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POLICY ADVICE

on the Allocation of Inter-Budgetary Transfers

**on the Resolution of the Cabinet of Ministers of Ukraine n°1149 of 8
December 2010, as modified by the Resolution n°7 of 12 January 2011**

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Introduction

The present policy advice was requested by the Ministry of Finance of Ukraine and a governmental Working Group on Regional Development and Reform of Inter-Budgetary Relations within the framework of the Council of Europe (CoE) Programme to Strengthen Local Democracy in Ukraine (2010-2013, funded by the Swedish International Development Cooperation Agency Sida). A more detailed discussion and a legal appraisal of the new draft law can be prepared as the next step.

The Resolution n°1149 has enacted the new formula (in fact, two separate formulae) for the allocation of inter-budgetary transfers on the basis of article 98 of the new Budget Code adopted in 2010. They replaced the previous formulae, enacted by the Resolution n°1195 of 5 September 2001 on inter-budgetary transfers between the State budget and local budgets, and by the resolution n°1782-2004 and 1306-2005 on inter-budgetary transfers between districts (*rayon*) or cities of regional (republican) significance and the budgets of smaller communities. These resolutions were modified several times and then annulled by the Resolution n°1149 (the third schedule of the Resolution). The objective of these resolutions was to determine the calculation and the allocation of the equalisation grants. The 2001 Budget Code provided for 1) direct financial relationship between State and local governments of about 700 local government authorities (regional and district levels, cities of regional/republican significance, Kyiv and Sevastopol), and 2) the obligation of the Cabinet of Ministers to prepare within two years a draft law to regulate the financial relations with lower level communities on the basis of the principles set out by the Budget Code. This was fulfilled by Article 42 of the 2003 Budget Law, implemented by further resolutions of the Cabinet of Ministers (namely n°1782-2004 and n°1306-2005).

The resolution n°1149 is still based on the methodology designed by the Resolution 1195-2001. There is one general formula for the equalisation transfers between State and local government, and one for the equalisation transfers at the district (or city of regional/republican significance) level. While maintaining the principles and the architecture of the budgetary relationships between State and local authorities, changes introduced by the new Budget Code necessitated a full revision of the formulae.

The main changes in the new Budget Code include the task assignment (loss of primary health care by lower level communities, more detailed lists of social tasks for the *rayon* level - *rayons* and cities of regional/republican significance), and the list of resources taken in consideration for the calculation of the tax potential index. Most importantly, the rule of freezing the tax potential of local authorities for three years was abandoned. Changes and additions to the lists of task assignments have blurred the distinction between expenditures taken in consideration for equalisation and tasks assignments disregarded for equalisation, but this is beyond the scope of this paper. There were also small changes in the lists of resources, taken in consideration or disregarded for equalisation. The new Budget Code has consolidated the extension of the equalisation system to the sub-district level (new Art 98).

Changes in the formulae are on equalisation, on factors taken in consideration in the various sectors, in particular in refining the calculation to reflect more precisely the assignment of expenditures and resources, and the introduction of a new expenditure source, the "development of the socio-cultural sphere". As a result, the power of central government is strengthened to control the evolution of local government expenditure; equalisation is strengthened in a way that bigger cities may benefit from the development of their own resources; there is also a de-concentration of the implementation power for the allocation of equalisation grants to lower level communities.

This paper will focus on legal and methodological aspects of the issue since the recent statistical data to assess the impact of the new formulae in economic terms was not provided. The expert recommendations of the Council of Europe are printed in **bold**. The previous CoE analysis and recommendations on the Budget Code provided to the government of Ukraine in 2004 are still relevant¹. The English version of the new Budget Code provided by the OSCE was used to prepare this paper.

To summarise, most changes of the Code are positive. Nevertheless, several problems are still pending and, above all, the system is still too static and can hardly respond to changes and policy initiatives of local self-government bodies.

¹ Marcou, G. (2004), «Фінансові умови процесу децентралізації в Україні після прийняття бюджетного кодексу», pp.23-54 in : Council of Europe / City Council of Dnipropetrovsk / Support Fund for Local Self-Government in Ukraine, *Забезпечення економічної та фінансової самостійності місцевих влад в Україні відповідно до положень європейської хартії місцевого самврядування*, Dnipropetrovsk, Ed. Grani.

