



SUBVENTION FOR SOCIAL AND ECONOMIC DEVELOPMENT: HOW TO PREVENT POLITICALLY INFLUENCED BUDGET FUNDS DISTRIBUTION?

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1 General Information

Politicians who are in power are financing the regions headed by their fellow party member at the other regions' expense.

Average subventions for social and economic development per capita in the regions where the Parliament coalition party controlled the region's council had been almost twice larger than in the regions where the ruling party held no sway.

Total subventions volume for the social and economic development in the period from 2007 to 2017 amounted to 28.4 million UAH. We have created an economic model indicating that the subventions are politically influenced. If, at the moment of approval of a decision on the subventions for the social and economic development distribution, the Parliament coalition party controlled the regional council, it led to increase of the subvention volumes allocated to such region by 31.69 UAH (hereinafter the amounts are stated in 2017 hryvnias¹) per capita (for reference: average annual subvention is 65.48 UAH per capita). In addition, during the years of Parliamentary or local elections, there were 57.73 UAH more funds per capita allocated than during the years with no elections. In general, during the period from 2007 to 2017, 19.1 billion UAH — or 67.17% out of total funds allocated for subventions — had been distributed based on political reasons instead of economic ones. Such politically influenced regional subventions distribution became a reality owing to the fact that, since 2006, such distribution has not been pegged to the population size.

Allocation of such funds to the State Regional Development Fund could be an alternative to subventions for social and economic development. De jure, the fund has almost the same purpose (infrastructure development, environment protection measures, facilities construction and modernization); there are strict distribution rules in force: 80% — pro rata to the population size and 20% — to the regions with low gross regional product. Such alternative is far from ideal, as the fund's purposes include creation of industrial parks; the experts have already stated their ineffectiveness in Ukraine². Even with such shortcomings, however, the State Regional Development Fund is the best alternative to the subventions for social and economic development, as the regional funds distribution would follow the strict rules.

The State Road Agency of Ukraine (Ukravtodor) funds has been distributed in the same political vein. As per our calculations, if the Parliament coalition party controls the region's council, the funds allocated for the repairs per 1000 km of roads in the region are being increased by 36.5 million UAH. For reference: Average annual funds allocated for the construction and repair works done by the Ukravtodor amounted to 84.7 million UAH per 1000 km of roads. In total, during the ten years, 32.5 million UAH — or 25.95% of the total amount of funds allocated for the repairs and construction — had been allocated for such purposes as per political bias. Should we distribute the funds pro rata to the road length, such funds might be insufficient for performing major repairs. Accordingly, there is a need for middle-term targeted financing — the Road Fund money resources should be allocated for the infrastructure that would most efficiently stimulate economic growth. If we establish a plan for regional financing of the road construction and repair for a few years in advance, it would be more effective than the situational funds allocation that depends on who is the ruling party now.

¹ Since the value of the allocated subventions' funds in hryvnias varied each year, we have unified the calculations to the 2017-year hryvnias.

² <https://voxukraine.org/longreads/industrial-park/article-ua.html> Editorial Board VoxUkraine. "Industrial parks of Ukraine": Walking into the same traps again?



Accordingly, our proposals on elimination of the political factors influencing the budgetary transfers among the regions are as follows:

- Subvention for social and economic development should be abolished due to its economic inefficiency.
- The funds allocated for this subvention should be directed to the State Regional Development Fund.
- The government should introduce the middle term planning for the Road Fund money resources allocation and prioritize it according to the regions' needs depending on the road infrastructure conditions instead of the roads length or political accords.

2 Political constituent in the allocation of funds for regional development in Ukraine

2.1 Subvention for social and economic development

Since 2005, the subvention for social and economic development has been approved as a budgetary transfer to the local budgets level.³ During the period from 2007 to 2017, total subventions volume amounted to 28.4 million UAH.

Among its priorities was the infrastructure build-up, facilities construction and modernization, repair works and other accident prevention measures. The same targets has been formally in place until now, notwithstanding the changes in a regulatory framework. Let us look into how the subvention has been de jure distributed in different years (Table 1).

Table 1. Regulatory provisions for allocation of the subvention for social and economic development

Year	Adopting entity	Decision principle for the subvention distribution among the regions
2005	Cabinet of Ministers	Pro rata to population size
2006–2013	Supreme Council (Parliament)	Discretely
2014–2017	Cabinet of Ministers	Discretely

Sources: The Supreme Council website

2005 — the first year the subvention distribution was performed pro rata to the population size in a region. In particular, the Law on the State Budget 2005⁴ stated: “The distribution of funds of the mentioned subventions shall be performed in accordance with the proposals from the peoples’ deputies of Ukraine agreed upon with relevant regional authorities and local government administrations taking into account the requirements for the proportional funds allocation among the consolidated budgets of the Autonomous Republic of Crimea, regions, cities of Kyiv and Sevastopol pro rata to the population size”.

