EXCESSIVE GOVERNMENT
CONSUMPTION IN UKRAINE:
SPILLOVER TO
INTERGOVERNMENTAL
FISCAL RELATIONS

by

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Abstract

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The thesis investigates the problem of excessive government consumption in Ukraine, pointed out to lie behind a great number of hardships that Ukraine has been facing with on its transition from an administrative to a market-based economic system. Public Choice Theory enables one to explain this phenomenon by peculiarities of Ukrainian politicians' seeking of the self-interest in a "political marketplace". Specifically, excessive government consumption results from the government's failure to cope with fiscal imbalances at the outset of the transition, with this failure produced by that seeking.

The arising mismatch between the government consumption expenditure and the government's capability constitutes a particular concern of this research. A specific possibility to do away with this mismatch has been demonstrated to be given rise to by meeting the optimality criterion for intergovernmental fiscal relations.

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Section I

INTRODUCTION

Fiscal problems appear to be a point drawing great many judgements from scholars and practitioners involved with numerous economic challenges brought about by Ukraine's transition from an administrative to a market-based economic system. This issue can already be remarked for an immense body of literature devoted to it. Consider, for instance, Dabrowski's (1998) treatment of fiscal hardships of transition economies. In his view, *"fiscal policy turned out to be one of the most complex components of the transition, since it has been reflecting problems existing in other areas of the systemic changes"*.

Problems regarding tax revenue collection by the government are of an unsurprisingly tremendous concern in the corresponding studies. Discussing properties of tax reform in Ukraine, Sultan (1999) focuses his attention on the so-called *fiscal burden*, defined as *"budget revenues plus extra-budgetary levies"*. This fiscal burden has been pointed out to have a streak of uneven distribution: being the case for the official economy only, it has essentially been tax payments made by market-based enterprises, facing hard budget constraints, that constituted it. The reason addressed by Sultan is that *"within the formal economy, most of agriculture, mining, energy, and many state enterprises form the "soft" segment which is supported by direct subsidies, tax exemptions, preferential credits, and forgiven tax arrears"*. This practice cannot but create disincentive effects for profitable enterprises operating in the official economy, since, in particular, redistribution of scarce financial resources from profitable and unprofitable enterprises is implemented.

This paper focuses on one special fiscal problem of Ukraine's economy ? namely, excessive government consumption, ? which is deemed lying behind not only the practice just described, but also a number of other economic hardships that Ukraine has been facing with. The body of literature, being, on the one hand, susceptible to judgements about its separability from the "counterpart" ? studies of excessiveness of general public expenditure, ? on the other hand, hardly appears to allow for this separability. The studies of excessive public expenditure A study by Yushchenko and Lysytsky (1998) turns out to be a pioneering work in this field.

The roundtable seminar organised by the National Bank of Ukraine in September 1998 symbolised a subsequent interest of scholars and practitioners to this problem.

The analytical framework employed here is *Public Choice Theory*. There have already been certain attempts to outline problems of the transition against concepts constituting this theory (a work done by Kiseleva and Chepurina (1996) provides a good example of this). The author's specific intention is to demonstrate how excessive government consumption, having non-negligible economic implications, results from the seeking of self-interest by Ukrainian politicians and bureaucrats.

Apart from this task, the research is aimed at examining the drive towards inflating the government consumption that "spills over" to fiscal relations between the different tiers of government in Ukraine. The claim stipulated refers to a certain criterion for optimality in intergovernmental fiscal relations, which is widely argued for, in particular, in numerous works on fiscal decentralisation in transition economies (e.g. Ter-Minassian 1997). The failure to meet this criterion is considered by the author as implying a mismatch between the government consumption expenditure and the government's capability, thus revealing an opportunity for a cut of that expenditure. This paper's approach towards a rationale behind meeting that criterion relies on Oates's (1990) canonical contribution on economics of fiscal federalism.

The argument in this paper develops in a following manner. Theoretical considerations, including those on Public Choice approach to public finance issues and a budgetary process, are first set out. Second, these considerations are applied to investigating the essence of excessive government consumption. Keeping to Public Choice approach, the forces driving the government consumption in Ukraine to the state of excessiveness are then discussed. And, finally, the focus is moved towards a link between optimality in intergovernmental fiscal relations and correspondence between the volume of the government consumption expenditure and the government's capability.

Section II

PUBLIC CHOICE AND BUDGETING

Getting in touch with *Public Choice Theory*

In economics one gets inevitably involved with problems of choice-making: a consumer is concerned with choosing a bundle of commodities to consume that maximises his or her utility subject to the budget constraint, a producer looks for a level of output that maximises his profits, an investor tries to maximise the return and/or minimise the risk by composing a portfolio of securities. Specifically choice can be regarded as *"the act of selecting among alternatives"* (JBC, 1998).

The examples made above deal with what is normally referred to as private choices, i.e. when a human being selects among alternatives for himself or herself only. However, the mankind has long recognised the need not only for private, but also for private choices. The latter imply selection among alternatives for several people. Some authors (consider, for instance, Gunning (1997) referring to the canonical *Calculus of Consent* by James M. Buchanan and Gordon Tullock) generalise public choices as being concerned with provision of public goods. Essentially, this the moment, at which an issue of polity is given rise to.

The crucial point here is that despite the fact that the word "public" implies something associated with a community, "public choices" do not actually represent choices made by the community. Instead, as JBC (1998) points out, choices, regardless of being private or public, are always made by individuals.

Providing account of individual economic agents' behaviour, neoclassical economic theory encompasses premises of self-interest, utility maximisation along with those of rationality and consistency in decision-making. With this in mind, one is likely to come up with a "striking" conclusion that politicians, as constituents of a polity, are motivated by the self-interest as in the marketplace, while being involved in public or collective choice-making. Factors of motivation, that can broadly be divided into monetary and non-monetary awards, may include salary, ideologies, power, public reputation, etc.

