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**Fiscal Decentralization
in Ukraine
in the Context of
Local Government Reform**

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Foreword

This White Paper proposes a vision of Government policy for fiscal decentralization in Ukraine. This document also contains recommendations regarding reforms that are interrelated with budget reform, such as: reforms to territorial systems of government and reforms in education, healthcare, culture and social security.

This White Paper reflects the results of stakeholder discussions of a Green Paper called “Fiscal Decentralization in the Context of Local Government Reform.” These discussions took place in Kyiv, Lutsk, Mykolayiv and Zhytomyr in March 2006. The text of this Green Paper and the report on the results of discussions can be found online at <http://www.icps.kiev.ua/eng>, the International Centre for Policy Studies website. The authors would like to give special thanks to all the participants in the debates, as well as to those who provided written comments on the Green Paper.

Overview

The goal of this White Paper is to identify Government policy on fiscal decentralization as a component of local government reform. An innovation introduced in this White Paper, compared to previous attempts to develop a policy on decentralization, is treating this issue in the context of other reforms. Another innovation is to foresee the possible consequences of taking various measures in this sphere. During the development of this White Paper, a series of debates was organized involving interest groups that will be affected by fiscal decentralization. Such consultations should help the Government find the most acceptable alternative for tackling this issue.

The goal of fiscal decentralization is to improve the quality of public services, that is, those services funded by the Budget and services provided by central or local governments. The purpose of fiscal decentralization cannot be simply to increase the share of local revenues in the Consolidated Budget or to better support the available network of budget-funded institutions. Only a better quality of specific services for specific individuals can ensure that transformations are going in the right direction. Any other goals are likely to lead to wasteful public spending and a worsening overall situation.

Today, there are few criteria for evaluating the quality of public services in Ukraine. Nor is there a single methodology for calculating the cost of providing public services. This makes it impossible to establish whether local budget revenues match spending needs or whether local governments use their funds efficiently. This White Paper proposes introducing a system of standards for the provision of public services to the general public. Such standards must contain a complete list of qualitative and quantitative indicators that will characterize each specific service. The objective calculation of all costs of providing a service of standard quality should become the basis for allocating resources to fulfill delegated functions.

The adoption of the Budget Code in 2001 was a successful bit of reform. The Budget Code made the entire system more transparent, logical and rational, and gave more fiscal freedom to local governments. It resulted in an upswing among municipalities and overall economic growth in Ukraine. Having not been supported by local government reform over the last five years, however, the positive achievements of budget reform have been undermined somewhat. One of the key recommendations of this White Paper is to follow a comprehensive approach to fiscal decentralization. As an isolated process, this kind of decentralization could be disastrous for reform.

This White Paper also proposes a specific sequence of reforms:

- **Reforms in key sectors financed by local budgets**—education, health-care, residential services, and social security—will determine what expenditures should be funded by local budgets.

- **Tax reforms**—the revision of local taxes and fees and the introduction of a property tax—should be done in the context of the entire tax system. This will determine the kinds of revenues that can be divided among local budgets and the State Budget.
- **Territorial reform** will create a new model of local government in Ukraine. New government units should emerge and powers should be divided among them.
- **Fiscal decentralization** will allocate spending authority among different levels of government and identify sources to fund the exercise of this authority.

Fiscal decentralization is not simply bringing order to relations between the State Budget and local budgets by making the principles and procedures for funding the established division of powers more transparent and understandable.

The current formula of interbudgetary transfers can certainly be improved and standards for the provision of public services introduced as the basis for such a formula in conjunction with the other four steps noted here. But, in and of itself, this is not fiscal decentralization, as it does not involve the redistribution of powers.

Basic issues in fiscal decentralization

Introduction

In recent years, reforms implemented in Ukraine, in particular budget reform, partly delegated authority to spend money for providing public services¹ to the local level (see APPENDIX 1). However, this reform was incomplete, as there has been no clear division of powers and responsibilities between the executive branch and local governments. Ukraine's territorial system of government was inherited from the Soviet Union, while the executive branch and local governments were built on the basis of the soviet top-down decision-making system.

What is fiscal decentralization?

Fiscal decentralization is the process of transferring functions, powers, competencies and responsibilities from the central Government to local governments. Such a transfer of powers and functions must be accompanied with a transfer of the necessary financial resources to exercise these powers by introducing local taxes or transforming or allocating a share of overall state taxes to local budgets that have been granted new powers. Fiscal decentralization is also the transfer of powers from higher levels of government to lower ones, such as from regional to municipal or local governments.

As a rule, when a central Government is interested in improving the system of public administration, it will decentralize the Budget. The central Government then limits its own activity to strategic functions and those of a national character, that is, those that are difficult to differentiate in relation to the needs of a specific individual residing in a specific location.

In short, the central Government tries to “unburden” itself of functions that focus on the provision of services to the general population and that need to reflect the special needs of residents that are based on place of residence, ethnicity, traditions, and so on. These functions are transferred to regions, municipalities or associations of cities, along with a part of the country's financial resources and the powers necessary to institute and collect taxes and borrow money. The Government maintains the function of financial cohesion or the function of ensuring a similar level of provision of one and the same service across the country. For this purpose, it allocates transfers and oversees or monitors the provision of these services by local governments.

¹ Public services are services funded by the Budget and services provided by central or local governments.

These unfinished reforms have given rise to a conflict of interests, with local governments unable to independently make decisions about spending at the local level. Yet, without this kind of independence, it is impossible to speak about real government at all levels.

According to the Constitution and the Law “On local government in Ukraine,” the basis of local government is the territorial community of a village, town or city. According to the Budget Code and the Law “On regulating fiscal relations between county budgets and budgets of county-level towns, villages and community associations,” transfers from the State Budget are planned only to the county level, that is, including county budgets, villages, and county-level towns located on the territory of the given county. In other words, these budget resources are actually distributed by the county administration and approved by the county council. Budget reform has had almost no impact on local budgets below the level of county budgets.

This means that, at the moment, only cities and towns of national and oblast significance have real budget powers. County councils represent the common interests of all territorial communities, while county budgets are expected to fund common socio-economic and cultural programs. According to the law, county councils are not the primary organs of local government. In practice, however, cities of oblast significance and counties are the basic units of local government. This establishes a conflict between the constitutional powers of government bodies and their fiscal powers.

