

# On Development of Finance Management Models in United Territorial Communities Under Budget Risk Conditions

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**Abstract**—The problems of functioning of finances of the united territorial communities (UTC) in the period of reforming local self-government and territorial organization of power are analyzed. These problematic aspects are accumulated into blocks that focus on constitutional changes in the context of the formation of an UTC, administrative-territorial reform, changes in the administrative-territorial structure, definition of indicators of the level of financial decentralization, regulation of the division of powers between local and executive authorities and functions to prevent their duplication, stimulate further integration of territorial communities and financial levels local government UTC resources. Therefore, in the context of these blocks the ways of locating the isolated problems are proposed. In this context, it is proposed to simulate the likelihood of budget risks occurring in order to prevent negative trends in revenue generation and budget expenditures UTC.

**Key words**—the united territorial communities (UTC), local government, financial levels, budget UTC.

## I. INTRODUCTION

The imperative of a democratic state is the independence of the local self-government institute, which is in the context of financial decentralization as a guarantee of the localization of depressed territories and a catalyst for regional development. However, considering the short time of its implementation and euphoria from its first achievements, it is characterized by a partial insufficiency of conduct, inconsistency with other reforms, and it increasingly acquires the features of a managed mechanism for the adoption of permanent changes to the state budget, codes, normative legal acts that narrow the powers of local authorities self-acting, influencing the formation of finance in the united territorial communities (UTC). To declare the achievements of financial decentralization, the attention should be paid to the problematic trends in its conduct in order to strengthen the positions of local governments of

UTC to increase their financial capacity and gain self-sufficiency in addressing issues of local importance.

## II. ANALYSIS OF RECENT RESEARCH AND PUBLICATIONS

The problems of the agglomerated territorial communities' finance forming are connected with a number of problems which have been identified by scientists as high priority in the context of the existing administrative and territorial structure changing [1], providing the omnipresence and completeness of local self-government [3], as well as forming a new approach to budget risk management. Researchers are convinced that the reform of local self-government should help to overcome the negative processes in the socio-economic and cultural development of agglomerated territorial communities, to provide residents with quality and accessible administrative and social services on the basis of sustainable development of a viable community, and on this basis - a significant increase and of Ukrainian citizens' life quality [4]. The analysis of theoretical studies has shown that the key issue that needs to be addressed before agglomerated territorial communities' finance would be developed is the definition of the strict boundaries between obligations and duties of central and local governments and authorities [5].

Identifying, avoiding, and localization of budget risks are problems affecting the efficient functioning of agglomerated territorial communities [11]. However, avoiding budget risks includes developing certain steps, among which the quantitative assessment of budget risks is dominant. Thus, in financial theory, the criteria for quantitative assessment of budget risk are the following: the average expected value of a possible outcome of the execution of the local budget (expenditures and revenues), as the probability of each result the frequency or weight of the corresponding value are used; the mean square deviation as a measure of variability of possible results. These criteria

must be used by local government bodies in each budget process. That is why the development and improvement of the methodology for developing and implementing budget risk management is a pressing scientific and applied problem. The finding ways to improve finances UTC in the context of minimizing budget risks is the essence of the illumination of the previously unsolved part of general problem.

### III. THE PURPOSE OF THE PAPER

Development of finance management models in united territorial communities under in the context of budget risk conditions is the main purpose of the paper.

### IV. DISCUSSION OF RESULTS

Considering this, we will identify the problems that need to be resolved for the effective formation and further development of UTC's finance in Ukraine. Accordingly, the problems are related to:

