

# BUDGET DECENTRALISATION: RESULTS AND CURRENT CHALLENGES

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**Abstract.** The *purpose* of the paper is to analyse the results of budgetary decentralisation in Ukraine, to identify the factors that have the greatest impact on its success, and to identify the urgent tasks for improving the financial capacity of hromadas. *Results.* The article analyses the content of the strategies for reforming the public finance management system for 2017-2020 and 2022-2025, as well as the reports on the implementation of the Strategy for the period February 2017 – December 2019 and for 2022. The paper identifies the main achievements and unresolved issues of implementation of these strategies. The study highlights the factors that have the greatest impact on the success of the implementation of the tasks of reforming the public finance system. The coefficients of budgetary centralisation and decentralisation are calculated on the basis of expenditures of the Consolidated, State and local budgets. The article examines the results of a survey of local government representatives conducted in 2023 from April 27 to May 4 by the Kyiv International Institute of Sociology within the framework of the Sectoral Support Initiative for Civil Society in Ukraine project on the availability of post-war recovery plans in hromadas. *Value / Originality.* The undisputed results of the budget decentralisation for the period 2017-2020 include an increase in the volume of local budgets' own financial resources and a certain improvement in the quality of public services provided to consumers, but it is noted that the goals of the Strategy for Reforming the Public Finance Management System were not achieved during this period. The authors note a significant improvement in the quality of strategic planning in 2021 compared to 2016. It is emphasised that the implementation of most of the budgetary decentralisation measures planned in the latest Strategy was prevented by the full-scale war with Russia. Among the unresolved issues of the reform are the following: significant dependence of local self-government on central government transfers, duplication of functions by district and regional state administrations, low human and institutional capacity of local self-government bodies, and the procedure for administering local taxes. One of the urgent tasks of budgetary decentralisation is the need to develop and implement post-war reconstruction measures.

**Keywords:** budget decentralisation, local budgets, Consolidated State Budget, State Budget, budget transfer payments, own revenues of local budgets, development of strategic recovery plans.

**JEL Classification:** G18, H77

## 1. Introduction

Ukraine's budget system has been undergoing reforms over the past thirty-three years, which is due, firstly, to its restructuring as a result of changes in the socio-economic system after Ukraine gained independence in 1991, and secondly, to the development of the public administration and local self-government system, the adoption of the Budget Code of Ukraine in 2001 and the approval of the budget process. However, the new priorities for the development of the budget system set in 2017, such as European integration and financial decentralisation

as part of the administrative-territorial reform, require more attention to the identification and analysis of the effectiveness of reform measures to ensure the achievement of the set strategic goals.

Ukrainian scholars pay a lot of attention to the issue of budget reform. For example, H. Nakonechna and N. Matviichuk (2019) analyse the results of budget decentralisation and identify areas for their improvement, O. Zakhidna and H. Petryshyn (2022) study the essence and role of decentralisation, justify the need to implement budget decentralisation in Ukraine, and analyse the results and prospects of its

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implementation. V. Bulavynets (2021) pays attention to deepening the theoretical and methodological provisions of budget decentralisation and explores its applied aspects. The study by A. Kruglashov, and V. Bureha (2021) identifies the positive and negative aspects of decentralisation in Ukraine in 2014-2020 that have a direct impact on the state of the budget decentralisation process. Without detracting from the contribution of these and many other researchers, it should be noted that the socio-economic environment is constantly changing, and thus there is a need to adjust the objectives of the budget reform to ensure their relevance.

## 2. Positive Trends in Budget Decentralisation

Over the past eleven years, the Cabinet of Ministers of Ukraine has developed and approved three Strategies for reforming the public financial management system (PFMS) (The Order of the Cabinet of Ministers of Ukraine "On the Strategy for the Development of the Public Finance Management System", 2013; The Order of the Cabinet of Ministers of Ukraine "On Approval of the Strategy for Reforming the Public Finance Management System for 2017-2020", 2017; The Order of the Cabinet of Ministers of Ukraine "On Approval of the Strategy for Reforming the Public Finance Management System for 2022-2025 and the Action Plan for its Implementation", 2021). Section III of the PFMS Reform Strategy for 2017-2020, entitled "Improving the Efficiency of Resource Allocation at the Level of Public Policy Formulation", singles out the area of "Intergovernmental Relations and Fiscal Decentralisation", which has the following expected results of its tasks:

Approval of the draft law on amendments to the Budget and Tax Codes of Ukraine, review and approval of the updated State Classifier of Social Standards and Regulations, updated industry (sectoral) social standards and regulations – 2018;

- introduction of medium-term budget planning at the local level – 2019;
- introduction of a local debt management system – 2020;
- introduction of a mechanism of public control over local finances – 2019 (The Order of the Cabinet of Ministers of Ukraine "On Approval of the Strategy for Reforming the Public Finance Management System for 2017-2020", 2017).

