Local Government Revenues: Increasingly Dependent on Kyiv?

Summary

The fiscal year 2004 will most probably see a decline in the non-transfer revenues of Local Government Entities (LGEs) in Ukraine, leading to an increase of redistribution via equalization transfers. There are two main reasons for this: the introduction of the flat-rate 13% personal income tax, which is assigned to 100% to the LGEs, will lead to decreased tax revenues of UAH 2.5 bn. Moreover, also the own revenues of LGEs (local taxes and other revenues) seem to stagnate. The trend of replacing own and assigned tax revenues with transfers does not work in the direction of an increased autonomy of local budgets, as it is desired by the Ukrainian Government in the longer run. Although the Constitution, the Law on Local Self-Governance and the Budget Code envisage a rather high level of fiscal decentralization and assert solvency of local governments as an underlying principle of the Ukrainian public finance, in reality local authorities are strictly constrained in their revenue sources and decisions, and local budgets are threatened to be underfinanced.

We therefore generally recommend a medium-term review of the Budget Code in order to accommodate its elements of local finance within the next two years. The following list of recommendations is thought as a contribution to the discussion.

1. If an increase of transfers is not politically desired, we suggest lowering the equalization coefficients in formula-based transfers in order to create incentives to LGEs to improve their tax base, and to reduce direct transfers.

2. In the case of assigned taxes (as the PIT), the central government should not give away taxes to 100%, but rather share the taxes according to a ratio which guarantees that both parties still have an interest in proper tax rates and collection.

3. One possibility to substitute both reduced transfers and a reduced PIT share would be to share the Enterprise Profit Tax (EPT), the simplified taxes on small business, and the Value-Added Tax (VAT) with the LGEs.

4. The land tax should be given more importance as a local tax by abolishing exemptions.

5. The vast array of genuinely local taxes should be revised in order to identify ‘loss-makers’, i.e. taxes which are too expensive to administer.
6. In the long run, more political weight should be given to LGEs in Ukraine. Changes in the structure of LGEs’ revenues should be embedded in administrative and political reforms to promote the fiscal independence and accountability of local decision makers.
1 Local Budget Revenues in Ukraine: Recent Trends

Table 1 presents the statistics of local budgets and consolidated budget revenues, the ratios of local budgets revenues to the consolidated budgets and GDP, and the level of GDP redistribution (the ratio of consolidated budget revenue to GDP), for the period of 2000-2004.

Table 1: Selected indicators of local budgets revenues in Ukraine

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (planned)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local budgets revenues, UAH bn</td>
<td>18.6</td>
<td>24.9</td>
<td>28.2</td>
<td>34.3</td>
<td>33.4</td>
</tr>
<tr>
<td>Consolidated budget revenues, UAH bn</td>
<td>48.4</td>
<td>53.9</td>
<td>61.9</td>
<td>75.2</td>
<td>78.0</td>
</tr>
<tr>
<td>Ratio of local to consolidated budget revenues, %</td>
<td>38.4</td>
<td>46.0</td>
<td>45.6</td>
<td>45.6</td>
<td>42.8</td>
</tr>
<tr>
<td>Ratio of local budgets revenues to GDP, %</td>
<td>10.9</td>
<td>12.2</td>
<td>12.8</td>
<td>13.0</td>
<td>11.8</td>
</tr>
<tr>
<td>Ratio of consolidated budget revenues to GDP, %</td>
<td>28.5</td>
<td>26.4</td>
<td>28.0</td>
<td>28.6</td>
<td>27.5</td>
</tr>
</tbody>
</table>


As can be seen from the table, the revenues of the consolidated budget have increased considerably (at least in nominal terms) over the reported years. Local budgets have followed the same trend up until the year of 2003 (the share of local budgets in the consolidated budget remained practically identical during the years of 2001-2003). Moreover, while the (forecast) level of GDP redistribution this year falls behind the level of the year 2000, the (projected) ratio of local budgets revenues to GDP for 2004 is higher than that of 2000.

