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**Tools for Financing Local Economic Development Policies in Ukraine:**  
**Taxation approach**

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## Executive Summary

The core problem of the paper is inappropriate national taxation policy in Ukraine that does not allow effective and efficient local economic development of municipalities in the country. In order to solve the problem, the research question of the thesis is what changes are to be made in the state and local tax policies to provide sufficient financing of local economic development. the goal of the research is to analyze the Ukrainian tax system on both state and local levels to provide feasible and the most effective tax policy modifications in order to serve efficiently as a financial tool for local economic development programs. The research involved not only Ukrainian research experience, but additionally practices of foreign scholars as well as case studies of similarly developed countries.

Although some attempts to decentralize Ukrainian fiscal system have been made, it does still remain highly centralized. As the consequences of tax system centralization local taxes perform too small role in budget revenues. Moreover, local governments have almost no autonomy in decision process over their income. In addition, high centralization leads to extreme dependence of municipalities on central policies. As the result, any change at the top seriously affects bottom level that can appear as revenue decrease and significantly lower predictability for municipalities. Finally, centralized tax administration system leads to unmotivated local governments regarding tax collection, and to existence of irrational taxes with higher costs than revenues.

In order to improve the described situation following policy recommendations were drawn in the research. They can be divided into four main parts. In the first part suggestions regarding general budget changes were developed. Second part encompasses local taxation modifications. Third part was devoted to detailed discussion on new property tax that should be introduced in Ukraine. Finally, last part of policy recommendations includes tax administration changes and suggestions on decentralization of tax administration system.

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## Introduction

Local economic development (LED) is a number of policies and strategies of municipalities that target improvement of business environment and sustainable economic development of a community. Since recently, right after the decentralization boom, local development became one of the main priority issues for municipalities in the Central-Eastern Europe and Balkan countries. The end of the 20<sup>th</sup> and beginning of the 21<sup>st</sup> century is the period for abundance of projects aimed at providing information, resources, and guidelines for local leaders on variety of approaches for local development. The challenge for the leaders of local governments was to revolutionize former socialist oriented politics with mainly central authorities dominance and revitalize instead a new approach with the main idea of empowering municipalities with broad autonomy. Ukraine, similarly, but later though, started the same process in line with the tighter European integration. Focus on local economic development in Ukraine has emerged starting from 1997 along with adopting the Law on Local Self-regulation of Municipalities and a number of other legislative documents, municipalities have more rights as well as responsibilities for implementing the mentioned improvements. Nevertheless, financing sources that are available in Ukrainian conditions are still limited.

Although the information regarding the factors to improve the economic development situation are available for Ukrainian local governments by in large, however, there is still considerable scarcity of tools to finance implementation of those factors. In other words, *the wider problem is lack of available sources or not favorable situation for effective financing of local economic development policies and strategies in Ukraine.* Among the most vital and commonly mentioned factors that influence economic development is infrastructure and communication improvements. However, it appear to be only a part of the whole set of measures that vary in terms of their significance, feasibility, and availability for the local

municipalities. To name some: enlarging human capacity, natural (climate, natural resources etc) potential, infrastructure and communication improvements, combating corruption, legislation regulations, empowering local stakeholders, etc. This information does not already seem to be innovative for local government in Ukraine. Alas the main difficulty is hidden in the availability of policies to finance the implementation of development plans and strategies.

*Narrowing the focus, the core problem of the paper is inappropriate national taxation policy in Ukraine that does not allow effective and efficient local economic development of municipalities in the country.* In order to solve the problem, *the research question of the thesis is what changes are to be made in the state and local tax policies to provide sufficient financing of local economic development.* Considering already high tax burden in Ukraine that reduces the private sector expansion, instead of increasing the tax rates other methods should be used. State and local tax policies include broadening the tax base, designing the most appropriate policy of incentives, tax holidays, rights of municipalities upon local taxes and fees, tax-shares. Tax administration in terms of improving compliance, enhancing revenue authorities' administrative capabilities plays not less significant role.

Consequently, *the goal of the research is to analyze the Ukrainian tax system on both state and local levels to provide feasible and the most effective tax policy modifications in order to serve efficiently as a financial tool for local economic development programs.* The research will examine the general impact of taxation on the local economic development as well as the significance of state and local tax policies as a financial support for LED considering the experience of western and other transition countries. In particular, the thesis will analyze the current tax system in Ukraine, will measure influence of concrete taxes on local development including evaluation of Ukrainian legislation and works of Ukrainian experts, and ultimately will explore the possible and sufficient mechanisms for empowering local governments with a range of tools to finance local economic development policies. Financing local economic development encompasses several other goals that are going along and are subject to investigate

in this research as well. All these accompanying goals and tasks establish something like criteria and guiding line on the way towards achieving the main one mentioned above. Noteworthy taking a closer look at them too.

Two intimately related goals are connected to revenue increase and financial management. In order to finance local development enlargement of financial resources are in need. Moreover, to be able to make decisions by local governments as for investments into local economic development independently own revenues are to be increased as a priority. Thus increase of own revenues is one of the most vital accompanied goal. In addition to the idea of finding more resources the issue of qualitative management cannot be left aside. Qualitative management means to some extent high level of transparency and sustainability of financial management. To add more, sustainability should be also present in balancing financial resources that is eventually will lead to improved creditworthiness of the municipality. To sum up, quote from *Budapest Model* work can describe the best criteria the tax policy model should correspond too: “To guarantee the sustainability of their financial management, local government must create a system that is transparent, plannable, and can adapt to and reflect changes. The first cornerstone for sustainable financial management is therefore the existence of a transparent financial management system.” (Pallai 2003, 84]

National policies alone are not enough to address the widespread and growing economic disparities between regions and localities and thus achieve the sustainable development. Local economic development fills the gap and appears to be a key issue. There are numerous definitions that describe LED. In *Local Government and Economic Development* edited by Sona Capkova, local economic development aims improving local citizens’ quality of life throughout various factors for insuring sustainable community development. (Capkova 2005) In cooperation with government, business, and civil society institutions, the notion encompasses processes of building the economic capacity of a local area, providing better conditions for economic growth and employment, empowering and engaging wider range

of participants for stable community progress. Increasing level of employment and fostering business activities lead to broadening tax base, i.e. revenues into local budget. In addition to the mentioned factors that influence local economic development, S.Capkova stresses the importance of establishment and strengthening of necessary institutions, “support of existing and new enterprises” (Capkova 2005), investments attraction, discovering new markets and “transferring new technologies” (Capkova 2005).