I. Resource estimates and equalisation

1. Tax potential

The indicator taken into account for equalisation is the tax potential, based on the list of resources considered for equalisation by the Budget Code. It is calculated for one year, and cannot be changed more than once a year except in some cases (Budget Code, Art.98.8), instead of three years (former Art.98.8). The idea was to leave the benefits of increased tax revenues without diminishing the equalisation grant; however, this did not allow increasing the equalisation grant in case of worsening of the financial situation.

According to the new formula of the inter-budgetary transfers between State and local budgets (par.6), the dynamics of the three years base period is better taken in account. The calculation of the tax potential of the year is not the same when the tax potential of the previous year is higher or, on the contrary, lower than the tax potential two years earlier. Then, the formula takes into account the evolution of the salaries because of their impact on the budgets (as a burden, but also as a tax base, since the income tax is a resource of local budgets). The formula also includes an actualisation coefficient (Z) of the tax potential with regard of the last year of the reference period. Lastly, the total revenue estimate includes an incentive coefficient (SD_{izak}) that reduces the total estimate taken in account in the formula in order to bow the impact on the amount of the equalisation grant.

However, **the actualisation coefficient and the incentive coefficient could have contradictory impacts on a budget** and hence, miss their goal, although the actualisation coefficient is based on growth coefficient of resources, such as it is $Z=1$, as long as the growth coefficient is higher than 1.162.

2. Equalisation and adjustment coefficients

Equalisation and adjustment coefficients were main targets of criticism under the previous budget codes.²

As it was the case of the previous Budget Code, the new one provides for an equalisation factor for the budgets of cities, communities and districts (Art.98.2,5°), but not for regions (*oblasts*) and the Republic of Crimea (Art.99). As it was the case in the previous regulations

² Ibid. p.34.

adopted by the Cabinet of Ministers, the equalisation coefficient is applicable to region budgets (Resolution 1149, par.7). According to paragraph 3, the equalisation coefficient is applicable also to the Republic of Crimea. **This inconsistency should have been corrected by the new Budget Code.**

The equalisation coefficient (a) is applied only to transfers from local budgets to the State budget, e.g. when the tax potential index is in excess of the amount of expenditure taken in consideration for equalisation (Budget Code, Art.100.2). The amount of the transfer T is given by: $T = a(V-D)$, where V represents the amount of expenditures and D the amount of the resources assigned to local budgets, estimated through the tax potential index. In the previous resolutions of the Cabinet of Ministers on the equalisation formula, the equalisation coefficient was itself calculated through a formula based on the basket resources and including an adjustment coefficient, the determination of which was quite controversial. The Budget Code still determines the value of this coefficient in the brackets from 0.6 to 1, in order to make possible incentives to increase revenues (ibid.). The Resolution n°1149 determines directly the value of the equalisation coefficient, making it clear that the level of equalisation is a political decision, as it is in all systems. **It is better to make it possible to discuss the justification of the equalisation level, than to hide it behind technical arguments on coefficients. However, the idea of the Resolution n°1195-2001 to base the equalisation coefficient on the dynamics of revenues was not unreasonable** (this was the square root of the ratio of the basket resources of the last year of the reference period on the basket resources of the first year of the reference period). **Such a variable could be adapted to the new formula of the calculation of the tax potential.** On the other hand, it could be argued that the variations of the basket resources are already taken in consideration in the calculation of the tax potential in the new formula. There is no definitive answer to this question without statistical simulation.

The main change of the Resolution n°1149 is that equalisation is strengthened, but for mainly large cities, which can keep a large part of the benefits of their development. The general rule is that the coefficient of equalisation is equal to 0.95, but is much lower in two cases:

- It is 0.6 for cities that are regional centres with more than 950,000 inhabitants, and the cities of Slavutitch, Yujnoukrainka and Symfiropil;
- It is 0.75 for Kyiv.

There is no special rule for Sevastopil.