To summarise these findings, one could say that the overall situation with local budgets funding seems quite positive. According to Table 1, a problem comes only this year, when the ratio of local budgets revenues to GDP is projected to fall after growing during the whole of the reported period. This result is troublesome as LGEs are made to bear the lion’s share of the tax reform costs in 2004, mostly because of the personal income tax reform, as analysed in the next section.

However, the statistics presented so far cannot tell the whole story, as they do not provide us with the composition of the local budgets revenues. The next chapter of the paper summarises the structure of local budgets revenues, and chapter 3 matches these findings against economically justified principles of LGEs’ financing. Chapter 4 discusses ways for enhancing stability of local budgets funding in

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1 This paper uses the estimate of Derzhkomstat as of February 2004 for the GDP in 2003, and for 2004 the forecast from the explanatory note to the Law on the State Budget 2004 is employed.
Ukraine, and Chapter 5 concludes the discussion with outlining policy recommenda-
tions.

2 The Structure of Local Budgets Revenues in Ukraine

The revenues of local government entities (LGEs) rest on three pillars: revenues from own taxes, revenues from assigned taxes, and revenues in the form of trans-
fers from the central government.

Table 2 presents the statistics for this structure. One should note that the strict di-
vision of LGEs’ revenues to “own” and “assigned” was introduced only from 2002 when the Budget Code came into effect. However, we have included the major components of local budgets revenues for the two previous years as well in order to analyse their development over a longer period of time.

Table 2: Composition of local budgets revenues in Ukraine, UAH bn

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net-of-transfers revenues</strong></td>
<td>14.2</td>
<td>17.6</td>
<td>19.4</td>
<td>22.5</td>
<td>18.9</td>
</tr>
<tr>
<td><strong>Own revenues, of which</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- land tax</td>
<td>1.4</td>
<td>1.6</td>
<td>1.8</td>
<td>2.0</td>
<td>2.0</td>
</tr>
<tr>
<td>- property (vehicles) tax</td>
<td>0.53</td>
<td>0.55</td>
<td>0.59</td>
<td>0.60</td>
<td>0.52</td>
</tr>
<tr>
<td>- genuine local taxes</td>
<td>0.49</td>
<td>0.51</td>
<td>0.54</td>
<td>0.59</td>
<td>0.47</td>
</tr>
<tr>
<td>- EPT from LGEs’ enterprises</td>
<td>0.28</td>
<td>0.06</td>
<td>0.15</td>
<td>0.15</td>
<td>0.13</td>
</tr>
<tr>
<td>- own revenues of budgetary entities</td>
<td>1.1</td>
<td>1.2</td>
<td>1.6</td>
<td>1.9</td>
<td>0.94</td>
</tr>
<tr>
<td>- LGEs’ property sales</td>
<td>0.22</td>
<td>0.33</td>
<td>0.62</td>
<td>1.0</td>
<td>0.99</td>
</tr>
<tr>
<td><strong>Assigned revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which PIT</td>
<td>6.4</td>
<td>8.8</td>
<td>10.8</td>
<td>13.5</td>
<td>11.0</td>
</tr>
<tr>
<td><strong>Central budget transfers</strong></td>
<td>4.4</td>
<td>7.2</td>
<td>8.8</td>
<td>11.7</td>
<td>14.5</td>
</tr>
<tr>
<td>Transfers, formula-based</td>
<td>4.1</td>
<td>4.2</td>
<td>4.3</td>
<td>5.9</td>
<td>7.4</td>
</tr>
<tr>
<td>Other transfers (subsidies)</td>
<td>0.3</td>
<td>3.0</td>
<td>4.5</td>
<td>5.8</td>
<td>7.1</td>
</tr>
<tr>
<td><strong>Total revenues</strong></td>
<td>18.6</td>
<td>24.8</td>
<td>28.2</td>
<td>34.3</td>
<td>33.4</td>
</tr>
</tbody>
</table>

As can be seen from the table, the nominal growth of local budgets revenues between 2000 and 2003 (UAH 15.7 bn) was almost equally shared by the increase of net-of–transfers revenues and transfers to LGEs from the state budget. However, out of UAH 8.3 bn increase of net-of-transfers revenues, UAH 7.1 bn was delivered by the growth of the PIT collection alone. The rest of the increase occurred mostly due to the growth of own revenues of budgetary entities\(^2\) and the land tax.

