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## Risks of administrative and financial decentralisation: theoretical hypotheses and empirical assessment

### Abstract

Despite the significant duration of decentralisation processes, no clear model of redistribution of resources, areas of responsibility and control at the national, regional and local levels has been introduced in Ukraine. Basic theoretical concepts prove that administrative and financial decentralisation is a complex and ambiguous process for the development of the country's economy. Along with the positive results, there are some risks of deepening the irregularities of development, complications in the implementation of macroeconomic policies, increasing corruption, etc.

Theoretical and empirical researches of decentralisation processes in the world allow us to identify trends such as the absence of a direct link between the level of the country's development and the degree of administrative and financial decentralisation; the focus and motives for decentralisation processes are different in different countries; elimination of macroeconomic imbalances is often accompanied by the processes of recentralisation. The level of decentralisation of power and public finances in Ukraine is characterised by a high degree of centralisation of public finances. The decentralisation processes prove to be fragmented with a high risk of deepening territorial social and economic differentiation.

**Keywords:** Decentralisation; Irregularity of Development; Public Finances

**JEL Classification:** H7; R58

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### Ризики адміністративно-фінансової децентралізації: теоретичні гіпотези та емпіричні оцінки

#### Анотація

Незважаючи на значну тривалість процесів децентралізації, в Україні не вироблено чіткої моделі перерозподілу ресурсів, зон відповідальності та контролю між національним, регіональним та місцевим рівнями управління. Базові теоретичні концепції засвідчують, що адміністративно-фінансова децентралізація є складним і неоднозначним процесом для розвитку економіки країни. Теоретичні та емпіричні дослідження децентралізаційних процесів у світі дозволили виділити такі тенденції: відсутність прямої залежності між рівнем розвитку країни та ступенем адміністративно-фінансової децентралізації; спрямованість та мотиви процесів децентралізації у різних країнах є різними; подолання макроекономічних дисбалансів часто супроводжують процеси рецентралізації. Рівень децентралізованості влади та державних фінансів в Україні характеризується високим ступенем централізації державних фінансів, безсистемністю імплементації реформ децентралізації, високим ризиком поглиблення територіальної соціально-економічної диференціації.

**Ключові слова:** децентралізація; нерівномірність розвитку; державні фінанси.

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### Риски административной и финансовой децентрализации: теоретические гипотезы и эмпирические оценки

#### Аннотация

Несмотря на значительную продолжительность процессов децентрализации, в Украине не выработана четкая модель перераспределения ресурсов, зон ответственности и контроля между национальным, региональным и местным уровнями управления. Базовые теоретические концепции показывают, что административно-финансовая децентрализация является сложным и неоднозначным процессом для развития экономики страны. Теоретические и эмпирические исследования децентрализационных процессов в мире позволяют выделить следующие тенденции: отсутствие прямой зависимости между уровнем развития страны и степенью административно-финансовой децентрализации; направленность и мотивы процессов децентрализации в разных странах различны; преодоления макроекономических дисбалансов часто сопровождается процессами рецентрализации. Уровень децентрализации власти и государственных финансов в Украине характеризуется высокой степенью централизации государственных финансов, бессистемностью имплементации реформ децентрализации, высоким риском углубления территориальной социально-экономической дифференциации.

**Ключевые слова:** децентрализация; неравномерность развития; государственные финансы.

## 1. Introduction

For Ukraine, the year 2014 saw the start of the formation of a legal framework for the practical implementation of administrative and financial decentralisation as well as some sectoral reforms with a focus on increasing capacity of territorial communities as basic units of local self-government. On the one hand, it was an objective consequence of economic and political inefficiency related to the existing system of public administration and an important condition of moving to a new round of economic and social development of Ukraine as a state.

On the other hand, despite the long delay of the processes of decentralisation of power, neither at the beginning of the reforms, nor after two years of their implementation (2015-2016), the government has been unable to develop a clear model of redeployment of resources, areas of responsibility and control between the national, regional and local levels of management. As a result, on the background of overall euphoria from the first positive results, there have often been some problems, with which territorial communities and regional authorities face up when obtaining new powers, as well as risks for either their functioning or overall social and economic development of Ukraine.