³ <http://zakon5.rada.gov.ua/laws/show/644-2005-%D0%BE> Policy on allocation of the subvention for social and economic development from the State Budget of Ukraine to the local budgets (...)

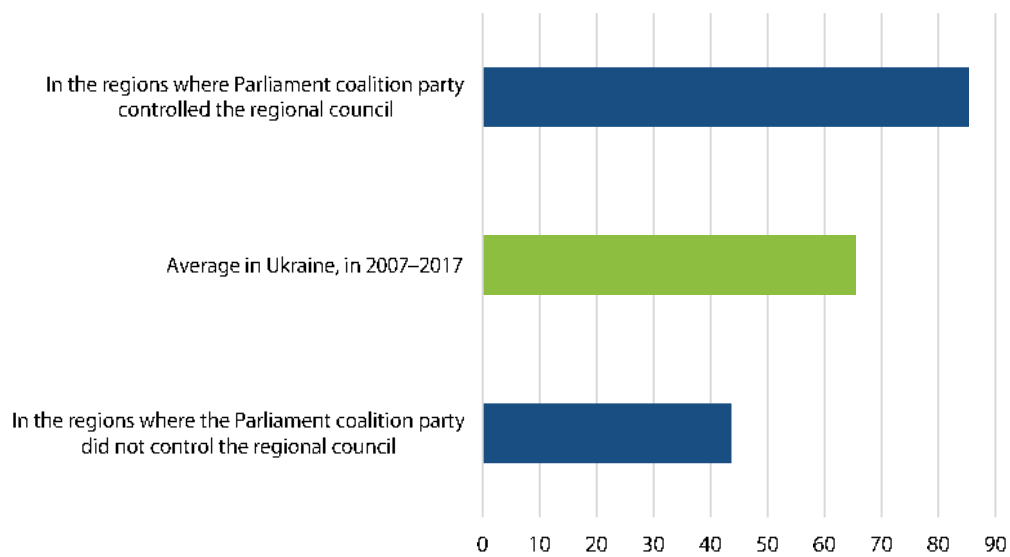
⁴ <http://zakon3.rada.gov.ua/laws/show/2285-15/ed20041223/page2> The Law of Ukraine “On the State Budget of Ukraine for 2005”



Since 2006, the allocation has been made selectively.⁵ From 2012, though, when the majority system for the Supreme Council elections was restored, the media published the information that the majority district deputies had started redistributing subventions to their districts.⁶ Though officially, from then on, the Supreme Council had been approving the subvention only in 2012 and 2013, and since 2014, the mandate to perform the subvention redistribution had returned to the Cabinet of Ministers, the allocation has been performed taking into account the proposals from the people's deputies.⁷

Such funds allocation method results in larger subvention volumes being sent to the regions where the local authorities are close to the ruling coalition. Accordingly, rather often, the regions controlled by the ruling party obtain more funds while the opposing regions receive less support from the center. As per empirical evidence, the same issue is relevant for India⁸, Brazil⁹, and even USA¹⁰.

Fig. 1. Average subvention per capita in 2017 hryvnias in different political circumstances



Source: The Supreme Council website, the Central Election Commission website

⁵ <http://zakon5.rada.gov.ua/laws/show/3235-15> The Law of Ukraine “On the State Budget of Ukraine for 2006”

⁶ <http://news.liga.net/ua/articles/politics/14786640-rozpodil-subvents-yi-deputati-mazhoritarniki.htm> Zakhar Kolisnichenko «Subventions allocation and the majority districts deputies»

⁷ <http://zakon5.rada.gov.ua/laws/show/106-2012-%D0%BF> Procedure and terms for providing the subvention from the state budget to the local budgets for conducting measures aimed at social and economic development of specific territories

⁸ https://www.giga-hamburg.de/en/system/files/publications/wp298_sharma.pdf, Chanchal Kumar Sharma (2017), “A Situational Theory of Pork-Barrel Politics: The Shifting Logic of Discretionary Allocations in India”

⁹ <http://www.nber.org/papers/w11273.pdf>, Lee J. Alston, Bernardo Mueller (2005), “Pork for policy: executive and legislative exchange in Brazil”

