralization in Ukraine can be considered unequivocally positive. Moreover, the steps taken have created new risks for the territorial development of the state and new challenges for regional policy, which must be taken into account in the next stages.

**Analysis of recent research and publications.** Theoretical and practical aspects of financial support of local government, formation of tax and budgetary potentials of administrative-territorial units were considered in the works of many domestic and foreign scientists, such as E. Balatsky, F. Veylenkurt, A. Varudakis, G. Gabori, S. Gray, IO . Yevtushenko, V. Kravtsiv, E. Konyarova, I. Lunina, R. Musgrave, V. Oparin, A. Osipov, K. Pavlyuk, Y. Pasichnyk, S. Slukhai and others.

Strengthening the financial basis of local self-government was studied in the works of such leading scientists as R. Arendt, R. Bal, A. Gosh, R. Ebel, T. Yefimenko, O. Zamaslo, S. Yilmaz, D. Kim, D. King, O. Kirilenko, M. Qureshi, E. Letuz, D. Martinez-Vazquez, D. Ostri, G. Peter, A. Rodriguez-Pose, R. Roy O. Sidorovich, D. Stegarescu, D. Traisman, K. Halbert.

At the same time, despite significant scientific achievements, the problem of strengthening the financial independence of local self-government in the context of decentralization remains unresolved. Currently, this concerns the problem of generating local budget revenues, which should ensure proper financial independence of local governments.

**The aim of the article.** The purpose of the article is to develop practical recommendations for strengthening the financial independence of local self-government in a decentralized environment.

**Key study finding.** The constitutional principles of local self-government in Ukraine determine the regulatory framework and financial basis for the activities of local self-government bodies. However, the development of local self-government for a long time took place only at the level of cities of regional importance, as the vast majority of territorial communities due to their excessive fragmentation and extremely weak material and financial base were unable to fully exercise their powers, ensure proper implementation of local and state.

With the ratification of the Association Agreement between Ukraine and the EU, our country has chosen the direction and priorities for further development. To confirm this vector, the Sustainable Development Strategy «Ukraine – 2020»<sup>1</sup> was adopted, which provides for 62 sectoral reforms, among which the most important are decentralization and public administration reform.

Reforming the system of local self-government in accordance with the priorities and provisions of financial decentralization provided for the need for large-scale changes in the administrative-territorial structure and financial system of the state, associated with a significant redistribution of powers, responsibilities and financial resources between state bodies and local government.

Prior to the beginning of the decentralization reform, the financial resources of the territorial communities in many administrative-territorial units were very limited. First, low revenues did not provide real opportunities for local governments to be financially independent and to influence socio-economic processes in the regions. Second, access to borrowing markets was constrained by high rates, the payment of which exceeded the burden on local budgets. Third, the mechanism of using budget funds did not ensure the satisfaction of public needs.

Amendments<sup>2</sup> to the Budget Code of Ukraine have expanded the revenue base of micro-budgets by including in the budgets of the united territorial community fees for the provision of administrative services, state duties and increase in tax collection. Stable sources of income were fixed for local budgets – personal income tax (according to the new insurance standards – 60% of united territorial community budgets) and income tax on enterprises and financial institutions of communal property.

Amendments<sup>3</sup> to the Tax Code of Ukraine enshrined in the budgets of the united territorial community excise tax on alcoholic beverages, tobacco products and fuel, as well as the right of local authorities to set tax rates (within the limits set at the state level) on real estate for residential and non-residential real estate.

However, neither at the start of the reforms nor after six years of their implementation has the government developed a clear model for the redistribution of resources, areas of responsibility and control between the national, regional and local levels of government. As a result, against the background of the general euphoria from a number of the first positive results, the problems faced by territorial communities and regional authorities are often ignored, gaining new powers, as well as risks for their functioning and for socio-economic development of Ukraine in general.

In general, the study of institutional changes in the financial independence of local self-government in Ukraine in the context of decentralization revealed a number of risks that may affect the mechanism of financial support of local government, and in particular the formation of local budget revenues in the near future.

1. *Risks of formation of local budget revenues from personal income tax.* Personal income tax occupies the largest share in the structure of local budgets (in 2014-2020, the share of personal income tax in local

<sup>1</sup> Указ про Стратегію сталого розвитку «Україна – 2020», 2015 (Президент України). Офіційний сайт Верховної Ради України <<https://zakon.rada.gov.ua/laws/show/5/2015#Text>> (2021, January, 14).

<sup>2</sup> Закон про внесення змін до Бюджетного кодексу України щодо реформи міжбюджетних відносин, 2014 (Верховна Рада України). Офіційний сайт Верховної Ради України <<https://zakon.rada.gov.ua/laws/show/79-19#Text>> (2021, January, 14).

