

## CRISIS SHARPENED THE WEAK POINTS OF LOCAL BUDGETS IN UKRAINE

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In Ukraine, financial and economic crisis reflected the situation of the whole economy and certainly, it influenced the welfare. Welfare is the function of state, but in Ukraine, the 80 per cent of this function is executed by local authority. And the share of local budget is very small (see chart 1). Welfare is secured at the expense of exclusive sources and state revenue sources in local budgets. Crisis affected the amount of financing of these spheres. Change of macroeconomic figures restricts the amount of financing. And now the main task for the government is to correct the local policy as to the principles of revenue formation and expenditure.

The data of local budgets at the last period should be analyzed.

In the first nine months of 2008 and 2009 as well as 2004-2007 the amount of **local budget expenditures** was grown. However, at the end of 2008 the trend of growing was slowing down, and in the first half of 2009 the expenditures decreased at 3,3 %. The capital expenditures decreased at 38,6 % as well as their part in the structure of general expenditure fund.

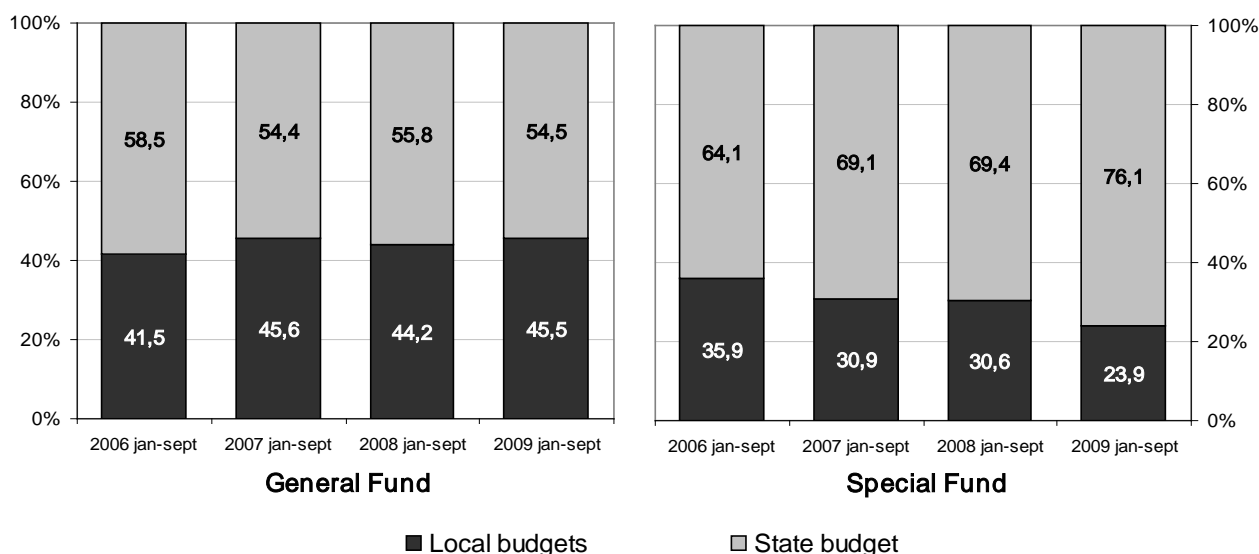


Chart 1. The shares of State and Local Budget Expenditures in Consolidated Budget Expenditures in January-September 2009 (Source: [www.ibser.org.ua](http://www.ibser.org.ua))

But, as the result of 9 months of 2009 the volume of expenditures was 88,8 billion UAH <sup>1</sup> which is 4,5 % more than the rate of previous period. Expenditures of general fund grew at 1,3 %, and expenditures of special fund decreased at 6,7 %, and their parts amounted 45,5 % and 23,9 % accordingly. Thus, we may say about the initiation of tendencies of pre-crisis period.

<sup>1</sup> 100 UAH equal 12,6 USD and 9,5 EUR (April 2010)

It should be mentioned that the level of plan execution as to the expenditures decreased by 1,0 ppt. and as a result of 9 month of 2009 the level of plan execution decreased by 1,3 ppt. again.