¹⁰ http://web.holycross.edu/RePEc/hcx/HC0806-Boyle-Matheson_Earmarks.pdf, Melissa A. Boyle, Victor A. Matheson (2008), “Determinants of the Distribution of Congressional Earmarks Across States”



Taking into account the experience of the said countries, we can assume that Ukraine is not an exception, and in our country, the politics influences the allocation of subvention for social and economic development as well. Even the superficial analysis of the information in the media demonstrates that such political influences are in place. The most notable example — vote for the 2014 budget by the people's deputy Oles Doniy in exchange for additional funds allocated to his district.¹¹ There are much more recent cases though: extremely asymmetrical subvention distribution among the districts in L'viv region that depends on the people's deputy loyalty to the authorities.¹²

If we look at the average numbers (Figure 1), we can see that average subvention per capita in the regions where the Parliament coalition party controlled the regional council exceeded by 41.65 the average subvention per capita in the regions where the ruling party held no sway.

Political effect can be traced on the level of the particular regions as well. For instance, when the Party of Regions was in power, the Donetsk region received major part of the subvention in comparison to the periods when the parties with little support in the East were in power. Even with adjustment for the military operations in Donbass area, which had started in 2014, the portion of the subventions during the period from 2010 to 2013 significantly differs from the years when the Party of Regions was not in power. Similar dynamics can be traced in Odessa and Lugansk regions where the Party of Regions enjoyed popularity (followed by the Opposition Block party). At the same time, during the periods when the parties usually supported in the Western parts of Ukraine had been controlling the Parliament, the L'viv region had been receiving larger portion of subventions as against the periods when the Party of Regions had been in power. The same dynamics can be traced in the Vinnitsa and Sumy regions, for example (Figure 2).

¹¹ <https://www.pravda.com.ua/news/2014/01/16/7009723/> Doniy voted for the budget in exchange for 30 million allocated to his district

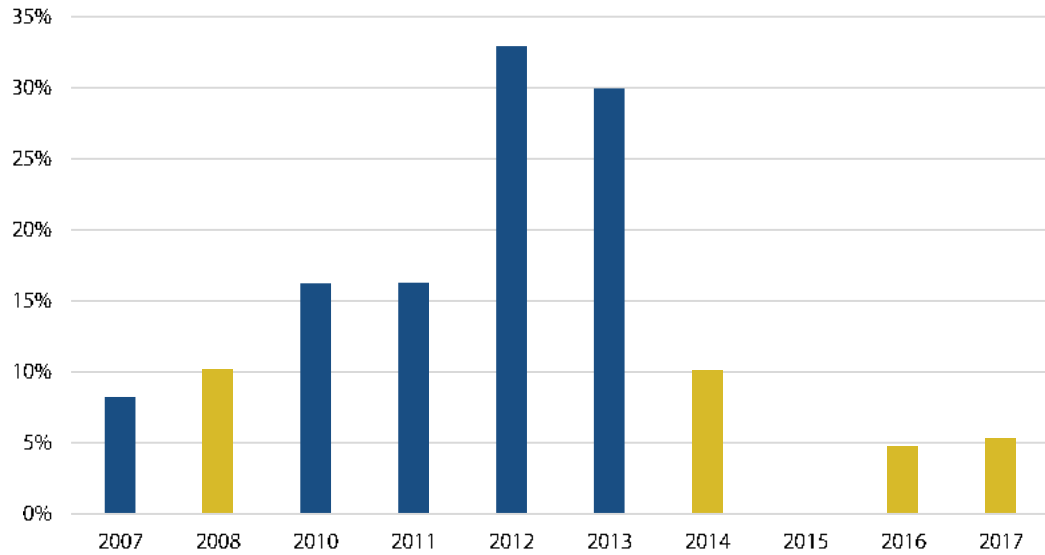
¹²

https://zik.ua/news/2017/10/27/poky_parasyuk_mahaie_nogamy_dubnevychi_tyagnut_derzhavni_groschi_na_svoi_1194123 While Parasyuk swings his legs, Dubneviches draw money to their districts