## 2. Brief Literature Review

It should be understood that administrative and financial decentralisation is a complex and ambiguous process aimed at the development of social and economic system of the country, which can be proved by basic theoretical concepts. Along with the positive perception of ideas of budgetary federalism (Oates, 1972) [1]; (Weingast, 1995) [2]; (McKinnon, 1997) [3], R. Prydom identifies the following main types of risks relating to decentralisation in his work «Dangers of decentralisation»:

- 1) decentralisation strengthens the irregularity of social and economic development of areas;
- 2) decentralisation complicates the implementation of macro-economic policies, which may cause macroeconomic instability;
- 3) decentralisation may be followed by decreasing efficiency of the social and economic system (in various forms) and increasing corruption at the local level [4].

R. Reinikka and J. Svensson (2004) [5] emphasise that there exists a threat of non-achievement of development objectives because of a considerable comminution of budgetary funds, while P. Bardhan and D. Mookherjee (2000) [6] see the danger of weakening the integrity and unity of the country due to the excessive strengthening of local elites. Nonetheless, all authors emphasise that every country, every region and every locality can take a chance and move to a new stage of development in a wholly discretionary manner, which is determined by decentralisation.

This thesis can be proved by the existence of different impacts of decentralisation on economic processes in different countries of the world. Assumptions that fiscal decentralisation lowers social and economic efficiency due to the deceleration of the development rates have not been proved by the instance of Switzerland (Feld 2004) [7]. In China, T. Zhang and H. Zou (1998) [8] found a prolonged negative trend of lowering of economic activity and paces of the country's development in terms of decentralisation, which was reversed in 2008. The empirical researches by Y. Qiao (2008) [9] allowed us to establish a positive correlation between the growth of rates of fiscal decentralisation and the rates of economic growth in China. The work by Y. Qian and B. Weingast (1997) testify to the fact that decentralisation has created incentives for local governments to achieve economic success [10]. According to the authors, exactly «rural» enterprises became a source of growth in China. Unlike this, M. Ponomareva and E. Zhuravskaya (2001) note that decentralisation in the Russian Federation is characterised by negative incentives of the development of areas, judging by withdrawing any additional revenues of subnational governments and reducing transfers of the central government [11].

As regards the deterioration of macroeconomic stability, empirical researches of results of decentralisation in Argentina and Brazil indicate an improvement of the economic situation (Dillinger, Perry and Webb, 2000) [12]. Besides it, a hypothesis of the existence of direct connection between decentralisation and the inflation rate cannot always be proved. J. Rodden, G. Eskeland and J. Litvak (2003) claim that active decentralisation of income in a row of countries has strengthened price stability [13].

One of the major risks of decentralisation is likely to be expansion of depression and strengthening of inequality of income because of the change of structure of state expenditures. At the same time, C. Sepúlveda and J. Martínez-Vázquez (2011) found out that decentralisation had a positive impact on the reduction in poverty and the increasing human development index in countries with a relatively large share of the public sector in the economy [14].

Decentralisation showed positive results towards the reduction of the level of poverty and improvement of availability of educational services in countries such as Bangladesh (2001) [15] and India (Bardhan and Mookherjee, 2006) [16]. However, other studies show that decentralisation may also have a negative impact on the level of poverty. L. West and C. Wong (1995) state that decentralisation has caused a reduction in the level of quality of social services in poor regions of China [17]. M. Ravallion (1998) [18] notes that decentralisation has stipulated a considerable inequality of budgetary expenses in poor regions of Argentina. Decentralisation can also increase differentiation of development through differences in social and economic potential of regions and territories.

On the other hand, decentralisation can become an impetus for a reduction in differentiation through the growth of transparency of distribution of budgetary resources and the efficiency of levelling mechanisms. Canada is a good example of successful improvement of the system of inter-budgetary levelling. According to A. Rodríguez-Pose and R. Ezcurra (2010), the strengthening of convergence or divergence in the country depends on different conditions, such as a level of development, an existing social and economic, innovative and geopolitical potential, an existing state of differentiation, and a presence of effective fiscal mechanisms of redistribution of income [19].