This year is going to be rather problematic for LGEs, as their revenues are forecast almost UAH 1 bn below the level of 2003. Net-of-transfers revenues are going to fall behind the level of 2002, mostly to a dramatic decrease of the PIT collection in 2004, which has been the core of non-transfer revenues during the recent years. The situation is exacerbated by the forecast fall of own revenues below the level of 2002 (and UAH 1.2 bn below the 2003 revenues). The increase of transfers that is planned for the current year will be apparently not sufficient to cover the resulting gap, and will be even slightly less than that between 2002 and 2003.

Net-of-transfers revenues

One of the alarming signs for local policy-makers should be the declining share of “net-of-transfers” revenues in total local budgets proceeds, i.e. local governments are being made increasingly dependent on resources directed from the state budget (see Table 3).

The Budget Code distinguishes two parts of “net-of-transfers” revenues: own revenues (that should be used for financing own expenditure tasks and are not taken into account in defining intergovernmental transfers), and "assigned" state taxes (assigned by the Central Government for fulfilling the "delegated" tasks and taken into account in defining intergovernmental transfers).

<table>
<thead>
<tr>
<th>Table 3: The shares of “net-of-transfers” revenues in LGE revenues and their share the consolidated budgets and GDP in %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>Share of net-of-transfers LGE revenues total local budgets revenues</td>
</tr>
<tr>
<td>Ratio of net-of-transfers LGE revenues to consolidated budget revenues</td>
</tr>
<tr>
<td>Ratio of net-of-transfers revenues to GDP</td>
</tr>
</tbody>
</table>


Table 4 presents the shares of genuine local taxes and other own revenues of local budgets in total local budgets revenues and their ratios to GDP. In principle, local taxes should be an important element of local governments’ revenues and the main

\(^2\) This revenue source was introduced from 2000.
instrument of their own fiscal policy. In Ukraine, these local taxes are the weakest component of local budgets own revenues, comprising a list of roughly ten tiny duties and fees that are subject to a (limited) influence of the LGEs as to defining their bases and rates ('genuine local taxes' in Table 2). Actually, this year the revenues from the local taxes are planned to decrease nominally below the level of the year 2000.

**Table 4:** Shares of genuine local taxes and own revenues of local budgets in total local budgets revenues and their ratios to GDP in Ukraine in %

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004 (planned)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share of genuine local taxes in total local budgets revenues</td>
<td>1.9</td>
<td>1.7</td>
<td>1.4</td>
</tr>
<tr>
<td>Ratio of local taxes to GDP</td>
<td>0.25</td>
<td>0.23</td>
<td>0.17</td>
</tr>
<tr>
<td>Share of own revenues in total local budgets revenues</td>
<td>20.3</td>
<td>19.2</td>
<td>16.9</td>
</tr>
<tr>
<td>Ratio of own revenues of local budgets to GDP</td>
<td>2.6</td>
<td>2.6</td>
<td>2.0</td>
</tr>
</tbody>
</table>

Source: own calculations based on State Treasury of Ukraine Reports and The Law on the State Budget of Ukraine 2004.