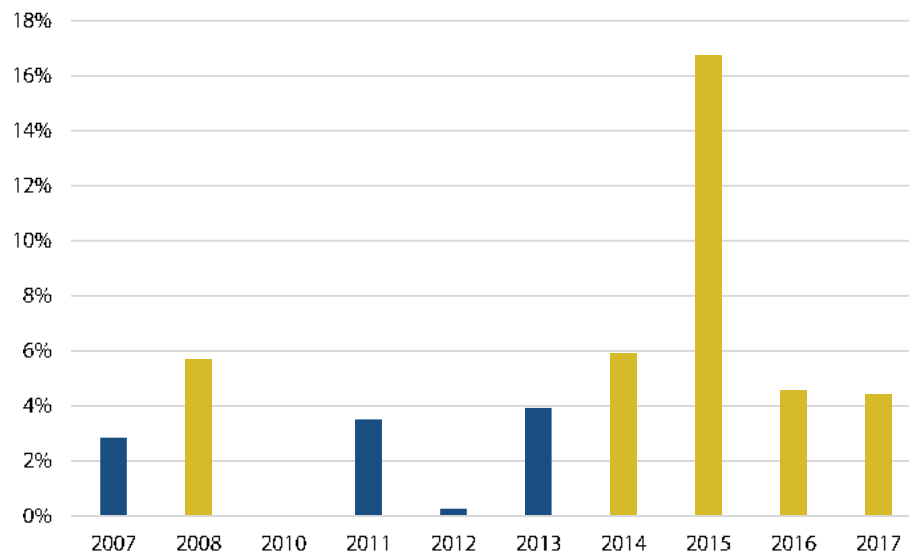


Fig. 2. Percentage of the total subvention volume allocated to the regions supporting different political parties in different years*

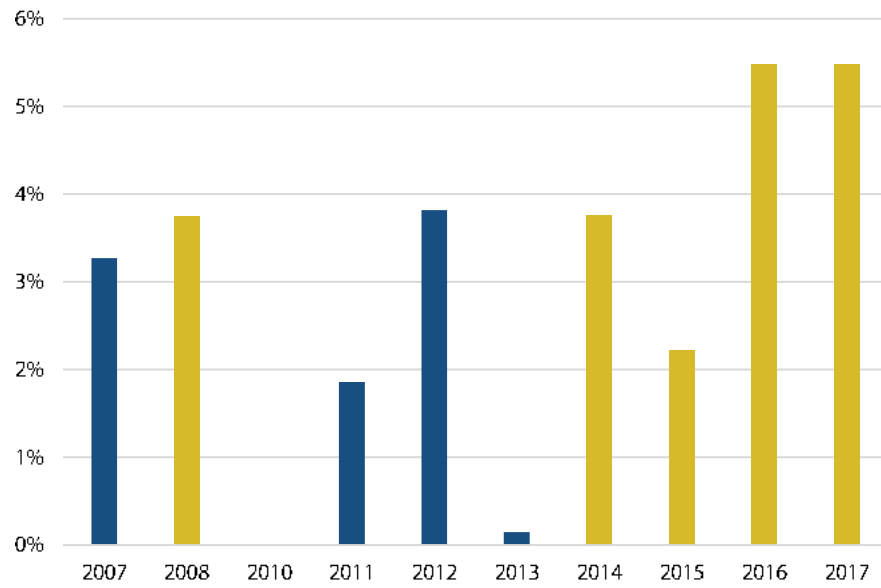
Percentage of the total subvention volume allocated to the Donetsk region in different years



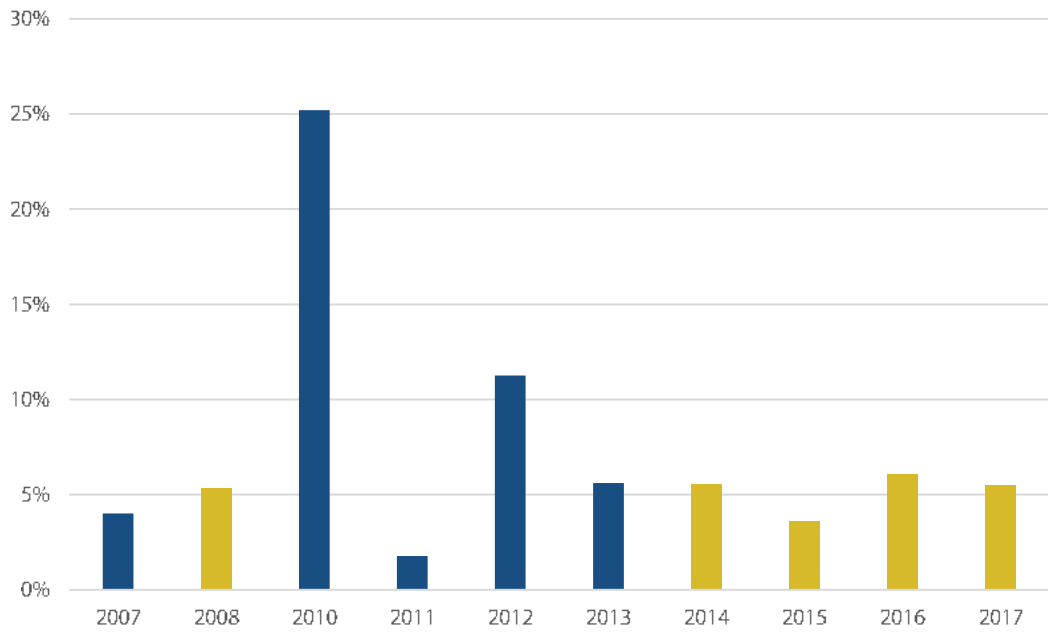
Percentage of the total subvention volume received by the L'viv region in different years



