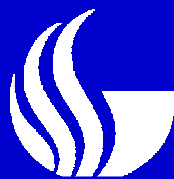


International Studies Program

Working Paper 04-08
September 2004

Ukraine: Assessment of the
Implementation of the New
Formula Based
Inter-Governmental
Transfer System

Jorge Martinez-Vazquez
Signe Zeikate



Georgia State
University

Andrew Young
School of Policy Studies



Ukraine: Assessment of the Implementation of the New Formula Based Inter-Governmental Transfer System

Working Paper 04-08

Jorge Martinez-Vazquez
Signe Zeikate
September 2004

International Studies Program
Andrew Young School of Policy Studies
Georgia State University
Atlanta, Georgia 30303
United States of America

Phone: (404) 651-1144
Fax: (404) 651-3996
Email: ispaysps@gsu.edu
Internet: <http://isp-aysps.gsu.edu>

Copyright 2001, the Andrew Young School of Policy Studies, Georgia State University. No part of the material protected by this copyright notice may be reproduced or utilized in any form or by any means without prior written permission from the copyright owner.

International Studies Program Andrew Young School of Policy Studies

The Andrew Young School of Policy Studies was established at Georgia State University with the objective of promoting excellence in the design, implementation, and evaluation of public policy. In addition to two academic departments (economics and public administration), the Andrew Young School houses seven leading research centers and policy programs, including the International Studies Program.

The mission of the International Studies Program is to provide academic and professional training, applied research, and technical assistance in support of sound public policy and sustainable economic growth in developing and transitional economies.

The International Studies Program at the Andrew Young School of Policy Studies is recognized worldwide for its efforts in support of economic and public policy reforms through technical assistance and training around the world. This reputation has been built serving a diverse client base, including the World Bank, the U.S. Agency for International Development (USAID), the United Nations Development Programme (UNDP), finance ministries, government organizations, legislative bodies and private sector institutions.

The success of the International Studies Program reflects the breadth and depth of the in-house technical expertise that the International Studies Program can draw upon. The Andrew Young School's faculty are leading experts in economics and public policy and have authored books, published in major academic and technical journals, and have extensive experience in designing and implementing technical assistance and training programs. Andrew Young School faculty have been active in policy reform in over 40 countries around the world. Our technical assistance strategy is not to merely provide technical prescriptions for policy reform, but to engage in a collaborative effort with the host government and donor agency to identify and analyze the issues at hand, arrive at policy solutions and implement reforms.

The International Studies Program specializes in four broad policy areas:

- **Fiscal policy**, including tax reforms, public expenditure reviews, tax administration reform
- **Fiscal decentralization**, including fiscal decentralization reforms, design of intergovernmental transfer systems, urban government finance
- **Budgeting and fiscal management**, including local government budgeting, performance-based budgeting, capital budgeting, multi-year budgeting
- **Economic analysis and revenue forecasting**, including micro-simulation, time series forecasting,

For more information about our technical assistance activities and training programs, please visit our website at <http://isp-aysps.gsu.edu> or contact us by email at ispaysps@gsu.edu.

Ukraine: Assessment of the Implementation of the New Formula Based Inter-Governmental Transfer System

Jorge Martinez-Vazquez and Signe Zeikate*

1. Introduction

Recent changes in the budget system of Ukraine

Since independence, Ukraine has tried to function with the system of public finance it inherited from Soviet times. Experience has demonstrated that this system, based on an outdated budget law of 1996, has not served Ukraine well and that it has become increasingly inappropriate for an economy struggling to make a successful transition to a modern market economy.

Among this system's more notable failures were its high degree of nontransparent and discretionary decision-making, its marked instability of both expenditure and revenue assignments for local governments, the lack of predictability for good budgeting practices, and the faulty incentives it provided for local governments to raise additional revenue and spend more effectively.

* We would like to thank Yury Hanushchak, Larisa Leshchenko, Katya Mainziouk, Irina Scherbina, Ihor Shpak, John Tissen, and especially Wayne Thirsk for their help in putting together the report. All remaining errors are those of the authors

Within the old system the budgetary process and relationships among governments at different levels have followed the model of the traditional budgetary "matroshka". As the first step in a sequential budgeting process, the Ministry of Finance has prepared a Consolidated budget for the country which partitioned budgetary resources between the State budget and budgets for all of the oblasts. Oblast budgets were primarily financed by an arbitrary combination of shared taxes and transfers from the State budget. Transfers were granted to cover any difference between planned expenditures and expected revenue and any oblast for which this difference was negative was required to make a contribution to the State budget.

Oblasts submitted their expenditure requests, or needs, using a norms-based calculation of what it would cost to finance the existing public sector infrastructure within an oblast. Using this system, the focus was on existing institutional network rather than on potential clients and actual needs.

After oblasts were informed of the size of their resource envelope, they in turn had to allocate that amount among their own budget and the budgets of the cities and regions that were subordinate to them. In turn, regions balanced their budgets and those of their constituent towns, villages, and settlements using a similar combination of shared taxes and transfers.

Almost every year since independence the subnational government finance system in Ukraine has been marked by a different pattern of tax sharing and transfer payment arrangements. For example, in 1997 and 1998, proceeds from the personal income and enterprise profit taxes were assigned exclusively to local budgets. In 1999, however, these income tax sources were once again shared between the State and oblast budgets. For the year 2000 the personal income tax was assigned entirely to local budgets and the enterprise profits tax became an exclusively State revenue source with the exception of Crimea and the city of Kiev. Under separate legislation these two subnational governments continued to receive all of the profit tax collected on their territory. The 2001 budget has preserved the revenue arrangements of the previous year. The fiscal instability associated with continuously changing revenue patterns and unclear expenditure responsibilities has adversely affected the ability of local governments to routinely and effectively plan and execute their budgets.

The year 2001 marked a new phase in intergovernmental fiscal relations in Ukraine. For the first time, a formula-driven local government finance equalization system was introduced. In addition, the formulation of local government budgets was based on objective, neutral criteria using uniform formula across the country to compute the revenue capacity and expenditure needs of local governments.