Gunning (1998) emphasises that, as a matter of fact, each politician has his own personal goal and the goals of several politicians may differ considerably. Thus, a collective decision, which is essentially the outcome of public choice-making, takes a form of interaction of these, sometimes conflicting, goals. An amusing remark made by Felkins (1998) is that having realised the claim made above in this paragraph, *"the Founding Fathers of the USA … tried to organise government in such a way as to minimise the impact of self-interest"*.

Having what was state above in mind, one should now identify the essence of *Public Choice Theory*. In the author's view, a definition provided by *** can best serve this purpose:

> "Public choice seeks to understand and predict the behaviour of politicians and bureaucrats in the polity by utilising analytical techniques developed from economics based on the postulate of rational choice… Public choice is an application of neoclassical economic tools (self-interest and utility maximisation) to explain political behaviour".

JBC (1998) claims that *Public Choice Theory* bridges traditional economic theory and traditional political science. The former *"has been narrowly interpreted to include only private choices of individuals in the market process"*, whereas the latter *"has rarely analysed individuals' choice behaviour"*.

Reasons for the emergence

It appears that development of *Public Choice Theory* was aimed at filling the gaps of the so-called traditional approach to Public Finance issues. Searching for optimal government policies given certain objectives was occupying minds of professional economists interested in public affairs before mid-1960s (Gunning, 1998). The principal question was *"what should a public actor, mindful of economic efficiency (and equity) criteria, do in a given context"* (Cullis and Jones, 1998).

An important peculiarity of the traditional approach was remarked by Buchanan () referring to Knut Wicksell's 1896 *Finanztheoretische Untersuchungen*: its normative focus brings about an implicit modelling of the government as a benevolent despot. That is, all the government is assumed to do adopt recommended policies and faithfully carry them out (Gunning, 1998). To be more precise, it is significant to note that the traditional approach accepts a particular set of institutions, individual preferences and rights, thus being concerned with what Cullis and Jones refer to the *outcome efficiency* of the government's economic activities, i. e. the provision that the economic efficiency (and equity) is subject to a policy to be adopted and carried out.

However, as Buchanan argues (Federal Reserve Bank of Minneapolis, 1995),

> "Once you start in that in that direction, you soon come to the question of how it is that taxes and expenditure decisions and budgets get made, so you are forced to think about the political process".

He goes on proceeding to a crucial question to professional economists:

> "What model of politics are you assuming before you start talking about what is good taxation? What is good spending?"

It is essentially questions of this sort that brought about a principal positive postulate of the mid-1960s Public Choice "revolution":

> "The seeking of self-interest by bureaucrats and politicians, and collective actions by various interest groups … result in the adoption of a particular stance of institutions and property rights" (***).

Rendering Wicksell's message, Buchanan () calls for *"changes in the structure of a political decision making process as a key to improvements in policy results"*. Within this premise, the *process efficiency*, as opposed to the outcome efficiency, turns out to be major concern. The process efficiency implies that the economic efficiency (and equity) is subject to how successfully the individuals' self-interests, that may offend it, are constrained in terms of the political decision-making process.

It is worth concluding the argument with Gunning's contention:

> "Public choice scholars have certainly not abandoned the aim of finding and recommending optimal government policies. However, they pay less attention to specific policies than to changes in government".

The essence of budgeting

A budgetary process is recognised to be "a formalised routine" constituted by a set of decision-making process and relations involving legislative and executive branches of the government. Mikesell (1989) points out in terms of budgeting[1] the government plays a role to some to a considerable extent similar to that played by a market, since budgeting determines parameters of the government expenditure[2] by specifying *"what government services will be provided, what individuals will receive these services, and how these services will be provided"*.

Broadly speaking, it is through budgeting that resources are allocated among the government's economic activities and between the government and private uses. Steiner (1974) identifies the essence of budgeting as implying determination of values of four variables in a "top-down" way:

a) the total size of the government expenditures;

b) the sizes of the expenditures for major programmes within the categories described in the previous section;

c) the sizes of the expenditures for projects accepted to constitute a particular spending programme;

d) the sizes of expenditures for activities within a particular project under a particular public programme.

It should, of course, be mentioned that the determined values are bound to a given period, usually one year, typically referred to as a *fiscal year*.

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[1] Terms "budgetary process" and "budgeting" are hereafter used interchangeably.

[2] The issue of the government expenditure is discussed in a greater detail in Section III.

Mikesell emphasises a separability of the components of a budgetary process: resource allocation and specification of the revenue basis with the latter aimed at answering a question "*whose real income will be reduced by extraction of resources to deliver the budgeted services*". This separability holds true because it is a property of the budgeted services that they are not provided in exchange for payment.

As it was argued above, budgeting makes the government's decisions about resource use to some extent resemble a market. However, certain features of the government-provided goods and services generate a fundamental difference between these two mechanisms: the government's decisions about the resource use cannot be made automatically. According to Mikesell, these features include:

1. The non-appropriability of the government-provided goods and services;

2. The difference between public and private resource constraints, with individual earnings typically standing for the latter and the total resources of the society ? for the former;

3. The monopolistic essence of the government provision of goods and services;

4. The mixed-motives environment of the government's economic actions.

The fourth property can be clarified with an example of free school lunches. On the one hand, this government programme contributes to improvement of the living standards of families with school children. On the other hand, it increases the food producers' incomes. Mikesell asserts that since "*these multiple and mixed objectives cannot be weighted scientifically, the budget process will be political*". Thus budgeting can be regarded as susceptible to analysis within the framework developed within the two previous subsections.