1. Reforming of the administrative-territorial system. The current system of administrative-territorial organization in Ukraine, validated by the Constitution of Ukraine, needs to be revised, since its structure and functioning mechanism do not correspond to modern realities. We have in mind the excessive shredding of settlements, the lack of unified approach to the classification of administrative-territorial units, the presence of other units in the administrative-territorial of the same level. Such a situation requires the prompt localization – consolidation, taking into account the regional characteristics and expediency, as it does not stand up to criticism on the fifth year of reforms [1]. In our opinion, the decision on this issue is the adoption of the Law of Ukraine "On the administrative-territorial system of Ukraine", which should set out the principles of implementation of state policy in this field, as well as approval of amendments to the Constitution of Ukraine, which will consolidate the construction of a new administrative-territorial system. However, the only reformatting of the administrative-territorial system can not eliminate the existing obstacles. This requires simultaneous action in the context of reforming central and local executive authorities and local governments. We emphasize that the Verkhovna Rada of Ukraine adopted Resolution No. 636-VIII [2], but without the reform of the Constitution it is impossible to reform in today's conditions which characterized by economic instability and unstable political situation, the aggravation of relations with neighboring states, permanent threat to territorial integrity and periodic conflicts with separatist manifestations. In addition to this, it will eliminate the dichotomy with the Laws of Ukraine "On Voluntary Association of Territorial Communities" and "On Cooperation of Territorial Communities" and other normative and legal acts in the direction of decentralization.

One can not overlook the fact that the implementation of administrative-territorial reform lags behind in terms of financial decentralization. By logic, the formation of administrative-territorial units with the corresponding economic potential should be formed first, then the local self-government system of these units should be built up, and finally, the distribution of powers and the allocation of financial resources for their implementation should be carried out;

2. Ensuring the universality and completeness of local governments. According to Y. Sharov, the reform of local government is a complex of complicated problems. The willingness for it is still insufficient, and some issues are currently being processed at a simplified level. At the same time, there is a huge positive experience in solving many issues, there is considerable potential for constructive approaches, models and instrumental tools for ensuring the effectiveness of the local governments, and reform should use this potential to open wide opportunities for its realization in updated conditions [3].

The reorganization of the system of local self-government in the direction of decentralization requires more effective functioning of local governments in the context of ensuring the provision of public services, because the low level of their accessibility and quality does not correspond to the principle of the universality and completeness of local self-government, hinders the development of territorial communities, depriving their members of constitutional guarantees and rights. Ensuring the completeness of local self-government is possible only if there are financially capable and self-sufficient territorial communities, the basis of which are functioning budget-making enterprises, an active network of institutions and organizations capable of providing a full range of these public services, an appropriate level of material and financial resources for the completeness and quality of their granting. Accordingly, in our opinion, the capacity of the community is ensured by its financial capacity, which is determined by the level of income per resident and the dynamics of revenues of local taxes and fees (reasoned by mathematical calculations). Consequently, these criteria need to be legally established, since the goal of ensuring the universality and completeness of local self-government is to build a financial and economic foundation for the implementation of the eccentric needs of members of territorial communities.

Regarding the problem of the availability of services in the territorial remoteness, it should be noted that the introduction of e-governance and the development of the appropriate infrastructure is an instrument that eliminates artificial obstacles to the implementation of the ubiquity and completeness of local governments.

Theorists and practitioners believe that "... the reform of local self-government should contribute to overcoming the negative processes in the socio-economic and cultural development of territorial communities, to ensure the creation and maintenance of a favorable living environment necessary for the full development of people, providing residents of territorial communities with high-quality and accessible administrative and social services on the basis of sustainable development of a capable community, and on this basis - a significant increase in the level and quality of life of Ukrainian citizens. Today Ukraine needs a new paradigm of local government, which integrates elements of many approaches and paradigms, but it must meet the Ukrainian specifics and clearly identify the significance, role and functions of local governments in the life of territorial communities and the state as a whole" [4]. However, for the formation of this new paradigm of local governments, it is necessary to reform the administrative-territorial system first, establishing it constitutionally;

3. Determination of indicators of the level of financial decentralization. A complex decentralization in Ukraine provided relevant results, including redistribution of functions between state and local authorities, transfer of most powers and financial resources directly to the level of local communities - closer to consumers of public services, formation and state stimulation of the association of territorial communities, liquidation of local state administrations, etc. At the same time, the effect of the implementation of financial decentralization, which, according to modern reforms, taking into account domestic features, acquires features of the budget, is minimized. The reasons for this are the lag in the implementation of the administrative-territorial reform, its inconsistency with other reforms, the contradiction between the interests of local governments and local communities, the lack of control and insecurity in the sources of formation and directions of the use of financial resources, the lack of a common methodology for determining the level of financial decentralization, the infantile public attitude before implementing changes.