The new rules for the budget process were stipulated in the Law on State Budget for the year 2001 and The Cabinet of Ministers Resolution number 1932 of December 29, 2000 “Procedure for Calculation of Inter-governmental Transfers (Equalization grants, Subventions, and Contributions to the State Budget) for 2001”. But the most significant change in the legal framework has been provided by the new Budget Code, which was adopted on March 22, 2001. The Budget Code establishes new foundations for the budget system of Ukraine. It also defines entirely new principles in the design of intergovernmental fiscal relations in Ukraine. Perhaps the most radical break with the past is that the Budget Code divides local governments up into three separate and independent local budgetary units: oblasts, cities and regions. Cities and regions are no longer under the subordination of oblast governments. Local government budgets for 2001 were still calculated by the Ministry of Finance only for the oblasts, as had been the case in previous years. The oblasts, in turn, prepare the budgets for cities and regions of oblast subordination. However, starting with the year 2002 each local government: oblasts, and separately cities and regions (686 units in all) were included in the direct and independent budget formation process by the Ministry of Finance.

The main objective of this report is to examine the performance of the new equalization grant system during its two first years, 2001 and 2002. The rest of this introduction summarizes the main performance issues, which are developed in more detail in the balance of the report.

A summary view of the performance of the Equalization Grant System in 2001

The new system of equalization transfers as specified in the Budget Code was not fully introduced until 2002, which coincided with the actual application of the Budget Code starting in January 2002. During 2001, the Ministry of Finance implemented the new equalization grant dealing exclusively with oblast governments, following the

approach it had followed during the entire transition period. Thus during 2001, the oblast governments were still responsible for distributing the “equalization funds” among regions and cities. The Ministry of Finance did not force oblasts, although it recommended them, to use the formula introduced in the Budget Code for the distribution of funds in 2001. Among other reasons, it was felt that the oblasts would not have had the data needed to implement the Budget Code formula. The oblasts appear to have used a variety of approaches, some similar to the formula in the Budget Code and others more traditional, to distribute the funds.

A critical aspect of the performance of the new equalization system is whether it has increased certainty and the predictability of budgets at the subnational level by actually delivering the transfer amounts it promised to deliver.¹ Unfortunately, there are no disaggregated budget execution data for 2001 at the city and region level, or so it appears.² The aggregate information available shows that in 2001 oblasts got the amounts of equalization grants specified in the budget. Actually, the aggregate funds received by the oblasts exceeded the funds specified in the 2001 State Budget. This “over-funding” appears to be closely related to the “transition mechanism” adopted by the Government for 2001. Oblasts were given 10 percent of the consolidated “general expenditure fund” with the objective of smoothing out the transition for those jurisdictions that would be most affected by the switch in funding mechanisms (from inputs and structures to population and clients). In some oblasts, it appears there were disputes between the oblast finance department and the cities and regions about the actual distribution of the transitional funds. The Ministry of Finance did not have the information or the channels to monitor the distribution of the funds during 2001.

¹ It should be noted that, as explained further down in the report, there are also donor jurisdictions which pay into the equalization fund.

² There have been conflicting messages regarding the 2001 disaggregated data. The mission had been delayed on the expectation that the Ministry of Finance would have had ample time to collect the 2001 data. It now appears that the data at the city and region levels were never collected. In fact, the Ministry of Finance appears to have continued to operate in 2001 as it has been operating until then. It only dealt with oblast governments and if it collected any data on the cities and regions of oblast subordination, these data were provided in an aggregate manner by the oblast government itself. This is consistent with the way the Ministry of Finance, we saw, managed the new equalization grants in 2001: it allowed the oblasts to define the amount of the equalization transfer to go to cities and regions. Since there was no clear mandate from the Ministry of Finance regarding how to distribute the equalization fund, there was no interest in collecting and verifying the data for the transfers from the oblasts to the cities and regions.

Thus, 2001 was definitely a transition year in the implementation of the new system of equalization grants. Although the Ministry of Finance used the new methodology in the Budget Code, the actual transfers were made only to the oblast governments and they were made responsible to implement the equalization grants to cities and regions. The Ministry of Finance encouraged, but did not require that, the oblasts use the Budget Code methodology.

A summary view of the performance of the Equalization Grant System in 2002

For FY 2002, the Ministry of Finance implemented directly the formula-based equalization transfer for all oblasts and regions and cities (of oblast importance), 686 budgets in all. The information available indicates that for the first two quarters of 2002 recipient jurisdictions received approximately half of the equalization funds budgeted for 2002. Thus, transfer payments appear to be generally on schedule. The approximation is due to the peculiar process used to distribute funds in Ukraine. Subnational jurisdictions are paid out of a “third basket” of state taxes. When these funds are not sufficient, the Ministry of Finance makes adjustments, but only with a lag at the end of the quarter.³ During 2002, the Government still used the same transition mechanism as in 2001: 10 percent of the “general expenditure fund”.⁴ And as in 2001, the 10 percent contingent funds were channeled through the oblast budget departments rather than being directly distributed by the Ministry of Finance to cities and regions. This would seem to go against the spirit of the New Budget Code, which aims at eliminating any budgetary dependence of cities and regions on oblast governments. The reasoning by the Ministry of Finance for using the oblast governments for this purpose is that oblasts were much more likely to have the right information on the local jurisdiction changes in tax bases (capacity) in the previous years, and hardship with funding social facilities (“unevenness of the network”). Note that all oblasts were given the 10 percent transitional funds, regardless of hardship or changes in tax bases. Overall the emphasis in the distribution of

³ The adjustments in 2001 were made only once at the end of the year.

⁴ In this area there has been no compliance with the Budget Code. The Budget Code provided a transition fund of 5 percent of the transfer amount for the first year of implementation, 4 percent for the second year, and so on until the eventual elimination of the transition funds. For 2003, the plan is to use a transition fund of 4 percent of the pool of equalization transfers as mandated in The Budget Code.

the transition funds appears to have been not to accelerate adaptation to the new funding scheme but rather to soften the blow implied by the change.⁵

In summary, with the inevitable problems in a new system plus some others, the new system of equalization transfers in Ukraine is fulfilling two of its most important goals: increasing objectivity in the subnational budget process and increasing budget predictability for local governments.

The evolving structure of equalization transfers and the future agenda for reform

Ukraine's new system of equalization transfers has many positive features, which should be kept and enhanced if possible. Some of these positive features include the use of virtual expenditure norms to derive expenditure needs, which are client-based (as opposed to input-based) and defined from the top to be affordable (within the means of the current budget). In addition, these norms are not mandatory for local governments. These have complete discretion to spend the funds. The new equalization grant is also quite transparent,⁶ and is likely to be strongly equalizing.