Section III

THE ISSUE OF EXCESSIVE GOVERNMENT CONSUMPTION

The previous section was mainly concerned with reviewing the major points of the Public Choice approach to Public Finance problems. The leading premise of that approach was shown to be regarding politicians that pursue their self-interests while being involved in a collective decision-making. In this section that doctrine is applied to an elaborate examination of the issue of excessive government consumption.

As is has also been indicated in the previous section, budgeting, through which the government expenditure becomes specified, can, in fact, be considered as a political process. Development of the argument in this section thus begins with an overview of the economic essence of government expenditure. Resorting to the concepts set out above, it is then demonstrated how politicians and bureaucrats driven by their self-interests can produce an inflation of the overall level of government expenditure along with a strong bias towards its consumption component. Finally, the issue of excessive government consumption is defined and its possible economic implications are discussed.

The economic essence of government expenditure

In macroeconomic theory **public** or **government expenditure** is typically referred to as extraction by a government of a part of the gross value added in order to enable the government to perform certain functions through

?? purchases of goods and services,

?? transfers either in monetary or in in-kind form[3].

According to their functional characteristics, government expenditure can be divided into two broad categories:

1. **Public** or **government consumption** ? provision of goods and services for direct consumption by the country's public sector (for example, wages and salaries for the public sector employees) and households (for example, financing of public schools)[4].

2. **Public investments** ? provision of inputs to enterprises' production, e.g. industrial ports and government-sponsored research programmes. The goal is to increase the marginal productivity of the factors employed by the enterprises.

The ramification of Public Choice approach

Discussing *"a generally increased awareness"* of the limitations of market allocation mechanisms, i.e. market failure, Cullis and Jones (1998) point to a drive among *Public Choice* economists towards considering non-market failure. The focus in this consideration is placed on *"the inflation of demand for the public sector activities"*.

[3] This definition takes account of the conventional equation of macroeconomic accounting ?

$$Y_t + M_t = C_t + I_t + G_t + X_t ,$$

The right-hand side of the equation represents the value added available in the economy over a given period (Y_t ? the domestic gross value added, M_t ? the value added imported from abroad), whereas the left-hand side represents the distribution of it within the economy (C_t ? the value consumed by the private sector, I_t ? the value invested by the private sector, G_t ? the value directed towards the government's uses, X_t ? the value exported).

[4] One might note that by providing goods and services for the households' consumption the government substitutes the private consumption expenditures for the public ones.

The centre of the argument embodies a premise of politicians' incentives and priorities. This issue with respect to the non-market failure appears to be outlined by Felkins (1998) under his reference to *The Meaning of Privatisation* by Paul Starr:

> "… The managers of the "bureaucratic firms" seek to maximise budgets, and thereby to obtain greater power, larger salaries, and other perquisites. Budget maximisation results in higher government spending overall…"

Contributing to the argument, Cullis and Jones emphasise that

> "In general, with a time horizon as short as the next election, it pays politicians to discount the future heavily."

This point can be summarised and slightly rendered in a following manner:

?? The activities of the interest groups in the government give rise to the excessive government expenditure;

?? Short-termed objectives of the members of these groups generate their inclination towards current rather than the future benefits. This essentially stands for the allocation aspect of the government spending: the government consumption expenditures are preferred to the investment expenditures.

Excessive government consumption defined

The term **"excessive government consumption"** denotes a situation when the consumption part of the government expenditure (1) depresses the investment part in a sense that the adverse redistribution of resources from the consumption to the investment part is effected and (2) depresses the economic agents' activities. The result is that given some fixed amount of the government expenditures neither the real economy, nor the government investments[5] turns out to be able not only to generate foundations for the economic growth, but also to maintain the output, and, correspondingly, the social welfare, at some predetermined levels.

The growth / welfare implication constitutes a primary problem brought about by the excessive government consumption. The secondary problem deals with an issue of financing. The government consumption that passes the excessiveness threshold typically gives rise to enormously high tax rates which, in turn, have disincentive effects on the economic agents' activities (Exeter, 1998) thus contributing to the shadow sector growth and criminalisation of the society. Borrowing ? another way of financing ? can be either explicit or implicit. The explicit borrowing ? from domestic and foreign sources ? can generate substantial costs of debt servicing especially for countries whose unstable macroeconomic performance induces investors to require a high risk premium. The implicit borrowing normally takes a form of monetary emissions, viewed as a major cause of hyperinflation, and wage and pension arrears.

[5] To be more precise in developing the argument, it has to be mentioned that the government investments, in turn, are often pointed out to generate an economic problem associated with their efficiency, or rather inefficiency. However, this is beyond the scope of this research.

Section IV

EXCESSIVE GOVERNMENT CONSUMPTION IN UKRAINE

As it has been pointed out in Section III, it is the seeking of self-interest by bureaucrats and politicians that inflates the government consumption expenditure. The primary objective of discussion in this section is to match this application of *Public Choice Theory* to conjectures on political peculiarities of Ukraine, which together with some other countries of countries of Central and Eastern Europe is involved in transition from an administrative economic system to a market-based one.

The traits of the Ukrainian polity are first examined in terms of Public Choice provisions outlined in the previous section. In particular, the intention is to clarify how specificities pertaining to the instances, that those provisions represent when applied to Ukraine's political system, drag the government consumption to the state of excessiveness. A mechanism, through which, in the author's view, Ukrainian politicians' interactions generate the excessive government consumption, is then described. The section closes with an empirical contribution regarding this excessiveness and its economic implications listed above.

Public Choice, the Ukrainian polity and excessive government consumption

It has been contended by few experts that comparison between Ukraine's socio-economic performance during the years of independence and that of many other transition economies can hardly be justified. The reason stipulated is that having gained the independence, Ukraine did not find itself "endowed" with adequate institutions of political governance, whereas countries like Poland and Hungary had already had this kind of institutions upon having made up their minds to undertake the economic transition[6]. In other words, Ukraine's economic reforms were significantly constrained by the need to establish the institutions of political governance.