Edward J.Blakely in 2004 in his *Planning Local Economic Development* introduced the fundamental classification of LED policies. According to the author, there are supply and demand side policies. The former embraces tax policy, debt covering mechanisms, infrastructure, and regulatory policies; whereas, the latter includes strategies for promoting and expansion of new businesses, improvement of environment, educational programs. (Blakely 2004)

Similarly, taxation policies can play double function in order to serve for local economic development. Firstly, local revenues in form of taxes are used for financing both operational and capital expenditures such as infrastructure, human capital, etc. Secondly, flexibility of the tax system (flexible local taxes, tax holidays and incentives) may serve as a tool to attract investments, stimulate old and establish new enterprises. However, the flexibility of the system is to have certain limits in order to stay fair and does not distort economic nature of business activities. Besides an issue of equality and non-interference, the costs of given incentives are usually less than the benefits gained. Moreover, it is also a case when holidays are given to those that do not need them.

In order to explore the topic deeper various literature materials will be used. Fundamental works of American and British authors helps to illustrate the necessity of taxes and local development policies in general. Then Ukrainian relevant literature opens the discussion of current situation in Ukraine as well as reveals the most urgent problems in areas related to taxation and local development. Ukrainian legislation is another set of sources that strives to describe the background as more precise as possible. Finally,

finding best solutions and searching for the most optimum model that would solve uncovered issues cannot be done appropriately and on enough academic level without profound experience of other countries. Thus an extensive number of works that were used for the thesis is devoted to the case-studies in different countries and cities.

One of the best case-study materials that were used in the paper is *The Budapest Model. A Liberal Urban Policy Experiment* edited by Katalin Pallai represents a set of studies devoted to Budapest financial system and its management. The authors of the studies clearly state that financial management is not simple “a technical issue”, but instead it is “an activity that enables the city’s leaders to translate their principles and objectives into practice and to implement their most important political decisions.” (Pallai 2003, 6] The study helps to understand not only current situation in Budapest finance, but also historical development during last twelve years, assessment of made reforms, problems Budapest government faced on different stages of its development, and the solutions made. Exploring the study discovers similarities with Ukrainian development that simplifies designing of the model for Ukrainian financial system of local municipalities.

Experience of other countries is extremely valuable for any research and especially when something new is to be introduced. An important issue is implementation or modifications of a property taxation system. A substantial part of the research will be devoted to this matter. An abundance of literature is available regarding property taxation successes and failures. The Fiscal Decentralization Initiative for Central and Eastern Europe foundation has thoroughly explored the introduction of property taxation in Eastern Europe. An experience of Croatia, Macedonia, Montenegro, Serbia, and Slovenia are available on their web-site. This research will be mostly focused on the practice of Slovenia. The article edited by Neva Zibik and Dusan Mitrovic “*Development of a Real Property Appraisal and Taxation System in Slovenia*” profoundly and in details describes the property tax system in this country in line

with accompanying tasks are to be accomplished in order to manage the system properly and most effectively.

Besides specific issues such, general discussion and recommendations on budget management is vital for the economic development too. Among other literature “*Budgetary Oversight and Accountability in Ukraine: The Case of General Secondary Education*” by Sergii Slukhaj was used. The article aims to present analysis of “the state of general budgetary oversight on the local level and goes into detail concerning fiscal accountability of educational units” [making public, p. 69] Even though the article does discover local budget policies on a particular example of secondary education, it still contains main principles, drawbacks and recommendations in general that can be used for municipalities. Thus it was used in this research to illustrate the importance of decentralization policies in taxation in order to reach substantial accountability level of local governments towards their community. The article is located in a book Making Public Finance Public. Subnational Budget Watch in Croatia, Macedonia, and Ukraine edited by Katarina Ott. In general, this book is used in the research to compare the budget situation on local level on the example of three case studies.

***The research will be examined using both qualitative and quantitative methods.*** Among The most important of them are data collection of previous experiences relevant to the field and further data analysis which will form the fundamental part of the research. Mainly, open methods of interviewing will be used as data collection methods. The qualitative research designs are limited to method of comparison, case-studies, and document analysis (mostly legislation).

***The structure of the paper.*** The thesis will be divided into three parts complemented with the introduction, conclusion, and bibliography. The introduction will present the topic, problem, and the research question along with the methodology of the thesis. Further, first part of thesis will depict general practices and current Ukrainian situation on financing local economic development, significance of

taxation in the issue, prospects of alternative ways of financing for Ukraine. The second part will analyze western and transition countries failures and successes of using tax policies for financing local economic development. And finally, the third part will focus on the practical recommendations to modify Ukrainian state and local tax policies to make them serve better for municipalities as a tool to finance local development programs. Conclusions will summarize achieved results and outline further research needs in the relevant topic.

Even though in the process of making the research various methods and substantial amount of literature will be used, there are still both advantages as well as limitations of the study. One of the main advantage is the high level of applicability of the research. It means that the thesis will try to approach its analysis and, which is more important, recommendations to the current, real, and feasible situation in a particular country Ukraine. Also the structure of the paper helps to trace the topic in a more logic and comprehensive way. Furthermore, involvement of not only Ukrainian research, but additionally foreign experience as well as case studies of similarly developed countries is one more advantage of the paper. Nevertheless, the research does contain touch still a rather wide issue that should be divided into several parts and explored individually. For example, problems of introduction of a new property tax system and decentralization of tax administration can be researched autonomously. Instead, the scope of this paper touches allowed to touch such important matters of taxation system just briefly.

## Chapter I. Current Ukraine Tax Policy System Analysis

Second chapter aims to describe current situation with taxation policies and level of local economic development approaches in Ukraine. In order to bring additional value to the research, the purpose of the paper was not only to explore the theoretical background of the taxation role for effective local economic development, but also particular implication of “good practices” from the experience of Eastern European countries to Ukraine. However, in order to design suggestions of needed changes in Ukrainian relevant policies, firstly, the most urgent problems is worth to explore.