However, there are several unresolved issues with the current approach and some other issues have emerged during the early implementation of the system, which will need to be addressed in the future. The most important ones are summarized immediately below:

- The coverage of the equalization grant system remains incomplete. The basic fiscal gap formula now used (expenditure needs minus fiscal capacity of a local government) excludes in the computation all "own expenditure responsibilities" of local governments on the side of needs and the "first basket" of revenues (or own revenues) on the side of fiscal capacity. It is highly unlikely that there will be a balance between "own expenditures" and "own revenues" across all regions, cities and oblasts. Currently, there is no information on this issue. These items represent between one-third and one-fourth of local budgets. There is a need to

⁵ Although also legitimate, the exclusive use of funds to soften the blow of change also can provide incentives to move more slowly in the adaptation process. A jurisdiction that keeps facilities with excess capacity open is more likely to receive transition funds the next year.

⁶ As we will see below, there is less than full transparency because, for example, many of the adjustment coefficients in the derivation of expenditure needs are calculated within the Ministry of Finance without full disclosure of what is involved.

investigate the relative importance of this issue and explore the expansion of the current formula to include these items now excluded.

- A second issue in coverage is how to structure the implementation of equalization grants below the rayon level, including towns and settlements.⁷ While it is not clear whether the Budget Code envisions a system at this level that is also implemented from the center, it is unlikely that the Ministry of Finance will compute and distribute grants for the thousands of these lowest tier governments. It is more likely that, in the future, regional (rayon) governments will still be in charge of implementing these transfers. The Central Government needs to examine how it would address this issue. One choice is to let regions decide how to organize these transfers on an individual basis. Another approach more in tune with the spirit of the Budget Code is for the central government to legislate very tightly the approach, including the formula, which the regions will have to use. An intermediate approach is to dictate to the regions the general parameters of the formulas they will have to obey.⁸ Parallel to the reform of the intra-rayon finances there may also be a need for an administrative reform. The regions themselves are quite uneven in population size and area. It would appear that there is considerable scope for increased efficiencies following the consolidation of the smaller units.⁹
- The measurement of fiscal capacity is based on a moving average of past year revenues. This remains problematic. This is not so much a problem because of the negative incentives to revenue mobilization which the approach may create (to a large extent this problem is controlled in the formula¹⁰), but because of the inability of this type of fiscal capacity computation to be forward-looking. This

⁷ The closing provisions of the Budget Code charge the Cabinet of Ministers with preparing a draft law that “normalizes” the intra-region (or intra-rayon) intergovernmental fiscal relations based on the provisions of the Budget Code itself.

⁸ See Wayne Thirsk. (2002). “A Fiscal Glance Inside a Set of Rayons.” FAO. Kiev (August) for an excellent discussion of the required changes in expenditure assignments inside rayons and potential formula transfers that rayons can be asked to implement.

⁹ As a general rule, cities under 50,000 inhabitants are put under the jurisdiction of the rayon government. But again there are large variations from big cities to tiny settlements. Administrative structure reform and related issues are being considered by a government working group.

¹⁰ As discussed below, the approach used in the formula to get around the negative incentives arising from the use of actual revenues in the calculations is to fix the relative index of fiscal capacity (which uses revenues from the past years) for a period of three years or so.

means, for example, that jurisdictions in a downward revenue trend because of economic structure changes (e.g., consecutive plant or mine closings) get consistently over-inflated fiscal capacity estimates. The way the Ministry of Finance has been dealing with this problem is to change the results of the formula when there is evidence that the actual revenues may be well under those predicted by the formula. These adjustments are being made through a process of consultations and dialog between the local governments and the Ministry of Finance. Although this adjustment process may be quite proper, there is the danger that it may open the back door to the old negotiation and bargaining that went on in the previous budget process paradigm. Thus, there is a need to reconsider the methodology used in the estimation of fiscal capacity. Planning for the future, with better data collection, there may be a possibility of using a modified representative revenue system or other sound approach to estimating fiscal capacity

- There seems to be a tradition being born of changing the formula by Cabinet Resolution every year. The government needs to be aware that frequent changes may convey an image of instability and a lack of commitment by the central authorities. The changes for 2002 have made the formula more complex. These increases in complexity, of course, have reduced transparency. It now is less likely that ordinary mayors and local councils will be able to compute their own transfers in advance. As a *modus operandi*, it would be preferable to examine in depth the needed changes and only introduce them after a period of several years.
- The Government is currently considering radical reforms of the PIT (personal income tax). It appears that most of the reform alternatives being considered will imply revenue reductions in the PIT of around 30 to 40 percent. Because the PIT is a key source of revenues for local governments, there will be a need to consider what changes will be needed in the equalization grant system besides the obvious increase in the overall pool of funds.
- In addition to the equalization grants, which provide lump sum or unconditional funding to local governments, the Central Government also implements several categorical or conditional transfers to local governments for communal services,

housing for the military, and for social assistance. There is also a system of capital development grants administered through the Ministry of Economy. Questions have been raised regarding the objectives and procedures with these grants. Currently the Ministry of Economy is studying the introduction of more objective procedures, including the use of formulas, for the implementation of capital grants. It is also necessary to define how these other grants should be considered in the context of the equalization grant.

We now proceed to take a closer look at the implementation and performance of the new equalization grants in 2001 and 2002. We close with some recommendations.

1.

2. Local Government Finance in 2001

Starting in 2001, local government finances were equalized on the basis of an explicit and uniform equalization formula.¹¹ The legal basis for the calculation and distribution of the new equalization grants among local governments was provided by Cabinet of Ministers Resolution no. 1932 of December 29, 2000 “Procedure for Calculation of Inter-governmental transfers (Equalization grants, Subventions, and Contributions to the State Budget) for 2001”¹² and the State Budget Law for 2001.

The Resolution of the Cabinet of Ministers for 2001 approved the formula and the procedures for the calculation of equalization grants. The appendixes of the Resolution show detailed calculations and the actual transfers from the equalization fund to local governments, and contributions from the better-off local governments to the equalization fund.¹³ The annual State Budget Law (in this case 2001) in relation to intergovernmental fiscal relations issues sets the general provisions for the formulation of local government budgets, including types and amounts of revenues that will be allocated to the local government, and kinds and amounts of intergovernmental transfers. The State Budget Law also regulates the procedures for the transfer of moneys to and from the Fund. In

¹¹ The term “local government” for the purpose of description of the year 2001 includes: Autonomous Republic of Crimea, oblast consolidated budgets and the budgets of the cities of Kiev and Sevastopol. Oblast consolidated budgets include budgets of regions (rayons) and cities of oblast significance.