Problems

Local government powers not matched by resources

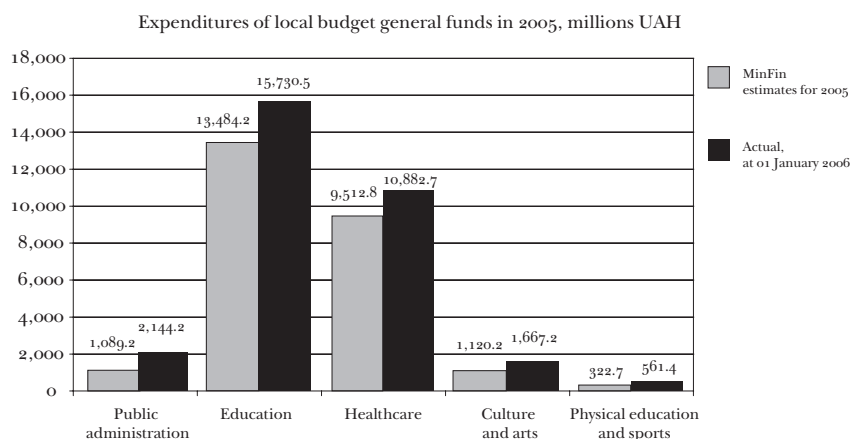
As there are no standards for the provision of public services, it is impossible to rationalize the size of funding gaps. With expenditures for current needs outpacing spending on development, the independence of local governments is limited, as is their capacity to carry out their proper functions.

The real need for spending on current needs of budget-funded institutions is determined by legislation that regulates social and cultural activities and must be undertaken by both heads of budget-funded institutions and local governments as a whole.²

² This is especially true of healthcare. In addition to documents regulating payroll, there are requirements established by: (1) the 17 August 1998 Cabinet Resolution №1303 “On introducing the free and discounted sale of medications under doctor’s prescriptions in outpatient treatment for specific groups and for certain categories of diseases;” (2) the 14 April 2004 Cabinet Resolution №477 “On raising spending on service provision to war veterans in treatment and prevention facilities;” (3) the 5 June 1998 Ministry of Health Order №153 “On approving charts of medical equipment for structural departments of healthcare institutions” and so on.

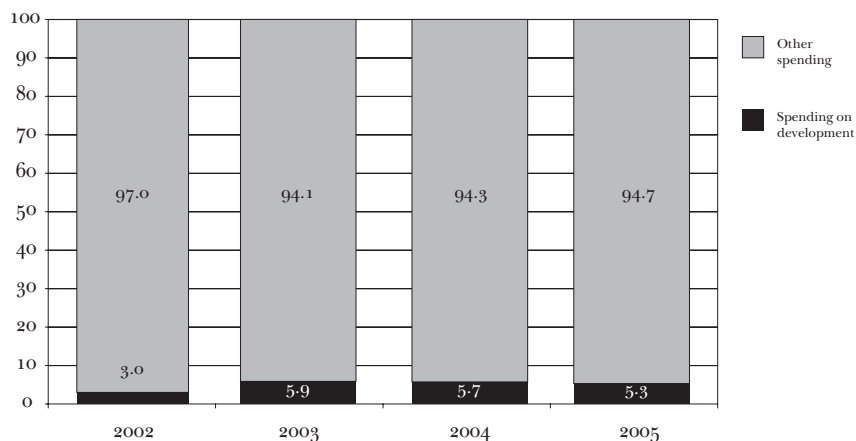
Standards established by law frequently fail to reflect the real disposable financial resources of local budgets. Under these circumstances, local governments have been given functions and powers from the state to provide public services to their populations, without having adequate funding to support the quality of this provision. Local budget spending on each of the delegated functions outpace Ministry of Finance estimates (see **CHART 1**).

Chart 1. Resource support for local budget spending on delegated functions



Decision-making by the central government often leads to the burden of funding social commitments shifting from the center to local governments. As a result, local governments are forced to spend practically all their budgets to fund current needs and cannot support local development. As can be seen from **CHART 2**, local governments have been spending less than 6% of their budgets on development in recent years.

Chart 2. Structure of local expenditures, %



Limited opportunities for local governments to improve the collection of taxes for local budgets

Local departments of the State Tax Administration are primarily concerned with handling taxes that are transferred to the State Budget. Local budgets are formed mainly out of national fees and taxes, such as personal income tax. These are completely regulated by the state. Local governments have few opportunities to influence the total volume of revenues from taxes and fees that form the base for local budgets, except for land taxes. As a result, the share of local budget revenues is critically small and there is little interest among local governments to raise tax revenues across the board.

Overly low rates for taxes and fees, especially local ones

Tax rates and government fees are set at the state level, as is the share of taxes and fees that is transferred to local budgets. These are overly low and frequently do not reflect the real capacity of Ukrainian taxpayers to pay. For instance, the ceiling for the fixed tax (UAH 200) has not changed since the time when it was introduced; the market fee is UAH 0.85–0.2.55 per point-of-sale for sole proprietors and UAH 3.40–34.00 for legal entities.³ This leads to lack of flexibility in tax and budget policies at the local level and to continued dependence on funding from the central Government. The lack of opportunities for local governments to implement flexible budget policies makes it difficult to optimize spending.

Low service quality in smaller communities

Schools and medical-obstetrical units (MOUs) in smaller communities are often understaffed. In Zhytomyr oblast alone, local budgets are forced to support 16 MOUs that are understaffed and that, as a result, cannot provide quality services to the local population. This means that even the funds allocated for the provision of services are not being used effectively. It is impossible to reorganize understaffed schools and MOUs, yet the central government almost entirely regulates such issues and will not allow the network of institutions to be cut back.

The roots of various problems

No clear division of functions and responsibilities for providing services

The Budget Code distributes revenues and expenditures among levels of the government, yet none of the government levels has been declared responsi-

³ See the 28 June 1999 Presidential Decree №761/99 “On regulating the mechanism for paying market fees,” as well as the 8 November 2005 State Committee for Regulatory Policy and Entrepreneurship Committee Letter №9752.

ble for the quality of services provided. As a result, it is impossible to establish who is to blame for the poor quality of public services.

Some kinds of spending, such as for educational, healthcare and other facilities, are funded by both local budgets and the State Budget, depending on whom they belong to. The division of spending commitments is not based on functions, but on an object-by-object approach, depending on subordination. This is one of the main contradictions in relations among the various budgets.⁴

Dependence on Kyiv for decisions regarding revenues and expenditures

This overdependence reduces incentives for local governments to concern themselves with local development. The decisions of the central Government have a direct impact on the revenues and expenditures of local budgets that makes it impossible for local governments to properly plan and carry out development at the local level.

Responsibility for providing healthcare services

According to the Budget Code, expenditures for providing healthcare services are divided among community, county and oblast budgets. Parceling out financial resources for healthcare gives rise to complicated inconsistencies between the territories served by hospitals, clinics and other institutions and administrative territories.