The chapter is divided into several parts. Along with describing current situation more reasons in favor of tax policies are presented below. Thus first paragraphs answer the question why modifications of Ukrainian tax system are selected as the most feasible tool for financing local economic development in Ukraine at the moment. Current legislation framework follows afterwards. It helps to understand work of local governments and Ukrainian tax regulations both on central and local level. For better comprehension of financial system of the country, brief look at the administrative picture of the country is presented further. Finally, tax system and local budget revenues potential is analyzed.

It is true that not only taxation can be used for financing LED. However, it appears to be the most feasible and effective tool. Following argumentation is presented in order to prove the importance of the selected research area. Several sources are widely known to finance local development strategies. The ones that can be currently applicable to Ukraine are state grants and subsidies, municipal borrowings in form of loans and municipal bonds, and favorable taxation system. State grants and subsidies are in wide use in Ukraine at the moment. However, the process of obtaining any additional funds from the government seems to be rather complicated process and the success of achieving the positive decision usually depends on connections, political affiliations that also limited with scarcity of national financial

resources. Thus the practice of state grants and subsidies can be used for local development; nonetheless, it cannot be considered as stable and permanent source for financing economic development.

The situation with municipal loans seems to be more promising. The main reasons are much easier process of obtaining loans, significantly wider range of lenders on Ukrainian market, higher level of experience, knowledge and skills in the issue. Nevertheless, substantial list of challenges still exist and thus a lot still needs to be implemented. Among the main remained problems are following: spending the obtained loans for covering operational costs or previous debts or debt services, tight restrictions regarding the currency, ceilings, requirements to both a lender and a borrower (e.g. the external borrowing can be done only by the cities with the population exceeding 800.000 people), time of borrowing (3 months in total) (Budget Code 2001), extremely high interest rates (in average 20%), etc. Fortunately, the necessary changes in legislation even though are too complicated to make, however, still possible. The key problem of loans as a source for financing economic development at the current Ukrainian stage is hidden in other related matters. The process of lending is tightly related to the public procurement, which is still weakly regulated in Ukraine, and thus leads to corruption. The price of potential corruption seems to overrate the benefits of lessening the current legislation for the authorities. The conclusion is as following, the policy with less radical transformations is needed.

Unfortunately, issuing bonds as a financing tool for local development is even less developed. Besides significant improvements, there are still quite a few hinders for boom of bond issuing in Ukraine. Overall, the obstacles can be divided into two main groups: problems at the national level, and of local character. Among the nationwide problems the following are the most striking: remained weak state regulation on the issue, not enough developed financial institutions and Ukrainian financial market, low level of integrity that results in limited access to the markets. Among the problems that are mostly depend on local conditions are lack of experience and relevant knowledge of the public officials on the issue, not enough motivation to use bonds for borrowings, low percent of usage the bonds as a tool for local

investments. Moreover, even adopting the needed legislation and improve institutional ground, the potential of bonds buyers should not be expected to increase rapidly. Negative previous experience of unpaid debts to the private companies as well as to the public has almost vanished any existed trust to invest into local governments. The process of gaining it back appears to be problematic or at least long-going. In addition, according to the organized surveys, Ukrainian population as well as most of the companies more likely to deposit the funds into commercial banks rather than to the public institutions.(Slukhaj 2006) The promoting and creation of reliable guarantees requires a long time as well. Finally, still rather unstable political and economic prospects of Ukraine delays the implementation of the policy to some decades.

Using method of exclusion, the development of appropriate tax policies for effective financing local economic development appears to be the most urgent and feasible at the moment. The budget reform of 2001 introduced important positive changes into the fiscal decentralization trend. In order to stimulate increase in own earnings by the municipalities ‘two baskets’ of revenues were designed: target taxes and fees for local budgets and state transfers as a second basket. The first set encompasses considerable shares of personal income and land tax (from 25 to 100% depending on the level of municipality), tax on the owners of vehicles, rent payment for municipal property, lump-sum tax on business, fees for registration, licensing and punishment of entrepreneur and other business activities. Moreover, the Code delegates the right to decide on how to spend the revenues to execute certain services which testifies certain level of accountability.(Slukhaj 2006)

However, current tax policy in Ukraine can be still characterized as mostly highly centralized and dependent mainly on state transfers to local municipalities. As it was mentioned earlier, the significant percentage of state transfers still dictates the accountability of local government to the central authorities instead of public. Even though some taxes are considered to be of local character, the rates for all of them are defined by the state. Despite explicit formulas for transfers from the state level to the regional, the

lower layers are not regulated and the situation leaves the discretion to decide upon amount of money transferred up to the regional councils. Similarly, the division of revenues between municipal and district councils is not enough clear.(Romanyuk 2007) Thus the situation can be still significantly improved and eventually serve for sustainable economic development by covering not only operational costs, but also capital expenditures.

Variety of different legislation documents such as laws, President's decrees, and Cabinet of Minister's directions regulate authority of local governments and especially tax system in Ukraine. However, the main ones are the Constitution, the Law on Self-government, the Law on Local Administration, the Budget Code of Ukraine adopted in 2001, annual Laws of Ukraine on the State Budget of a certain year, and finally annual budgets of Ukrainian municipalities.

Certainly, at the first and the higher level of Ukrainian legislation is the Constitution of Ukraine that was adopted in 1996. As in any other country, the rule of law and the supremacy of the Constitution of Ukraine as the fundamental law regarding any issue and budget matters particularly are clearly embedded into the system. All other legislation is to correspond and be subordinated to the Constitution. It assigns that all tax and non-tax revenues along with expenditures are to be included and regulated exclusively by the law. Some division, balance between executive and legislature powers is mentioned in the law as well. In general, the Minister of Finance on behalf of the executive power is able to make tiny modifications as for key spending units, selecting source, type, currency of borrowing for covering budget deficits, but all the rest is strictly in the functions of the Parliament.

The administration and finance system are extremely centralized in Ukraine. There are three tiers that play its own role in the tax implementation, regulation, and collection processes with different levels of autonomy and rights. On top of the hierarchy is central government, then oblast (kind of state or province) goes, and rayons (districts) and cities or villages are at the bottom level of subordination. There

is certain ambiguity in terms of obligations and powers of different tiers. Unclearness of the situation brings contradictions or doublings of powers and leads to sometimes overcontrol or ignorance regarding provision of tasks and execution of responsibilities.