The main portion of expenditures of local budgets constitutes the expenditures on socio-cultural sphere. In 2008 the part of social expenditures restricted by 1,2 ppt. This trend was continued in January-June 2009 – its share reduced by 1,5 ppt.; instead of this, the share of social subvention grew. Thus, in the period of 9 month of 2009 the total portion of so called “social budget” (all social expenditures) was 88,0 % which is 4,1 ppt. more than in the previous period. The volume of this costs grew at 10,3 % and reached 68,2 bln. UAH. Expenditures on education, health care and social protection and security grew (by 0,85, 0,57, 0,68 ppt. accordingly). The most significant changes were in educational sphere – the part of expenditures grew by 1,6 ppt. to 37,4 %, and their portion changes by 1,6 ppt. to 1,5 %.

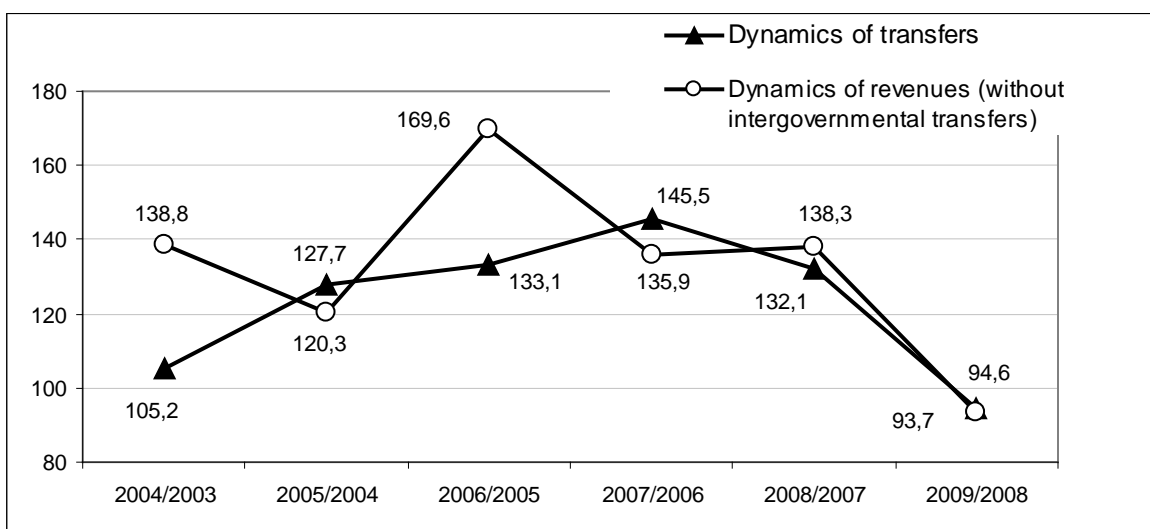
The declination range of other expenditures on local budgets were in the frame of 1,0 ppt. comparing to the January-September 2008. Thus, we can say that the volume of costs which are directed to social sphere grew too.

The expenditures on economic activity and other functions reduced (by 0,50 and 0,12 ppt. accordingly). The financing of public administration amounted 4,3 bln. UAH which is 0,1 ppt. less than in the same period in 2008. Their portion in total expenditures of general fund reduced by 0,5 ppt. to 5,5 %.

Thus, the positive in this situation was that even in the period of crisis the expenditures enlarged totally and in the social sphere particularly. Other changes we can attribute to statistics fluctuation.

Let’s analyze the dynamic of intergovernmental transfers (see graph 1).

*Graph 1. Dynamics of Local Budget Transfer and Revenues in January-September 2004-2009 (Source: www.ibser.org.ua )*



The volume of general transfers increased yearly in 2004-2008, but in the first half of 2009 their amount reduced. The share of transfers in revenue volume was 45,1 % which is 0,3 ppt. less

than in the same period in 2008. The accession of transfers reduced significantly at 1,4 % as well as the share of equalization grant. However, in January-September 2009 the largest part of transfer occupied the equalization grant (55,9 %), and their share grew from 54,5 to 55,9 %.