Current studies on organizing healthcare actively promote the idea of integrating funding and management for primary and secondary healthcare services in order to maximize the flexibility of choice among various types of healthcare services and approaches to treatment. For example, there is no need to introduce formal divisions of functions in legislation in order to determine where and how to provide dialysis in a hospital or in out-patient clinic. Both in Denmark and in Sweden, where there is the greatest level of decentralization in favor of local government bodies, responsibility for healthcare services has been transferred as a general function to the regional (provincial) level.

A World Bank survey of public spending management recommends integrating funding and support for healthcare at the oblast level in Ukraine. The same proposal was made by advisers from Great Britain's Department for International Development (DFID) in 2003.

⁴ See "Public Finances in Ukraine during the Transition Period" by I. O. Lunina, Kharkiv, Fort, 2000, p. 191–193 (in Ukrainian).

The Budget Code requires the state to compensate local governments for the loss of resources or the need for additional spending when making relevant decisions. However, there are currently no clear rules for compensating for such losses. Examples of such imbalances are:

- annual exemptions, written into each year's Law on the State Budget, that relieve defense and aircraft construction companies and health resorts from paying land tax;
- failure to implement Art. 103 of the Budget Code, according to which the offering of tax exemptions that reduce the revenues of local budgets needed to carry out local functions must be accompanied by subsidies to compensate for the loss of local revenues;
- an imbalance in funding for benefits to various groups. Some benefits are funded through mutual off-sets on payments to NAK NaftoGaz Ukrainy, the national oil and gas company, some are covered only partly, such as public transit fares, while some are not funded at all, such as benefits to servicemen;
- lack of mechanisms in current legislation for local governments to refuse to carry out delegated functions that are not supported by funding. This forces each local government to try to tackle this problem on its own.

No separation of provision of services and quality control at the oblast and county levels

Oblast and county administration functions simultaneously as executive and oversight body. While Ukraine adopted a Budget Code and assigned revenues to specific levels of government, it neglected to identify mechanisms and forms of oversight over the provision of services by local governments. In other words, state oversight of targeted budget spending exists in name only and there is no mechanism for overseeing service quality at all. The Budget Code divides powers related to revenues and expenditures among levels of government, but does not divide responsibility for the provision of services and for the quality of those services.

Steps to effective fiscal decentralization

Better financial support for functions delegated by the state

To increase funding for those responsibilities that have been delegated, the state should:

- objectively identify the volumes of local spending that will be used to calculate interbudgetary leveling transfers;
- improve the way that interbudgetary transfers are calculated;
- regulate situations where local governments refuse to carry out responsibilities that have been delegated to them but are not funded properly;
- establish institutions to handle budget disputes among different levels of government;⁵
- introduce a targeted (program) approach to drawing up and fulfilling local budgets.

To objectively identify the volumes of resources that will be used to support delegated functions, a system of standards for the provision of public services to the population needs to be established. Public debates have demonstrated that local governments are positive about this idea.

These standards should be developed and rationalized for every specific type of public service. They should also provide a comprehensive list of qualitative and quantitative indicators that characterize the specific service. For example, standards for services provided by a medical-obstetrical unit should include both a list of medical services provided to patients free-of-charge and a list of medications, equipment and materials needed to support these services, including payroll. In addition, these standards should include a component related to user access to services in terms of time or distance.⁶ Finally, the standards should be approved by a specific law or Cabinet resolution.

⁵ These must be special courts or, for example, the Accounting Chamber. Without such a body and a procedure for handling disputes, it will be impossible to achieve transparency and discipline among all participants in the budget process.

⁶ For example, 24-hour access to the services of a family doctor or establishing a radius of no more than 5 kilometers from a family doctor's office.

The monetary aspect of standards for providing public services to local populations needs to become the basis for determining the distribution of equalization transfers (automatic transfers).

Better distribution of spending powers among government levels

The current division of spending among levels of government that is written into the Budget Code is presented in **TABLE 1**.

Table 1. Types and division of expenditures among local budgets

Types of expenditures	Type of local budget					
	Oblast, Crimea	County	Oblast-level cities	County-level towns	Village	Hamlet
Local administration	✓	✓	✓	✓	✓	✓
Education:						
<i>A) pre-school</i>		✓	✓	✓	✓	✓
<i>B) primary and secondary</i>	✓	✓	✓	✓	✓	✓
<i>C) post-secondary</i>	✓					
Healthcare:						
<i>A) primary</i>	✓	✓	✓			
<i>B) secondary</i>	✓					
Social security	✓	✓	✓			
Culture and arts	✓	✓	✓			
Physical education and sports	✓					
Transport	✓	✓	✓	✓	✓	✓
Residential services development programs	✓	✓	✓	✓	✓	✓

Public debates reveal that local governments do not currently think it logical to delegate them additional expenditure-related functions. They see the main problem as adequate financial support for those functions they have already been delegated.

The option of transferring expenditure-related functions from local governments back to the central government also raised different reactions. Local governments actually do not think that transferring payroll functions regarding staff at state-financed institutions would solve the problem of inadequate funding for this function. Moreover, they say, the transfer of the payroll function to the state level could cause problems, as it is easier to ensure timely and accurate payroll delivery at the local level. Local governments view this option as a step back towards centralization.

Reforming local budget revenues

Changing the concept of local taxes

Current Ukrainian legislation does not define local taxes and fees. The 17 June 1993 Cabinet of Ministers Decree “On local taxes and fees” provides only a list of local levies.

The concept of local taxes should be based on three criteria for setting taxes and fees at the local level:

- that they do not entail high administrative costs;
- that revenues are as equal as possible across local budgets;
- that revenues are not too dependent on business cycles.

Identifying a list of local taxes and mechanisms for administering them

The current system of local taxes is not effective for two reasons: its insignificant share, at most 3% over 2003–2005, of local taxes and fees in the overall revenues of local budgets and a lack of growth in such revenues.

The main conclusion of public debate was that reforms to the system of local taxes and fees must be concentrate on canceling inefficient taxes, developing a flexible system of tax rates, and expanding the list of local taxes to reflect the characteristics of territorial economic development.

These public debates made it clear that the current levy system⁷ needs to be reformed. To establish a stable and adequate revenue base for local budgets to fund local government functions, certain new taxes must become part of⁸ local taxes:

- **Real estate tax.** This tax offers low tax-base mobility, efficiency of administration at the local level, few cyclic fluctuations in revenues, and the possibility of tracking the state of a given property and assess it on-site. Participants in public debates mostly favored the institution of this tax. (see Box next page)
- **Land tax.** This tax also offers stable revenues. Once a real estate tax is in place, these two can be merged into a single tax, the property tax.