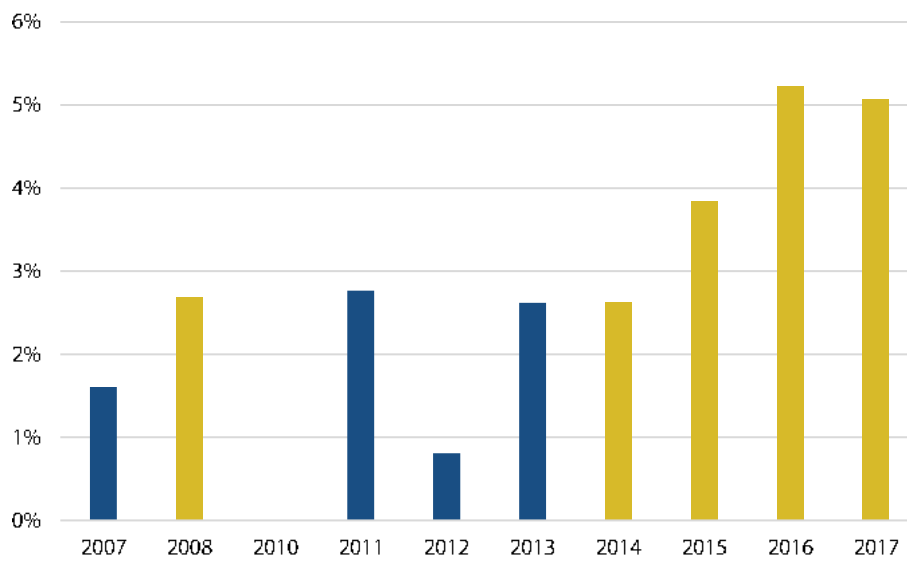
Percentage of the total subvention volume received by the Vinnitsa region in different years



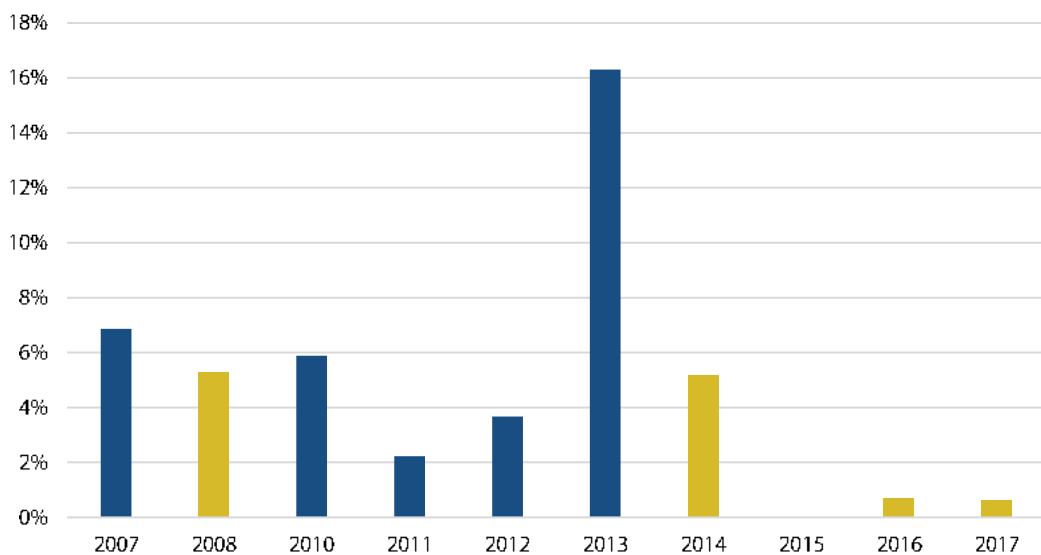
Percentage of the total subvention volume received by the Odessa region in different years



Percentage of the total subvention volume received by the Sumy region in different years



Percentage of the total subvention volume received by the Luhansk region in different years



Sources: The Supreme Council website

*The blue color indicates the years during which the Parliament majority had been controlled by the Party of Regions; the yellow color — the years during which the Parliament majority had been controlled by the parties supported in the Western Ukraine.