Even though Ukrainian municipalities are to use and to create non-budgetary funds, tax revenues are still the main financial resource for performing the tasks and investing in local economic development. Theoretically, non-tax revenues in form of rental fees, sales of owned property, and capital market profits together with local borrowings can be an additional financial resource. Nonetheless, in fact, as it was already mentioned it does not still play a significant role in financial system of municipalities for various reasons. Moreover, non-tax revenues are in many cases related to capital revenues, which are to be separated from operational and discussed separately. Thus nationally collected taxes that return to municipalities as inter-budgetary transfers along with local taxes are currently the most beneficial resource.

Although Ukrainian governments did some attempts towards decentralization and liberalization of local tax policies, however there is still limited autonomy of municipalities regarding making decision on their own revenues. Partially, according to the World Bank analysis this problem relates to “the high administrative and compliance costs of these taxes. Only a small part, on average less than 3 percent of total local revenue, comes from “own” local taxes. Given the small revenue mobilization of own local taxes and the rigidities embedded in how all revenues are spent, local governments are increasingly dependent on transfers from the central government. The rate for most taxes on the list of own local taxes is fixed centrally. In general, local taxes and fees are needlessly complicated in their structure and have a high frequency of payments, which contributes to the high tax compliance costs in the country.” (World bank document 2007, 1) Further on, the problem of centralized tax administration abolishes any desire of local governments to obey the accurate collection of taxes. The fact that any contributions of

municipalities for the sake of controlling tax payments will not result in increase of local revenues discourage local officials for such actions.

More examples of disadvantages for municipalities of too centralized fiscal system are worth mentioning. Any changes in the central government policies are becoming usually as negative consequences. Taking into account not stable both political and thus economical situation in Ukraine, in line with frequent changing of central governments monetary and fiscal policies are varying too. Sometimes it reaches radical changes. Well known example with Free Economic Zones which were considered as know how for one government, were criticized and abolished by another. An example of Yavoriv district in Lviv region can be applied. Considerable economic growth of local areas with special tax incentives testifies 30% increase of economic activities comparing to the pervious periods. (Lessons learned in Poland) Thus one matter is to discuss whether this tool (i.e. taxation free zones) is a good means for the economy of cities, but another issue how these changes affect other municipalities' economies that do not belong to such zones. In any case quick shifts do not give positive results. Each government that comes to power tries to cancel some tax exemption, but instead grant other ones. This kind of jumps severely affects local governments' revenues that come to their budgets in form of transfers. Such exemptions cause first of all unpredictability of local budgets, which is one of the biggest hinders for local development; and secondly, the exemptions simply cause decrease in local budget income. Obviously, central authorities do reimburse increased expenditures to certain extent. Nevertheless, the procedure of this lost compensation is not developed yet.

Still important feature of Budget Code 2001 is allowing local governments to levy certain local taxes. Nonetheless, this opportunity is also extremely restricted. According to the budget code of Ukraine, among local taxes the most vital are market fee, communal tax, license fee for placing of trade and services objects, tax for advertisement. The rest are fees that do not bring sufficient income. To name few, fee on the jockeys at the hippodromes, fee for parking cars, resort fee, fee for pets owners and some

others. The main restriction is absence of freedom to set rates by municipalities over these taxes. Besides this, the rates are fixed in nominal numbers that are not influenced by inflation rates. Thus the importance of local taxes for municipalities is lowering gradually.

Moreover, in addition to lowering the revenue capacity of local taxes, the administration costs are increasing. All taxes in Ukraine including local are subject to collect exclusively by the Central Tax Administration. This factor also adds to the costs of the administration a tax. One more feature of local tax system that increases tax management costs is extreme complicatedness of a tax. Again, because local governments do not directly face any loss as for tax administration matter, they usually avoid simplifications of choosing tax bases. As the results, it is often a case when a tax collection costs much more than the tax revenues.

Among popular recommendations that are given to Ukraine in terms of taxation system changes is modification of Personal Income Tax (PIT) allocation regulations. To put it in other words, so far any person is obliged to pay PIT (indirectly though) to the municipality where a person works, however, he or she can reside in another place. The problem is that a municipality that does not have enough capacities for work places increase suffers from high expenditures because of high numbers of inhabitants. Instead, another municipality with abundance of companies but with worse living conditions avoids spending much on improving living conditions, but earns a lot from PIT shares. Thus according to European experience such situation leads to making poorer regions even poorer and rich ones even richer. Nevertheless, there is another side of the matter that is fairness. If a municipality was able to attract some business to the area it has a clear right to count on taxes that these businesses or people who come to work there have to pay. To say more, not only natural conditions play a significant role in attracting business. Infrastructure development is one more vital indicator for business in location selection. Infrastructure development demands high investments' level. One way to finance infrastructure improvements is local budget. Thus developing infrastructure municipalities attract business and then acquire their taxes for

compensating expenditures on infrastructure. Even though people pay certain amount of money in form of taxes in another location other than they reside, they still spend the most of their earnings in an area where they live. Thus a municipality without high business activities has an advantage of receiving all taxes such as value added tax and others. To sum up, the current situation allows balancing areas with commercial and residual specification.

To summarize the chapter, first it would be logical to start with the aim that was set at the beginning. Basically, the part on current situation in Ukraine tried to help to understand existing tax policies and situation with local economic development in the country. Currently in Ukraine municipal loans and bonds are not well-developed. Among known financial ways for local development municipal loans and bonds can be used. However, in Ukrainian case still weak financial markets and rather strong corruption in procurement processes hinder thriving of these financial tools for local economic development. Thus improvement of tax policies seems to be the most feasible instrument. As it was shown above, even considering some attempts to decentralize Ukrainian fiscal system, it does still remain highly centralized. It can be seen after analysis of the Budget Code of Ukraine (2001) that in line with the Law on Self-Government are appeared to be two the most important laws for municipalities in terms of budget forming. Regarding taxation, Ukraine can be characterized as too centralized in both fiscal and tax administration system. As the consequences of tax system centralization although local taxes do exist as a notion in Ukrainian legislation, however they perform too small role in budget revenues. Moreover, local governments have almost no autonomy in decision process over their income. In addition, high centralization leads to extreme dependence of municipalities on central policies. As the result, any change at the top seriously affects bottom level that can appear as revenue decrease and significantly lower predictability for municipalities. Finally, centralized tax administration system leads to, from one side, unmotivated local governments regarding tax collection, and from another, to existence of irrational taxes

with higher costs than revenues. Considering drawbacks uncovered in this chapter, it seems to be logical to develop policy recommendations.