These new rules can be justified by the necessity to support development poles for the economy of the whole country, and by the higher development costs in these cities compared to the rest of the country. On the other hand, **these coefficients limit the redistribution of resources throughout the country**. An assessment on this issue should require data on the situation of "donor" local governments in the whole system. However, according to Article 64 most additional resources included in the basket benefit exclusively Kyiv and Sevastopil, and **Kyiv benefits both from additional resources and from the privilege to redistribute less**. As regards Slavutych, the question is for how long the consequences of the Chernobyl catastrophe have to be compensated. **If the argument is to re-develop this area, the advantages should no longer benefit exclusively Slavutych but also other local governments of the area**, subject to determining precisely the area concerned.

3. Equalisation at the sub-district level

The estimate of the basket resources and the calculation of the tax potential are based on the same method as for the equalisation between State and region, district and city (of regional/republican significance) budgets, with some simplifications. In the calculation of the expected revenue taken in consideration for equalisation, the income tax payments are ruled out for the military (par.5 of the formula); it is unclear why this provision is applicable only for equalisation at the district level and not for the income tax of military living in cities of regional/republican significance. Is it because of the mobility of the military? Or is it an indirect way to diminish the tax potential of these communities, and hence to increase their equalisation grant?

The main issue is the power to determine the equalisation coefficient. According to paragraph 3 of the formula, the coefficient has to be fixed between 0.6 and 1, and the decision-making power on the coefficient is assigned to State district administration for all communities of the district territory, and to the executive committee of Sevastopil, or of the cities of regional/republican significance respectively for the communities located within the city territory. Surprisingly, there is no such rule for Kyiv, despite the fact that there are also a number of communities with self-government rights on the territory of the city of Kyiv³. The

³ See DPA/LEX 7/2009, CoE Appraisal of the Draft Law on Kyiv.

Resolution should be completed on this point, which raises the issue on whether this power should be assigned to the executive committee of the city or of the inner city; article 20 of the current law on the city of Kyiv (1999/401) does not provide a clear direction on this issue.

As regards paragraph 3 of the formula, the lack of legal framework on the exercise of this power is questionable. The only rule is that the State district administration or the executive committee has to determine the "level and the application" (*ВИЗНАЧЕННЯ ВЕЛИЧИНИ ТА ЗАСТОСУВАННЯ*) of the equalisation coefficient, and that the equalisation is based on the real yield of the basket resources of the last year of the reference period at the time of the determination of the inter-budgetary transfers. These provisions leave a very wide discretion to the decision-making authority. Whereas this discretion may be accepted for cities of regional / republican significance with regard to communities with self-government rights on their territory (since it derives from the concept of the existence of a community at the city level), it is much more disputable as a power of the State district administration with regard to cities or smaller communities with self-government rights located within the district territory. By contrast, the power granted to the State district administration and to executive committees of cities of regional / republican significance to allocate the expenditure for the development of the socio-cultural sphere has to follow a formula (par.23).

The de-concentration of the power to determine the equalisation coefficient upon the State district administration is, as such, a reasonable solution, due to the number of small communities existing in Ukraine, but the legal rules should provide a framework avoiding unreasonable or arbitrary decisions with regard to some local communities. **For example, the Resolution could be amended to fix the equalisation close to the maximum (e.g. 0.95, as the general rule in the first formula), with the possibility to fix a lower coefficient for municipalities having achieved an increase of resources as a result of municipal initiatives, or having involved resources from the second basket (resources disregarded for the calculation of the equalisation grant) for the financing of tasks taken in consideration for the equalisation.**

II. Spending needs

In the new formulae, the norm of expenditure per inhabitant (or user, or else) (financial ratio of budget adequacy, in the English translation of the Budget Code, or spending needs) is given directly in the main equation of each sector, but this is not a substantial change, since

the calculation of the expenditure norm resumes factors that were already included in the equation of the former resolutions. But this is a simplification of the main equation and this is useful when other factors are introduced, in the new formulae, in order to achieve a more precise determination of the grant according to the needs.

The CoE experts focus on two issues: the expenditure assignment taken into account for the equalisation, and the determination of expenditure norms.

1. The expenditure assignments taken into account for the equalisation

The scope of the expenditure assignments taken in consideration for equalisation is broader than the list of tasks assigned to each category of local government. This was already the case in the formula of the Resolution 1195-2001, with contingencies for "other activities" (*інші заходи*) and for "non distributed reserve funds". Additionally to these two categories, the new general formula introduced by the Resolution n°1149 includes two new categories: "additional financial resources for local budgets" (V_a) and "expenditures for development of the socio-cultural sphere" (V_{sk}) (see par.12).