Summarizing the above, let us note that the study formulates indicators of financial decentralization and evaluates the success of its implementation on these key indicators. However, it is not necessary to state the full-scale effect of its realization. The insignificant period of its implementation and inertial dependence on financial decisions of state authorities illustrate the centralization of both powers and resources;

4. Settlement of the distribution of authorities between local governments and executives and functions to prevent their duplication. "The key issue that needs to be solved before building local government finances is to identify the boundaries between those tasks that the central government and local authorities should address" [5]. Within the framework of reforms, local governments of different levels - the territorial community, district, region - receive the powers that are most effective at their level (executive committees of the relevant councils), and the financial, material and other resources required for this are declared by the European Charter of Local self-government: "The right and ability of local governments ... to regulate and manage a significant number of public affairs that fall within their competence in the interests of local government population" [6]. We emphasize that the powers of executives of the respective councils are divided into two types: own (self-governing) - those that fall within the competence of local self-governments; delegated - those that are the competence of the executive authorities, which the state "shared" with the executives of the councils.

Consequently, there should be an effective division of own (self-governing) and delegated authority with the resources allocated to them to ensure the principle of subsidiarity. However, most of UTCs are not capable of inheriting infrastructure and community-owned objects requiring expanded reproduction to form an adequate amount of own funds to perform even their own powers. In most cases, revenues are expected on intergovernmental transfers and donors' assistance, which contradicts to the main goal of local self-government reform - the ability to independently settle local issues in the interests of local communities on their own. Such a situation raises the

question of association of territorial communities as a symbiosis of the territory, infrastructure and financial resources to solve the problem of lack of funds for socio-economic development. Local governments, having more authority, receive the proper level of financing. However, these authorities should be clearly distributed between local governments on the basis of compliance with the principle of subsidiarity. Indeed, I. Legkostup noted that the presence of a large number of authorities in the joint management of different levels of government leads to the dispersal of responsibilities, as well as different levels of financial security of institutions in one industry and reducing the efficiency of service delivery in general [7]. Considering the postulates of the Law of Ukraine "On Local Self-Government in Ukraine" [8],

In the context of own and delegated powers we have to classify expenditures of UTC's budgets. Since the revenue side reflects the own and transferred financial resources, so expenditure approach should be the similar, not distribution according to functional classification.

We would like to emphasize that the real financial support of delegated and legally established powers and functions is a problem in the context of the financial independence of local governments of UTC, the limits of which, as declared by the current legislation, should be clearly observed and enforced.

However, in order to resolve the division of powers between local authorities and executive authorities, another important problem is the elimination of local state administrations (district, region) and the delegation of their powers. We believe, it is necessary that the Institute of Prefects should work and these powers have been transferred to the executive committees of local councils, but this requires changes in the administrative-territorial system;

5. Stimulation of further association of territorial communities and the formation of UTCs. Small territorial communities (there are almost 12 thousand in Ukraine), are not able to fully realize their powers and provide high-quality public services to the community. The local budgets of such communities often are not even sufficient to finance their own powers, therefore, the union with other territorial units is a prospect of achieving their financial stability, and the main goal of reforms is the formation of a capable UTC. Currently, the Law of Ukraine "On voluntary association of territorial communities" is in action, the incentives of state financial support to the association of territorial communities are launched and they are significant. Art. 10 in particular declares "... providing the united territorial community with funds in the form of subventions for the formation of the appropriate infrastructure in accordance with the plan of socio-economic development of such a territorial community" [12]. Respectively, the legislative regulation of the mechanism for allocating this target subvention and the financing of infrastructure projects by the State Fund for Regional Development has had a positive effect on the increase in the number of UTCs, by intensifying the process of association - against 159 UTCs in 2015, 257 UTCs were formed in 2016, and as of 1.01.2018 in Ukraine there are 665 UTCs registered [13].



6. Low level of financial support of UTC. Theorists and practitioners are unanimous that "... the availability of sufficient financial sources for local governments to solve local issues, largely determines the reality of local self-government in country" [11]. At the same time, "... one of the main principles of the formation of equitable relations between the state power and local self-government is a clear allocation of state financial sources on the stable basis" [5].