## **Chapter II. Policy Recommendations for Financing Local Economic Development Policies in Ukraine**

Previous chapter was devoted to the analysis the tax system of Ukraine both on central and local levels. In its turn, this part of the research aims to solve the second task of the thesis problem that is discovering the feasible and most effective tax policy modifications in order to serve efficiently as a financial tool for local economic development programs. To be precise, the chapter will touch general necessary changes in the financial management of local governments, and afterwards will argue as detailed as possible in favor of the designed tax policy model best suited for Ukraine. The arguments will be divided into several subparts that are all striving to answer one question what changes are to be made in the state and local tax policies to provide sufficient financing of local economic development.

To recall, designed tax policy model should correspond to certain criteria such as transparency, sustainability, and adaptability to the dynamic changes. Dozens of changes can be made in the tax policies. However, leaving status quo in fundamental financial management approaches might lead to failure in implementation of the model however good it can be. Thus it is extremely important to touch firstly the general necessary changes in financial management of Ukrainian local municipalities. Transparency and sustainability of the system can be achieved by introducing changes in the budget system. Although there is no “best” or ideal example of Budget system in the world so far and each law is to be drafted in order to fit the country’s legal, cultural and political conditions, however, certain classical world recognized standards are to be followed, included and obeyed in any country’s legislation.

First urgent change concerns separation between operational and capital budgets. Capital revenues have in its majority one-time character in a certain year and cannot be counted as operational costs the same as for operational expenditures. Especially balance of purely operating budget can be considered as an indicator of sustainability. In case city’s municipality is to involve capital revenues for

current costs sustainability disappear. Similarly, combined budgets are much harder to trace the level of city development. One more argument in favor of budget separation is scarcity of capital resources, i.e. assets etc. that will end sooner or later. Thus to be able to react to and to plan adequately city's needs budget is to be divided.

There is another widely known system of budget separation that is called CLI model. The name goes from its authors the French Credit Local International Conseil (Pallai 2003, 156). The main idea of the model is division of the municipality's budget into three parts: operating revenues and expenditures, loans and debt services, accumulated and capital-type revenues and expenditures, i.e. capital budget.

Furthermore, top-down approach should be used within certain boundaries clearly defined in the law. To recollect, the fact that cities, villages, and regions cannot adopt and even plan their local budgets lead to considerable hinders in the local development processes. It becoming a more vital problem when the adoption of the national budget is delayed after the start of fiscal year it is designed for. Although it would be almost impossible to make down-top approach and compile the state budget based on the adopted local fiscal documents, the problem can be solved by partial top-down approval. In other words, the legislation should state that in case of postpones in terms of approval of the State Budget Law in set terms, the local municipalities are to adopt their legislation within the ceilings set in frame of strategic financial plans of the nation.

In order to combat economic fluctuations or possible problems, more discretion for the Minister of Finance is needed. One of the biggest problems of the current budget law in terms of authoritativeness principle is visible, manifested overcontrol upon the budget drafting and reporting. The Finance Minister as well as the Cabinet has definitely miserable power over the budget modifications. From one side, it is supposed to prevent corruption. However, in reality the room for corruption lies in the not enough transparent annual State Budget Laws, whereas totally "tied hands" of an executive power hinders in fact

execute the functions properly. Moreover, considering that Ukraine is a parliamentary-presidential republic, the Prime-Minister as well as all other ministers are appointed by the majority, i.e. ruling coalition, which should be responsible for the entire policy of the government. So, electing the prime-minister and then control every second step of the person seems to be not logical, but rather bureaucratic.

Moving from general to specific, local taxation is the main area for financing local economic development policies. However, it would be useful not only to introduce essential changes, but also prove that local taxes play a significant role for LED. First argument in support of local taxation is that it can enlarge autonomy of local governments that is guaranteed by law. According to the Law on Local Self-Governments, municipalities, i.e. local governments are independent financial institutions that are to decide autonomously on their annual budgets and particularly revenues and expenditures. (Law on Local Self-Government) Nonetheless, it is true only to certain extent in Ukrainian conditions considering abundance of delegated responsibilities from the central government. Concluding from stated above, municipalities should obtain real independence in decision making that is given them by the law. The financial autonomy of local governments can be achieved only by significant increasing in own revenues that is in another words are local taxes, fees, and other charges.

Going further, predictability of a budget depends heavily on the percent of own revenues in the budget. Predictability of a budget is another vital criterion that was not mentioned above. Sustainability was used instead. Nevertheless, ability to predict a budget, i.e. revenues and expenditures for the next year, or several following years is an important indicator of city development. In the situation when local budgets rely mostly on central authority there is space neither for independent decision, nor for predictability. The situation worsens when central authority is politically not stable. Municipalities are happy with whatever is sent from the center. No long-going planning, investment programs or creditworthiness on a local level can be expected. Thus expanding the area of own revenues and liberalization of tax rates ceilings policy will grant municipalities with better understanding and

predictability as for their future. Eventually it should lead to the desire to invest into local economic development programs.

Obviously, any arguments cannot persuade the biggest adherents of centralization. The issue of local taxation is very questionable and splits financial and economics related specialists into polar camps, i.e. for and against liberalization of tax policies for local governments. Anyhow, it can be hardly questioned that freedom given to municipalities regarding taxation is appeared to be an additional opportunity for local governments. Whether it would be used rationally or misused is another matter. One of the ways to use local taxes as a financial tool for financing local economic development programs is to use taxation as incentives for foreign investments. There are two main kinds of incentives: fiscal and financial. Fiscal incentives include full or partial holidays from tax, tax deductions and credits, and tax exemptions (e.g. from import duties). Financial incentives can be in the form of cash grants from the public authorities or subsidies in form of free locations, utilities, infrastructure benefits etc.(Fergus 2007) Briefly tax incentives and their description were summarized in the article by Fergus Cass and borrowed for this research as an Appendix 1.

One of the main modifications that is made by this research is to transform a property tax that is to be a purely municipal. As it was described in the second chapter, Ukrainian tax system has land tax that is currently considered as own tax with certain limitations. First main limitation is its partiality that goes to the local budgets, i.e. only part of the gathered revenues are allowed for municipal spending. The rest goes to the central budget. Only capital city Kyiv and another city with subordination directly to the central government, Sevastopol, receive a substantial part of the tax. Thus radical changes in property tax system are needed.