The expenditures for "*additional financial resources of local budgets*" give rise to no other provision in the formula, in contrast to other assignments, which are developed by one or several paragraphs determining how their estimate is calculated. They can be referred to by Art 94.4 of the new Budget Code, but were already open in the 2001 Budget Code (same article), although it seems that they have not been used. These expenditures are not taken in consideration in the calculation of the indicator of the "non distributed reserve funds" (par.41). From paragraph 6 it could be understood that the amount of these "additional resources of local budgets" is taken into account in the total amount of the basket resources estimated by the Government on the basis of macro-economic data at the very beginning of the process of determination of the equalisation grants. This contingency is not reflected either in the formula of inter-budgetary transfers at the sub-district level, be it as a resource from the upper level or as category of expenditures without assignment. Furthermore, the calculation of expenditure amounts has to proceed according to separate sectors and to the sector breakdown established in Chapter 14 of the Budget Code (par.9 and 11 of the Resolution n°1149). Lastly, these "additional financial resources" are not the supplement of planned expenditure provided for local governments of mountainous areas, since this supplement is noted V_g in the formula (for example, par.15). As a result, the function, the calculation or even the amount of such expenditures is not known; it is not clear whether

they have really been planned or not. If this category of expenditure has been planned, and since there is no formula for its calculation, this would mean that the Cabinet of Ministers could allocate discretionally additional resources to any local government, for any purpose, from such a budget appropriation in the State budget. If this is the case, it undermines the whole equalisation system, since its results could be bypassed by discretionary decisions of the Cabinet of Ministers. **Therefore the recommendation is to either to remove this contingency, or to add specific regulations for its use.**

The expenditures for the “development of the socio-cultural sphere” are mentioned in paragraph 40 of the formula. There is no such category in the expenditure assignments of the new Budget Code. This category of expenditures is defined by this provision as the difference between the forecast level of expenditure for the term of the planned budgetary period and the level of expenditure at the moment of the determination of the volume of the inter-budgetary transfer, for the expenditures provided by programmes of the respective administrative-territorial unit, in particular in the following sectors: culture and arts; education; physical culture and sport; health care with regard to children, young people, women and family; social protection of specific categories of the population. Although paragraph 40 is far from being clear, it seems that this expenditure category is specifically devoted to financing programmes assigned to the said purposes, in contrast to the related expenditure sectors that are basically assigned to recurrent expenditures. This expenditure is also provided by paragraph 10 of the formula of inter-budgetary transfers at the district level. This is an answer to one of the problems identified in the application of the 2001 Budget Code, e.g. that it is not evolutionary and did not provide for financing of the development policies in the sectors covered by the equalisation. To that extent, the introduction of the new expenditure category is quite positive, subject to the amount of resources that can be allocated to it⁴.

This suggests a way out of this difficulty, while keeping with the basic principles and structure of the Budget Code. In Ukraine, the spending power of local government is tightly directed by the expenditure assignments of the Budget Code, and the financing is closely linked to these expenditure assignments, so that local authorities have very little room of manoeuvre when managing the functions assigned to them; moreover, they have frequently to deviate resources from the second basket, theoretically assigned to expenditure of purely local interest, because the expenditure norms are too low and resources do not suffice to

⁴ Cf Marcou G. (2004), «Фінансові умови процесу децентралізації в Україні після прийняття бюджетного кодексу», op. cit. p.29.

meet the needs. **The expenditure for socio-cultural development, in fact for the funding of local programmes in the fields of education, health care, social protection, culture and arts, physical culture and sport, can be a way of releasing more spending power to local authorities. The undetermined “additional financial resources of local budgets” could be used in such a way and, in that case, both expenditure categories could be amalgamated in order for local governments to have a guaranteed volume of resources that they could use more freely in sectors subject to equalisation. This would be a step forward for decentralisation in Ukraine, and it would meet the Recommendation of the Committee of Ministers of the Council of Europe (2005)¹ on the financial resources of local and regional authorities, according to which equalisation should not affect the freedom of choice of local authorities within the limits of the budget available (par.49).**

The new Budget Code has removed primary health care from the expenditure assignments of local communities and cities of district subordination taken in consideration for equalisation (art.88). As a consequence, health care has disappeared from the formula on inter-budgetary transfers at the district level. This is reasonable in principle because of the huge number of small local communities in Ukraine. This means that health services established in such municipalities have to be funded fully by the district budget. Does it prevent these municipalities to spend part of their budget for health care? This is unclear, but according to article 91, point 21, this is not forbidden. According to this provision, among expenditures disregarded for equalisation there are “other programmes related to the exercise of own powers approved by (...) the relevant council in accordance with the law”. This can apply to any matter.