⁷ See the Cabinet Decree “On local taxes and fees.”

⁸ That is, they must be transferred into the disposal of local governments to help them establish their own revenue bases, along with the power to change rates within limits established by law.

Taxing property and immovables owned by legal entities

The introduction of a tax on real estate owned by legal entities is likely to lead to a higher tax burden on businesses. This can be mitigated by including property tax among gross expenditures when calculating liabilities for corporate profit tax or by reducing the overall corporate profit tax rate.

Corporate profit tax revenues are almost entirely transferred to the State Budget. Thus, if either of these options for reducing the corporate tax burden is used, there may be an additional need to redistribute financial resources among levels of government.

- **Fixed tax for small businesses.** At the moment, this tax has nearly all the features of a local tax: local governments can establish rates for small enterprises within the stipulated limits, currently UAH 20–200 per month, while revenues are transferred to local budgets.⁹
- **Fees for business activities (licenses and patents).** This is a promising source of revenue, on the condition that the power to establish rates is also transferred to the local level. The threat of tax competition will serve to limit rates on such fees.
- **Fixed farm tax.**

Table 2. Taxes to review during the reform process

Taxes to keep	Taxes to drop
• Communal tax	• Fees to hold local auctions
• Advertisement tax	• Fees to shoot movies and TV programs
• Market fees	• Fees to play the sweepstakes at races
• Resort fees	• Fees on winnings at races
• Parking fees	• Dog license fees
• Apartment lease fees	
• Fees for the use of local symbols	
• Fees for holding auctions, tenders and lotteries	
• Fees for permits to locate POSs	

⁹ Limits for fixed tax rates were established by a 3 July 1998 Presidential Decree “On the simplified system of taxation, accounting and reporting for small businesses.”

Instituting the right to add surtaxes to taxes and fees

To provide local governments with the option of flexible funding for expenditures, they need to also have the right to establish surtax on certain existing taxes.

To make the administration of **personal income tax** more effective, local governments should be given the power to establish a surtax to this tax within a limit specified by the central government. According to current law, the personal income tax rate will be raised to 15% in 2007. The 2 pp increase has not been included in the calculation of interbudgetary transfers. Thus, within the limits of these 2 pp, it should be possible to allow local governments to establish a surtax on this tax that can be added to local budget revenues. Among others, it can serve as a stable and important source for development budgets.

Steps to reform local taxes and fees

1. Adopt a Law “On local taxes and fees” that:

- explains the purpose of local taxes and fees;
- presents a new list of local taxes and fees;
- cancels local taxes and fees that have little impact on the volumes of revenues from local taxes and fees;
- pegs the size of tax obligations to indicators that match the state of economic development, such as the minimum wage.¹⁰

2. Amend the Budget Code to allow local governments to establish surtaxes to some taxes, such as personal income tax.

The results of the public debates that were organized in four Ukrainian regions showed that the majority of local governments do not want to have the power to independently institute local taxes because this will increase their accountability before voters. On one hand, if they set low tax rates, they will need greater transfers from the State Budget or they will have to raise the rates for other local taxes to compensate the loss of revenues. Currently, the best option seems to be for the central government to establish ceilings for taxes or limits for surtaxes.

¹⁰ See <http://www.mbr-ukr.org/>.

Limits to fiscal decentralization

To achieve the maximum positive impact from fiscal decentralization, the process must take place in a complex that includes other critical reforms: territorial administration, political, tax, social security, residential services, and so on. The interconnectedness of these reforms is self-evident:

- without reforming the country's territorial system, Ukraine will continue to have administrative units that are incapable of carrying out their functions in full;
- without implementing political and administrative reforms, there will be no distribution of functions among executive bodies of local councils and local representations of the central government, as these are currently combined in local administrations;
- without implementing tax reform, real estate tax, which must become one of the stable sources of local revenues, will not be instituted.

The Government must establish a procedure for implementing reforms.

To achieve the maximum positive impact from fiscal decentralization, reforms need to follow a clear sequence:

- sectoral reforms: identify directions for developing the education, health-care, social security, and residential services systems;
- tax reform: identify local taxes and fees, institute real estate tax, and match them to overall state revenues;
- territorial reform: identify the country's territorial system of administration;
- fiscal decentralization: distribute functions and the necessary financial resources to carry out these functions among levels of government.

Participants in public debates mostly agree that a necessary condition for decentralizing Ukraine's State Budget is implementing territorial reform, since the current base level of local government does not have the capacity to provide quality services.

To successfully decentralize the country's budget system, territorial reform should establish a base level of local government that will have the capacity to provide quality services to the local population. At the same time, this level of local government must have the minimum required tax base to fund these services.

The most realistic option to achieve the goals of fiscal decentralization is administrative and territorial reform that leads to consolidation around the tax base and separation of counties (see **APPENDIX 2**). This option focuses on the tax base of oblast-level cities, county-level towns or large villages consolidating adjacent hamlets.

A number of new territorial units (TUs) will thus be established on the territory of today's counties. These units will consist of "centers of economic life" and adjacent hamlets. Whenever the borders of cities and towns expand to absorb adjacent hamlets, the existing TUs will remain. Whenever smaller hamlets or county-level towns merge, this will be considered a new TU¹¹ with all the powers of a community.

From the perspective of smaller settlements and county-level towns, this option allows them to consolidate into cities, towns or new TUs. Basic TUs can be established on the basis of a county-level town by merging adjacent settlements that already have established close economic ties to the town. These TUs will be the basic unit of the territorial system of government. This option also complies with the European Charter on Local Government.

At the same time, there will be the option of voluntarily merging the resources of towns and new TUs, including financial resources, to handle common issues. In this instance, for example, an educational district or residential services sector district can be set up and certain functions and resources delegated to them.

With the elimination of counties as separate territorial units and, as a result, county budgets, the revenue base that is thus released will be redistributed among the new basic TUs.

According to this option:

- a three-tiered territorial system of government will be established: the state, oblast and basic (new TUs and towns) levels. This three-tiered system offers the optimal administrative and territorial division of the country;
- all basic TUs will have the same rights;
- basic TUs will have both the administrative and the financial capacity to provide local services.

Under this option, smaller communities will not necessarily continue to be simply unincorporated settlements but their councils may be delegated certain functions and resources to form their own budgets by decision of the nearest municipal council or the council of a new TU. Nevertheless, this municipality or new TU will remain the basic unit of government.

¹¹ Possible options for naming such a new TUs are community, municipality, or district.