**3. The purpose** of the article is to determine the main trends and risks of decentralisation in the world and assess the level of decentralisation of power and public finance in Ukraine.

## 4. Results

The controversy of decentralisation and empirical analyses of the relevant processes worldwide allow distinguishing several new trends during the last decade.

Firstly, there is no direct correlation between the level of the country's development and the extent of administrative and financial decentralisation, yet more prosperous countries are predisposed to deeper decentralisation. This can be explained by the fact that such countries can let themselves distract smaller part of budgetary resources for financing nationwide functions and allow local authorities to keep a larger share of budgetary revenues to financing their own needs if we consider their high level of budgetary revenues per capita.

As of 1 January 2016, Denmark (35.2%), Sweden (24.8%), Finland (22.3%) and Norway (15.7%) 2016 were characterised as European countries having the highest revenues of local budgets in relation to GDP, namely having over EUR 40,000 per capita (Figure 1). However, the average level of decentralisation in the EU was 11.1%, while revenues were estimated at EUR 28.9 thousand.

Secondly, the focus of the processes of decentralisation in different countries is different. Whereas Denmark, Sweden, Finland, Romania, Estonia, Bulgaria and Slovenia deepened their decentralisation during 2004-2015, then the Netherlands, England, Lithuania, Hungary, Luxembourg and Ireland directed their economic policies towards the strengthening of centralisation (Figure 1).

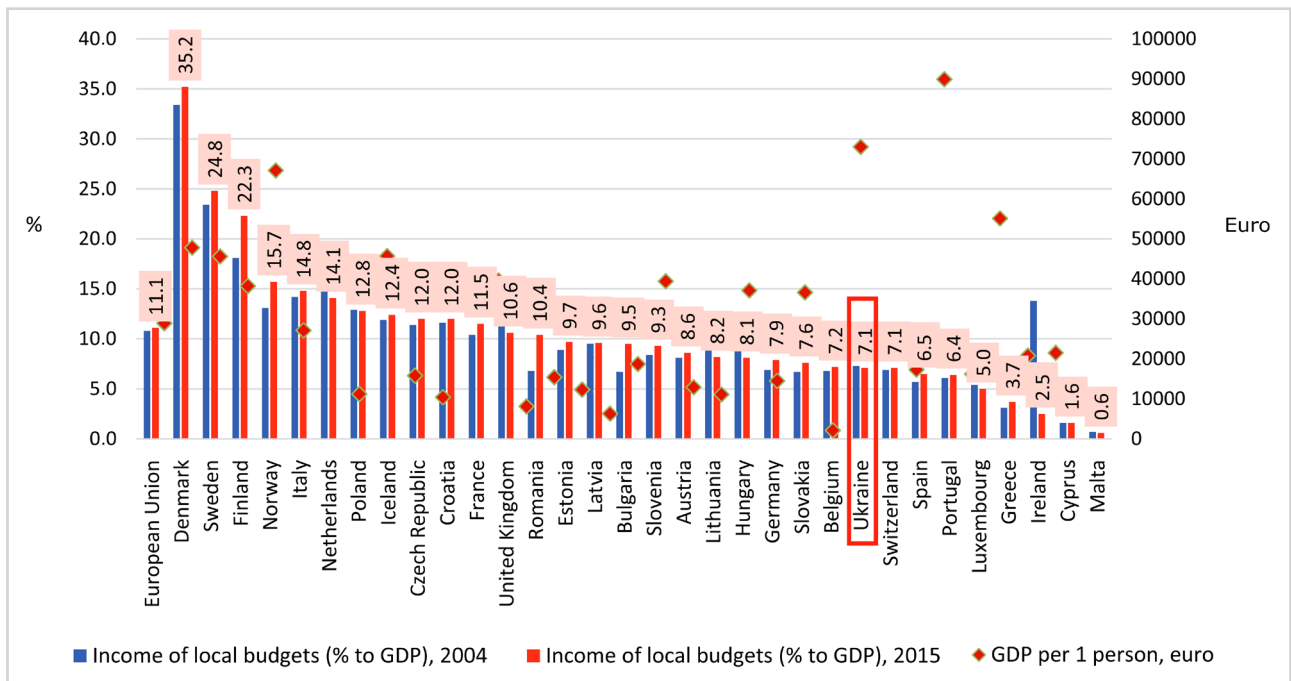


Fig. 1: The comparison of revenues of local budgets of European countries (% to GDP) and GDP per capita for 2004-2015  
 Source: Compiled by the authors based on <http://ec.europa.eu/eurostat/data/database>