As can be seen from Table 2, most of the own revenue sources are rather unreliable. The land tax, which could be a major element of the local finance, is plagued with privileges and exemptions (most of them are granted by the central government with LGEs getting no compensation), and is projected to stop growing in 2004. The tax on vehicles (called "property tax") also suffers from numerous exemptions. The enterprise profit tax from enterprises that are the property of LGEs is very small and declining, probably because of deteriorating solvency of such enterprises due to fixed tariffs for their services. The decline of these revenues is a good sign, as it is not the task of LGE to run businesses, but the shortfalls should be compensated. Own revenues of budgetary entities are a rather non-transparent source of local budgets funding, e.g. in 2003 more than UAH 1 bn of these revenues were obtained through such sources as "charitable contributions" and the like. The envisaged fall of these revenues in 2004 is mostly related to a dramatic cut in the planned "contributions". The proceeds from sales of LGEs’ property increased quite significantly from 2000-2003, perhaps due to improved administration of this process. However, the planned stagnation of these proceeds in 2004 may indicate that this resource will soon be depleted. The rest of own revenue sources of local budgets are rather insignificant.

On the whole, own revenues constitute only a small share in local budgets revenues (around 17% in 2004), and their stagnancy, as matched against growing expenses,
is dangerous for the solvency of local governments, because the Central Government is not obliged to compensate them for shortages in financing their own obligations.

The major element of **assigned taxes** is the personal income tax (PIT), which yields the lion’s share of local budgets revenues. Although assigning the proceeds from the PIT to local budgets has been a positive advancement in endowing them with an appropriate revenue source, the introduction of the 13% flat rate in 2004, coupled with a nearly all-embracing social privilege\(^4\) envisaged for this tax, endangers the solvency of the local governments this year. The personal income tax yielded more than UAH 13.5 bn to local budgets in 2003, representing almost 40% of total revenues of local budgets in that year. The forecast of the Central Government for 2004 is around UAH 11 bn, which is going to constitute less than 33% of local budgets revenues. But there are serious doubts that even this target will be met, as considerable de-shadowing effects and additional revenues from tax base expansion\(^5\) are assumed in this estimate. Although the Government claims to provide a sufficient level of compensation to local budgets through the transfer mechanism, the PIT reform might turn out to threaten the stability of local finance and further contracts the room for local governments’ own fiscal policy.

**Transfers**

As Table 5 shows, the structure of local budgets revenues in Ukraine is increasingly dominated by transfers from the central government. Their share in total local budgets revenues has nearly doubled since 2000. There are two major types of transfers: formula-based transfers and additional grants (subsidies) that can be directed to LGEs for different purposes, from financing investment activities in a region to overcoming consequences of natural calamities. The formula-based transfers can take two opposite directions: from the central level to local governments (which are then called “equalization transfers”) and the funds that are directed from LGEs to the state budget (their role has become rather insignificant, as seen from Table 5). Transfers are based upon the formula that has the general form:

\[
T_i = (a_i (G_i - R \cdot FC_i)) \cdot P_i
\]

where \(T_i\) is the transfer (positive if a region is a recipient and negative if it directs funds to the state budget), \(a_i\) is the equalization coefficient (currently set in the range from 0.6 to 0.9 for donor LGEs and at the level of 1 for recipients), \(G_i\) is the per capita public expenditure level, \(R\) is average per capita assigned revenues for all regions, \(FC_i\) is an index of the fiscal capacity of region \(i\) relative to the average, and \(P_i\) is the population of region \(i\). The per capita expenditure needs \(G\) are set by the central government with regard to the expenditure categories. The index of

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\(^4\) This privilege will be a deduction from the taxable income and, by the rules of its calculation, can seriously erode the tax base.

relative fiscal capacity $FC_i$ measures actual per capita assigned tax revenues during the basic (past) three years relative to the country average.\(^6\)

The formula has two decisive parameters. Parameter ‘a’ determines the degree of equalization among the regions after the transfers. The fiscal capacity parameter $FC_i$ can be influenced by the region itself through better policies in business and tax affairs. Provided that the equalisation parameter $a_i$ is 1, any fiscal gap will be compensated, and any fiscal surplus will be taken away. As regions can themselves influence the degree of fiscal capacity, an incentive to do so can only come from a proper design of parameter $a_i$, which the regions cannot influence.