Conclusions

The proposals presented in this White Paper can provide a basis for designing the reform of both the budget system and local government. The main point is that the Government must answer two questions before implementing these reforms:

- what services it is going to provide at the state or at the local levels;
- whether fiscal decentralization will serve to raise the quality of these services and improve the efficiency of public administration, including its impact on economic growth.

The answers to these questions should be the basis for making decisions on how to carry out the separate reforms in terms of public services, taxation and budgeting.

Appendices

Appendix 1

Key laws on local government

1. THE 8 OCTOBER 1991 LAW №1635–XII “On the budget system of Ukraine” (no longer in effect)

This Law introduced a hierarchy in the distribution of resources among different levels of government and it established a three-tiered budget system structure: the State Budget, the Crimean Republican Budget and local budgets. It also decreed that the central government approved decisions on the size of resources to be transferred to the oblast level, oblast governments decided on the size of resources transferred to oblast-level cities and counties, while county governments decided on resources transferred to towns of county significance, villages and hamlets.

2. THE 17 JUNE 1993 CABINET OF MINISTERS DECREE №3293–XII “On local taxes and fees”

This Decree identifies types of local taxes and fees, their ceilings and the procedure for calculating them. Local governments can choose types of local taxes from the set list, meaning that they cannot introduce their own taxes. They can also change the rates of local taxes and fees within established limits, but these limits have little range. Local governments do have a significant impact neither on the tax base nor on the rates of local taxes and fees. Yet, being able to independently resolve local issues and, of course, to fund necessary expenditures are two central criteria for evaluating the independence of local governments.

3. THE 28 JUNE 1996 CONSTITUTION OF UKRAINE

This document establishes local government in Ukraine. It sets the most important powers of local governments, the material and financial basis for local government, and key principles for running local budgets. The Constitution guarantees state funding for local governments to carry out their functions.

4. THE 6 OCTOBER 1998 LAW №163–XIV “On local government in Ukraine”

This Law elaborates on constitutional provisions regarding local government, its principles, functions, legal status and the responsibility of both local governments and local officials. It also establishes support for material and financial bases, including local budgets. The independence of local budgets is guaranteed by their own revenues and overall state revenues assigned to them on a permanent basis by law, as well as by the power to independently decide on the areas for spending local budget funds according to law.

This Law contains a list of forms for public participation in the budget process in order to strengthen the accountability of local councils to voters: local referenda, town hall meetings, local initiatives, public hearings, advisory committees, and community commissions.

5. THE 15 JANUARY 1999 LAW №401–XIV “On the capital of Ukraine—the heroic city of Kyiv”

This Law establishes the special status of Kyiv as the capital of Ukraine, special features of the executive branch and local government in this metropolis, in accordance with the Constitution and Ukrainian law. It also establishes the special nature of local government and the activity of executive bodies in Kyiv and provides special conditions for forming the municipal budget, in particular the transfer of 100% of corporate profit tax, personal income tax and land tax to the municipal budget.

6. THE 17 MAY 2001 LAW №2419–III “On local state administrations”

This Law determines the organization, functions and procedure for acting of local executive bodies and their cooperation with local governments. It establishes that local state administrations can fulfill local government functions delegated by the relevant councils.

7. THE 21 JUNE 2001 BUDGET CODE OF UKRAINE №599–IV

The Budget Code instituted reform of Ukraine’s budget system. Key innovations in the Budget Code included: decentralizing spending powers by distributing expenditures among levels of government, long-term assignment of revenue sources to local budgets, formula-based calculations of budget transfers on the basis of revenue clusters, a clear structure for the system of targeted subsidies and subventions, and the establishment of requirements to and limits on local borrowings.

Appendix 2

Options for reforming territorial administration

Participants were invited to discuss three possible options for implementing the reform of territorial administration:

Option 1. Maintaining status quo

System parameters	
Territories, including the Autonomous Republic of Crimea, Kyiv and Sevastopol	27
Counties and oblast-level cities	about 700
Village councils and county-level towns	about 12,000

The country's current territorial system of administration is an obstacle to further fiscal decentralization. Many small councils do not have enough financial resources and competent specialists to undertake additional responsibilities or to fund more services.

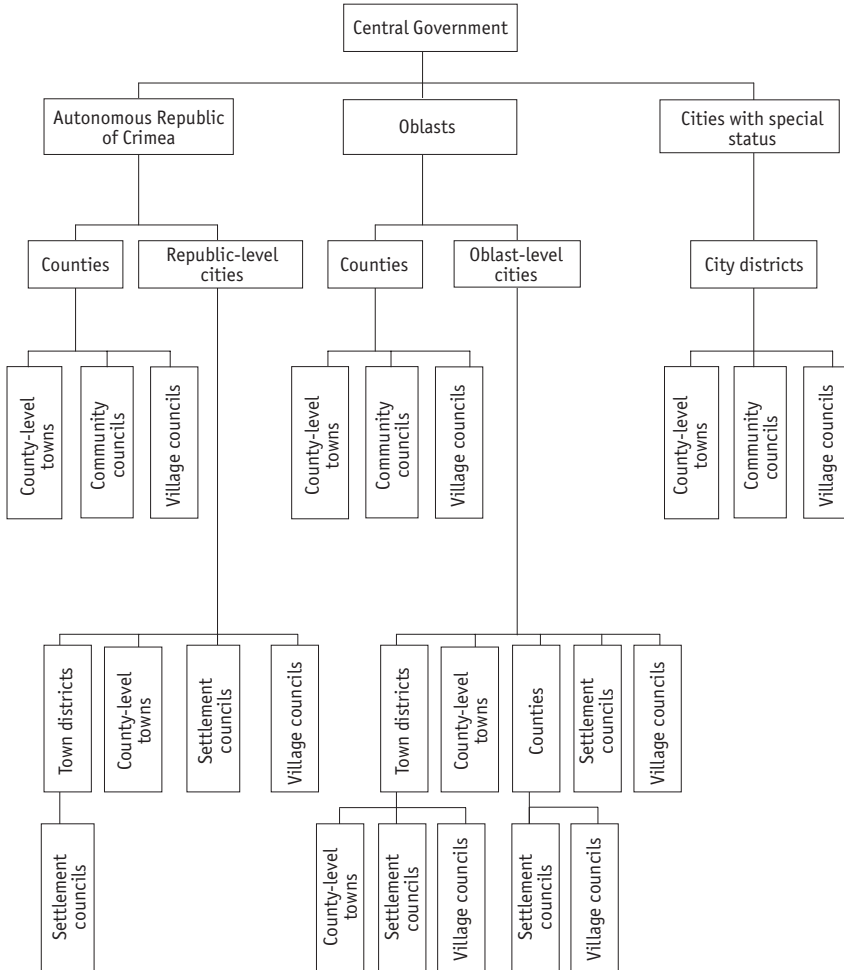
The current system also does not correspond to the European Charter of Local Government:

- basic territorial units do not enjoy equal rights: some are parts of other units, such as towns that belong to cities and villages and hamlets that belong to counties;
- the current system establishes more than three layers of government, which is irrational from the perspective of the European Charter of Local Government;
- territorial units, villages, hamlets, and county-level towns mostly do not have the administrative and financial capacity to provide public services.