2. The determination of expenditure norms

The expenditure norms, defined by Art 94 of the Budget Code as “financial ratios of budget adequacy” (*Фінансовий норматив бюджетної забезпеченості*), are used to determine the spending needs to be covered in all expenditure sectors and for each local government budget. They are based on the historical structure of expenditures. In general, the new formula is more refined than the previous ones, and should improve the results of the system of inter-budgetary transfers. However, the negative effect is the lack of flexibility, which hampers the initiative of local governments. Therefore, the power given to the State district administration and to executive committees of cities of regional/republican significance to increase locally the expenditure norms and reallocate resources (formula of

inter-budgetary transfers at the district level, par.22) has to be approved, but this is certainly not sufficient. On the other hand, some specific assignments are protected: it is not possible to diminish the appropriations for treating diabetic persons (par.18 in fine) and for schools specialised in several scientific and technological matters in Kyiv and Sevastopil (par.24 in fine) after the vote of the local budget. Such provisions can be seen as a guarantee for some groups of the population or of users; but they seem also to respond to particular problems. More generally, it is seldom justified to impinge adjusting the budgets during its execution, and such provisions should be maintained only if there are crucial reasons to do so.

The problems are related to two issues: the denominator and the adjustment coefficients. The denominator is the number of inhabitants, of users or another subject relevant for the function. In some cases the choices reflected in the formula may be disputed.

As regards the general costs of the **maintenance of local government bodies**, the different denominators for the various levels are not justified (par.13-16): the number of employees for Kyiv and Sevastopil, the regions and the Republic of Crimea; the number of inhabitants for cities of regional/republican significance; the standard personnel structure determined by the central government for districts and lower level communities. The first solution is especially problematic, since there no incentive to keep the staff under control. Furthermore, the increased adjustment coefficient for local communities of district subordination, compared to previous norms, will facilitate the functioning of these municipalities, but at the same time it could make inter-municipal cooperation more difficult, if the pressure of needs is weaker.

The formula on health care expenditure (par.17-20) reflects an important effort to rationalise the allocation of resources, in a sector that represents an always larger part of public expenditure. It is close to the formula of the Resolution n°1195-2001, as regards coefficients. Main changes result from taking into consideration the gender and age structure of the population, and the health condition of the population, reflected by health care costs for diabetes.

As regards education (par.21-24), the formula is based on ratios calculated according to the number of pupils or students, differentiated according to the type of school and of territory. Then, an adjustment coefficient is applied to the type of expenditure considered. There are great differences among these coefficients. They probably reflect important differences in unit costs, but this is not apparent in the formula, which gives only a number of pupils or

students at the national level and the coefficient. Even if it is based on the real costs, **this method is not satisfactory because it does not make it possible to review the existing organisation with respect to needs, which can change over time, in order to reallocate resources.** An additional factor to be considered would be the evolution of the number of pupils and students over time (three years would be too short, may be 5 years); another one could be the number of demands for the respective types of schools that could not be satisfied.

In the sector of social protection (par.25-37), we have also a great variety of functions taken into consideration in the expenditure assignments, making the formula rather complicated. Depending on the task, the expenditure estimate is based on the number of beneficiaries or on the number of places in institutions where persons have to be cared for. This is justified for expenditure assignments requiring to care persons in institutions, in particular for certain categories of invalid persons or elderly having lost too much of their autonomy. But the number of places may be misleading: it derives the calculation of the expenditure need from the existing capacities, whereas these capacities might be quite insufficient with respect to the needs. Therefore, **the expenditure norm should be based on an assessment of the capacities and needs in order to determine where the development of capacities is necessary and where, on the contrary, resources could be reallocated.**