Instead of this, the share of additional transfers reduced from 1,7 to 1,2 % as well as the share of special grants (subvention) – from 43,5 to 42,9 %. The portion of social subvention enlarged from 28,8 % to 39,0 % (by 10,2 ppt.) in the volume of all special grants: accordingly to this, the portion of other transfers reduced from 14,7 to 3,9 (by 10,8 ppt.). In other words, shares of general grants and social payments grew.

The negative fact is that in 2008 some subventions weren't financed, among them subventions for providing benefits and housing subsidies to the population, for payment for electric power, natural gas, solid household fuel, water and sewerage, providing the housing for certain employers in the state activity sector. Some other subventions were financed at 0,1 % of plan, such as: equipping the hospitals and ambulatories, charging the local vehicles, subway (the Metro) construction. The first half of 2009 demonstrated the improvement of situation: the level of non-execution of subventions was lower; it concerns such subventions as payment for the electric and heat power, water and sewer services, building restoration. And as a result of 2009 almost total amount of special grants was financed.

Thus, the amount and share **of transfers in local budget revenues** reduced in January-September 2008 and 2009. Share of general transfers and portion of social subsidies in total amount of transfer grew. Such allocation of shares in a benefit for social transfers together with the enlarge of social expenditures, certainly, is positive as the improving of welfare, but negative due to the restriction of local government's capability to spend their money due to their own view. Also we can consider that the reduction of transfers' portion and the growth of revenues' portion in local budgets' structure as positive factor, which can show that regions start to enlarge their capability to mobilize revenues sources more effective.

In the context of above mentioned, we can see the strange situation that in 2008 **the amount of transfers from local budgets into state budget** increased as well as in the first half of 2009. However, if we take into consideration that several budgets are self-sufficient in financing we will understand that they can direct some money to the state budget. It concerns budgets of industrial high developed regions and cities (towns) with profitable enterprises.

Though the total amounts of transfers from local budgets into state budget decreased at 166,5 mln. UAH and amounted 5,5 % of local budget expenditures in January- September 2009 (compare to the respective data of 2008 - 5,8 %). Totally, the restriction of transfers from local budgets into state amounted 63,2 % in January-September 2009, at the same time own revenues of local budgets also demonstrated reduction. It should be mentioned that this is the smallest index in

some previous years. Therefore, the tendency of increasing the amount of transfers into state budget formed in previous period changes to opposite one.

To explain the changes in the system of budget spending the process of **budget filling** should be analyzed (see graph 1).

The largest sources for local budget revenue are *state* taxes such as personal income tax (78 % of incomes), single tax on small business (3 %) as well as *exclusive* taxes – land payment (13 %), tax on transport vehicles (3 %); income of 14 others taxes is insignificant.

There were an annual enlarge of rate of local budgets' revenues in 2004-2007, but in 2008 we can see the gradual reduction of these rates which amounted 150,1 % in January and 135,9 % in September. The sharp fall of these rates began in October 2008: 128,0 % in October, 113,6 % in November, 115,6 % in December. The revenue reduced at 4,4 % in January-June 2009 compared to the respective figures of 2008. The level of revenue plan' execution reduced from 49,2 % to 43,2 % in general fund and at 9,5 ppt. in special fund.

In other words, the smallest increase of own revenues of local budgets was in 2008. Tendency of reduction of revenue incomes initiated in the first half-year of 2009 was continuing in January-September 2009. There was only 51,3 bln. UAH which came to general and special funds together which is 5,4 % (2,9 bln. UAH) less, than in the previous period. The level of plan execution was reduced from 72,9 % in the three quarters of 2008 to 65,4 % in the same period of 2009.

Regional section demonstrate us that the most amount of revenues came to the budgets of Kiev city, Donetsk, Dnipropetrovsk, Kharkiv region – these are the most developed industrial regions. At the same time, the revenues to local budgets were reduced comparing to the three quarters of 2008, and the biggest restriction was in Kiev, it is characterized by huge incomes to budget and sometimes even by plan's over-fulfilment.

The average level of budget incomes from **general fund** was 995,4 UAH per capita in January-September 2008 which is 3,9 % less than in previous period.

The **special fund** reached 8,0 bln. UAH which is 22,8 % less than in the analogical period of 2008 – among others, the capital transactions revenue reduced at 47,9 %. There were 39,7 % decreasing of incomes to special funds and 20,3 % decreasing of property taxes.