<sup>3</sup> Закон про внесення змін до Податкового кодексу України та деяких законодавчих актів України щодо податкової реформи, 2014 (Верховна Рада України). Офіційний сайт Верховної Ради України <<https://zakon.rada.gov.ua/laws/show/71-19#Text>> (2021, January, 14).

budget revenues was 53-87%). There are three aspects that can lead to risks of filling united territorial community budgets at the expense of personal income tax.

The first is the high share (role) of individual legal entities that transfer personal income tax to their employees in the total amount of its revenues to the territorial community budget. That is, it is about how much local budgets depend on personal income tax revenues, which are transferred by large taxpayers. If such revenues are provided by one or two businesses, there is a risk of a significant reduction in community budget revenues in the event of closure, relocation of production to another region or in case of unfavorable market conditions. The second risk for the formation of united territorial community budget revenues from personal income tax revenues is the share of budgetary institutions and organizations in these revenues. The high share of budget institutions in the amount of personal income tax to community budgets, on the one hand, is a fairly stable source of budget, but, on the other hand, the prospects for the development of such a community is low, as there is a situation where funds accumulated from personal income tax (as the main sources of formation of own budget revenues) go to pay for employees of the budget sphere. And the third risk associated with the receipt of personal income tax in territorial community budgets is informal employment. The number of officially employed citizens has a direct impact on the formation of local budget revenues, as it is their salaries that are actually the basis for the formation of personal income tax revenues.

2. *Reduction of income of certain territorial communities as a result of cancellation of the gasoline excise duty income to local budgets.* In 2017-2020, local budgets had a kind of bonus to fill their budgets, which was provided to them from territorial community businesses (gas stations) located on their territory, part of the national excise tax on fuel produced in Ukraine and imported into Ukraine. But from 2021, this tax will be fully credited to the State Road Fund.

3. *Insignificant or missing tax revenues from public utilities.* This leads not only to the fact that utilities company do not make a profit<sup>1</sup>, but also to the inefficient (and often illegal) use of local budget funds that come to utilities company to finance targeted programs or to increase their authorized capital. As a result, it becomes a brake on the effective development of united territorial communities.

To eliminate these risks it is advisable:

1. To increase revenues from the main source of local budget revenues – personal income tax – it is necessary to change the procedure for administration of personal income tax – at the place of residence of an individual. Although in Ukraine personal income tax goes to both state and local budgets (in accordance with the proportions set by the Budget Code), the question of the rationality of its distribution between local budgets does not lose its relevance. We are talking about the possibility of changing the procedure for crediting personal income tax to local budgets at the place of residence of the individual payer. Nowadays, personal income tax is paid to the appropriate budget at the location of the employer<sup>2</sup>. That is, for many years there has been a situation in which residents of the territorial community, working outside it, support the development of the community where the enterprise is located (because personal income tax goes to the community budget where the enterprise is located), while workers and their families receive social services educational, medical, cultural) in the communities where they actually live. And this already leads to a certain disproportion in the availability of sources for the development of territorial communities.

Foreign experience of personal income tax administration in countries where it is credited to local (regional) budgets shows that the tax is credited at the place of residence and not at the place of work of individual payers (USA and Scandinavia<sup>3</sup>).

Changing the procedure for enrolling personal income tax at the place of residence of an individual for territorial communities (especially those who are "exporters" of labor) in Ukraine can provide a number of positive changes in the direction of decentralization:

- strengthen the financial independence of territorial communities, as each community will receive one of the main sources of budget revenues;
- opportunities for the implementation of social and infrastructure projects will increase due to the increase in the level of own income of the territorial community;

<sup>1</sup> Гончаренко М. В. (2017). Механізми формування фінансових ресурсів територіальних громад в умовах децентралізації. *Механізми державного управління*, 2, 62-67.

<sup>2</sup> *Бюджетний кодекс України, 2010* (Верховна Рада України). *Офіційний сайт Верховної Ради України* <<https://zakon.rada.gov.ua/laws/show/2456-17#Text>> (2021, January, 16).

<sup>3</sup> Cerniglia, F. (2020). Decentralization in the Public Sector: Quantitative Aspects in Federal and Unitary Countries. *Journal of Policy Modelling*, 25, 749-776.

- the motivation of local governments to develop favorable living conditions, improve the quality and quantity of social services provided to community residents will increase, as local budget revenues will be directly correlated with the number and income of the population;

- strengthen the interest of local governments in increasing the number of employed residents (on which budget revenues will depend).