At the same time, the "Report on the Implementation of the Strategy for Reforming the Public Finance Management System for the period February 2017 – December 2019" (no report for 2020) lists the following among the main expected results of the Strategy (Report on the Implementation of the Strategy

for Reforming the Public Finance Management System in 2017-2019, 2020):

- Increasing the own financial resources of local governments;
- improvement of the financial support for the expenditure powers of local governments;
- introduction of medium-term budget planning at the local level;
- strengthening the capacity of local governments to manage local debt, transparency and accountability.

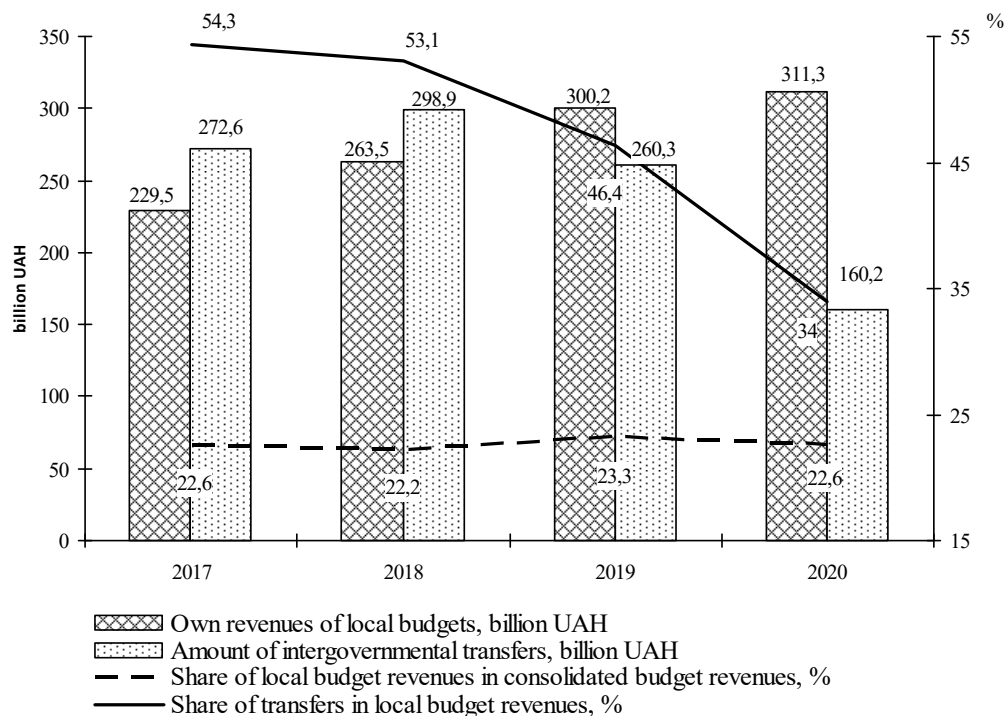
Thus, the Ministry of Finance of Ukraine, as the compiler of the report, has its own vision of the priority goals of budget decentralisation, which does not fully coincide with the vision of the Cabinet of Ministers.

In 2017-2020, the own revenues of local budgets of Ukraine increased by 81.8 billion UAH, or 26.3%. The share of transfers decreased from 54.3% to 34% during this period. Nevertheless, the share of local budget revenues in the consolidated budget remained almost unchanged in 2017-2020, fluctuating around 22%, indicating that the growth of local budget revenues was parallel to the growth of consolidated budget revenues in Ukraine (Figure 1).

Among the positive developments in the process of budgetary decentralisation over the period under review, the Report's authors noted the following:

- Expansion of the list of taxes to be paid to local budgets;
- strengthening the financial resources of local governments as a result of the creation of amalgamated hromadas;
- horizontal equalisation of the tax capacity of local budgets, which allows most of the funds to remain at the local level;
- provision of quality public services to consumers by expanding the expenditure powers of local governments on the principle of subsidiarity;
- delineating the responsibilities of state and local authorities for the maintenance of educational and healthcare institutions.

According to the information provided in the "Report on the Implementation of the Strategy for Reforming the Public Finance Management System for the period February 2017 – December 2019" (Report on the Implementation of the Strategy for Reforming the Public Finance Management System in 2017-2019), the calculation of the regional competitiveness index, which reflects the indicators of misuse of budget funds, illegal payments and bribes, unjustified budget expenditures, transparency of political decision-making and the quality of audit and reporting standards, was not carried out during the specified period. Also, the provisions of the Budget Code on the introduction of medium-term budget planning were temporarily suspended until the end of 2020.