¹² Further in the document - Resolution of the Cabinet of Ministers for the year 2001.

¹³ As explained below in more detail, the equalization system in the Budget Code adopts a “fraternal” approach to funding the equalization pool. While worse-off local governments receive an equalization grant, better-off local governments have to contribute, in both cases according to an explicit and objective formula.

actuality, Article 44 of the 2001 State Budget Law delegated responsibility to the Ministry of Finance to work out the procedure for the distribution of intergovernmental transfers. This procedure was approved by the Resolution of the Cabinet of Ministers for the year 2001.

A brief description of the Equalization Mechanism in 2001

Before we get into the details of the equalization mechanism for 2001, it is necessary to make clear that the methodology followed for the computation of transfers this first year deviated in important ways from the system contained in the Budget Code. These deviations were in large part necessary due to the lack of time and information the Ministry of Finance had in putting the budget together for 2001. There is consensus, however, that the system implemented in 2001 respected the paradigm and principles behind the new Budget Code. The deviations from the Budget Code included:¹⁴

First, the transfers for cities and regions were not implemented directly by the Ministry of Finance as envisioned by the Budget Code. Rather the oblast governments were commissioned one last time to compute and implement equalization grants for their cities and rayons under guidance of the Ministry of Finance. Despite the fact that oblasts were supposed to use the formula developed by the Ministry of Finance, some oblasts only partially followed the formula either because they did not have the information to implement it or preferred to use other methods. As discussed below, the Ministry of Finance did not have the ability to monitor in detail the doings of oblasts and there were some significant deviations from the formula with subsequent complaints from cities and regions.

Second, there was a transition mechanism in place to soften the budgetary dislocations (or so-called disproportions) implied by the new approach to computing expenditure needs based on clients as opposed to facilities. Oblast governments were granted authority to deviate to plus or minus 10 percent for the computation of expenditure needs in each functional area. As discussed further below, the government

¹⁴ See *Intergovernmental Reform Monitor. Budget and Fiscal Review*. Fiscal Analysis Office. Verkhovna Rada, Budget Committee. June 2001, page 5.

provided the oblasts with additional funds to manage this transition mechanism but the funding was different from that envisioned in the Budget Code.

Third, local revenues considered for the calculation of fiscal capacity and the equalization transfer were all revenues assigned that year to the local government, including the land tax. On the other hand, the Budget Code envisions a second basket of local revenues, of which the land tax forms part, that are excluded in the calculation of equalization transfers.¹⁵

Fourth, the State Budget Law for 2001, surprisingly, asked the oblasts to customize their sharing rates for the PIT with the cities and regions, going against the principle in the Budget Code of uniform sharing. The objective of this guideline was to avoid “unnecessary” transfer dependence of cities and regions from the oblasts.

The amount of equalization grants from the state budget to the local government budgets and local government contributions to the equalization pool T_i is calculated as the difference between estimated expenditure need for each local government V_i and the forecasted (by uniform formula) amount of revenues to be collected on the respective territory D_i : $T_i = V_i - D_i$

Therefore, the amount of the transfer T_i is positive when estimated expenditure needs exceed forecasted revenues and negative when forecasted revenues are larger than estimated needs. In fact, Ukraine’s equalization system uses a mixture of funding approaches: a) a fraternal or “Robin Hood” system, since local governments with fiscal capacity in excess of expenditure needs contribute to the fund (although literally they pay the central government), and b) a vertical funding system, since the central government contributes to the overall amount of transfers (in other words, the total amount transferred exceeds the [fraternal] contributions of richer local governments.)

Revenues

For 2001, the forecasted revenues for each local government D_i is composed of receipts from *national taxes* and *fees* assigned to local government budgets (**D_i assign**)

¹⁵ The enterprise profit tax on communal enterprises is also part of this second basket according to the Budget Code. However, in 2001 those tax revenues were temporarily assigned to the central government.

and *own revenues* (**D_i own**).¹⁶ In addition, for the Autonomous Republic of Crimea (ARC) it is necessary to add the receipts from the *enterprise profit tax and excise tax*¹⁷ and for the City of Kiev those from the *enterprise profit tax* (**D_i special**). The current revenue assignments make those two special (asymmetric) allocations. Thus, we have that: **D_i = D_i assign + D_i own + D_i special**

The share of national taxes and fees that are allocated to each local government budget (D_i assign) is calculated on the basis of a fiscal capacity index **K**¹⁸. The index K is calculated for each local government on the basis of the actual execution of these taxes and fees for the years 1998, 1999, and the first ten months of the year 2000 (as approved in Appendix 2 of the Resolution of the Cabinet of Ministers for the year 2001.)

The following national taxes and fees were included in the D_i assign and calculated based on fiscal capacity index for 2001:

- 1) Personal Income tax¹⁹
- 2) Land tax
- 3) Stamp duty
- 4) Fees for issuing licenses and certificates for business activities
- 5) Fees for state registration of business entities
- 6) Fees for trade patents
- 7) Fines for violation of rules (except those paid to State Road Inspectors and those paid by authorization of the Antimonopoly Committee)
- 8) Fines, penalties and financial sanctions paid for violations of legislation related to taxes, fees, and mandatory payments
- 9) Uniform tax for small business entities.

¹⁶ Note that, starting in 2002, as discussed below, the procedure followed in the Budget Code and the basket of “own” revenues was excluded for the purpose of the calculation of equalization grants.

¹⁷ Excise tax that is paid on domestic goods except on petrochemicals.

¹⁸ Detailed calculation of K is showed in Appendix 2 of this report.

¹⁹ Actually the personal Income tax for each local government is calculated on the basis of a fiscal capacity index separately from the rest of the taxes and fees.

A fixed part of the agriculture tax and proceeds from the sale of non-agricultural land were also allocated to each local government (as a part of D_i assign) but calculated using a different methodology. Amounts of these taxes were also fixed in Appendix 2 of the Resolution of the Cabinet of Ministers for 2001 for each local government.

As just mentioned above, the personal income tax for each local government was calculated separately from the rest of the taxes and fees on the basis of a fiscal capacity index. The amounts were approved in Appendix 3 of the Resolution of the Cabinet of Ministers for 2001. The Resolution (Article 21) requires that the Verkhovna Rada of ARC and the Oblasts Radas²⁰ approve the shares of the receipts from the Personal Income tax that will be paid to the cities' regions within the ARC and oblasts jurisdiction.²¹ The Resolution of the Cabinet of Ministers for the year 2001 also requires that when collections from personal income tax exceed forecasted amounts, 75% of that "surplus" amount shall be paid to the city or region budget and 25% to the ARC or oblasts budget.²² Clearly, these measures are transitory because they leave allocations of revenue sharing between the oblasts and cities/regions to the discretion of the oblasts. Recall that in 2001, the Ministry of Finance had to implement the new equalization grant through the oblast budgets.