The Budget Code has set the equalisation parameter $a_i$ in the range from 0.6 to 1, but in practice the central government fixes it to 1 for the recipient regions every year since the Budget Code introduction. It means that the recipient regions have no incentives to increase their revenues for closing the fiscal gap, as it will be fully covered from the State Budget anyway. For the donor regions, however, the equalisation coefficient fell within the brackets of 0.8 and 1 in 2002, and 0.9 and 1 in 2003. Thus the richer regions were obliged to give away almost all their fiscal surplus. For this year the Government has foreseen a special scale that sets the values of $a$ from 0.6 to 0.9, depending on the assigned revenues growth rate of the respective LGE during the base period of three years (the higher the rate of growth is, the less surplus resources are transferred to the State Budget). Although it is in principle a much more efficient and economically justified arrangement, the envisaged values of revenues growth seem to be set at too high levels. For example, to be assigned the second to maximum equalization coefficient (0.85 instead of 0.9) an LGE has to demonstrate a growth of more than 56% compared to the base period (or 25% growth on average for two years in a row)! Thus the ‘overly effective’ nature of the equalisation procedure will probably not be changed in the desired manner, and a tuning-down of the growth coefficients would thus be advisable.

\(^6\) The actual calculations of transfers are somewhat more complicated because there are different formulas for each major expenditure category, and because adjustments are made to consider regional differences in expenditure needs $G$ (due to differences in costs) and in tax revenue losses as a result of tax exemptions granted by the central government (see Ulrich Thiessen, "Fiscal federalism in transition: A suggested framework of analysis and empirical evidence." DIW Research Notes 16, 2002, Berlin).
### Table 5: Intergovernmental Transfers in Ukraine

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004 (plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transfers from the state budget to the local budgets, UAH bn</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which equalization transfers</td>
<td>4.1</td>
<td>4.2</td>
<td>4.3</td>
<td>5.9</td>
<td>7.4</td>
</tr>
<tr>
<td>of which direct subsidies</td>
<td>0.3</td>
<td>3.0</td>
<td>4.3</td>
<td>5.8</td>
<td>7.1</td>
</tr>
<tr>
<td><strong>Transfers from the local budgets to the state budget, UAH bn</strong></td>
<td>1.4</td>
<td>2.5</td>
<td>2.9</td>
<td>2.4</td>
<td>1.6</td>
</tr>
<tr>
<td><strong>Share of transfers from the state budget in total local budgets revenues, %</strong></td>
<td>23.7</td>
<td>29.1</td>
<td>31.2</td>
<td>34.2</td>
<td>43.4</td>
</tr>
</tbody>
</table>


Furthermore, the calculation of the fiscal capacity $F_{Ci}$ is simply oriented at the tax collections from the three base years without considering the true tax collection potential of the LGE.\(^7\) Such practices have probably been one of the effects that have led to a decrease in the number of donor LGEs from 89 in 2002 to 56 in 2004. Summing up, the formula approach provides fewer incentives to improve tax collections by the LGEs than possible.

Only one-half of the funds directed from the central government to the regions consist of transfers based on the formula approach (see Table 5). The other half consists of direct subsidies\(^8\) that are most frequently granted as investment support and subsidies earmarked for social spending. As Table 5 shows, the share of transfers in local revenues is dramatically increasing. Moreover, direct subsidies have grown in particular. Due to this latter condition, transfers are still subject to annual bargaining between centre and the individual regions to a wide extent.

