Trends in Financing
Regional Expenditures in
Transition Economies

The Case of Ukraine

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The reader of this excellent research paper will feel privileged for having been offered such a deep insight into the hardships, challenges and perspectives facing the diverse population of a young nation in Eastern Europe.

This essay, written by Nina Bubnova and Lucan A. Way is an exceptionally enlightening piece of contemporary transition economies and sociology. The subject - subsovereign finance and administration in a post-soviet economy and society - is hardly explored by anyone beyond general wisdom; the findings - the interplay between macrofinancial austerity and institutional crisis - give us a real flavor of how much the old system still dominates the hearts and minds of the people, including entrepreneurs, state and local government officials.

Ukraine is facing particularly tough challenges in its way to modernization. All countries of the former Soviet Union except for Russia are struggling not only with the traditional agenda of transition, i.e. to establish a market economy and a parliamentary democracy, but also with the even more fundamental tasks of building an adequately functioning state with all its necessary institutions. Local government finance and administration is even more difficult to building up in the absence of an efficiently operating central government.

This situation is further exacerbated by the need for an unprecedented fiscal austerity whereby regional and local governments are obliged to provide an increasing amount of social services with a sharply decreased central allocation of funds and a growing number of social assets involuntarily taken over from state-owned enterprises fighting for their own survival. The lack of adequate supply-side adjustment on the part of a slowly modernizing corporate sector makes the impact of macroeconomic stabilization even more painful for the regional and local authorities. Since forced rationalization of regional and local expenditures is not based on structural reforms of public finance and modernization of the operation of service providers, there is a general deterioration of the quality of almost all services coupled with the complete lack of predictability and reliability of the whole human infrastructure operated by the localities. The whole system seems to be unsustainable from both financial and political point of view.

What to do next to break this stalemate is potentially one of the greatest challenges facing not only the central, regional and local governments of Ukraine but also the international financial organizations wishing to contribute to a broad-based development. This paper was not designed to give us precise answers either. But it will be completely impossible to find efficient tools enabling us to inject constructive dynamism into this painstaking institution building process without fully understanding the nature of the present system. For this to happen we have now a truly enlightening "compulsory" reading material.

Lajos Bokros
ABSTRACT

Since the collapse of the Soviet Union, real revenues at the local level in Ukraine have more than halved. This report examines how fiscal resources are distributed and how managers attempt to preserve basic services in the face of such severe fiscal constraints. We find that -- despite the negotiated nature of some expenditure determination -- a redistributive logic underlies the budget process. At the same time, we identify a number of coping mechanisms undertaken by local managers that may hinder Ukrainian development. Different forms of barter arrangements now account for approximately a third of local expenditures. We contend that such practices distort incentive structures and may ultimately promote arrears. In addition, several aspects of the situation in Ukraine allow local managers to avoid difficult but necessary expenditure cuts and accumulate arrears. Local managers are not punished for accumulating energy arrears and current intergovernmental allocation mechanisms discourage them for making reductions in expenditures. At the same time, managers' almost exclusive focus on paying wages -- at the expense of materials and investment -- is likely to undermine the quality of services provided. Reform of the fiscal system must focus on hardening budget constraints and creating a transparent budget allocation process that better promotes effective use of resources. In conclusion, we briefly examine the current practice of municipal borrowing, which many cities see as a solution to their budgetary problems. We find that such practices are insufficiently regulated and generate the danger of spiraling debt.
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EXECUTIVE SUMMARY

Localities in Ukraine today face the daunting task of preserving basic government services in the face of a severe fiscal crisis. While localities have been given increasing responsibilities in the social sphere, they face immense obstacles in raising revenue to pay for these essential services. Local governments have been seriously hurt by staggering declines in officially reported production. Real-estate tax revenues, the foundation of a large proportion of local revenues around the world, are unavailable to localities in Ukraine, which lacks a developed property market. As we see in Figure 1 below, the level of real expenditures has halved since 1992.

Figure 1
Decline in real local expenditures and GDP 1992-1996

![Graph showing decline in real local expenditures and GDP from 1992 to 1996.]

Source: Ministry of Statistics

Arrears have risen significantly and the availability and quality of services, by most accounts, have declined. In accordance with recent legislation, local financial officials, who used to focus primarily on calculating budgets based on set norms, now have the difficult responsibility of ensuring that budgetary organizations cut costs, reduce arrears, and have incentives and means to raise revenues. How such officials cope with this difficult task will have a large impact both on macro-economic stability – which to a large extent hinges on the reduction of arrears – and efforts to preserve social protection – which rests on the continued provision of basic services.

This report examines key issues faced by regional financial managers confronting the challenges of fiscal crisis. A number of authors have reviewed the existing institutional arrangements governing intergovernmental relations in Ukraine. This study builds on those

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studies and investigates how regional governments actually function within this institutional framework and how they respond to fiscal austerity. In this report, we hope to provide a deeper understanding of the constraints and options available to regional managers as they seek to deliver services in a situation of fiscal decline.

This report is based on data gathered and interviews conducted in Khmelnytsk and Donetsk oblasts as well as Kiev. We examine the distribution of resources across oblasts in Ukraine as a whole as well as the situation in Donetsk and Khmelnytsk oblasts. In many ways, the oblasts represent the spectrum of conditions faced by regions in Ukraine. Donetsk is a relatively rich, large, highly industrialized oblast in the east. Its per capita income is third only to that of Kiev city and Dnipropetrovsk. It is also dominated by coal and steel. Khmelnytsk is a small, poor and rural oblast in the center of Ukraine that has a per-capita income which is the fifth lowest in all of Ukraine. It has received subsidies from the center for the last four years.

The report examines key issues faced by regional financial managers confronting the challenges of fiscal austerity:

- Part I provides a brief overview of the fiscal system in Ukraine. We contend that the current system retains many of the same basic characteristics and operating principles as in the Soviet period.

- Part II examines the distribution of resources across oblasts as well as at the sub-oblast level in Khmelnytsk. We find evidence that some individual allocation decisions are made on an *ad hoc* basis. The determination of expenditure levels is in part the product of negotiation. However, in contrast to several neighboring post-socialist countries, the existing system of tax sharing and central transfers tends to benefit poorer regions. At the same time, we find that fiscal austerity is exacerbated by inconsistent and unreliable transfer of central transfers or subsidies to the oblast as well as by lack of compensation for the transfer of enterprise social assets to municipalities.

- Part III of our report is devoted to an investigation of the ways municipalities cope with severe fiscal constraints in Ukraine.

  - In Section 1 of Part III, using evidence from Khmelnytsk and Donetsk, we examine the social impact of deficit by looking at how managers cope with underfunding. We find that, as in many regions, managers tend to reallocate most liquid resources to wages, allow arrears to build up in communal services and avoid purchases of equipment.

  - Next, in Section 2, we examine the institutional incentives for rationalization as well as the extent to which managers rationalize resources to cut costs. We