Despite the logic of changing the procedure for crediting personal income tax of local budgets at the place of residence of an individual, it is accompanied by certain difficulties and problems:

- the complexity of tax administration is growing, which will require additional costs and time;
- the need for constant control of the employee's place of residence for the correct and timely transfer of tax;

- achieving a positive effect for communities can be offset if a significant number of unemployed people live within it (for example, pensioners or people who are not officially employed anywhere).

One of the main risks of changing the direction of personal income tax inclusion in the local budget at the place of residence of individuals can be considered a decrease in the motivation of local governments in the development of large enterprises in their community. Because no matter where the resident of the community will work, the tax on his income will go to the budget of the community where he lives. Foreign scholars are inclined to believe that the most acceptable option is a separate accounting for the calculation of personal income tax (depending on the place of residence of employees), its payment and reporting will be carried out by one tax agent – the employer. And such territorial agent will be controlled by several territorial bodies of fiscal service.

From our point of view, this approach is the most acceptable for the state, as it will save budget funds (compared to the option of allocating and transferring personal income tax amounts to the State Treasury Service of Ukraine) and will be easier to control (compared to option under which individuals will independently act as tax agents).

2. At the national level to ensure the receipt of part of the deductions from income tax of private enterprises to the budgets of united territorial community (for example, from 10% of income tax of private enterprises coming to regional budgets, 5% to the budget of united territorial community, where the company is located) by amendments to the Budget Code of Ukraine. This would, firstly, be a partial compensation to united territorial community budgets for the loss of excise revenues from fuel, and secondly – an additional incentive for local governments to attract private business to the territory of territorial community.

It should be noted that this practice is used in some European countries. For example, in the Czech Republic in 2019, 3.9% of the total consolidated budget revenues from corporate income tax were received by municipal budgets, and in Denmark, local budgets received 15.24% of total revenues from corporate income tax<sup>1</sup>.

3. Local governments need to strengthen control over the effective use of funds by utilities. To do this, it is necessary to make the activities of utilities as transparent as possible (by publishing information on the official websites of communities, as well as conducting an independent audit of their activities); to develop the procedure for appointing the heads of utility companies on a competitive basis, which will involve professionals in their management; set tariffs for utility services that would allow them to operate on a self-sustaining and profitable basis.

4. Increase the value of real estate tax in the formation of local budget revenues by recalculating all real estate, as well as changes in the mechanism of tax administration, in particular, in the tax base (establishing a tax base based on market or estimated real estate value).

To increase local budget revenues from the taxation of real estate other than land, it is necessary:

1) to conduct a total recalculation of privately owned real estate of both individuals and legal entities, by imposing an obligation on real estate owners to verify the data specified in the documents on ownership with the relevant data of the State Register of Real Property Rights.

2) to change the base of collection and the procedure for setting the tax rate. Experts of the group "Tax and budget reform of the resuscitation package of reforms"<sup>2</sup> for the tax base propose to establish the value of real estate, calculated indirectly on the basis of mass valuation per unit area on which they are located, using a formula that takes into account various characteristics of such area, soil properties, purposes of use,

<sup>1</sup> Eurostat (2021). *Database* <<https://ec.europa.eu/eurostat/data/database>> (2021, January, 10).

<sup>2</sup> Дубровський, В., Черкашин, В. (2016). Як удосконалити податок на нерухоме майно в Україні? *Європейський інформаційно-дослідницький центр*, 1, 1-39.

etc.); and to set the tax rate uniform across the country, without any differentiation in terms of real estate (residential or non-residential, commercial or industrial), citing the prevention of corruption among local governments or pressure on them by stakeholders (owners of significant volume real estate) when rates are set.

This approach seems logical at the present stage of Ukraine's development. However, we offer some modifications:

– to introduce periodic (for example, once in 5-7 years) double valuation of the market value of real estate (public and private appraisers), and to determine the tax base as the arithmetic mean of the established values.

– to establish a single tax rate throughout Ukraine (in terms of individuals and legal entities). For example, for individuals – low (0.1% of the estimated (market) value of real estate), and for legal entities to set a higher tax rate – for example, 1% of the estimated (market) value of the object).

**Conclusion.** The most important principle of local self-government is the principle of independence. The completeness of the implementation of this principle is determined by the level of economic independence of territorial communities and its main component – financial independence. At the same time, ensuring the independence of these bodies from the state authorities in resolving financial issues is a priority, because it is a key condition for the realization of all other rights and opportunities of local government, which are guaranteed by law.

Analyzing the successful experience of reforms of administrative-territorial organization and local self-government of European countries, it should be noted that the basis of financial self-sufficiency of local self-government is the own income of territorial communities, which is formed primarily by local taxes.