Thirdly, the reasons for decentralisation are different in different countries. Efforts to democratise their own political systems are characteristic for post-Soviet countries of Eastern Europe (the waves of decentralisation in 2000, 2004 and 2006). Instead, decentralisation in Greece and Italy has purely economic motives and is based on efforts to improve the effectiveness of delivery of public services particularly in areas such as education, medicine and public transport.

Fourthly, during the past 20 years, the EU member states has shown a general trend in recentralisation after the 2008-2009 crisis against a background of overall growth of decentralisation in the world (Figure 2). This trend confirms the theoretical hypothesis about the opposite effect of decentralisation and macroeconomic stability and can be explained by the need to overcome macroeconomic imbalances, from which many European countries suffered during the economic crisis. Moreover, we can affirm that budgetary recentralisation in Europe is still taking place.

Even Poland, the only European country that did not experience the fall of GDP during the crisis and continued to increase the pace of economic growth after the crisis, and which is considered to be one of the most successful instances of decentralisation reforms, shows similar decentralisation trends. The growth of revenues of state and local budgets (as % to GDP) of Poland confirms a significantly increased role of the state budget during the last years (20.6% to GDP in 2009 and 22.7% in 2015) and a return of the income indicator of local budgets as part of GDP to the level of the year 2004, which was 12.8%.

Such ambiguity of positive results and risks of decentralisation in different countries is largely conditioned by its simultaneous impact on virtually all subject-object relations within the social and economic systems at the national, subnational and local levels and between them. On the other hand, it is extremely difficult to separate the consequences of decentralisation from the effects of other processes in society, as well as institutional changes in the public sector. The above almost makes it impossible to simply copy the experience of other states and requires an in-depth analysis of the opportunities and potential threats in the decentralisation process within each country with comprehensive consideration of peculiarities of its social, economic and political development, experience of implementing reforms, as well as other factors of objective and subjective character.

If we assess the level of decentralisation of power and public finance in Ukraine against the background of global and particularly European experience, then we can come to the following conclusions.

Today, Ukraine is the most centralised country in Eastern Europe characterised by a relatively low level of decentralisation in comparison with developed countries of Europe and the world (Figure 1). However, among the group of countries with revenues less than EUR 4,000 per

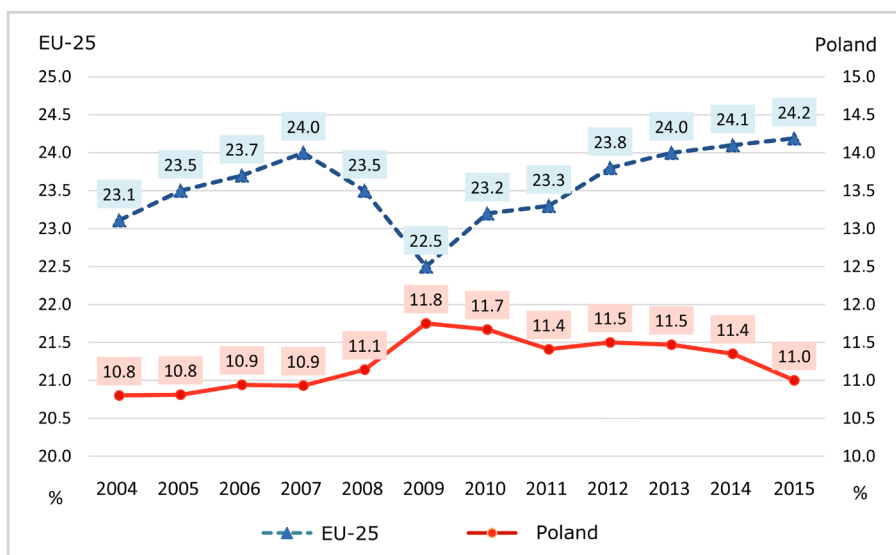


Fig. 2: Revenues of state and local budgets (as % to GDP) of the EU member states and Poland, 2004-2015