First of all, what is valued property tax from the point of author's view. It is a kind of tax that is levied for any real estate property as well as lands and is to be paid by both individuals and business. One

of the main features of the tax is its value characteristic. The amount of tax depends greatly on value of a land or a property that is to correspond to current market prices. In this way, any economic changes as for inflation rates, country or a particular city development will simultaneously affect amount of the tax. Similarly, as value of a property becomes higher, the higher revenues are coming to a local budget. Thus municipalities become extremely motivated to amplify the value of their certain areas and lands. In order to raise the value cities are to improve infrastructure, i.e. transportation system, utilities provision, roads, conditions of living, surroundings, etc. Additionally, cities apparently become more stimulated for developing relevant recreation sites for the sake of attracting more people to certain areas. Automatically, small business will locate their firms in such places where inhabitants spend the most of their time. In this way, improving an area a city can count on more business activity their and obviously will receive higher revenues from the valued property tax. Once more, desire to obtain high property tax collections engages local governments to quick development of their cities.

For the purpose of showing that the property taxed can be used as an effective tool for financing local economic development policies, it appears to be necessary to involve experience of other countries. Generally speaking, the tax is used in quite a number of countries, however, not all of them are good for our comparison. Eastern-European countries are might be the best option to use as an example because of their similarities in terms of development stages and economic history. Almost all European countries have some kind of property tax. As long as European Union does not provide any particular requirements regarding the tax, variations of the tax are quite visible. Differences are hidden mainly in approaches to tax base, rates, and dissimilarities of what is property or real estate in different countries.

This research describes the experience of Slovenia as it is considered as the most appropriate and feasible for implementation in Ukrainian. The property tax in Slovenia in the way how it functions at the moment was introduced in 2006, and it was based on pervious real property tax which was modified in

order to achieve more fairness, transparency and rationality of the tax use. Underneath are listed the main “principles of the new real property tax system:

- 1) Regardless of ownership, all real property shall be taxes.
- 2) In principle, taxable persons shall be the owners of real property.
- 3) The revenue from this source shall remain with municipalities.
- 4) Tax rates shall be such as not to change significantly the existing tax burden on a real property item – this notwithstanding, municipalities’ revenue from this source shall increase moderately, thus reducing the necessity for transfers from the state budget.
- 5) The method for tax base (i.e. market value) determination shall be uniform.” (Zibik and Mitrovic, 7)

Now one more significant feature of the Slovenian property tax is his total belonging to local government’s budget. The same proposed by our research for Ukrainian case. Even though there are abundance of innovative things that are to be introduced along with tax implementation, but if the tax would not be considered as local all reforms will have a high chance to fail. Talking again about Slovenia, it is still important to remark that a small portion of the tax revenues are transferred to the central authorities in order to finance “the maintenance of common databases or registers of real property, and to cover the costs of the Real Property Mass Appraisal Service.” (Zibik and Mitrovic, 7)

Furthermore, taxable objects, tax base and tax rates are important characteristics to review. The same as it was recommended for Ukrainian case, both buildings and land that can be sold or purchases. However, in Slovenia case “land with objects that are not buildings have been exempted from tax” (Zibik and Mitrovic, 7) Type of ownership does not play any role. Thus any real property that belongs to individual person or an institution with (state, private, municipal) ownership is to be taxed. The base of the tax is market value or real property according to the appraisal system. The main idea is to assess the

market value of a property based on economic role of it. Only in this way it has a chance to improve real property administration. All these main features of the property tax play an important role in its introduction and should be taken into account in the process of its thorough design. Meanwhile, the regulations as for the tax rates are a bit confused, for Ukrainian implementation a universal tax rate is strongly advised. First of all, this will equal all Ukrainian regions that comply with the principle of fairness and transparency. Moreover, simplicity is important besides transparency also for reduction of costs for tax management.

In addition to basic fundamentals that should be put in the design of the property tax, some accompanying tasks should be made. Even though the tax rate was advised to be universal, some differences must be included. It is recommended that the principle of universality has to apply to geography of the tax, i.e. the tax rates or ceilings are to be nationwide. Nonetheless, for compliance with fairness principle property that is the base for the property tax should be divided into several zones and different tax rates are to be used. According to Slovenian experience all real property was split into several groups: agricultural real property, forest land, apartments, individual houses, garages, commercial real property such as offices, commercial real property such as retail, industrial real property, and undeveloped building land. (Zibik and Mitrovic, 13-14). Similar division can be made in Ukrainian property tax system too.

Second task on the way to introduce the new valued property tax is developing appraisal system. Slovenian the Real Mass Appraisal Act provides “appraisal models for the different groups of real property of the same type, classification of real property based on land and buildings cadastre, in accordance with the definition of valuation object, database on real property values, and a database on contractual prices and rental by type of transactions.” (Zibik and Mitrovic, 11) So first of all a data base of real property including market values should be created. Additionally, the data base should be dynamic. This means that changes in economic development of the country, inflation rates the market value has to

be revised too. This revision (value indexation) can be done on year to year basis or once per several years. Obviously, as frequently the indexation is made more accurate market prices appear to be.

Tax exemptions is one more vital issue that should be considered in the development of the tax. Socialistic past of Ukraine and permanent election process that is currently going force central government as well as political parties that are in the Parliament to debate all the time about various exemptions and reliefs in any field of people life. Similarly, it should be expected that the property tax regulations will be amended with abundance of subsidies. Taking into account that this tax should be devoted to local budgets the discussion over tax exemptions granted by the state powers can be even tougher. Thus this issue is to be approached only from rational side, but not from political. Again, applying to Slovenian case it can be seen that there are some exemptions that have economical reasonability. To remind, all real property that belong not only to business entities, but also to the state institutions as well as non-governmental organizations should be taxed. There are three categories in Slovenia that fit to the exemption list. First is “public assets, public areas, aquatic areas, and protection forests, i.e. real property the disposal of which is restricted, or which is subject to other levies, such as concessions” (Zibik and Mitrovic, 8) should be granted with property tax exemptions. Similarly, according to international legislation, foreign, international, and diplomatic entities on a reciprocal basis are to be exempted too. Finally, the third group for tax reliefs include “cultural monuments, real property used for religious rites, for humanitarian, educational or medical activities” with important remark “is not used as a residence or for the performance of a profitable activity” (Zibik and Mitrovic, 8) Additionally to Slovenian example, considering Ukrainian tradition to grant social benefits to physically disabled, elderly, and other socially unprotected population, the exemptions can be designed also for them.