In the sector of culture and arts (par.38), the calculation of the expenditure needs is based on the population: the expenditure norm is divided by the number of inhabitants. This **formula is not adequate. The needs are not a function only of the population, but also of the cultural heritage.** For municipalities having the same population, the one that has a more prestigious heritage will have to incur additional maintenance costs, without which the risk of decay is serious. According to Art 87.14 of the Budget Code, the restoration of monuments of national significance is assigned to the State budget. It is obvious that the State will have a restrictive concept of the monuments of national significance for budgetary reasons. There is no targeted item for such expenditure at the local level among expenditures assignments of local governments subject to equalisation, but this could be included in the expenditure assignments on "culture and arts". Therefore, **this factor should and could be taken in consideration in the formula.** This recommendation has already been formulated in 2004⁵. As long as the investment capacity of local government

⁵ Ibid. p.32.

remains very low, it will not be possible to finance such expenditures from the development budget, as provided by Article 71.3 of the Budget Code (“preservation and development of historical cultural locations and reserves of Ukraine”).

For the calculation of the expenditure for physical culture and sport (par.39), the expenditure norm is divided by the population, whereas the expenditure is shared between the regional and the district levels, but the expenditure norm is based on the level of expenditure of 2003. This is likely to limit the volume of this expenditure. The formula takes in account not only the population but also the expenditure for high level sport education. This latter assignment is surprising because Art 87.12 (a) of the Budget Code recognises the responsibility of the State budget for the training of the reserve and of the main staff of the national teams, for the master schools of a list approved by the Cabinet of Ministers. This is a rather national than local responsibility, and there is no logic in involving local governments in this task. It would be more adequate to **remove this factor (V_{svsm}) from the formula.**

To conclude, **the expenditure norms and the formulae to calculate the share of each expenditure assignment in the budget of local government have been improved compared to the previous regulations, but they are still too static and leave local authorities too little margin of manoeuvre to build their budgets.** Furthermore, the tight assignment of resources to tasks leaves very little capacity for savings to local governments; as a result it is difficult for them to yield a surplus that could finance part of capital expenditure, whereas the level of resources of the second basket and of the development budget is too low in most local communities to compensate. The move towards more flexibility reflected by the “expenditure for socio-cultural development” and the – undetermined – “additional financial resources of local budgets” should therefore be more important.

Another point to be emphasised is **adjustment coefficients**. There is no consideration for the particular charges of touristic communities. In many countries, tourism has become a key sector of the economy. Whereas Ukraine has an important potential in this respect, it is surprising that this issue is not at all mentioned in the expenditure assignments of the Budget Code, neither in those taken into consideration for equalisation nor in those disregarded for equalisation. **The formula of inter-budgetary transfers could take into account a coefficient for the additional expenses that tourist municipalities have to cover:** for example for roads, water supply and sewerage, development of sight points,

etc. This recommendation had also already been made in 2004.⁶ The supplement for communities of mountain areas meets these needs only partially. These municipalities need overcapacities compared to the permanent population, but their financing is based on the permanent population. For example **the calculated additional costs for specific infrastructure could be expressed in an adjustment coefficient that would be applied only to local communities meeting certain conditions (to be defined by the law) and registered in a list approved by the Cabinet of Ministers.** Developing tourist capacities would in turn support economic development in the areas concerned.

Conclusion

As emphasised by the CoE Recommendation (2005)¹, “a substantial degree of equalisation is a prerequisite for the success of fiscal decentralisation and sound local self-government. At the same time, financial equalisation is a prerequisite for the success of policies geared to economic stability and balances, sustainable regional development” (par.40). The efforts of Ukrainian authorities to improve equalisation have to be recognised. However, the Council of Europe also emphasises that equalisation has to be reconciled with the freedom of choice of local self-government bodies, especially in their spending power (par.49). New steps in this direction in the equalisation formula, including expenditures for the development of the socio-cultural sphere and additional resources of local governments have to be confirmed and funded. Nevertheless, the main weakness of the Ukrainian local finance system remains the lack of own tax power of local authorities, which is a basic condition of fiscal decentralisation (ibid par.13 and 16).

Appendices:

1. Marcou, G. (2004), Financial Conditions Of Decentralisation In Ukraine Following The Introduction Of The Budget Code (under CoE-EU Project).
2. CoE Recommendation (2005)¹.

⁶ Ibid. p.33.