Turning now to the second component of forecasted revenues, local government *own revenues* (D_i own), the 2001 methodology distinguished user charges for the children in boarding schools for 2001 from all other own revenues. These user charges for the children in boarding schools were calculated and approved separately in Appendix 4 of the Resolution of the Cabinet of Ministers for the year 2001. Each type of local government own revenues was calculated on the basis of the approved amount (of own revenues) in 2000 and multiplied by a coefficient K_{OWN} equal for all local government - 0.75.²³ Own revenues comprised the following:

²⁰ "Rada"- Council; "Verkhovna Rada" – Highest Council

²¹ The language used is that the amounts should ensure that the budgets are balanced and might not be reconsidered during the budget year.

²² The exception is when the city or region budgets have been allocated a larger share than 75%.

²³ The Resolution of the Cabinet of Ministers for 2001 (Article 19) prohibits increasing the overall amount of taxes and fees that were allocated to local budgets, as stipulated in Appendix 4.

- 1) Local taxes and duties
- 2) Receipts of interest from budget surplus funds
- 3) Craft tax
- 4) Receipts of dividends
- 5) Fees for leasing of property
- 6) Receipts from the sale/privatization of property
- 7) Receipts from local lotteries
- 8) Fees for use of natural resources of local importance
- 9) Fees for extending the local governments guarantees
- 10) Other revenues set by the legislation.

Let us address D_i special the last component of the forecasted local revenues. For this component the Resolution of the Cabinet of Ministers for 2001 defines exactly the total amount of each tax for ARC and the City of Kiev.

All in all, local governments forecasted amount for the general fund for the year 2001 constituted Hr.13 279.9 mill which exceeded the Ministry of Finance's calculated amount by Hr. 1 181.6 mill (including the budget of Kiev – Hr. 946.5 mill and the consolidated budget ARC –Hr. 208.4 mill). Local governments increased them by a total of Hr. 25.5 mill, of which: the ARC –Hr. 3.5 mill, Kirovograd oblast –0.3 mill, Mykolayiv oblast –12.8 mill, and Khmelnytsky oblast – 8.9 mill.²⁴ The actual execution of the local governments' general fund (excluding intergovernmental transfers) in 2001 was Hr 15 084.5 mill or 6.6% higher than the local governments' forecast.

Expenditure

The estimated amount of local spending was defined separately for each sector based on unified normative spending for the entire state. Expenditure norms or normative spending for such functions as administration, health care, physical culture and sports, social programs dealing with families, women, and children were calculated on a per capita basis. In addition, normative spending for education was calculated on a per student basis, for social protection and social security on a per recipient basis, and for

²⁴ These data are reported in the “Researchers Report on Transfers.”

housing and communal sector on the basis of per square meter of housing stock and streets and squares with capital and road lights and so on.

The amount of total expenditure needs for each local government was calculated as the sum of expenditure needs calculated for each function separately:

$V_i = V_i \text{ administration} + V_i \text{ health} + V_i \text{ education} + V_i \text{ social} + V_i \text{ culture} + V_i \text{ mass media} + V_i \text{ sport} + V_i \text{ housing} + V_i \text{ transfer of assets} + V_i \text{ capital invest.} + V_i \text{ water rescue} + V_i \text{ law enforcement} + V_i \text{ other measures} + V_i \text{ repayment of wages} + V_i \text{ non distributed reserve.}$

Examples of calculation of expenditure needs for some of the functions are shown in Appendix 1 of this report. Essentially, the steps are as follows. First, the Cabinet of Ministers proposes and the Verkhovna Rada approves the consolidated budget envelope for the public sector for the coming year and what share of that is to go to subnational budgets.²⁵ Second, the Cabinet of Ministers proposes and the Verkhovna Rada approves the priority apportionment of the aggregate subnational expenditures into the delegated functions that comprise public administration, education, health care, culture and arts, and so on. Third, based on those amounts, the Ministry of Finance computes the basic expenditure norms for the entire country normalizing by population, number of students, etc. Fourth, given the basic norm for each expenditure category, the expenditure need for each local government is equal to the product of three items: a) the basic expenditure norm (per capita, or per student, etc); b) the population or the number of students, etc. in the local government; and c) a vector of coefficients that work to adjust the expenditure need up or down for special needs and/or differential costs of service provision.

The Transitional Fund

According to Article 50 of the State Budget Law for the year 2001, the fund should be established that is not distributed on an equalization formula basis but is allocated to the ARC and Oblasts budgets for further distribution among cities and regions within the relevant territory. The Fund is calculated as 10% of each oblast and ATC consolidated budget expenditures.

²⁵ This fraction has been typically between 30 and 35 percent. There are plans to increase the fraction to 40 percent in 2003.

The rationale for the allocation of the 10 percent additional grant for local governments was to give them more flexibility in service financing and to smooth out the transition period from the institution-based to the client-oriented financing.

One reason the Ministry of Finance decided to distribute the fund from the oblast and ARC level, was that oblasts and ARC should have better information on the necessity for additional funding and transitional adjustments needed for the regions and cities. The Ministry of Finance advised that five percent (out of ten) could be used for adjustment in case of marked revenue decrease and another five per cent could be used for financing existing infrastructure, especially large social institutions that might suffer due to changes in the financing system. This division of the Fund in five and five percents was not legally required but was an initial philosophy of the Ministry.

Oblasts and ARC were to support any redistribution with objective justifications for that and to use unified criteria for all regions within the oblast and for cities in ARC.

According to the Ministry of Finance prepared information to the Cabinet of Ministers on the implementation of the Regulations of the Cabinet of Ministers,²⁶ approximately 70% of Oblasts²⁷ centralized or partially centralized that financing for their own budget needs. There were cases when the Fund was left as undistributed reserve for the oblasts' budget (Kyiv, Khmel'nitsk Oblast) or situations where money was used to finance the centralized capital investments (Khmel'nitsk Oblast).

It is also mentioned that there were many cases when oblasts reduced city and region budgets determined in accordance with the equalization formula and used these resources to increase their own general program financing²⁸.