Another widely remarkable peculiarity of Ukraine's political system was that during the Soviet era the communist party appeared to play the role of a tool, with a help of which certain grouped forces were fulfilling their will to effect control over the country. Specifically, as Eggertsson (1994) asserts, the communist party was employed as a monitoring mechanism.

While having brought about the need for the institutions of political governance described above, the break-up of the communist regime enabled the so-called political clans, which, in fact, were nothing but modified forms of the grouped forces mentioned above, to succeed in gaining the power since the country badly needed to be governed. Moreover, as Eatwell *et. al* (1998) emphasise, the incentives to exert control over the country were preserved. These clans can be classified by interests of power groups that they represent. The power groups are in turn, formed in accordance with various characteristics ? industrial (e.g. agrarians, energy dealers), geographical (e.g. Dnipropetrovsk, Western Ukraine), etc.

The absence of the viable state governance system may well lead to a political instability in a sense that any or most of the empowered interest groups feel apprehensive of losing the power quite suddenly with a particular possibility of being "toppled" by other interest groups. The concept of the government expenditure growth outlined above in this subsection, which implicitly refers to

[6] The author expresses sincere appreciation to Victor Lystysky for his suggestion of this point.

economies with long-standing market traditions, is thus likely to be modified: the time horizon for the interest groups in the case of Ukraine becomes even shorter. The government consumption thus becomes driven to the state of excessiveness.

Causes of the problem

In the author's view, the possible ways to resolve the problem of the excessive government consumption essentially turn out to be predetermined by its causes. The countries of Central and Eastern Europe undertaking the transition from administrative to market-based economic systems have been facing certain fiscal imbalances, regarded as the transition "challenges", that were brought about by:

1. Factors inherently associated with the administrative economic system ? (a) financing of the public expenditures primarily through budgetary and extra-budgetary operations with only a secondary role played by the private savings, (b) substantial structural distortions and (c) huge liabilities of the government;

2. Factors given rise to by the basic attempts to move to the market-based economic system ? (a) the "outburst" of the socially oriented public expenditures in the late 1980s and early 1990s, (b) reduction in profitability of state-owned enterprises due to the unjustifiable relaxation of the government control over their operations and (c) growth of the government's liabilities induced by significant disproportions between the market prices and regulated ones with the latter requiring compensations for the producers in a form of subsidies and/or tax privileges (Dabrowski, 1998).

In the author's view, the idea of the economic transition process is establishment of certain institutions and mechanisms thus preventing these imbalances from turning into a burden for the society in a form of the excessive government consumption. In other words, **the excessive government consumption is**

directly caused by the government's failure to establish the necessary institutions and mechanisms during the transition, i.e. by the incorrectly chosen transition strategy (Diagram 1).

The process of building those institutions and mechanisms is known to be of two phases (Exeter and Fries, 1998). The first phase encompasses some fundamental reforms:

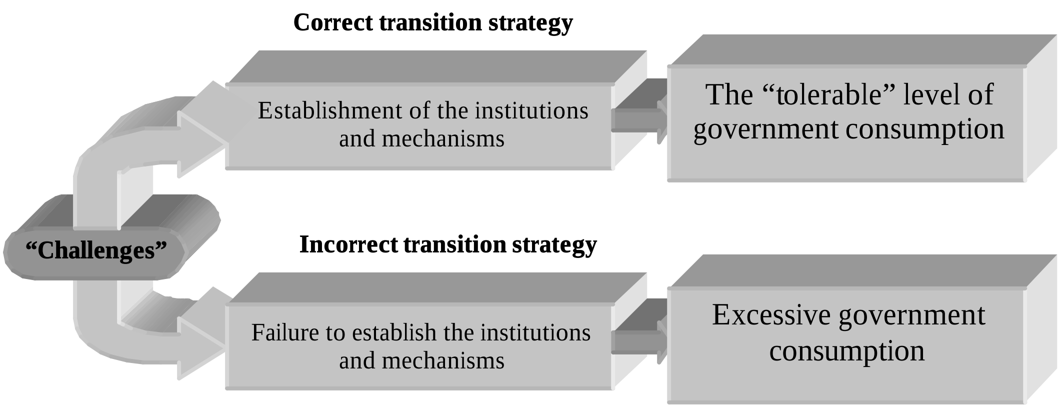


Diagram 1. The transition challenges and strategies.

?? The mission of **privatisation** is to bring about a private firm with a large extent of corporate governance, whose fundamental property is not only production of goods and services, but also value creation. The large extent of corporate governance can also abolish the government expenditures for wages of the government sector employees, caused by the problem with the state-owned enterprises discussed in the previous section.

?? **Liberalisation** involves creation of an environment for institutions brought about by the privatisation. That environment includes (a) building up an efficiently functioning price system, whose task is to provide the economic agents with adequate information on production costs and market demand

and (b) foundation of a voluntary exchange system that has competition as the mode of operation.

?? **Enhancement of the government's economic activities** is focused on in the next sub-section.

The second phase refers to establishment and development of market-supporting institutions and mechanisms. Financial markets and institutions appear to be the most vital of them; their mission with respect to easing the burden of excessive government consumption is mobilisation of private savings in order to neutralise negative economic impacts associated with financing of that consumption.