Pros	Cons
1. Under the current territorial system of government, there is no need for further fiscal decentralization.	1. It will be extremely difficult to implement budget and tax reforms. 2. The quality of public services in villages and hamlets will continue to be poor. 3. The system does not correspond to the European Charter of Local Government.
What problems does it tackle?	What new problems does it create?
It will reduce conflicts at below the county level mostly by temporarily "freezing" it.	It will require initiated reforms to be completed, that is, the clear division of functions.
What capacities does it require?	How much does it cost?
The capacity to complete the reforms that were launched earlier.	Spending to complete the reforms initiated earlier.

This option involves completing the reforms initiated by the Government along with the adoption of the Budget Code in 2001, such as balancing functions and responsibilities below the county level.

Figure 1. Ukraine's current territorial system of government



Option 2. *Merging communities and counties*

System parameters	
Territories, including the Autonomous Republic of Crimea, Kyiv and Sevastopol	27
Merged counties and oblast-level cities	unknown
communities (consolidated villages containing 4,000 residents and more)	unknown

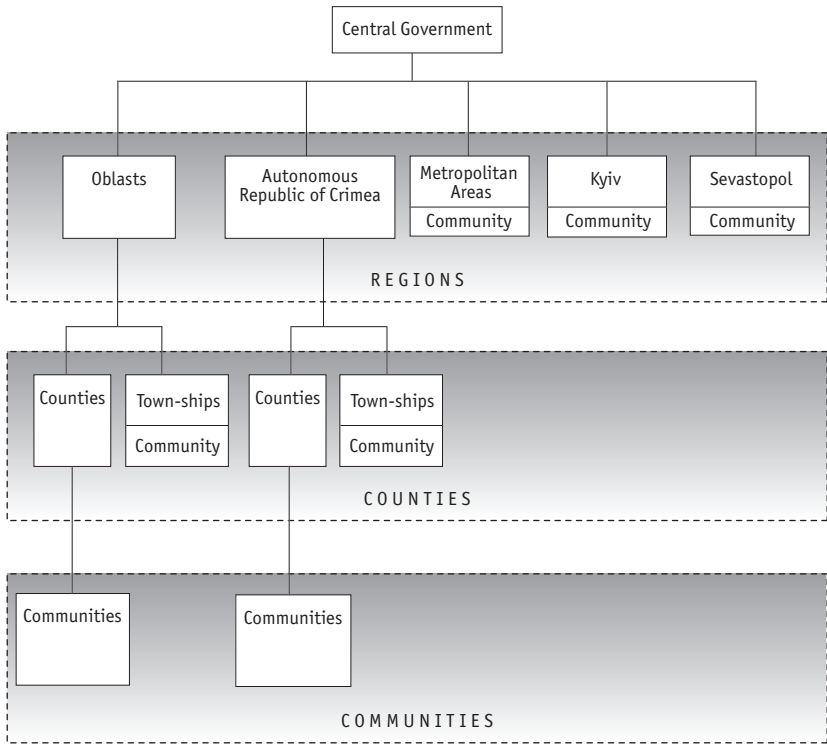
This option involves four steps:

- merging village councils and transform them into communities consisting of at least 4,000–5,000 residents, with possible exceptions;
- merging counties to cover at least 70,000 residents;
- setting up townships, that is, towns with the combined powers of a county and a town;
- to metropolitan areas, that is, cities covering at least 750,000 residents with combined powers of a city and an oblast.

Pros	Cons
Larger counties and communities should have more competent local governments. Consolidation should offer better conditions for fiscal decentralization (but not so good as the third option).	The problem of dividing services between the county level and the local community remains. Community level governments will still not be able to provide proper quality services.
What problems does it tackle?	What new problems does it create?
<ol style="list-style-type: none"> 1. According to the plan, this option should result in competent governments at the community level that will have the capacity to provide services locally; however, the feasibility of this option is still open to discussion. 2. This option should reduce the costs of managing, as, the merger of counties will lead to fewer county administrations. 3. This option brings those services that are delegated to the community level territorially closer to voters. 	<ol style="list-style-type: none"> 1. The problem of human resources: how to form new, competent governments. 2. The need to develop and institute new procedures for interbudgetary relations to match the new distribution of functions, expenditures and revenues. 3. Forming communities based on population size is problematic, as population numbers tend to vary and the question arises: what to do with a community whose population has shrunk below the established level. 4. Cutting the number of budgets that have direct ties to the State Budget actually increases centralization.

What capacities does it require?	How much does it cost?
<ol style="list-style-type: none"> 1. The capacity to convince residents to merge into communities; otherwise, this option will require a separate mechanism for merging into communities. 2. Qualified personnel at the community level. 	<ol style="list-style-type: none"> 1. This requires financial incentives to persuade communities to merge voluntarily. The cost of such incentives has not been evaluated, but the real lack of resources makes it impossible to implement this option. 2. This is the costliest of the three options.

Figure 2. Merging communities and counties



Option 3. Consolidating the tax base by increasing the number of counties

System parameters	
Territories, including the Autonomous Republic of Crimea, Kyiv and Sevastopol	27
Cities and counties with community powers	unknown

In focusing on the tax base of oblast-level cities, county-level towns and large villages, adjacent villages and hamlets will be incorporated, leading to the creation of several new territorial units on the territory of existing counties. These TUs will consist of “centers of economic life” and neighboring villages and hamlets. Where the boundaries of cities are expanded to include adjacent villages, such TUs will remain metropolises. Where villages, hamlets and county-level towns are merged, a new type of TU will be created: townships, that is, counties with the powers of communities.

This option allows hamlets, villages and county-level towns to merge into cities or counties. As basic TUs, counties can be established on the basis of county-level towns by incorporating adjacent villages with established close economic ties. These TUs will become the basic level of the county’s territorial system of government and, thus, correspond to the European Charter of Local Government.

At the same time, there will be the option to voluntarily combine the resources of cities and counties, including financial resources, to tackle common problems. In this instance, these communities will be able to create districts, such as educational districts, residential services districts and so on, and delegate certain functions and resources specifically to these districts.

With the elimination of existing counties as separate TUs and therefore county budgets, the released revenue base will be redistributed among the new basic TUs.