With the approval of the Budget Code (March 22, 2001) it was stated (Section VI Closing Provision Article 3) that during the first five years after the enactment of this Code an inter-governmental transfer from the state budget of Ukraine may be provided to reduce the actual disproportion across local budgets that results from the uneven allocation of the set of budget-funded entities.

²⁶ Document On the Results of the Implementation check up of the Cabinet of Ministers of Ukraine resolution #1932 dated December 29, 2000.

²⁷ Vinnitsa, Volyn, Donetsk, Zhitomir, Zakarpattia, Zaporizhia, Lviv, Mykolaiv, Odesa, Poltava, Rivne, Summy, Ternopil, Kharkiv, Kherson, Khmel'nitsk, Chernivtsy, Chernihiv Oblasts centralized their regions' financing in the amount of 101,1 mln. Hryvna.

²⁸ For example – Donetsk and Lviv Oblasts.

According to the Budget Code, starting in 2002 the amount of additional transfers had to be calculated as five percent of the overall amount of equalization grant from the state budget of Ukraine to local budgets. It is also stated that for the following years the amount of the grant should be reduced by one percent, meaning that in the year 2003 the grant should be four percent and by the year 2006 the amount of the grant should be equal to the one percent of the state grant to the equalization fund.

With the adoption of the State Budget law for the year 2002 this provision was changed (for the year 2002) and an additional fund was calculated using the same methodology as in year 2001.

At the same time, it has been planned to apply the rule stated in the Budget Code (allocation of intergovernmental transfer to reduce the actual disproportions across local budgets due to uneven location of budget-funded entities. The transfer is calculated for the year 2003- 4% of state grant to the equalization fund) starting from the year 2003.

In the existing version, the Budget Code does not delegate the right (or responsibility) to any institution (Cabinet of Ministers or Minister of Finance) to work out procedures for the fund distribution among local government budgets. Considering the two previous years practice, it is advisable to set up procedures and clear rules for the fund distribution of the transitional funds by oblasts to cities and regions.²⁹ Such criteria may be, for example, to provide assistance only to local governments with declining revenues over the last three years and to those that are consolidating and closing physical facilities.³⁰

Adjustment coefficient

According to Article 31 of the Resolution of the Cabinet of Ministers for 2001, oblasts were allowed to use an additional adjustment coefficient for the calculation of expenditure amounts for the respective functions of cities and regional government budgets. These calculated deviations could not be more than +/- 10 percent of the calculated expenditure need in accordance with the equalization formula. In practice, this

²⁹ To a large extent the issue revolves around what the Ministry of Finance capable of monitoring at the subnational level, rather than setting criteria.

³⁰ Apparently it is not uncommon for a town of 15,000, for example, to have four high schools with four swimming pools.

requirement was not complied with in many Oblasts. For example during the calculation of expenditures on education, many oblasts made some adjustments but the +/- 10% rule was not applied in Zhitomir, Zakarpattia, Lviv, Kherson, and Chernihiv oblasts. Some oblasts increased their own financing or made adjustments without applying the formulas specified in the Procedures of the Cabinet of Ministers. A similar situation arose in the calculation of other functions, like *Art and Culture*. Also, different per capita norms were used in Odesa and Ternopil'ska Oblasts for the calculation of expenditures on *Physical Culture and Sport* and so on.³¹

What did actually happen with the distribution of the 10 percent additional funds in 2001? According to the Ministry of Finance, in practice there were not always justifications for how the funds were distributed by the oblasts, and in some cases different approaches were used for different regions within the same oblast. According to the information provided by the Fiscal Analysis Office in the report "Budget and Fiscal Review,"³² the most severe violation of the formula approach was in Ternopil'ska and Odesa Oblasts where they actually changed the calculated per-capita expenditure norms. Non-application of the established formula was also observed in the Odeska Oblast. Finally, the relative fiscal capacity indexes were not followed in the Crimea, Volyn'ska, Kyiv'ska, Odeska, Sumska, Kherson'ska, and Chernihiv'ska Oblasts.

All observed violations can be summarized in two categories: (a) centralization of expenditure resources intended for redistribution at the oblast and ARC level and (b) failure to use the additional adjustment coefficients (Table 1). Oblasts that applied additional adjustments failed to use the coefficients for such adjustments by different functions. But, on the other hand, it needs to be stressed that neither the Resolution of the Cabinet of Ministers for 2001 nor the 2001 State Budget Law specified possible coefficients or the criteria that should be used for the calculation of these coefficients. Therefore, to a large extent the failure to apply adjustment coefficients may have been driven by the lack of clarity and support in the corresponding legal framework. (See Table 1).

³¹ Document On the Results of the Implementation check up of the Cabinet of Ministers of Ukraine resolution #1932 dated December 29,2000.

³² Report prepared by the Fiscal Analyses Office, June 2001, Kiev

Table 1: Summary of Application of the Procedure in Determining Transfers from Oblasts to Regions and from ARC to cities

Oblasts	Application of Formula	Additional adjustment of expenditure needs within 10%		Other
		Allocation of Expenditure Resources	Application of Adjustment Coefficient	
Crimea	Indexes of fiscal capacity are not applied	Partially centralized by Oblast	Partial	Funds were centralized for Oblasts general funds expenditures (health, education, construction)
Vinnytska		Partially centralized by Oblast	Partial	
Volynska	Indexes of fiscal capacity are not applied	Partially centralized by Oblast	Partial	
Dnipropetrovska		Not applied	Not applied	Adjusted distribution of expenditure resources through repayment of loans of previous periods
Donetska		Partially centralized by Oblast	Partial	
Zhytomyrska		Partially centralized by Oblast	Partial	
Zakarpatska		Partially centralized by Oblast	Partial	
Zaporizka		Partially centralized by Oblast	Partial	
Ivano-Frankivska		Partially centralized by Oblast	Partial	
Kyivska	Indexes of fiscal capacity are not applied	Partially centralized by Oblast	Partial	
Kirovogradska		Partially centralized by Oblast	Partial	
Luhanska		Partially centralized by Oblast	Partial	
Lvivska		Partially centralized by Oblast	Partial	Centralized proceeds from sale of non-arable land for oblast investment programs
Mykolaivska		Partially centralized by Oblast	Partial	
Odesa	Own formula	Partially centralized by Oblast	Partial	Funds were centralized for education expenditure, updating of libraries and computerization of rural schools
Poltavska		Partially centralized by Oblast	Partial	
Rivnenska		Partially centralized by Oblast	Partial	
Sumska	Indexes of fiscal capacity are not applied	Partially centralized by Oblast	Partial	
Ternopil'ska	Changed expenditure norms	Partially centralized by Oblast	Partial	