Afterwards, the fact that the tax can stimulate municipalities for growing faster has a direct relation to accountability principle. According to the principle, government is to be responsive and accountable towards those who pay taxes and make available the functioning of the government. In this

case, local governments are to become much more accountable and take into account opinions of their residents or business institution located in a city more seriously. The reason is the following, if a municipality would neglect public opinions and requests individuals as well as business will not be involved in the city life as much as they can. Thus the value of certain areas will decrease. As a consequence, the tax revenues will fall as well.

Another issue that can improve accountability of local governments towards their population is freedom of setting tax rates for local taxes. Naturally, some cities are developed better than others. The reason is not only poor management, but also natural conditions, better trade conditions, etc. Thus there are should be tools to equal such kind of disparities. Ability to set rates for local taxes appears to be an opportunity for municipalities to attract business from other regions. As long as proposed valued property tax has local nature, the rates should be set also by municipalities. Nevertheless, in order to secure the tax system collection, to avoid possible corruption schemes there is to be a certain ceilings for the tax clearly fixed and monitored by the central government. In addition, it is highly recommended for the sake of avoiding corruption, central authorities may decide on exemptions for particular social groups of society for the whole country.

Finally, the matter of tax administration can be significantly improved and become one more tool for local development. Obviously the main focus of the chapter was devoted to the local taxation modifications. Nonetheless, tax collection and administration is a significant factor in improving financial management of a municipality. There are variety of methods and tactics on how to improve the administration system. To remind briefly, it was already clearly stated the tax administration is a responsibility of the State Tax Administration. All taxes including local are collected and then redistributed at the central level. As a consequence local authorities are not interested in increase tax collection percent. Another disadvantage regarding local taxes, which is totally ignored in Ukraine, is their high costs comparing to revenues. Thus the recommendation is to make local governments be responsible

for collection of taxes which compose the main bulk of a local budget. Although much clearer regulation is needed, however, some clarifications are appeared to be already obvious. Thus in case of the introduction of tax reform proposed above, local taxes including valued property tax will eventually bring the main percent of local revenues. However, because shares of personal income tax will still be a significant contribution to municipalities in terms of their income this tax is to be collected by local tax administrations as well. Thus State Tax Administration system should be decentralized in line with fiscal system.

Furthermore, the reform also ought to help to define the rationality of a local tax. Giving power to administer local taxes to municipalities will stimulate local governments to count whether a tax is worth keeping or it should be either eliminated or modified because of high costs to manage. However, it is important to take into account that in case a tax has too high costs the solution is not always to abolish it. Another option is to try to simplify it as much as possible. Firstly, by their nature, local taxes are to be simple and thus less costly. Exceedingly complicated systems of tax administration lead to overlapping and contradictions in performing the functions of employees of the tax administration. Coping with rather difficult matter as taxes requires high skilled labor forces that are to be constantly retrained. To sum up, to reduce complexity of the tax system as well as increase professional level of tax authority workers are two main factors that will significantly improve the situation with taxes.

Principle of simplicity which will lead to higher transparency can be also applied on the central level. Abundance of formulas that are needed to calculate the tax shares are incredibly complicated. Moreover, the components of formulas are difficulty enough too. According to World Bank analysis “The structure of the formula in 2001 and the modified version after the implementation of the Budget Code in 2002 were already burdened by too many factors and sub-formulas. Since then, there has been further backsliding through the addition and changing of factors and coefficients to make the formula the “black box” it is today. The equalization formula encompasses around 70 main sub-formulas and literally

hundreds of factors and adjustment coefficients (for estimating both expenditure needs and revenue capacity). This occurs for each of the equalization formulas: for oblasts, for rayons, and for the formula from rayons to villages and settlements. All of these formulas are similar; and the differences lie in some of the factors.” [Word Bank document, 33] Even if all formulas would be simplified there is still another hinder for appropriate transfer system which is oblast level. Oblast is the second tier of the system and it is oblast’s government who receives first the equalization funds and only then transfers are distributed among the cities (the first tier). Thus the role of second tier should be reduced in order to complete the functions of state transfers and other equalization grants in more effective way.

Simplicity, transparency, accountability, predictability are leading principles that must help significantly for local economic development. If all tax collections and administrations, regulations, and state transfers will be simpler it would be much easier to trace and predict expected revenues and expenditures. Eventually, implementation of all mentioned innovations will increase transparency of budget and tax systems of Ukraine which is to be one of the main goals for executing local development. To add more, a local government that is able to predict their budget for several years can easily plan strategically and implement their development plans with less risky.

Although decentralization of tax administration system will amplify the accountability level of local governments to the community, one remark is to be made. Decentralization among some other disadvantages has corruption increase potential. So striving not to prosper bribery and illegal avoidance of tax payments comprehensible mechanisms of central control over local tax administrations is to remain.

Finalizing the chapter it seems to be useful to summarize recommendations listed above. All recommendations can be divided into four main parts. In the first part suggestions regarding general budget changes were developed. One of the most important budget changes that are to be made is separation of operational and capital budgets for sustainability and transparency reasons. Also existed top-

down approach of budget compilation should be modified with some remarks. In other words in case central budget is not approved by the end of fiscal year municipalities should have a right to approve their own budgets for the same sustainability reason. Second part of suggestions encompasses local taxation modifications. The most important proposed change regarding local taxation is providing more independence to local governments. It can be done in several ways: firstly, by allowing more discretion on local taxes, broadening list of local taxes. However, all local taxes should be simplified as more as possible in terms of tax basis, rates, and administration. Tax autonomy is needed for municipalities for the sake of their sustainable growth. One of the possible new local taxes that can improve significantly financing of local economic development policies that was suggested here is valued property tax. Briefly the tax should be based on several principles. Tax should be purely local, universal for the whole country, however, with differences depending on created zone division. Additionally, the tax rate should be based on updated market value of real property. Moreover, the value should be revised yearly according to economic indicators of the country. The forth part of suggestions include tax administration changes. Basically, improving of professional level of the State Tax Administration employees is needed. Additionally implementing as more simplifications into tax administration formulas as possible will be useful. And another important recommendation is to decentralize tax management system too. Delegating responsibilities over tax collection to local governments will encourage municipalities for better control over taxpayers and will help to uncover irrational taxes that require more costs for their administration then bring revenues.