**Figure 1. Dynamics of local budget revenues in 2017-2020**

Source: compiled by the authors on the basis of (Report on the Implementation of the Strategy for Reforming the Public Finance Management System in 2017-2019, 2020; The Budget of Ukraine 2021: Statistical Collection, 2022)

Despite the positive developments noted in the Report, the following "PFMS Reform Strategy for 2022-2025" lists the following main shortcomings of the system (The Order of the Cabinet of Ministers of Ukraine "On Approval of the Strategy for Reforming the Public Finance Management System for 2022-2025 and the Action Plan for its Implementation", 2021):

- The unsatisfactory state of the strategic planning system due to the weak link between strategic planning, budget planning and public investment planning;
- lack of medium-term budget planning;
- poor quality of budget planning on the part of key spending units;
- imperfect liquidity management of the single treasury account and foreign currency accounts of the state budget;
- lack of clear division of powers between executive authorities and local self-government bodies;
- insufficient transparency and accountability in the use of local budget funds;
- a formal approach of the developers of regulatory legal acts to financial and economic calculations of revenues and losses of the state and local budgets;
- insufficient competence of personnel to implement the reform at the central and local levels;
- insufficient institutional and managerial accountability.

Thus, the Strategy for 2022-2025 set the following strategic goals (The Order of the Cabinet of Ministers of Ukraine "On Approval of the Strategy for Reforming the Public Finance Management System for 2022-2025 and the Action Plan for its Implementation", 2021):

- Adherence to overall fiscal discipline in the medium term;
- improvement of the efficiency of resource allocation at the level of public policy making;
- ensuring effective execution of the state and local budgets;
- increasing the level of transparency and accountability in public finance management;
- development of human resource management in public finance.

It should be noted that the latest Strategy has significant positive differences from the previous one, such as clearer formulation of goals and objectives, establishment of links with other strategic documents, identification and presentation of indicators for achieving each strategic goal in quantitative or relative units with periodicity for each year of the Strategy implementation, which significantly improves the conditions for monitoring and controlling the implementation of the tasks. The document also outlines approaches to minimising the risks of implementing the Strategy, identifies the coordinator (MFU), develops a reporting system and determines

the possibility of updating strategic goals based on the results of annual reports.

### 3. The State of Budget Decentralisation in the Context of Russia's Armed Aggression

Russia's full-scale military aggression has prevented the implementation of most of the budget decentralisation measures planned in the Strategy, including the introduction of medium-term budget planning, the division of powers between executive authorities and local governments, and the strengthening of financial transparency and accountability of local governments.

Under martial law, in 2022, transfers from the state budget decreased by 56.9 billion UAH compared to the previous year, and the share of local budget revenues in the Consolidated Budget of Ukraine was

19%, which was due to changes in the parameters of the State Budget in terms of revenues under martial law, i.e., a more significant increase in State Budget revenues due to international grants. At the same time, local budget revenues increased by 40.4 billion UAH (Figure 2).

According to O. Zakhidna and Kh. Petryshyn (2022), the budget decentralisation reform in Ukraine is complete. However, this opinion is not supported by this paper, as at the end of 2021, a four-year strategic plan for further reform of public finance was approved, one of the points of which contains a task to further strengthen budget decentralisation.

The validity of the statement that the reform is ongoing is also supported by the identification of unresolved problems and unfulfilled tasks to ensure the financial capacity and autonomy of hromadas (Table 1).

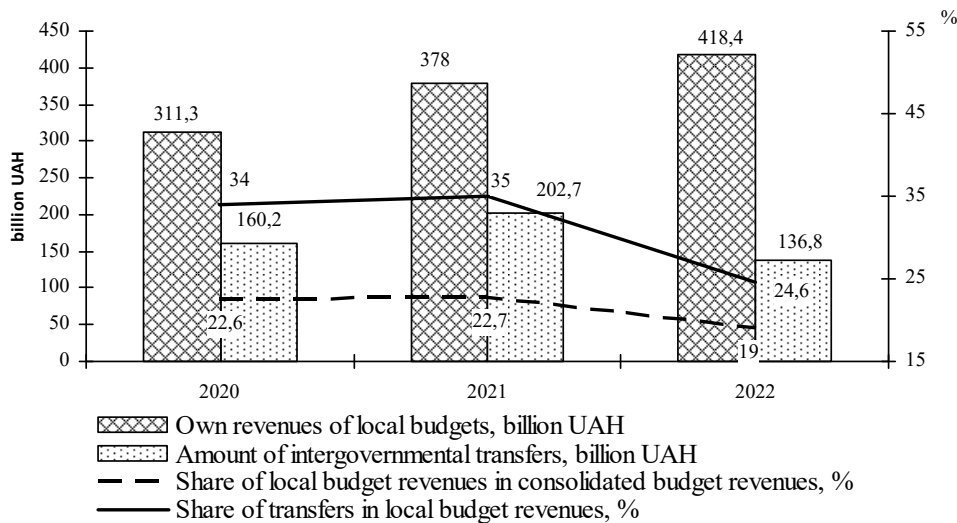


Figure 2. Dynamics of local budget revenues in 2020-2022

Source: compiled by the authors on the basis of (Report on the Implementation of the Strategy for Reforming the Public Finance Management System in 2022, 2023; The Budget of Ukraine 2021: Statistical Collection, 2022)