Kharkivska		Partially centralized by Oblast	Partial	
Khersonska	Indexes of fiscal capacity are not applied	Partially centralized by Oblast	Partial	
Khmelnyska		Partially centralized by Oblast	Partial	
Cherkaska		Partially centralized by Oblast	Partial	Centralization of funds for health expenditures
Chernivetska		Partially centralized by Oblast	Partial	
Chernihivska	Indexes of fiscal capacity are not applied	Partially centralized by Oblast	Partial	Centralization of funds for transportation of pupils to schools, purchase of medical equipment

Source: “Budget and Fiscal review”, Fiscal Analyses Office, June 2001

Procedures for the Flow of Funds under the Equalization Grant – for 2001

Ordinarily, if a developed national Treasury system for budget execution exists, there would be little concern for how the funds should flow into the local government budgets on the account of the equalization funds. This should be little else than a matter of internal public accounting. Although Ukraine is proceeding with the introduction of a modern Treasury system, the current situation is such that local governments still need to worry about the timely delivery of funds that have been budgeted. The past transition years in Ukraine are full of instances when subnational governments got no funds that had been budgeted or got them with significant delays. In addition, there is an important issue with incentives to increase tax collections. The procedure for the transfer of flows actually takes importance of its own in the case in which there is an “over execution” of the budgeted amount. In these cases subnational governments get to keep a share of the over executed funds, the rationale being that subnational governments will be interested in the smooth collection of state taxes in such cases. Even though the tax administration is a national agency, de facto there is a dual subordination of tax administration officials to local authorities too. For this reason, there is a belief that local authorities can influence the actual performance in the collection of national taxes.

Thus, the 2001 State Budget Law (Article 42) defines a “third basket” of state taxes and fees from the state general fund that should be used to transfer funds to local governments for equalization purposes. The taxes in the “third basket” include:

- 1) Duty for the special use of national forests
- 2) Duty for the special use of national mineral resources
- 3) Fees for the use of other mineral resources of national nature
- 4) Value added tax (VAT)
- 5) Excise taxes on goods manufactured in Ukraine (except petrochemicals)
- 6) Excise taxes on goods imported into Ukraine (except for petrochemicals and transport vehicles)
- 7) Import and Export duty
- 8) Fee for the documents processing to get a visa
- 9) Fines for tax law violation, and
- 10) Seven more different types of payments.

The oblast branches of the State Treasury of Ukraine are responsible for the daily transfer of the fund using the daily remittance rate for each local government. The daily remittance rates are established as the ratio of the amount of planned transfers to the forecasted amount of collected state taxes and fees used for equalization transfers within a particular oblast. These daily remittance rates and the total amount of the equalization transfer are stated in the Appendixes of the State Budget Law.

The provisions for 2001 were that if the amounts of transfers from the State budget (due to unforeseen changes in actual budget collections) were smaller than the forecasted amount, the State Treasury not later than December 20 of the current year had to offset the difference using moneys from the general fund of the state Budget of Ukraine. Note that local governments that have to make contributions to the state Budget of Ukraine had to follow the same procedure using daily remittance rates, as determined in the Appendix of the State Budget Law although the monthly payment should not be higher than 1/12 of the total amount.

If the collected amount of taxes and fees that are allocated from the state general fund for the payments of equalization transfer are higher than the planned amount, the over executed amount is divided between the central government and the respective local government budgets and accounted as an additional grant to the local government budget.³³

A glance at the data on the execution of the equalization transfers for the first quarter of 2001 reveals that the real execution of the fund is not the same for the different oblasts and cities and varies from 16% to 39% of the annual amount³⁴. The local government payments to the fund varies from 5% to 21% of the annual norm. See Table 2.

Table 2: Execution of Equalization Transfers in January – March 2001

Oblasts	Equalization Transfer	Deduction	Equalization Transfer	Deduction	Equalization Transfer	Deduction
	Planned for the 2001 thousand of Hr		Executed at the first quarter thousand of Hr		Executed at the first quarter (%)	
Crimea		50 531.5		2 616.7		5.18%
Vynnytska	249 291.9		76 055.6	-	30.51	
Volynska	176 756.3		53 834.8	-	30.46	
Dnipropetrovska		34 651.6	-	5 960		17.20
Donetska	114 006.8		17 816.5	-	15.63	
Zhytomyrska	217 358.1		53 546.4	-	24.64	
Zakarpatska	241 359.2		63 283.0	-	26.22	
Zaporizka	11 798.5		2 546.2	-	21.58	
Ivano-Frankivska	255 124.0		73 576.4	-	28.84	
Kyivska	177 163.0		66 802.7	-	37.71	
Kirovogradska	159 766.0		45 304.1	-	28.36	
Luhanska	200, 462.1		48 710.1	-	24.30	
Lvivska	286 997.8		78 432.2	-	27.33	
Mykolaiivska	137 259.1		34 363.7	-	25.04	
Odeska		4 572.0	-	932.7		20.40
Poltavska	91 227.9		19 369.5	-	21.23	
Rivnenska	204 151.0		60 657.5	-	29.71	
Sumska	122 599.4		37 511.8	-	30.60	
Ternopil'ska	213 343.7		64 147.2	-	30.07	
Kharkiv'ska	116 970.0		26 976.1	-	23.06	
Kherson'ska	178 544.3		54 865.9	-	30.73	
Khmelnitska	205 779.6		49 269.3	-	23.94	
Cherkaska	164 107.3		37 420.0	-	22.80	
Chernivetska	140 396.5		54 295.7	-	38.67	

³³ Division of the over executed amount of state general funds to local budget in 2001 was 50% for –the State budget (except ARC), 12.5% for Oblasts budget, and 37.5% for cities and regions. For the ARC the share was 62.5%.

³⁴ The norm for the first quarter is 25% of the annual amount.

Chernihivska	147 212.0		42 166.7	-	28.64	
Kyiv		2 260 230.1	-	456 090.7		20.18
Sevastopol	6 023.3		1 342.5	-	22.29	
Total	3 817 697.8	2 349 985.2	1 062 293.9	465 600.1	27.83	19.81

Source: "Budget and fiscal review", Fiscal Analyses Office, June 2001

On average the execution of the equalization fund for the first quarter was 27.83% of the annual plan.³⁵ At the same time, there were local governments for which the execution of the equalization fund was below the average; for example, Donetska Oblast –15,63%, Poltavaska Oblast-21,23%.