Source: Compiled by the authors based on <http://ec.europa.eu/eurostat/data/database>



person, Ukraine has one of the highest levels of decentralisation with the country's EUR 2.1 thousand per person. Therefore, it should be emphasised that both points are important for Ukraine, i.e. reallocation of budget resources and powers to the local level and provision of sustainable economic growth, GDP growth and, consequently, the financial basis of public administration in general.

Unlike European countries, the processes of decentralisation in Ukraine has testified its unsystematic implementation during the last decade (Figure 3). Despite declarations of every new government about the necessity of such a reform in Ukraine, nothing had been done in terms of its implementation up to 2014. In addition, we observe dependences between the level of decentralisation and the state of social and economic stability in Ukraine. Rather, the country's positive pre-crisis period in terms of its social and economic development was characterised by increasing centralisation of public finances.

5. Conclusions

The motives of administrative and financial decentralisation in Ukraine are to be explained by a need to develop democracy and local self-government in the country and to rationalise financial relations and distribution of responsibilities between the management levels. The above substantially complicates the selection of appropriate mechanisms and tools of decentralisation for Ukraine, which would allow achieving both goals. Also, the implementation of the principles of decentralised management in Ukraine is complex because functions and powers are transferred to territorial communities, of which a large number do not have sufficient potential to promote

economic development. In Ukraine, decentralisation is carried out almost simultaneously with the reform of the administrative and territorial system and a number of sectoral reforms.

The first stage of implementation of the decentralisation reform in Ukraine showed strengthening of imbalances in the development of areas and administrative and territorial units. Namely, Ukraine was unable to avoid the risk of deepening territorial social and economic differentiation, and the mechanisms of direct regulation (in particular, budgetary equalisation) and indirect influence aimed at stimulating economic activity of communities have failed to resolve the problem of irregularity of endogenous potential of community development and effectiveness of its usage.

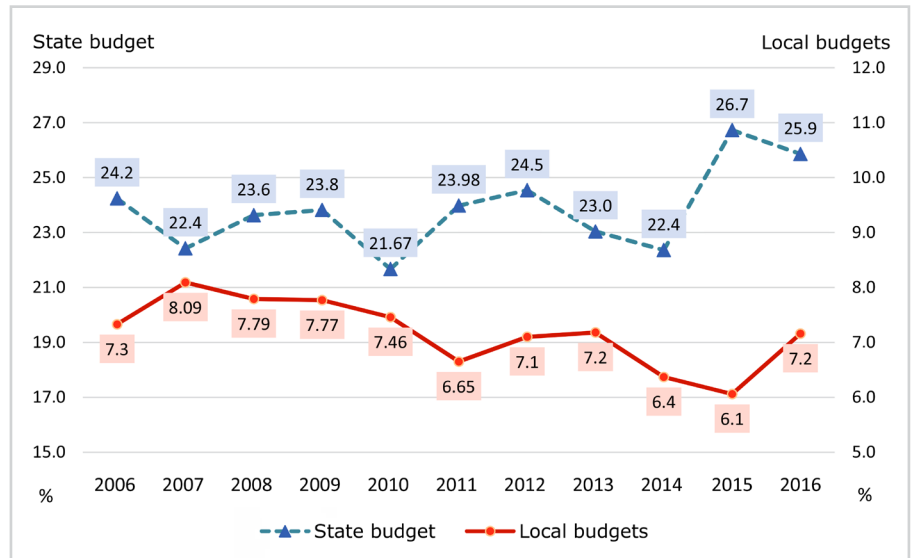


Fig. 3: Revenues of state and local budgets (as % to GDP) of Ukraine, 2006-2016  
 Source: Compiled by the authors based on data from the State Statistics Service of Ukraine and the State Treasury Service of Ukraine

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