### 3 Principles of Financing LGEs and Current Implementation

Local budgets in Ukraine evidently need to obtain a reliable own revenue source if they are not to become increasingly dependent on transfers from the central government. As our above-presented analysis has shown, at the moment it seems that the transfer revenues of LGEs are increasing and non-transfer revenues decreasing accordingly. If this is not to result in a) higher fiscal dependence of LGEs on the Central Government, and b) more inter-regional re-distribution, the rules governing the own revenue base of LGEs have to be reconsidered in the medium term. Before entering this discussion, some scientifically accepted principles regarding local government revenues should be laid out:\(^9\)

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\(^7\) Thiessen (2002) suggests to learn from Russian approaches to calculate the local fiscal capacity, which also use local GDP as benchmark.

\(^8\) Please refer also to “How to improve public investment efficiency in Ukraine?” (T22), IER, February 2004.

1. Lower levels of government should have significant own revenues determined within limits by themselves.

2. The revenue sources for sub-national governments should be sufficient, stable and predictable.

3. Taxes levied by them should primarily concern relatively immobile factors of production such as land or fixed capital.

4. If a transfer system is needed as a supplement (which is mostly the case), it should be based on rules, be transparent, and it should consider the potential revenue-raising capacity of the LGE.

In the following, we will shortly check the three pillars of LGE revenues against these principles:

A. **Local taxes and other own revenues** are currently not significant (with only one-fifth of total LGE revenues) and can be influenced by LGEs to a limited extent only. The revenue potential of the land tax, which could be a major element of the local finance, is definitely under-used. Taxes on factors of production constitute only a small share in the LGEs’ own revenues, and their collection seems to stagnate despite the economic growth in the country. Moreover, the variety of local taxes most likely involves high collection costs.

B. **Assigned taxes** are dominated by the personal income tax, which is almost entirely devoted to LGEs. This revenue source is relatively stable over business cycles: more stable than the business profit tax, but less stable than the value added tax. The problem with the assigned PIT is rather that it is entirely devoted to LGEs, but decided upon by the central governments and the parliament. As the central level has no revenues from this tax, incentives to design the PIT in a way which ensures stable revenues for LGEs may not be strong enough. For instance, the introduction of the flat-rate PIT may cause the LGEs’ assigned revenues to decline, with the consequence of increased transfers.

C. **Transfers on the formula base** are consistent with principle 2, as they have a stabilising effect on regional revenues. Principle 4 is met theoretically, as the formula approach is transparent on the first view and considers the fiscal potential of a region or municipality. The first problem with transparency is that the formula has to be calculated for 689 LGEs, which makes it hard for the public to spot possible strange results of the budgeting process. And as stated in the last section, the formula approach provides fewer incentives to improve tax base and collections by the LGEs than possible. The increasing share of direct transfers as subsidies opens a lot of room for inter-governmental bargaining.

In the following we are going to discuss possible changes in the intergovernmental fiscal structure in Ukraine that could reverse the recent trends towards increasing fiscal dependency.
4 Approaches to Enhancing the Stability of Local Budgets

Local taxes

First of all, what makes for a good local tax? It should in principal be paid by the residents of a local community who would subsequently receive it back in the form of local expenditures\textsuperscript{10}. This simple arrangement allows for an independent local fiscal policy that is conveyed by an elected government and reflects the wishes of resident taxpayers. In particular, the local tax should be stable and therefore be based on rather immobile factors such as land or other fixed assets, such as the property tax.\textsuperscript{11} But the property tax is unlikely to become a quick fix for the revenue problems of LGEs. The administration of a property tax is expensive due to the valuation problem and its legal implications, which is why, for instance, in Germany the property tax has become less significant during the recent decade.\textsuperscript{12} We would therefore not consider a general property tax as a first priority.

However, a possible starting point for an asset-based tax could be the land tax, which should serve as a substitute for the absent taxation of farm profits. The government could strengthen local finance by reforming the existent land tax. The majority of the existing privileges for this tax that are set on the national level (e.g. industry- and ministry-specific) should be abandoned.