Enhancement of the government's economic activities

The first phase of the economic transition should also involve the enhancement of the government's economic activities, i.e. creation of the institutions and mechanisms, through which the government's economic activities are "handled". The global renovation of a focus on a government's economic role (see the World Bank, 1997) contributes significantly to identification of these institutions and mechanisms. Following the two-part strategy *"to make every state a more credible, effective partner in its country's development"* pointed out by the World Bank (1997), the enhancement of the government's economic activities can be regarded as having two aspects

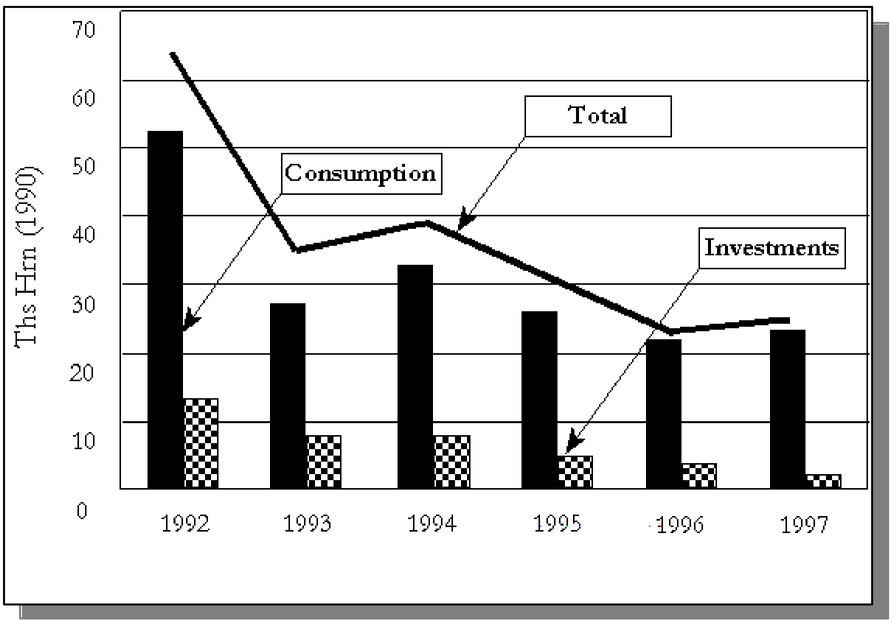
1. **Matching the government's economic activities to its capability**, with the latter standing for *"the ability to undertake and promote collective actions efficiently"* (The World Bank, 1997), that is, at minimal costs. Essentially, this part calls for an administrative, i.e. deliberate, contraction of the government consumption.

2. **Raising the government's capability *"by reinvigorating public institutions"*** (The World Bank, 1997). In general, this means *"making the state more responsive to people's needs"* (The World Bank, 1997). In particular, this might imply a need for the government's revision of the current spending programmes and the way they are adopted and carried out.

A spillover of the excessive government consumption to intergovernmental fiscal relations calls for bringing the government's economic activities in line with the government's capability. This is the subject of discussion in the subsequent section.

The empirical contribution

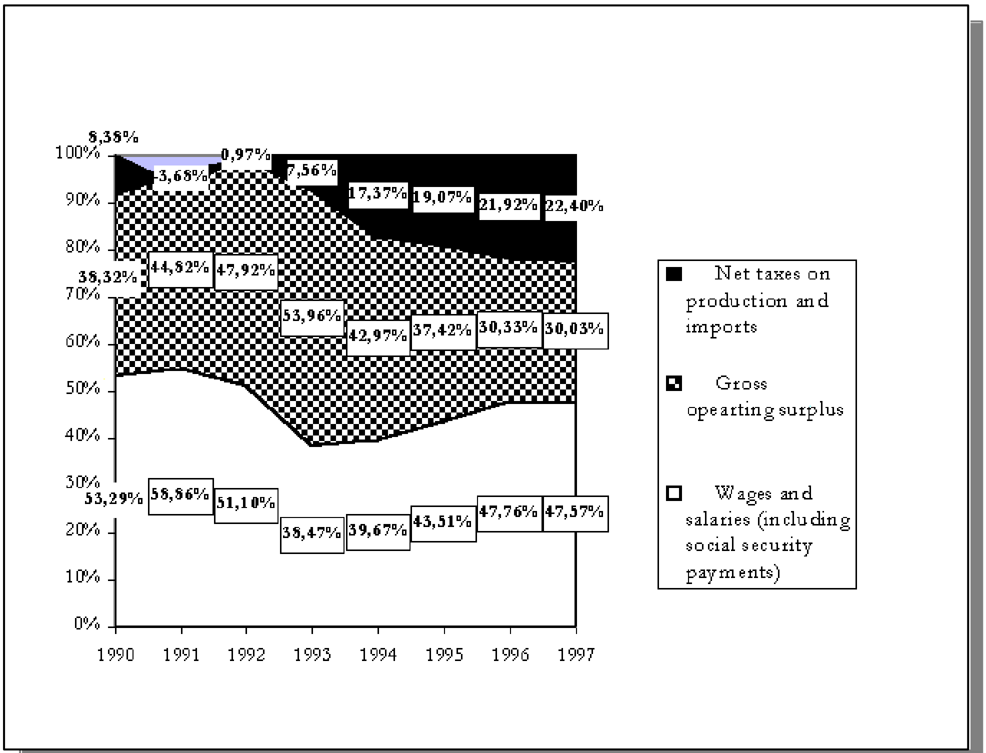
Statistics indicate a substantial discrepancy between the consumption and investment parts of the government expenditures over the six years since Ukraine has become independent (Diagram 2). One can also note a persistent growth in that discrepancy beginning from 1993.



Source: Hansen (1998).

Diagram 2. Government spending in Ukraine (in 1990 prices).

Foundations for the economic growth could hardly come from the falling public investments. Moreover, the adverse income distribution in Ukraine over the same period does not allow for a conjecture that those foundations could come from the real economy: beginning from 1992 Ukrainian enterprises' gross operating surplus, i.e. a major source of the augmented production, has been exhibiting a gradual decline (Diagram 3)[7].