Thus, **the crisis led to the restriction of own revenues of local budgets.**

We should be point on the significant tendencies of incomes of certain local taxes and fees.

The largest share of local budget revenues has tax payments. Tax payments amounted 42,7 bln. UAH, which is 1,1 % less than the same indicator in 2008 (it amounted 39,4 %). Main changes in the structure of tax revenues were the decline in the portion of the personal income tax to 77,3 % (in previous period it was 79,5 %) and the growth of the portion of land payment from 11,6 to 14,8 %.

The single largest source of local budget revenues is *the personal income tax*. It influenced the capability of local authority to execute their functions. Therefore, it was negative fact, that the dynamic of monthly revenues from personal income tax was slowing from 154,4 % in January to 114,0 % in December, moreover from October through sharp speed. The share of personal income tax declined to 77,4 % in the first half of 2009 from 79,9 % in previous period. And incomes from this tax amounted 97,7 % of it in previous period, the real incomes reached 32,3 bln. UAH which is 1,3 bln. less than the previous indicator. For comparison, the speed of growth of this tax in 2007 was higher then in 2006. It can be followed that the additional negative factors, influencing the personal income tax, appeared as a result of financial crisis. Among them – the restriction of employers' number and salary decrease, huge number of employers on forced vacations or restricted timetable of work, the increase of unemployment people at 0,5 %, decline of wage premiums' volume in the IV quarter of 2008.

*The single tax for small and medium entrepreneurship* amounted 1,3 bln. UAH in January-September 2009 which is 4,6 % less than in previous period. Incomes from *exclusive local taxes and fees* reached 604,0 bln. UAH, which are equivalent to this amount in previous period. Their share in general fund continued to demonstrate digressive trend and reached only 1,3 % in the mentioned period.

The share of non-tax revenues decreased at 62,9 % excepting the revenues from property and entrepreneurship (increased at 11,4 %), administrative charges and fees, income from noncommercial and incidental sale (increased at 5,8 %).

Totally, income of *the first tax basket* (taxes which are taken into account by calculation of transfers, among them personal income tax, single tax etc.) decreased at 1,1 bln. UAH or 2,8 % in January-September 2009 comparing to the same period of 2008. The share of this basket was 84,1 % in general fund which is 1,4 % less than in previous period. The main factor which influenced these revenues was the reduction of nominal incomes of personal income tax.

The volume of *the second tax basket* (taxes which aren't taken into account by calculation of transfers, among them land payment, tax on transport vehicles etc.) in January-September 2009 was 6,9 bln. UAH which is 8,2 % more than the analogical indicator in previous period. The growth was caused by the increase of incomes from *land payment* which is also the main sources of local revenues. The share of this tax reached 72,3 % in the structure of the second basket.

That period has another negative fact – the increase of number of local budgets which didn't execute the revenue plan. The number of those budgets was 6 (1 town budget and 5 rayon (sub-regional unit) budget) in January-September 2007, which is 0,86 % of total number, and in the same period of 2008 this number reached 48 (25 town budget, 22 rayon and budget of Kyiv city), which is 25,3 % of total number.

Thus, we can say that the crisis reflected the personal income tax and single tax which incomes started to restrict from 2008.

Just summaries the tendencies formed in local budget sphere:

1. Increase of total expenditures and expenditures on social sphere;
2. Reduction of amount of intergovernmental budget transfers;
3. Increase of the share of equalization grant and social subventions;
4. Decrease of transfers from local budget to state budget;
5. Reduction of own revenues of local budgets;
6. Decrease of expenditures on economic activity and public administration;
7. Non-financing of some special grants;
8. Increase of the number of local budgets which didn't execute revenue plan in 2008 (there were no such types of budgets in 2009);
9. Sharp decrease of incomes of personal income tax which is the largest source of budget.

Our analyses demonstrated that financial crisis influenced the separate parts of local budget revenues.