Other problems depopulate the financial gains of UTC and need to be determined other. Thus, not all local UTC budgets receive the necessary amount of their own revenues. According to the amendments of the Budget Code of Ukraine, as of today, local taxes provide maximum 10% of local budget revenues, and art. 9 of the European Charter of Local Self-Government declares that at least half of the funds of local self-government must come from local taxes and fees.

Therefore, local self-governments of UTC should use incentives to support the development of small and medium-sized businesses, improve the financial results of budget-forming enterprises, optimize the administration of property taxes to create an electronic database - the register of legal and natural persons - owners of residential and non-residential real estate with inventory all real estate as well as land owners.

The problem of the need to reduce the level of interbudget transfers in local budget revenues was identified (Table 1).

TABLE I. REVENUES OF LOCAL BUDGETS OF UKRAINE FOR 2005-2018 (UAN BILLION)

Year	Revenues of local budgets	Interbudget transfers	Local budget revenues (excluding transfers)
2005	53,7	23,4	30,3
2006	75,9	36,0	39,9
2007	107,1	48,8	58,3
2008	137,5	63,6	73,9
2009	134,6	63,6	71
2010	159,4	78,9	80,5
2011	181,5	94,9	86,6
2012	225,3	124,5	88,1
2013	221,0	115,8	92,3
2014	231,7	130,6	89
2015	294,5	174	120,5
2016	366	195,4	170,6
2017	458,9	229,5	229,4
2018	566,9	304,7	262,2

Source: compiled by the author according to the State Treasury Service of Ukraine [14]

As it is illustrated in the table 1, local budget revenues are growing rapidly during decentralization period, but this is mainly due to interbudget transfers, which increased by 12.3% in 2016 compared to 2015, and by 31.6% in 2017 and 75.1% in 2018. Therefore, there is a significant increasing of local budget revenues - the growth rate is 24.3% in 2016 compared to 2015, in 2017 - already 55.8% and in 2018 - 92.5% against the background of low rates increasing of local budget revenues without interbudget transfers, that contradicts the basic ideas of financial decentralization.

The calculations for the indicators of table 1, confirm the dependence of the increasing of revenue of local budgets and UTC budgets, including interbudget transfers (correlation at the level of 0.99). Accordingly, the level of

influence of interbudget transfers on local budget revenues is 1.82 (Fig. 1) with the influence of other factors at the level of 10.93. In turn, local budget revenues have a different dependence nature on local budget revenues without taking into account interbudget transfers with correlation at 0.98. According to table 1, the level of impact of local budget revenues, excluding interbudget transfers, on local budget revenues in general is 2.13, while other influence factors have level of 1.73. Therefore, the impact of interbudget transfers on local budget revenues is undeniable.

7. Unpredictability and inability to quantify budget risk. Because risk is a probabilistic category, calculations based on empirical data and statistical methods of analysis are used in the process of uncertainty evaluation and quantifying the risk level.

To summarize the methodological bases for making financial management decisions, the concept of assessing the budgetary risks of local budgets (including UTC budgets) involves the following steps: selection of financial indicator X (or several) as a effective indicator of the consequents of the risk situation and the decisions taken; determination of the law of probability distribution and characteristics of a random variable X; establishment of a specific value of risk, its quantification.

The distribution function of a random variable X is a function F(x), which makes it possible to determine the probability of a random event {X < x}, that is, the probability that the random variable X will be smaller than a number x<sub>i</sub>:

$$F(x) = P\{X < x\}. \quad (1)$$

For discrete (discontinuous) random variable X, the distribution function is usually given in the form of a distribution series

$$\left\{ \frac{x_1}{p_1}, \frac{x_2}{p_2}, \dots, \frac{x_i}{p_i}, \dots, \frac{x_n}{p_n} \right\}, \quad (2)$$

where  $x_i, p_i (i = \overline{1, n})$  – possible values of the random variable X and their respective probabilities.