Thus, according to this option:

- a three-tiered territorial system of government is established, consisting of the state, oblast and basic (counties and cities) levels. This three-tiered system reflects the optimal administrative and territorial division of the country;
- all basic TUs will have the same rights;
- basic TUs will have both the administrative and the financial capacity to provide public services.

Under this option, villages, hamlets and county-level towns will not necessarily continue to be mere populated settlements: the appropriate municipal or county council can decide to delegate them certain functions and resources. But that city or county will continue to be the basic level of government (TU).

Reform of the country’s administrative system will thus include three components:

- Each basic TU will have its own council, elected by all eligible voters residing on its territory. The executive functions of a basic TU will be fulfilled

by the council's executive committee, which will be subordinated to the council itself. Each basic TU will have its own budget and direct relations with the State Budget.

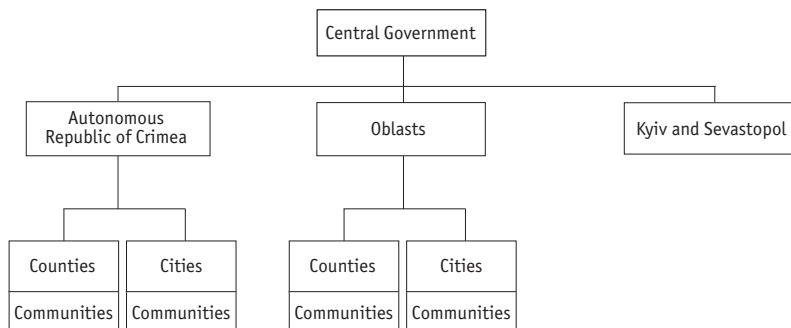
- With their executive functions transferred to these executive committees, state administrations will serve only to enforce and oversee adherence to the law. At the same time, this will make it possible to increase the responsibility of state administrations by expanding them to a territory that is broader than today's counties. This kind of consolidation will result in a reduction of both the number of state administrations and, hopefully, the number of civil servants. This approach should make it possible to economize on public spending and to rechannel the released funds among basic TUs.
- There is no single rule for creating new basic TUs. It will be necessary to analyze the situation in each county or city and to adopt decisions based on local circumstances.

Pros	Cons
<ol style="list-style-type: none"> 1. A real three-tiered territorial system of government should make it possible for the Government to continue the process of fiscal decentralization in the most effective manner, because it will be relatively easy to determine what services must be provided by each TU and to avoid duplication of functions and powers. 2. After a transitional period, all residents of TUs will receive the same level of services regardless of which hamlet they reside in. 3. New basic TUs will have more capacity to provide delegated services, as they will have a bigger tax base. 4. All taxpayers within TUs will pay the same level of taxes and fees for the same set of services. 5. By eliminating the intermediate level, the provision of transfer payments for interbudgetary leveling will become simpler and more efficient. 6. This corresponds to the European Charter of Local Government. 	<ol style="list-style-type: none"> 1. The level of taxes and quality of services can be different on the territory of a future basic TU. As a result, there is the issue of the transitional period: how to achieve the standard level of services and taxes for the entire population of a city or a county. 2. Those who currently receive better quality services may end up with poorer quality of services and vice versa. Those who currently pay lower taxes/fees for services may have to pay higher taxes/fees to ensure better quality services.

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What problems does it tackle?	What new problems does it create?
<p>1. This option resolves the conflict between counties and the towns, hamlets and villages subordinated to those counties. County-level towns will become independent of counties and will have direct relations with the State Budget. Where communities around a town are incorporated into it, the town residents will have a majority in the municipal council because most of the population will be residents of the town.</p> <p>2. The number of levels of government will go down and it will be easier to divide responsibilities among them.</p>	<p>1. The growing number of budgets with direct relations with the State Budget could create additional technical problems with delivery. At the same time, unless interbudgetary reforms are carried out simultaneously, that is the institution of standards for providing public services, the financial security of local governments is unlikely to improve.</p> <p>2. This option will move certain administrative services away from village residents to the center of a TU. However, this communication issue can be resolved, for example, with the help of telephone, mail or internet.</p> <p>3. This option could run into opposition from village councils, as it essentially sets up their demise, and the resistance of those supporting decentralization and local government, as it actually leads to a certain amount of centralization at the level of a basic TU.</p> <p>4. The procedure and criteria for merging villages and hamlets need to be established: how to include them in the tax base?</p>
What capacities does it require?	How much does it cost?
<p>1. It is necessary to justify the elimination of village councils, by showing what they do and how much they cost.</p> <p>2. New procedures for interbudgetary relations need to be developed.</p>	<p>1. Expenditures related to establishing the borders of counties.</p> <p>2. Expenditures related to creating a new system of local government: the new TU councils and executive committees.</p>

Figure 3. Consolidating around the tax base or breaking up counties



Appendix 3

Stakeholder positions

The drafting of this White Paper was preceded by a process of consultations with stakeholders on the basis of a Green Paper called “Decentralizing Ukraine’s State Budget in the Context of Local Government Reform.” The Green Paper presented a view of problems connected to fiscal decentralization, their roots and possible solutions. The aim of holding consultations with stakeholders was to get feedback and stakeholder opinions of the proposed issues.

Stakeholder debates on the Green Paper were scheduled in four Ukrainian cities:

Zhytomyr—11 March 2006, Lutsk—13 March 2006, Mykolayiv—15 March 2006, Kyiv—17 March 2006

Representatives of local and central government bodies and community organizations and specialists were invited to participate in these debates.

The results of the debates

During these debates, stakeholders **identified four problems** with funding the activities of local governments:

- The powers delegated by the central government to local governments are not properly supported by resources. As there are no standards for the provision of public services, the volumes of these financial gaps cannot be rationalized. Expenditures on current needs outpace spending on development, which limits the independence of local governments.
- The tax administration primarily functions to ensure that taxes are transferred to the State Budget. Other than the land tax, local governments have few options to affect revenues from the taxes and fees that form the revenue base for local budgets.
- Local tax and fee rates, as well as taxes and fees established at the state level and transferred to local budgets, are too low and often do not match the real capacity of Ukrainian taxpayers. For instance, the fixed tax ceiling, UAH 200, has not changed since the time it was instituted. The current land tax is a nominal UAH 9–12/ha per year, while market fees are UAH 0.85–2.55 per POS per day for sole proprietors and UAH 3.40–34.00 per POS per day for legal entities.
- Opportunities for local governments to optimize the network of budget-funded institutions are also very limited. Understaffed schools and medical-obstetrical units cannot be closed. Meanwhile, the central government almost entirely regulates these issues.