The restriction of employer's number and salary level, huge number of employers on forced vacation influenced the main source of budget revenues – *personal income tax*. Revenues from it decreased, and also these tendencies start to appear already from the IV quarter of 2008, just when the financial crisis spread, and continued in January-September 2009. Accordingly, the revenues of general fund of local budget reduced. The amount of special purposed grants to social protection and social secure as well as the capital expenditures reduced for certain period.

The portion of *single tax on small business* and its revenue are also reduced evidencing the restriction of entrepreneurial business. Therefore the single tax didn't secure the stability of local budgets.

Revenues from *land payment* and portion of this tax in the structure of income increased. This fact can directly show that it is truly important exactly for local budgets.

Instead of this, the share of *tax on transport vehicles* didn't changed, because the number of vehicles in exploitation is just growing. This tax should be considered as the basic and one which is profitable to be mobilized particularly at the local level.

The restriction of local budgets revenues influenced the welfare. The main direction of expenditures – on social protection and social secure – was cut down. And these are the main directions of expenditures. It is clear, that after short decrease, the share of subventions on social maintenance in the volume of transfers increased again. Moreover, the share and volume of social expenditures increased again too.

Searching on answer to the question like “*what tendencies were caused by crisis and what just continued from previous period*” can give us the interesting results. Evidently, in the sphere of

revenues all mentioned tendencies were caused by crisis. The growth of expenditures on health and education as well as the reduction of expenditures on social maintenance evidence only the redistribution of social budget. Instead, the growth of transfers' volume and its share in local budgets' revenues resulted from the crisis and state's attempts to prevent it. The purpose of these changes was to prevent the sharp reduction of budgets. The decrease of share of grants equalization and increase of share of subvention for social protection happened at the same manner.

**We may say that the crisis in Ukraine escalated the non-solved problems as to the filling the revenue part of local budget and its expenditure.**

Instability of revenue from personal income tax as well as the single tax on small and medium business doesn't make them the main taxes for local budget. Even the increase of single tax rate initiated by the central government doesn't improve the situation. The revenue part of local budget should be based on taxes with another quality, able to provide the income independent of the stage of cycle of economic development and the most of all – to support the anti-crisis budget process at the local level.

Particularly, more attention should be paid to the modification of taxation, such as land payment and real state tax, which together with the tax on transport vehicles should become the local (exclusive) taxes. In Ukraine, the first two taxes should be moved to the local (together with the assignment to local authority the right to establish them) and the third is needed to be gradually implemented.

The forecast on the situation concerning the change of structure and amount of revenues in local budgets is expected to be the next: after crisis the level of employment will growth and then the amount of salary will increase too. Thus, the incomes from the personal income tax will grow. This concerns other three revenue sources – land payment, single tax for small and medium enterprises and tax for transport vehicle too. In consequence of state regulation, their shares should gradually increase in order to maintain the stability of income.

When the economy shows the post-crisis trends, the taxes and fees, which incomes are less than costs on their gathering, will demonstrate that they are needless for budget. Excessive number of these taxes and wretched volumes of revenues from them show the old taxation principles which should be changed.

Some changes in expenditures showed, that the weak point of local budget is the social expenditure. Insufficiency of exclusive sources for social expenditures requires the transfers from the state budget. This is because the state takes care of people. However, in that case the capability of local authority to fill the local budget and to use the funds for social purposes (the self-governing of local communities) is narrowing in general.

After economy starts the post-crisis development, it is expected that the balance between subvention and general grant gradually will change in favor of the latter. This will enforce the

initiative of local community to provide their own policy and not to admit the excessive intervention by the state in their own affairs.

Thus, the strengthening of local budgets and allowing the local authority to maintain the welfare should be realized in three directions:

supporting the self-sufficiency of local budgets at the expense of their own revenues,

purposive and effective expending of funds,

budget resistance not only to fluctuation of the market but also to the global financial shocks and crisis.

Therefore, the accent in reforming the local budget should be paid to the approaches of formation of revenues – the preference should be given to those taxes which are not only truly local (exclusive), but also not sensitive to cyclic fluctuation. Rational structure of expenditures, necessity of additional funds from the state budget and condition of their providing depend on the above principles. Transformation of the local budget policy should be aimed at the increase of people well-being and on the enforcing the initiative of local authority to mobilize and to spend the funds efficiently.