The mathematical expectation of discrete random variable  $m_X$  is calculated by the formula:

$$m_X = \sum_{i=1}^n x_i p_i. \quad (3)$$

The variation of a random variable is calculated by the formula:

$$\sigma_X^2 = \sum_{i=1}^n (x_i - m_X)^2 p_i, \text{ або } \sigma_X^2 = \sum_{i=1}^n x_i^2 p_i - m_X^2. \quad (4)$$

For continuous random variables, the distribution law is convenient to characterize by the probability distribution density

$$f(x) = \frac{dF(x)}{dx}. \quad (5)$$

The following expressions are used to calculate the mathematical expectation and variance of a continuous random variable:

$$m_x = \int_{-\infty}^{+\infty} xf(x)dx, \quad \sigma_x^2 = \int_{-\infty}^{+\infty} (x-m_x)^2 f(x)dx. \quad (6)$$

Note that in practical financial calculations, the density of probability distribution of the selected financial indicator is considered to be distributed according to the normal distribution:

$$\varphi(x; a, \sigma) = \frac{1}{\sqrt{2\pi}\sigma} e^{-\frac{(x-a)^2}{2\sigma^2}}, \quad (7)$$

where  $a$  – mathematical expectation of a normally distributed random variable;

$\sigma = \sqrt{\sigma_x^2}$  – its average square deviation.

Qualitative risk assessment methods suggest that it can generally be represented by the benefit-loss ratio of a particular decision-making.

$$r = H_g : H_n, \quad (8)$$

where  $H_g$  – possible win;  $H_n$  – possible loss.

However, the disadvantage of such risk factor is that it does not allow for subjective risk factors to be taken into account.

The most common risk quantification approach used in risk-based decision-making models is the following:

$$r = H \times p, \quad (9)$$

where  $r$  – risk indicator;  $H$  – expenses value;  $P$  – risk probability.

Summarizing the above, we propose next approach to analyzing and evaluating budget risk for local budgets (including UTC budgets), taking into account the internal factors of its occurrence: 1) identification of local budget indicators - expenditures of general and special funds of local budgets without taking into account interbudget transfers; revenues of general and special funds of local budgets without intergovernmental transfers; 2) determination of statistical characteristics of the distribution of selected indicators of the state of local budgets; 3) identification of the functions of distribution of indicators of local budgets and determination of value of budgetary risks for their estimation; 4) determining the riskiness level of local budgets of Ukraine by calculating the probability values of large deviations from the mathematical expectation of values of selected indicators.

We estimate the possible losses of revenue because of budgetary risk under the proposed approach. Losses of risk for local budget revenues will be determined on the basis of the mathematical expectation of revenues to their budgets for general and special funds. In this case, we use the definition of mathematical expectation of the value of the indicator according to the approach of P. Chebyshev. Accordingly, the mathematical expectation is calculated as the sum of all possible values of the index multiplied by their probabilities.

Budget risk losses are defined as the remaining between the value of top quartile and mathematical expectation of value of the corresponding revenue indicator of general or special fund of local budgets.

The calculations given in Table 2, illustrate that, although the riskiness of revenues of the general fund of local budgets has less probability than the risk of revenues of the special fund, the losses from the budget risk of falling the first are much higher compared with the losses from the risk of recession of the other (UAH 47 million against 2.5 million UAH). At the same time, the losses from the risk of declining budget revenues of communities on both funds are quite significant - more than UAH 50 millions and equally to the losses of risk of declining general fund revenues of local budgets. In fact, it can be argued that the risk of declining of local budget revenues is determined by budget risk based on the revenues of the general fund of community budgets ( $p_I=0,24$ ;  $p_I=0,2$ ).

TABLE II. ASSESSMENT OF POTENTIAL LOSSES FROM THE RISKS OF A FAST DECREASING OF LOCAL BUDGET REVENUES

Revenues	$p_I$ (decreasing)	Lower quartile values (UAH)	Upper quartile values (UAH)	Mathematical Expectation of Actual Income (UAH)	Risk losses (UAH)
General Fund	0,2	18154153	51131950	3630830,6	47501119,4
Special Fund	0,88	1609423	3969938	1416292,3	2553645,7
Together	0,24	19763576	55101888	4743258,3	50358629,7

Source: calculated by the author.

Determined factors of structural imbalances of expenditures of general and special funds of local budgets necessitate the estimation of losses in case of occurrence of budgetary risks, formed by determined imbalances. Budget risk losses are determined based on the mathematical expectation of local budget expenditures on funds. In doing so, we use the definition of mathematical expectation of the indicator value based on the P. Chebyshev approach. Accordingly, budget risk losses are defined as the remaining between the upper quartile value and the mathematical expectation of the corresponding indicator.