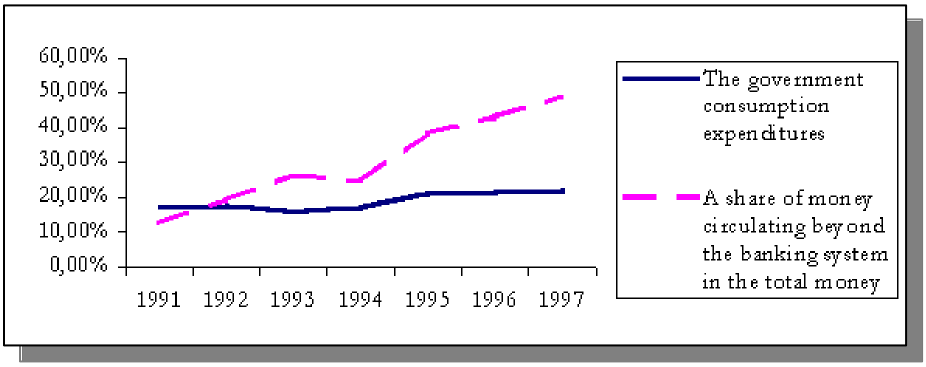


[7] It is worth being mentioned that the GDP, when regarded as the total domestic income, consists of the income received by the population (wages and salaries), enterprises (a gross operating surplus) and government (taxes net of subsidies).

Source: Yushchenko and Lysytsky (1998).

Diagram 3. Ukraine's GDP by income categories.

The trend depicted above illustrates another remarkable instance: growth of the share of revenues from net taxes on production and imports in the GDP. The data also appear to support the correlation between the tax burden and a size of the shadow sector: the share of the money circulating beyond the banking system in the total money supply has been persistently rising since 1991 with an exception of a small drop in 1994 (Diagram 4).



Source: Yushchenko and Lysytsky (1998).

Diagram 4. Measuring the impact of the excessive government consumption on the size of the "shadow" sector.

The extensive use of monetary emissions to finance the government consumption as causing the hyperinflation during the first few years of Ukraine's independence and the problem of arrears in wages, salaries and other social payments have been discussed in numerous writings. The external borrowing has also contributed to the macroeconomic instability due to the two inherent features (Hansen, 1998):

?? the speed of the debt accumulation, which was especially formidable during the first half of 1997 characterised by the overall interest in the "emerging markets";

?? high rates of return on borrowed funds; that could mostly be attributed to lessening of that interest due to the East Asian and, subsequently, Russian financial crises.

Section V

SPILLOVER TO INTERGOVERNMENTAL FISCAL RELATIONS

The previous section was, in particular, concerned with identifying the direct causes of the excessive government consumption. These causes have been associated with the government's failure to bring about the institutions and mechanisms aimed at preventing the fiscal imbalances at the outset of the transition from "turning into" excessive government consumption. This failure has been pointed out to result from peculiarities of Ukrainian politicians' pursuit of the self-interests.

The government's economic activities unmatched to its capability have been addressed as a ramification of this failure. The purpose of this section is to discuss one particular instance of this mismatch ? namely, the excessive government consumption problem reflected in the intergovernmental fiscal relations in Ukraine. In particular, it will be demonstrated that the government consumption expenditure is unmatched to the government's capability because the central government's expenditure authorities comprise too much of what should be under the local government's expenditure authorities.

In Section IV the Ukrainian polity's traits have been combined with *Public Choice Theory* premises in order to explain the issue of government consumption excessiveness. In this section the similar pattern is preserved in tackling the problem of an adverse allocation of expenditure authorities between the central and the local governments in Ukraine. It is, of course, of a sheer significance to set out a criterion or criteria for optimality in intergovernmental fiscal relations, so that a deviation from that optimality would imply that this allocation can be considered as adverse, i.e. generating that mismatch. Specifically, the question, what is meant by that "too much" mentioned in the previous paragraph, should be answered. Finally, empirical evidence for the Ukrainian government's failure to meet those criteria is to be provided.

Public Choice, the Ukrainian polity and intergovernmental fiscal relations

As it has been argued above, in Ukraine the break-up of the Soviet system lead to a situation, when, on the one hand, the power had been transferred to the political interest-groups, and, on the other hand, the incentives to administratively control the economy had remained. Discussing this in a dynamic aspect, Kiseleva and Chepurina (1996) point to the phenomenon of the bureaucratic capital. The issue that having done away with Stalin's totalitarianism, the Soviet *nomenclature* started building up a property stock of its own. At a certain moment that stock failed to manageable with the administrative economic system preserved. That is, the interest groups became motivated to undertake at least partial liberalisation in order to reap the benefits managing that capital legally.

The implication of this phenomenon appears to summarised well by Litvack, Ahmad and Bird (1998):

> "Governments in many developing countries are often not very responsive to their citizens and decision making is not transparent and predictable… Democratic systems are often frail, rendering the electoral system a highly problematic method of achieving accountability."

In other words, it was not in Ukrainian politicians' self-interest to become accountable to the country's citizens. Specifically, one can infer that the government expenditure decisions were essentially out of the efficiency and effectiveness concerns, while being, as it was pointed out above, strongly biased towards the consumption.

The point held here is that the fiscal decentralisation, as referred to by Bird and Wallish (1994) and Litvack, Ahmad and Bird (1998), cannot but embody a tremendous threat to the practices just described. These practices, in their "crude" version, induce the local authorities to be, in fact, pseudo-local authorities, on the one hand, being ruled by the communist party and, on the other hand, implementing nothing but the central government policies at the local level (Eatwell et. al, 1998). According to Litvack, Ahmad and Bird (1998), fiscal decentralisation involves determination of "who sets and collects what taxes, who makes what expenditures and how any "vertical imbalance" is rectified" [8]. The effectiveness of the govt expenditure appears to be a leading objective. This objective is supposed to be accomplished by matching the expenditure with the citizens' demand for it. A mechanism to be employed is that the activities of the local authorities, provided with the new expenditure responsibilities, become subjected to the scrutiny of the local electorate (Bird and Wallich, 1994). Specifically, the voters (or taxpayers) gain the right *"to appoint and remove the elected officials"* thus becoming able to convey their preferences to the local authorities along with making the latter accountable to them. The result coined by Bird and Wallich is that *"residents obtain what they want (and able to pay for), rather than what the centre provides"*.