Certainly, not in all of the regions the effect is obviously noticeable, that is why we have performed a deeper regression analysis. It is discussed below.

2.2 Econometric modelling of the subvention distribution

We have studied the data in more detail (262 observations in the regions of Ukraine in the period from 2007 to 2017). As it turned out, if you calculate subventions per capita, certain main influence factors can be traced (Table 2, more thoroughly in Annex 1).



Table 2. Main factors influencing the subvention for social and economic development volumes (per capita calculation)

Factor	Ratio	Mean difference
Region council is controlled by the Parliament coalition party at the moment of the subvention approval decision	31.685**	12.875
The year of Parliamentary or local elections	52.73**	25.405
Region's area as a percentage of the total area of Ukraine ¹³	-8,389.4***	2,892.6
Unemployment in the previous year	-16.621***	5.7051

Sources: The Supreme Council website, the Central Election Commission website, the State Statistics Service of Ukraine, CES calculations

** Significant effect on 95% confidence interval

*** Significant effect on 99% confidence interval

If the Parliament coalition party controls the region's council as of the moment of the approval of the decision on distribution of the subvention for social and economic development, it increases the amount of the subvention to such region by 31.69 UAH per capita. During the years of Parliamentary or local elections, there had been 52.73 UAH more funds per capita allocated than during the years with no elections. It is a rather significant increase taking into consideration that the average subvention for social and economic development per capita amounts to 65.48 UAH.

Among the other economic and socio-demographic factors influencing the amount of subvention, the unemployment rate and the region's area as a percentage of the total area of Ukraine have a negative effect (the less unemployment and the larger the percentage of the total area, the more subvention funds are allocated). It is interesting that the main indicator of the regions' economic development — gross regional domestic product — does not influence the subventions volume. Simultaneously, the negative effect of the unemployment indirectly confirms that the subventions are distributed as per political factors and not economic ones (logic suggests that the regions with higher unemployment rates should receive more subventions).

We have tried to examine if the situation has changed since 2014, after the decentralization reform was announced. We have found no significant changes relating to political influence in our calculations.

We have multiplied the political effect of elections and concurrence of the local controlling party with central coalition parties by the population size in the regions where such effects were present. Then, we have calculated the obtained effects value. Altogether, during 11 years, 19.1 billion UAH of the subvention for social and economic development had been distributed as per political influences instead of socio-economic factors. In total, during 11 years, there had been 28.4 billion UAH allocated for social and economic development. This means that around 67% (i.e. more than two thirds) of the subvention funds are being distributed according to the political factors.

¹³For Donetsk and Luhansk region, only the territories controlled by Ukraine were taken into calculation



2.3 Construction and repair works on the Ukrainian roads

Among the other budget transfers which have risks of the politically influenced distribution one can single out the conduction of the construction and repair works on the roads of Ukraine in the period from 2007 to 2017. As per the Distribution procedure in 2003,¹⁴ there was no formula for the distribution of the funds allocated for the road construction and repair works. In 2017,¹⁵ the funds for the road construction and repairs were transferred from the general fund to the special one; under the established procedure, 35% of the Road Fund should be distributed as per the formula that includes the index of the roads length in the region. It is the portion of the fund that is allocated to the financing of the country roads. What is happening with the financing for the state roads, though? These are still financed on a discretionary basis.

We have decided to analyze if there is a political influence on the allocation of the funds for the road infrastructure development¹⁶, and have created the similar model to measure it (Annex 2). As per our calculations, if the Parliament coalition party controls the region's council, the funds allocated for the repairs per 1000 km of roads in the region are being increased by 36.5 million UAH annually. For reference: Average annual funds allocated for the repairs and construction works performed by the Ukravtodor amount to 84.7 million UAH per 1000 km of roads.

If we calculate the total volume of funds allocated during the 10 years period for the road construction and repairs as per the political influence, we get the amount of 32.5 billion UAH. In terms of percentage, the politically distributed funds amount to 26% of the total amount of funds allocated for the road construction and repairs.