According to the table. 3, the risk of declining general budget expenditures is more probable than the risk of declining of special fund expenditures, and the losses from the risk of declining general fund expenditures are much bigger than the losses from budget risk of declining special budget funds (UAH 39 million versus UAH 8.8 millions).

At the same time, the losses from the budget risk of declining local budget expenditures for both funds are quite significant - over UAH 54 million, but unlikely, i.e. almost impossible, as our calculations show (at 10% probability level). It should be noted that the budget risk of local budget expenditures is determined by the budget risk of expenditures of the general fund of the community budgets ( $p_I=0,48$ ;  $p_I=0,38$ ).

TABLE III. ASSESSMENT OF POTENTIAL LOSSES FROM THE RISKS OF A FAST DECREASING OF LOCAL BUDGET EXPENDITURES

Expen- ditures	$p_I$ (decreasing)	Lower quartile values (UAH)	Upper quartile values (UAH)	Mathematical Expectation of Actual Income (UAH)	Risk losses (UAH)
General Fund	0,48	16678716	47251909	8005783,68	39246125,3
Special Fund	0,38	2969044	9615471	1128236,73	8487235,1
Together	0,1	19647760	56867380	1964776,01	54902604,9

Source: calculated by the author.

According to the results of the research, we will evaluate the budgetary risk and losses from the risk of a fast increase in local budget expenditures for general and special funds.

The calculations (Table 4) illustrate the riskiness of a fast increase in general budget expenditures, which is less probable than the risk of a fast increase in special fund expenditures. At the same time, the losses from the budgetary risk of fast growth in general fund expenditures are much higher than the losses from the risk of fast increase in the expenditures of the special fund of local budgets (UAH 22 millions versus UAH 3.6 millions).

TABLE IV. ASSESSMENT OF POTENTIAL LOSSES FROM THE RISKS OF A FAST INCREASE IN LOCAL BUDGET EXPENDITURES

Expenditures	$p_2$ (increasing)	Lower quartile values (UAH)	Upper quartile values (UAH)	Mathematical Expectation of Actual Income (UAH)	Risk losses (UAH)
General Fund	0,52	16678716	47251909	24570992,68	22680916,3
Special Fund	0,62	2969044	9615471	5961592,54	3653879,3
Together	0,9	19647760	56867380	51180642,76	5686738,1

Source: calculated by the author.

Therefore, given the above, we can conclude that the impact of the factors on the functioning, local finances, and, accordingly, the finances of the UTC is undeniable. We believe that this situation requires localization, especially under the conditions of reforming the system of local self-government and territorial organization of power.

Summarizing our research, we note that in order to increase the effectiveness of forming and ensuring the further development of UTC's finance in Ukraine, it is necessary: to reform the administrative-territorial system, consolidating all constitutional changes that will contribute to the full implementation of the reform of the system of local self-government and territorial organization of power; to establish a clear list of own and delegated powers, since the absence of such a division of powers between levels, authorities and officials of local self-government produces a duplication of these powers, creating inconsistencies, contradictions and competition in accordance with the competences, powers and functions, and thus forms the legal field to avoid liability for their failure to comply; to overcome public distrust of local self-government as a result of their corrupting, secrecy and lack of transparency of the local governments through the formation of public institutions for controlling their activities for the participative participation of members and representatives of the territorial community in budgeting in particular; to overcome the crisis in the personnel policy of local self-government, the system of training, retraining and qualification of officials, officers of local governments; to eliminate the excessive centralization of financial, material and other resources, which reduces the motivation of the combined territorial communities and local governments to receive them and does not stimulate them to self-development and the manifestation of the local initiative.

## V. CONCLUSION

In today's conditions, the implementation of the above-mentioned recommendations is an important task for the further development of local self-government in the context of financial decentralization. It will result in the formation of financially capable UTCs and the revival of the socio-economic potential of territorial communities, which will create opportunities for the efficient functioning of their finances and the prerogative for further integration of Ukraine into the European space. So, it is particularly relevant to study foreign experience for further restructuring and strategic development of the finances of the united territorial communities.

The practical value of the proposed approach is to optimize budget risks UTC.

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