[8] Fiscal decentralisation is hereafter regarded as involving delegation of the expenditure responsibilities from the central to the local level of governance.

Setting out a criterion for optimality in intergovernmental fiscal relations

Tackling the issue of optimality benchmark in intergovernmental fiscal relations, the arguments in studies of fiscal federalism and fiscal decentralisation in transition economies concur at what might be referred to as a “clarity principle”, which should apply to these relations. As Litvack, Ahmad and Bird (1998) argue,

> “Both theory and experience strongly suggest that it is important to state expenditure responsibilities as clearly as possible in order to enhance accountability and reduce unproductive overlap, duplication of authority and legal challenges”.

Those studies have widely accepted a “rule of thumb” or, in a context of this research, a criterion for this optimality. For instance, Ter-Minassian (1997) considers it as taking place *when “responsibility for each type of public expenditure is given to the level of government that most closely represents beneficiaries of these outlays”*. Thirsk (1998) refers to a principle, which call for *“assigning every expenditure task to the lowest level of government which is capable of implementing the task”*. Specifically, the accepted practice is that the expenditure, the amount of which is not sensitive to the demand in any particular locality, e.g. defence and judiciary system, should be under the central government’s authority, whereas the so-called *locality-specific* expenditure, such for medical care and building theatres, i.e. something that is really subject to peculiarities of the demand in a particular locality, should be under the local governments’ authority. It can thus be inferred that intergovernmental fiscal relations that fail to meet this criterion may be regarded as being as being out of the optimality.

The efficiency of resource allocation within the government constitutes a chief argument for following the rule just described. As it was stated in the previous sub-section, this efficiency consideration is driven by a desire to match the amount of goods and services that the government provides to the citizens' willingness to pay for them. Oates (1990) contends that

> "… Economic efficiency is attained by providing the mix of output that best reflects the preferences of the individuals who make up society, and if all individuals are compelled to consume the same level of output of a good when variations in individual consumption ? or, in this case, variations in consumption among different subsets of the population ? are possible, an inefficient allocation of resources is the likely result".

There is another consideration involved in the argument for following the rule. It is that assigning locality-specific expenditure to the central government level would make the government incur much greater costs of providing goods and services to the citizens. This consideration appears to be much more relevant to the subject of this research than the previous one since it helps establishing the link between unoptimality of the intergovernmental fiscal relations and mismatch between the government's economic actions and its capability.

Here is the rationale behind this consideration. The government's provision of goods and services, the benefits of consuming which are "bound" to particular localities[9] is concerned. Oates (1990) argues that if any given local government is obliged to provide the local public goods by its own means, i. e. by financing the provision through local taxation, the expenditure decisions would be *"tied more closely to real resource costs"*. That is, the residents of the locality would be more

[9] Following Persson and Tabellini (1994), such goods and services are hereafter referred to as *local public goods*.

inclined towards weighting the benefits of any local government spending programme against its actual costs.

There is just the opposite occurring when those local public goods are chosen to be provided solely by the central government; the provision costs will thus be born in all localities. In this case a free-rider problem is introduced. Specifically, each particular locality would have an incentive to lobby for the greatest possible amount of local public good that it can be provided with, since it is required to pay a rather small fraction of the localities' total contribution to the central budget. The result is that the locality would obtain more of local public good than it would have obtained had it been obliged to provide that good by its own means, i.e. through the local taxation. So, the unproductive waste of funds would arise[10].

In summary, the failure to follow the rule described above would make it more costly for the government to provide goods and services, which are to be consumed by a particular locality's residents. The reason is that the free-riding incentives are involved.

There is a point, which is worth being employed for concluding the argument developed thus far. As it was stated above, the greatest benefits from the structure of intergovernmental fiscal relations can be reaped when goods and services for the countrywide consumption are provided by the central government and those for the locality-specific consumption are provided by the local governments. Oates (1990) refers to the system that possesses these features as *"a federal organisation of government"*. Specifically,

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10 Persson and Tabellini (1994) arrived at this conclusion by resorting to mathematical modelling techniques. The derivations are provided in the Appendix.

> "In a federal system there exist both a central government and subcentral government units, each making decisions concerning the provision of certain public services in its respective geographical jurisdiction".

Oates goes on by asserting that

> "From an economic standpoint, the obvious attraction of the federal form of government is that it combines strengths of unitarity with those of decentralisation. Each level of government, rather than attempting to perform all the functions of the public sector, does what it can do best".

Guarding against the possibility of being mislead, Oates distinguishes between the federal organisation of government and another system, which, on the one hand, failing to allow for the benefits of the former, can, on the other hand, be erroneously taken for it. Referring to 1957 *Administrative Organisation* by Poul Meyer, Oartes maintains that the federation encompasses *decentralisation*, *"which represents a genuine possession of independent decision-making power by decentralised units"*, whereas its "counterpart" deals with *deconcentration*, *"which implies only delegation of administrative control in the administrative hierarchy"*. As it will be pointed out below, the latter appears to pertain to the intergovernmental fiscal relations in Ukraine.

<u>The empirical contribution</u>

The basic structure of intergovernmental fiscal relations in Ukraine and general principles applying to them are stipulated by three pieces of legislation:

?? *The Constitution*;
?? *The Law on Local Self-Governance*;

?? *The Law on Budgetary System*.

It is not to come as a surprise that both the structure and principles are essentially subject to the existing mechanism of local self-governance. It is therefore important to overview this mechanism first.