Table 3. Politically influenced distribution of the budget transfers during 2007–2017

	Volume of the construction and repair works performed on the motor roads¹⁷	Subvention for social and economic development
Overall politically influenced distribution	32.5 billion UAH	19 billion UAH
The ratio of politically distributed funds to the total amount of the funds	26%	67%

Sources: The Supreme Council website, the Central Election Commission website, the State Statistics Service of Ukraine, response to the request from the State Road Agency of Ukraine, CES calculations

¹⁴ <http://zakon3.rada.gov.ua/laws/show/1731-2003-%D0%BE> The procedure for the state budget funds allocation for financing the infrastructure development and maintenance of general use roads.

¹⁵ <http://zakon3.rada.gov.ua/laws/show/1085-2017-%D0%BE> Procedure for allocating funds to the State Road Fund.

¹⁶The volume of the construction and repair works performed by Ukravtodor (Source: State Road Agency of Ukraine)

¹⁷Data for the 2007–2016 period. The State Statistics Service of Ukraine data for the roads length are available up to 2016 inclusive only. We have analyzed 10 years of data.



3 Conclusions and recommendations

One can debate long on the subject of methods for reducing political influences in distribution of the subvention for social and economic development, yet there is already an alternative — the State Regional Development Fund. According to the Budget Code, “...the funds of the State Regional Development Fund shall be allocated for the execution of the investment programs and regional development projects (including the cooperation and voluntary association of territorial communities projects) aimed at the regional development, establishment of the industrial and innovation parks infrastructure that match the priorities stated in the State Regional Development Strategy and related regional development strategies”. That is, the State Regional Development Fund’s purpose is almost the same as the purpose of the subvention for social and economic development.

It should be noted that such an alternative is not an ideal solution. A number of economic experts and researchers had pointed out the shortcomings of the industrial parks¹⁸. Yet such fund has a number of advantages over the subvention:

- 80% of the fund is distributed pro rata to the population size, the remaining 20% are allocated to the regions with gross regional product per capita lesser than the 75% of the average value of this indicator in Ukraine. Such binding renders impossible the political influences on funds distribution among the different regions;
- the projects that receive the fund’s resources are determined by tender process.

There are certain reservations as to the latter. Competitive selection is far from ideal. According to experts¹⁹, the fact that at least half of the committee members have to be people’s deputies creates a threat of lobbyism related to certain projects within the region.

If we compare the State Regional Development Fund with the subvention for social and economic development, however, the former definitely looks more economically effective, even taking into account all of its shortcomings, as it stipulates the funds distribution among the regions by the fixed rules, not the politicians’ discretion.

The subvention for social and economic development is being distributed under the political influence; therefore, it is economically inefficient. The State Regional Development Fund is a good alternative to the subvention; the tender procedures require improvement, though: the influence of the people’s deputies on the funds distribution should be reduced.

The same goes for the funds for the road construction and repair. The politically influenced distribution of the funds for the road construction and repair is inefficient. Should we distribute the funds pro rata to the road length, however, such funds might be insufficient for performing major repairs. We can reduce effects of the politically influenced distribution of the funds for the road construction and repair, though, if instead of the pro rata principle the middle-term target budget planning would be used. If we establish a plan for regional financing of the road construction and repair for a few years in advance, it would be more effective than the situational funds allocation that depends on who is the ruling party now. The middle-term budget planning for the road repairs and construction should stipulate not the roads length principle or a political conjuncture, but the regional needs principle (taking into account the road conditions in various regions) based on the economic growth priorities.

¹⁸ <https://voxukraine.org/longreads/industrial-park/article-ua.html> Editorial Board VoxUkraine. “Industrial parks of Ukraine”: Walking into same traps again?

¹⁹ <https://www.prostir.ua/?news=na-scho-vytrachayutsya-koshty-derzhavnoho-fondu-rehionalnoho-rozvytku> Who are the beneficiaries of the State Regional Development Fund resources?

Accordingly, our proposals with respect to elimination of the political factors influencing the budgetary transfers among the regions are as follows:

- Subvention for social and economic development should be abolished due to its economic inefficiency.
- The funds previously allocated for this subvention should be directed to the State Regional Development Fund.
- The government should introduce the middle term planning for the Road Fund money resources allocation and prioritize it according to the regions' needs as per the road infrastructure conditions instead of the roads length or political accords.