The current system of local taxes and fees in Ukraine is not effective and some taxes are difficult to apply to local budgets, especially in rural united territorial community. Institutional reform of the domestic system of local taxes and fees in the context of decentralization should be considered in the context of building a model of local taxation, within which the powers of local governments will include the right to introduce a list of local taxes and fees and tax rates in accordance with tax law. boundary limits. A necessary precondition for the objectification of the exercise of such powers is the regulatory (at the national level) regulation of the requirements for these taxes and fees, as well as the formalization of the procedures for their introduction and administration.

## References:

1. *Ukaz pro Stratehiuu staloho rozvytku «Ukraina-2020», 2015* (Prezydent Ukrainy). [Decree on the Sustainable Development Strategy "Ukraine-2020", 2015 (President of Ukraine)]. *Ofitsiyni sait Verkhovnoi Rady Ukrainy*. [The official website of the Verkhovna Rada of Ukraine] <<https://zakon.rada.gov.ua/laws/show/5/2015#Text>> (2021, January, 14). [in Ukrainian].
2. *Zakon pro vnesennia zmin do Biudzhethnoho kodeksu Ukrainy shchodo reformy mizhbiudzhethnykh vidnosyn, 2014* (Verkhovna Rada Ukrainy) [Law on Amendments to the Budget Code of Ukraine on the Reform of Intergovernmental Relations. 2014 (Verkhovna Rada of Ukraine)]. *Ofitsiyni sait Verkhovnoi Rady Ukrainy* [The official website of the Verkhovna Rada of Ukraine]. <<https://zakon.rada.gov.ua/laws/show/79-19#Text>> (2021, January, 14). [in Ukrainian].
3. *Zakon pro vnesennia zmin do Podatkovoho kodeksu Ukrainy ta deiakykh zakonodavchyykh aktiv Ukrainy shchodo podatkovoi reformy, 2014* (Verkhovna Rada Ukrainy). [Law on Amendments to the Tax Code of Ukraine and Certain Legislative Acts of Ukraine on Tax Reform, 2014 (Verkhovna Rada of Ukraine)]. *Ofitsiyni sait Verkhovnoi Rady Ukrainy* [The official website of the Verkhovna Rada of Ukraine]. <<https://zakon.rada.gov.ua/laws/show/71-19#Text>> (2021, January, 14). [in Ukrainian].
4. Derzhavna kaznacheiska sluzhba Ukrainy (2021). [State Treasury Service of Ukraine (2021)]. *Holovna storinka*. [Homepage] <<https://www.treasury.gov.ua/ua>> (2021, January, 17). [in Ukrainian].
5. Honchachenko, M. V. (2017) Mekhanizmy fopmuvannia finansovykh pesupsiv teptytopialnykh hpomad v umovakh detsentralizatsii. [Mechanisms of formation of financial resources of territorial communities in the conditions of decentralization]. *Mekhanizmy depzhavnoho uppavlinnia*. [Mechanisms of state management], 2, 62-67 [in Ukrainian].
6. *Biudzhethnyi kodeks Ukrainy, 2010* (Verkhovna Rada Ukrainy). [Budget Code of Ukraine. 2010 (Verkhovna Rada of Ukraine)] *Ofitsiyni sait Verkhovnoi Rady Ukrainy*. [The official website of the Verkhovna Rada of Ukraine]. <<https://zakon.rada.gov.ua/laws/show/2456-17#Text>> (2021, January, 16). [in Ukrainian].
7. Huphula, T. V. (2017). Finansove zabezpechennia sppomozhnosti teptytopialnykh hpomad: ppoblemy ta shliakhy yikh vypishennia [Financial support of the ability of territorial communities: problems and ways to solve them]. *Naukovi visnyk Mukachivskoho depzhavnoho univepsytetu* [Scientific Bulletin of Mukachevo State University], 1, 132-136. [in Ukrainian].

7. Cerniglia, F. (2020). Decentralization in the Public Sector: Quantitative Aspects in Federal and Unitary Countries. *Journal of Policy Modelling*, 25, 749-776. [in English].
8. Perekalskyi, S. V. (2015). Sovershenstvovanye mekhanyzma uplaty naloha na dokhody fyzycheskykh lyts kak napravlenye ukrepleniya mestnykh biudzhetrov [Improving the mechanism of personal income tax payment as a way to strengthen local budgets]. *Vestnyk Saratovskoho hosudarstvennoho sotsyalno-ekonomycheskoho unyversyteta* [Bulletin of Saratov State Socio-Economic University], 3, 116-118 [in Russian].
9. Eurostat (2021) *Homepage* <<https://ec.europa.eu/eurostat/data/database>> (2021, January, 10). [in English].