According to Clause 140 of *The Constitution*,

> "Local self-governance is a right belonging to a territorial community ? residents of a village, rural community, which represents a voluntary unification of residents of several villages, settlement, city or town ? to resolve the matters of local significance independently, while being constrained by The Constitution and laws of Ukraine".

Clause 2 of *The Law on Local Self-Governance* defines the way local self-governance is carried out:

> "Local self-governance is carried out by territorial communities of villages, settlements, cities and towns both directly through councils of villages, settlements, towns and cities and their executive bodies and through regional and oblast councils, which represents mutual interests of the territorial communities of villages, settlements, cities and towns."

The attention can now be shifted to peculiarities of the intergovernmental fiscal relations, and, in particular, to their expenditure component. Thirsk (1998) claims that *"The Constitution envisions a highly decentralised system of local governments"*. Specifically, as it is stipulated by Clause 143 of *The Constitution*, territorial communities of villages, settlements, towns and cities, as well as regional and *oblast* councils, would design, authorise and effect control over the expenditure programmes regarding socio-economic and cultural development of corresponding geographical entities.

This inclination towards following the rule set out in the previous subsection appears to be reinforced by Clauses 19 and 20 of *The Law on Budgetary System*. These clauses prescribe that the central budget would finance implementations in education, science, culture, health care and social protection areas that are of the country-wide importance, whereas the local budgets would be obliged to finance the similar implementations of the locality-specific significance.

The picture, however, ceases seeming bright once certain provisions of *The Law on Local Self-Governance*, that specify authorities of different tiers of the government in the expenditure programmes mentioned above, have been chosen to be examined. Under Clause 64 of this law, the local government expenditures fall into two broad categories:

?? those associated with the local self-governance entities' own authorities,

?? those associated with the local self-governance entities' authorities delegated by the central government's executive body.

Thirsk (1998) argues that

> "While The Constitution envisions a highly decentralised system of local governments, The Law on Local Self-Government offers a seemingly more limited view of decentralisation by partitioning the expenditure responsibilities of local governments between delegated and own authorities."

As it is stipulated by Clause 32, the delegated authorities of the local self-governance entities would, in particular, include provision of education and medical care services across a given locality without a charge. Under the delegated authorities, the local self-governance entities would, for example, be obliged to supply residents, who have certain privileges, with free medications.

Essentially, as Thirsk (1998) claims, in education and health care areas the *"local governments would act as agents of the central government"* and provide the corresponding local public goods on the latter's behalf. The instance referred to in the previous sub-section as *deconcentration* thus turns out to arise. As one can conclude from what was stated above, deconcentration implies the failure to meet the criterion of optimality of intergovernmental fiscal relations. It hence appears to be the case that in Ukraine the government consumption expenditure is unmatched to the government's capability.

Section VI

CONCLUSIONS

Applying Public Choice approach to peculiarities of Ukraine's polity can help explaining the phenomenon of excessiveness of the government consumption expenditure. This excessiveness can be defined as a situation when the consumption part of the government expenditure, first, depresses the investment part in a sense that the adverse redistribution of resources from the consumption to the investment part is effected and, second, depresses the economic agents' activities. The inability to generate foundations for growth within the economy constitutes a chief implication of this problem.

Public Choice Theory manages to bridge traditional economic theory and traditional political science. Taking account of neoclassical premises on individual economic agents' self-interest, utility maximisation, rationality and consistency in decision-making, this theory predicts that collective decision-making would in fact reflect the seeking of the self-interests by politicians and bureaucrats with the so-called public choices being inevitably substituted for the private ones.

Feeling apprehensive due to re-election prospects, politicians would be likely to "discount the future heavily" in a sense that "short-run" benefits would, essentially, be preferred to "long-run" benefits. That is, resource allocation for government expenditure, which is carried out through a budgetary process, would be considerably biased towards consumption. In Ukraine, being a country involved in transition from an administrative to a market-based economic system, this bias appears more acute, since in the absence of the viable state governance system representatives of the political interest groups would feel much more apprehensive about their future. This feeling would, in turn, result in incompatibility between the politicians' seeking of self-interest and the need to establish certain institutions and mechanisms in order to cope with fiscal imbalances emerging at the outset of the economic transition. The excessive government consumption problem thus comes into existence.

Being determined to resolve this problem, one would, in particular, desire to match the government consumption expenditure to the government's capability. The failure to meet the criterion for optimality in intergovernmental fiscal relations, i. e. authorising the central government to provide some goods and services for locality-specific consumption, would augment the provision costs because certain localities would be inclined towards free-riding on other localities' contributions by pushing for an expansion of the level of local public goods provided. The government consumption expenditure would thus be beyond the government's capability.

The opportunity to reduce the government consumption in such a manner appears to be the case for Ukraine. As far as certain components of the locality-specific consumption expenditure are concerned, under the existing legislation, the local governments would act as agents of the central government in providing specified local public goods.

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APPENDIX

When the local public goods provision is financed, for example, by the country-wide lump-sum tax, the central government's budget constraint c an be written as

$$Jt \; ? \; \overset{J}{\underset{j?1}{?}} g_j \;,$$

where J is the number of localities, g_j represents the amount of local public goods to be provided for a j-th locality and t is the country-wide lump sum tax (Persson and Tabellini, 1994). The residents of the j-th locality would thus have an incentive "*to push for an expansion of* g_j*, since ? if successful ? they pay only a fraction* $1/J$ *of the cost*" (Persson and Tabellini, 1994). Resorting to mathematical modelling techniques, Persson and Tabellini demonstrate that under this pattern it is a Nash equilibrium in the central government policy choices to provide the amount of the local public goods for the j-th locality, that would be greater than the level of g_j the residents of this locality deem optimal if left to provide it by their own means. So, the unproductive waste of funds would arise.