Annex 1 Determination model for the factors influencing the per capita volumes of the subvention for social and economic development

We have created the model using the volumes of the subvention for social and economic development from the state budgets in the period from 2007 to 2017²⁰. We have designed the political variables based on the Central Election Commission's data on the Parliamentary and local election results.²¹ Since the website contains the information on the local election results starting from the 2006 (the decision on the distribution of the subvention in 2007 was taken in 2006), we have analyzed the subvention distribution starting from the Budget of 2007.

In addition, we have used such economic and socio-demographic variables as the average salary in the region, gross regional domestic product, region's area and population size, region's unemployment rate, and the GDP deflator from the State Statistics Service of Ukraine's data.²²

In addition, we have designed the binary variables taking into account the launch of the decentralization policy (after 2014) and the regions with military activities (Donetsk and Luhansk regions after 2014).

In total, the dataset includes 262 observations. As these are panel data, we have created a fixed effects model (Table 4).

Table 4. The factors influencing the per capita volumes of the subvention for social and economic development²³

Factor	Ratio	Mean difference
Region council is controlled by the Parliament coalition party at the moment of the subvention approval decision	31.685**	12.4
Average salary in the region during three months prior to approval of the decision on distribution of the subvention	0.017	0.013
Gross regional product for the previous year (per capita, UAH mln)	-536.06	357.48
Region's area as a percentage of the total area of Ukraine ²⁴	-8389.4***	2700.5
The year of Parliamentary or local elections	52.73**	21.539
In 2015 (when the decentralization policy came into force) and later, the region council is controlled by the Parliament coalition party at the moment of the subvention approval decision	-16.226	25.239

²⁰ rada.gov.ua

²¹ cvk.gov.ua

²² ukrstat.gov.ua

²³ The regional data have been sourced from the rada.gov.ua, ukrstat.gov.ua and cvk.gov.ua websites.

²⁴ For Donetsk and Luhansk region, only the territories controlled by Ukraine were taken into account



2015 or later	59.095	84.542
Unemployment in the previous year	-16.621***	5.7051
Donbass area, after the start of the military operations	-32.921	31.085
R²	0.12	

.....
Sources: The Supreme Council website, the Central Election Commission website, the State Statistics Service of Ukraine, CES calculations

** Significant effect on 95% confidence interval

*** Significant effect on 99% confidence interval



Annex 2 Determination model for the factors influencing the volume of the construction and repair works performed on the general use roads (UAH thous. per 1000 km of roads)

Creating a model explaining which factors influence the volume of the construction and repair works performed on the general use roads, we have used the same variables as with modeling the subvention for social and economic development (Annex 1). Dependent variable is expressed in thousands of hryvnias per thousand kilometers of roads. Dependent variable data are for the 2007–2016 period. We have multiplied the roads length data for the Donetsk and Luhansk regions by the fraction of the territory controlled by Ukraine.

Our model demonstrates that: if the Parliament coalition party controls the regional council, the funds allocated for the repairs per 1000 km of roads in the region are being increased by 36.5 million UAH. Unlike in the previous model, the effects of the area and unemployment proved to be insignificant. As it turned out, parliamentary or local elections in different years also had no effect on the distribution of the Road Fund. Instead, in this model, the influential factors are as follows:

- situation in Donbass area, after the start of the military operations;
- gross regional product for the previous year (per capita, UAH mln);
- average salary in the region in the previous year.

Since, similar to the previous model, these are panel data, we have created a fixed effects model (Table 5).

Table 5. Factors influencing the volume of the construction and repair works performed on the general use roads (UAH thous. per 1000 km of roads)

Factor	Ratio	Mean difference
Region council is controlled by the Parliament coalition party at the moment of the subvention approval decision	36,538	16,755**
Average salary in the region in the previous year	71.451	17.005***
Gross regional product for the previous year (per capita, UAH mln)	-1,808,494	665496.3***
Situation in the Donbass area, after the start of the military operations	-129,340	53,750**
Region's area as a percentage of the total area of Ukraine ²⁵	2,918,400	3,668,800
The year of Parliamentary or local elections	-29,683	30,698
In 2015 (when the decentralization policy came into force) and later, the region council is controlled by the Parliament coalition party	-24,932	45,495
2015 or later	103,720	110,110
Unemployment in the previous year	5,757.4	8,857.7
R2	0.13	

Sources: the Central Election Commission website, the State Statistics Service of Ukraine, response to the request from the State Road Agency of Ukraine, CES calculations

** Significant effect on 95% confidence interval

*** Significant effect on 99% confidence interval

²⁵For Donetsk and Lugansk region, only the territories controlled by Ukraine were taken into account