## Conclusion

The last chapter is devoted to conclusions of the research and aims to summarize briefly the main outputs of the thesis. Executed work in the research allowed to accomplish the goal and tasks set before and solved problems put in front of the research. The problem that has to be solved was related to the limited sources currently available in Ukraine for municipalities on the way to implementation of sustainable local economic development policies and strategies. Consequently, the core question that was to be answered in the research was what innovations or modifications should be implemented on central and municipal levels for improving the situation with financing local economic development policies. In order to answer the question following tasks were elaborated: analyzing current Ukrainian tax system and based upon the results designing policy recommendations that are feasible and realistic for implementation in Ukraine.

According to the tasks the paper was divided into two chapters. First one was devoted to the description of Current Ukraine Tax Policy System Analysis. The second one aimed to draw Policy Recommendations for Financing Local Economic Development Policies in Ukraine. In addition brief introduction opened the discussion outlining the purpose, tasks as well as took a look at available literature in the topic.

Main outputs of the research are also separated into two parts. The main conclusions of current situation analysis go first and then summarized suggested policies are following. Based on the argumentation that the market of loans and bond issuing is not well developed in Ukraine tax policies were considered and selected as the most feasible instrument for financing local development policies. Moreover, even though municipal loans do exist in Ukrainian practice and Ukrainian loan history has already faced both failures and good practices, this financial policy is more applicable for bigger cities at the moment. Moreover, the expenditure side of borrowed funds have many difficulties partially because of

their unprofessional management. Thus modifications and innovations in tax system was a subject to explore.

Another conclusion, general though, is that forward and rapid steps towards decentralization of Ukrainian financial system should be made. In terms of hinders for local economic development highly centralized tax system leads to incredibly overdependent municipalities on central authorities. Consequently, it discourages local governments and even make it unavailable to forecast their revenues for the following year. Predictability is one of the most vital characteristics for establishing sustainable growth. In the situation when city's authorities almost cannot plan their budgets even for the next year it is appeared to be impossible to develop and comply with any strategic development. Furthermore, tax collection and management is centralized in hands of the State Tax Administration that is totally responsible for this function. This fact does simplify responsibilities of municipalities, but at the same time, it discourages them to contribute to as much percent of planned paid tax as possible.

Generally outlined problems above can be effectively solved by implementation of the following suggested policies. Obvious main recommendation of the research is to provide more autonomy to local governments in terms of financial planning and management. To go in deep, own revenues in form of local taxes should be seriously expended. It should be accomplished into several ways. Municipalities are to have rights to set and to change tax rates for local taxes. However, central authorities should remain their control over establishing the tax rate ceilings for the entire country. Introduction of new more appropriate taxes and abolishment of irrational should be done.

The system of some local taxes is frequently too complicated thus it does not bring as much effect as it was planned. Thus rates, basis, and kinds of the taxes should be revised and reconsidered from the point of their rationality, administration costs, fairness, and revenue they convey to the budget. Increase of local tax role for municipalities will allow to start performing the functions of a tax which is

not used at the moment. To explain, the idea of a tax is not only to get as much income as possible, but also regulate, limit some activities. For example, “location of gambling objects fee” that was proposed by World Bank (World Bank document, 28) aims not as much as to earn money, but instead to regulate gambling business in a city to some extent. Another example relates to modification of local taxes. Exited resort fee should be replaced with tourist fee. The resort fee is taken from the owners of hotels, hostels, private apartments that host tourists based upon the amount of people they hosted. Thus it motivates owners to lessen officially the amount of coming tourists to their entity. Instead, the proposed tourist fee should be levied on a tourist and included into the price of their accommodation. Certainly, it will not solve the entire problem because of abundance of not registered private apartment and hotels, but at least it will guarantee the tax collection from officially registered hotels. The fee can be also included in museums, tourist tours, and excursions tickets.

Valued property tax as a local tax is highly advised to introduce. The main feature of the tax is market based value of real property. This base will encourage local governments to improve their city’s zones for increasing maker value of the property and land there and consequently increase local revenues. The tax should be also collected and managed on a local level, but with certain control and subordination to the State Tax Administration in terms of appraisal system. Delegation of responsibilities and rights by central tax administration system to local level will also solve the problem of irrational taxes that demands more expenditures on their administration than they bring income.

In addition, not only changes on local level should be made, but also general modifications in budget system should be introduced. Clear separation of operational and capital budgets should be enforced by the central government for both state budget and for local ones. Furthermore, top-down approach of budgets approval should be modified in order to increase predictability for local governments in terms of their.

Finally, although the research tried to provide as detailed policy recommendations as possible, the scope of the paper did not allow to draw more particular steps for each of recommended policy implementation. Thus further research papers can be focused on each of policies that were recommended here in more details. For instance, the issue of local taxation and particularly modifications with resort fee into tourist fee can be thoroughly analyzed and developed in a separate paper. Also concrete steps can be drawn what should be changed in Ukrainian legislation to introduce efficiently valued property tax. Thus the thesis has set the framework where central government and local municipalities should work for financing local economic development policies.

## Appendix 1. Data on tax and incentives

Company taxation	The top rate of tax applied to the taxable profit of rate % companies.
Tax holidays	Full or partial reduction of profit tax for a defined period.
Tax credits	Reductions in taxable profit, by: amounts related to total investment; accelerated depreciation of fixed assets; employment costs; research and development costs; or other factors.
Grants Cash	grants, based, for example, on number of new jobs created or to reimburse training costs.
Subsidized locations	Subsidized access to premises or sites, e.g. in industrial parks; assistance with cost of infrastructure.
Free trade zones	Areas in which there is a special regime for import duties, sales taxes and profit taxes and which may also be exempt from other rules and requirements; generally related to production for export.

Source: Cass, Fergus. "Attracting FDI to transition countries: the use of incentives and promotion agencies." *Transnational Corporations*, Vol. 16, No. 2 (August 2007)

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