Shared taxes

As the identification of a genuinely local tax is difficult, the tax sharing approach should be further considered, which means distributing the proceeds from national taxes to local governments according to fixed shares. The only assigned tax at the moment is the PIT, and the fact that it is assigned to LGEs to 100% may tempt the Central Government to neglect the revenue-generating potential of this tax, as pointed out above. We suggest considering the possibility to assign a certain share of the Value-Added-Tax and the Enterprise Profit Tax to LGEs, and to reduce the 100% ‘local share’ of the PIT accordingly. Many experts claim that shared taxes create disincentives to collect own taxes, but this depends a lot on how the share is actually calculated. While the VAT revenues of the whole country could be evenly distributed according to local population or similar parameters, the EPT revenues from local business should be shared with the centre, i.e. the sharing approach would work in the opposite direction. The following advantage would emerge: the LGEs would face incentives to pursue business-friendly policies in order to increase the absolute value of “their” share from the EPT.


\textsuperscript{12} The costs to administer the (non-land) property tax in Germany climbed to more than 30% of the property tax revenues, which was one reason to practically abolish this tax. It is hard to believe that a Ukrainian version would be more effective.
Administrative aspects are not expected to be a major obstacle to increased tax sharing. As taxes are collected by the centrally organised State Tax Administration, there should be no problem to enforce standard collection and sharing procedures.

**Transfers**

There is no doubt about the fact that transfers from the centre will be inevitable in the near future to ensure the solvency of LGEs and a certain degree of uniformity regarding the supply of public services in Ukraine. The introduction of the formula approach to calculate transfers has been a step in the right direction in order to make the transfer process more transparent and efficient. But the discussion of the general transfer formula above has shown that the current system:

- is still too much designed as a simple equalisation mechanism with not enough focus on the “fiscal activation” of LGEs;
- is still subject to annual changes by the central government;

The formulas to calculate the transfers should therefore be changed. First, the potential tax base should be calculated on the basis of the regional economic performance, as suggested above in footnote 7. Second, the equalisation coefficient should be set to values significantly below 1 both for the donor and recipient regions. Then, only half to one-third of the shortfall in local tax collection would be compensated or taken away, which would create more incentives for LGEs to improve their revenue capacity and increase tax collection.

**5 Conclusions and Policy Recommendations**

On the basis of our analysis we may conclude that presently there is strong evidence of a discrepancy between the declared policy of the State Government of promoting fiscal decentralization in Ukraine and real practices as towards the revenue aspect of local budgets.

1. The share of genuinely own revenues of LGEs is relatively low (~20%).
2. The reform of the PIT in 2004 threatens the stability of local finance.
3. The role of transfers from the Central Government to local budgets has been growing considerably, and will further increase due to the PIT reform.

We assume that this situation is not really politically desired in the long run. The duty of making local budgets balanced and void of hidden deficits should become of paramount importance for Ukrainian tax policy. For this end, we suggest the following recommendations:

1. If an increase of transfers is not politically desired, we suggest lowering the equalization coefficients in formula-based transfers in order to create incentives to LGEs to improve their tax base, and to reduce direct transfers.
2. In the case of assigned taxes (as the PIT), the central government should not give away taxes to 100%, but rather share the taxes according to a ratio which guarantees that both parties still have an interest in proper tax rates and collection.
3. One possibility to substitute both reduced transfers and a reduced PIT share would be to share the Enterprise Profit Tax (EPT), the simplified taxes on small business, and the Value-Added Tax (VAT) with the LGEs.

4. The land tax should be given more importance as a local tax by abolishing exemptions.

5. The vast array of genuinely local taxes should be revised in order to identify ‘loss-makers’, i.e. taxes which are too expensive to administer.

6. In the long run, more political weight should be given to LGEs in Ukraine. Changes in the structure of LGEs’ revenues should be embedded in administrative and political reforms to promote the fiscal independence and accountability of local decision makers.

A.K, N.K. Lector R.F., April 2004

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Please refer also to “Setting up a Framework for Efficient Local Budget Expenditures” (T20), IER, January 2004.