During the debates, most stakeholders **agreed on the need to implement measures** to further fiscal decentralization, including:

- Introducing standards for the provision of public services. All stakeholders supported this measure. Identifying norms, such as, how many hryvnia should be spent to treat one patient must include the doctor's salary, the value of medications, meals and so on, to make it easier to plan local budgets based on spending needs rather revenue distribution.
- Setting up separate departments under local governments that will be responsible for administering taxes and fees that are transferred to local budgets. This would help local governments collect these taxes and fees more efficiently.
- Raising the ceilings for taxes and fees established by the state and transferred to local budgets, especially fixed taxes and market fees.
- Revising the list of local taxes and fees. Cancel those whose administrative costs are higher than the revenues they generate—such as parking fees, dog license fees, and so on—or raise the rates. Consider the possibility of instituting new local taxes, especially a real estate tax.
- Giving local governments the power to organize their own healthcare, educational, social, and cultural networks.

Consultations with stakeholders revealed **disagreement** on several points:

- Transferring payroll to the state level could be undesirable, as it is easier to ensure timely and accurate payment of salaries at the local level. Local governments mostly view such a transfer as a move towards centralization. In addition, decentralizing payment of salaries is associated with the resolving the problem of wage arrears, while centralization is viewed as risking that new arrears will emerge.
- Some representatives of local governments supported none of the options: 25% of the 74 respondents who filled in the questionnaire favored maintaining status quo in the territorial system of government, 33% supported merging communities and counties, and 23% preferred consolidation around a tax base. The remaining 9% or so of participants did not respond or proposed yet other options for reform.
- The idea of providing local governments with more freedom to set rates for taxes and fees that are transferred to local budgets was not supported by representatives of local government. They pointed out that elected local governments are unlikely to be motivated to take such unpopular measures as raising taxes. Evidence in support of this argument is the preservation of low rates for market fees in those regions where the consultations were held.

Appendix 4

Participants in the consultation process

The authors would like to thank everybody who participated in the debates and provided comments on and proposals for the Green and White Papers.

Specialists:

- Vasyl Kudryashov, Deputy Director, Financial Research Institute;
- Vitaliy Ostrovetskiy, Department Manager, Financial Research Institute;
- Artem Rudyk, Senior Fiscal Analyst, Municipal Budget Reform Project, USAID.

Organizations that participated in the debates:

Debates on the Green Paper in Zhytomyr, 11 March 2006

Oblast and municipal bodies:

- Zhytomyr Oblast Financial Department
- Zhytomyr Municipal Financial Department
- Department of Economy, Zhytomyr Oblast State Administration
- Zhytomyr Oblast Residential Services Sector Department
- Zhytomyr Oblast Health Department
- Department of Industry and Infrastructure Development, Zhytomyr Oblast State Administration
- Zhytomyr Oblast Territorial Department, Anti-Monopoly Committee
- Office of the Oversight and Auditing Department in Zhytomyr oblast
- State Tax Administration, Zhytomyr oblast

NGOs and media:

- Zhytomyr Regional Business Support Fund
- Zhytomyr Association of Academics and Business Consultants
- UkrInform
- Zhytomyr Youth Press Club

Debates on the Green Paper in Lutsk, 13 March 2006

Oblast and municipal bodies:

- Volyn Oblast State Administration
- Lutsk Municipal State Administration
- Volyn Oblast Main Financial Department
- Lutsk Municipal Financial Department
- Department of the Treasury in Volyn oblast
- State Tax Administration in Volyn oblast
- Kovel Municipal Financial Department
- Volodymyr-Volynskiy Municipal Financial Department
- Novovolynsk Department of Economy and Finance

County bodies in Volyn oblast:

- Ratne County Financial Department
- Stara Vyzhivka County Financial Department
- Liubeshiv County Financial Department
- Kamin-Kashyrskiy County Financial Department
- Liuboml County Financial Department
- Manevychi County Financial Department
- Ivanychi County Financial Department
- Rozhyshe County Financial Department
- Turiysk County Financial Department
- Shatsk County Financial Department
- Horokhiv County Financial Department
- Kivertsi County Financial Department
- Kovel County Financial Department
- Lokachi County Financial Department

Local bodies in Volyn oblast:

- Kivertsi Municipal Council
- Boholiuby Village Council
- Hirka Polonka Village Council

NGOs:

- Kivertsi County Regional Development Agency
- Lutsk-1432 Center for Municipal Reforms
- Volyn Regional Department, Association of Ukrainian Cities
- Nasha Sprava [Our Business], a community organization

Debates on the Green Paper in Mykolayiv, 15 March 2006

Oblast and municipal bodies:

- Mykolayiv Department of Economy
- State Tax Administration in Mykolayiv oblast
- Department of the Treasury in Mykolayiv

Budget-financed organizations:

- Mykolayiv State Agricultural University
- M. Kropyvnytskiy Central Library for Adults
- Mykolayiv State P. Mohyla Humanitarian University

Local bodies:

- Mykolayiv Municipal Council

Business:

- VAT Mykolayiv Alumina Plant
- Mykolayiv Oblast Chamber of Commerce and Industry
- DP Zorya–MashProyekt
- VAT Mykolayiv Yantar Brewery
- VAT Damen Okean Shipyards
- Municipal Organization of Industrialists and Employers

NGOs:

- Oblast branch of the All-Ukrainian Human Rights Committee
- Mykolayiv Oblast Civic Rights Organization
- Dana, a community organization
- Dobra Nadiya [Good Hope], a community organization
- Perspektyva [Prospect] Center for Socio-Economic and Political Studies
- Turbota Pro Litnikh Liudey v Ukrayini [Care for Elderly People in Ukraine], a community organization
- The Municipal Consumer Rights Association
- Municipal Expert Group on Rates
- Ukraina, a national-democratic association
- Tretia Khvylya [Third Wave] Club
- Mykolayiv Municipal Development Fund

Media:

- TRK Mart, a television and radio company

Debates on the Green Paper in Kyiv, 17 March 2006

Government bodies:

- Ministry of Economy
- Ministry of Finance
- Presidential Secretariat
- Kyiv Main Health and Medical Support Department
- National Security Council Secretariat

NGOs:

- Association of Ukrainian Cities
- Municipal Budget Reform Project, USAID
- European Business Association
- Foundation for Local Self-Government
- Public Center for Institutional Development
- Tax and Customs Policy Sector Public Council, Ministry of Finance
- Center for Ukrainian Reform Education (CURE)
- Sustainable Financing of Territorial Administrative Reform Project, DFID
- Center for Political and Legal Reforms
- Financial Research Institute
- Institute of Economic Forecasting, National Academy of Sciences