Table 1

#### Main results and unresolved issues of budget decentralisation in Ukraine

Achievements in budget decentralisation	Unresolved issues and problems
Inter-territorial equalisation of incomes based on the index of tax capacity of territories	Significant dependence of local governments on central government transfers
Stimulation of hromadas' financial initiatives through the possibility to retain 50% of tax revenues at the local level if their total amount exceeds the national average	The existence of district and regional state administrations that duplicate the same functions due to the incomplete decentralisation reform
Increase in local budget revenues by assigning 25% of the environmental tax to hromadas, 100% of excise tax, 100% of single tax, 100% of property tax and some resource payments	Poor human and institutional capacity of local self-government bodies
Hromadas gained broader powers and responsibilities, which led to an expansion of the list of services provided locally (opening of modern administrative service centres (ASCs))	Unresolved issue of local tax administration

Source: compiled by the authors

Thus, the indicators of budgetary centralisation (Table 2), which ranged from 73-90% in 2014-2023, indicate excessive centralisation of intergovernmental fiscal relations in Ukraine. The suspension of decentralisation processes, which is justified by the needs of wartime, a significant reduction in the amount of funding for hromadas due to objective reasons, and a lack of qualified employees in local governments currently make it impossible to successfully implement and complete the necessary reforms.

However, the current urgent need is to prepare for the development and implementation of post-war reconstruction measures, namely: restoring the balance of power in accordance with the principles of decentralisation, increasing the investment attractiveness of the regions, professional competence of personnel, the quality of planning and forecasting, monitoring and control.

The results of a survey of 101 representatives of local authorities, conducted in 2023 from April 27 to May 4 by the Kyiv International Institute of Sociology as part of the Sectoral Support Initiative for Ukrainian Civil Society project, showed the following:

Only 31% of hromadas have a strategic document on recovery;

existing recovery plans are not fully developed;

41% of hromadas tend to believe that such a strategic document is not needed;

41% of hromadas have projects and initiatives underway or planned for 2023-2024 to overcome the devastating impact of the war, while 55% of hromadas have no such projects underway or planned (Research on post-war reconstruction initiatives, 2023).

This situation is extremely negative, as advance planning of a system of measures to restore the socio-economic infrastructure of hromadas can serve as a basis for restoring the balance between levels of government and ensuring the financial viability of local authorities after the war.

#### 4. Conclusions

The undoubted results of budget decentralisation in 2017-2020 are the growth of local budgets' own financial resources and a certain improvement in the quality of public services provided to consumers, but the goals of the Strategy for Reforming the Public Finance Management System were not achieved during this period. The Strategy for 2022-2025 is a better strategic planning document, but the implementation of most of the budget decentralisation measures planned in it was prevented by the full-scale war with Russia. The issues of significant dependence of local self-government on central government transfers, duplication of functions by rayon and oblast state administrations, and their existence in general, low human and institutional capacity of local self-government bodies, and administration of local taxes remain unresolved. The urgent tasks of budgetary decentralisation include the need to develop and implement post-war reconstruction measures, which should include: restoring the balance of power in accordance with the principles of decentralisation, increasing the investment attractiveness of the regions, professional competence of personnel, quality of planning and forecasting, monitoring and control.

Table 2

#### Calculation of budgetary centralisation and decentralisation indicators for the period 2014-2022

billion UAH

Year	Consolidated budget expenditures	State budget expenditures	Local budget expenditures (excluding transfers)	Coefficient of budgetary centralisation*	Coefficient of fiscal decentralisation**
2014	511	422	89	0,83	0,17
2015	660	564	96	0,85	0,15
2016	812	671	141	0,83	0,17
2017	979	781	198	0,80	0,20
2018	1313	1013	300	0,77	0,23
2019	1433	1121	312	0,78	0,22
2020	1575	1257	318	0,80	0,20
2021	1841	1341	500	0,73	0,27
2022	3190	2705	485	0,85	0,15
2023	4441	4014	427	0,90	0,10

Source: compiled by the authors on the basis of (Consolidated budget expenditures by element, 2023)

\* Fiscal centralisation ratio = central budget expenditures together with official transfers to local budgets ÷ total consolidated budget expenditures for the respective year.

\*\* Fiscal decentralisation ratio = own expenditures of local budgets without the amount of official transfers to the State Budget ÷ total expenditures of the Consolidated Budget of Ukraine for the respective year.

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