The existing mechanism to transfer funds proved to be highly sensitive to the ability to forecast different factors that influence revenue execution such as tax refunds, seasonality etc, and that would determine the actual execution of planned revenues. As noted above, this mechanism for the transfer of funds was created to ensure local governments receive the funds that have been budgeted in a smooth fashion and at the same time stimulate the incentives for local governments to contribute or facilitate the collection of national taxes. It is not clear how well the system is working. It is inevitable that mistakes will be made in revenue forecasting. It seems that such a low level of fund transfer in Donetska Oblast in the first quarter of 2001 could not be exclusively the result of poor tax effort of this oblast. But whatever the cause of the mismatch between forecast and actual flow of funds, the timely receipt of transfer funds is crucial for good planning and effective execution of local budgets. Of course, the 2001 system did not harm everyone; in fact, there were several oblasts that benefited from the over execution of funds.³⁶ It is not clear why the overall fund that was approved at the beginning of the budget year in the amount of Hr thous 3 817 697.8 was changed on November 15, 2001 with the budget amendments and approved in the amount of Hr thous 4 017 232.6. The overall execution of the equalization fund in 2001 was Hr thous 4 231 918.1 or approximately 5% higher than planned after amendments. See appendix 5 and 6 for

³⁵ There are different possible explanations for the "over-fulfillment" of the plan. A significant one is that the central government provides an incentive to local governments for their support for the collection of central government taxes (which accepts outright the dual subordination of tax administration officials to local authorities). The incentive consists of sharing 50/50 any state revenues in basket three that are collected above the amounts budgeted.

³⁶ Because of the over execution of state taxes and fees that are used for the payments to the equalization funds and in accordance to Article 45 of the State Budget Law there were some oblasts like Kiev Oblast – Hr 135.9 mill, Rivenska Oblast – Hr 22,02 mill., Chernivetska – Hr 15.9 mill., Chernihivska Oblast – Hr 40.8 mill. that received an additional equalization grant.

planned and executed per *Capita* local government general fund expenditures and revenues in 2001.

Other Transfers to Local Government Budgets

In addition to the equalization grant, the Government implemented in 2001 a series of special purpose or conditional transfers. The State Budget Law (Article 40) outlined the following special purpose transfers to the local government general fund:

- 1) For liquidation of aftermath of natural disasters - Hr 57.7 mill
- 2) For additional expenses of Slavutich (Kiev Oblasts) for the closure of the Chernobyl AES – Hr. 5.0 mill
- 3) For social – economic development of Yalta – Hr 10.0 mill
- 4) For the reconstruction of the City of Odesa opera house and preservation of historical buildings in Lviv – Hr 20.0 mill
- 5) For the Capital city of Ukraine – Hr150.0 mill.

A few other special transfers were allocated to the local government special purpose fund:

- 1) For privileges and subsidies related to the payments for electric power, natural and condensed gas, housing and communal services – Hr 2 896.4 mill
- 2) For socio-economic development of Sevastopol – Hr 31.7 mill.

3. Local Government Finance in 2002

The legal framework for the formulation of local government budgets and intergovernmental transfers in 2002 included, besides the new Budget Code now in force, the State Budget Law for 2002, and the Cabinet of Ministers Resolution number 1195 of September 5, 2001 “On the Approval of the Formula for the Distribution of Intergovernmental Transfers (Equalization Grants and Transfers to the State Budget) Between the State and Local Budgets³⁷.”

³⁷ Further down in this document – Procedure of the Cabinet of Ministers for the year 2002.

The most important innovation in 2002 is that the Ministry of Finance for the first time calculated the intergovernmental transfers for each of the 686 local governments including not only oblasts and the ARC, but also cities and regions.³⁸ The total amount of the equalization fund approved in the State Budget Law for 2002 (Article 34) is Hr 4.252 billion with the local government contribution amounting to Hr 3.091 billion. Thus, approximately 73 percent of the pool of equalization resources were contributed by the local governments and the balance of 27 percent were contributed by the central government (the state budget.)

Equalization Mechanism

The equalization formula for 2002 is substantially that used in 2001, but for 2002 the formula increased in complexity. The basic formula $T_i = V_i - D_i$ for 2001 was augmented with two coefficients α and β , where α - determines degree of equalization and β calibrates the forecasted amount of revenues. After adjustments the equalization formula for the year 2002 is as follows:

$$T_i = \alpha_i (V_i - (D_i - \Delta D_i \beta_i))$$

The process for computing the equalization grant in 2002 followed more closely than in 2001 the general guidelines in the Budget Code. In particular, the calculation for the equalization formula in 2002 does not include all revenues allocated to the local government budgets nor does it include all local government expenditures. In 2002 the basket for own revenues was excluded from the calculations as were the so-called "hard" or "own" local public services (those of a housekeeping nature such as water and sewerage supply, roads and refuse removal and the general maintenance of local public sector infrastructure).

Expenditures included in the transfer formula, by contrast, were "delegated" responsibilities involving the provision of so-called "soft" or people-related services such as education, health care and social protection. These expenditure responsibilities, in which there is a national interest in the outcomes and performance, are said to be "delegated" by the State to local governments. The "delegation" of these responsibilities

³⁸ For the description of the 2002 local government budgets the term local government will include oblasts, cities (including Kiev, and Sevastopol), regions and the ARC.

provides the central government with the authority to regulate budgetary performance of local governments in these areas, but at the same time with the obligation or responsibility to ensure that these local government expenditure responsibilities are adequately funded through a combination of assigned revenues and transfers.

Another important innovation in 2002 is that, for the first time, in compliance with the Budget Code, the Ministry of Finance excluded the oblast governments and computed directly the equalization transfers for the 686 cities and regions of oblast significance. During 2002 the government also improved the mechanism for the payment of equalization grants into the local budgets. The balance due from the daily remittance rates is adjusted every quarter, rather than annually as in 2001, and paid directly to the cities and regions. Most of these innovations in 2002 were made possible by the fact that since January 2001 the State Treasury of Ukraine has been servicing the revenue side of local government budgets.

Revenues

The revenues - D_i that are allocated to the local government budgets in the first basket and need to be included in the calculation and determination of the equalization transfer are stated in Articles 64 and 66 of the Budget Code and summarized in Table 3.

Table 3: Composition of Revenues Assigned to Budgets of Local Governments and taken into Account in Calculation of Equalization Transfers

Type of Revenue	ARC	Oblast	Region	Kiev and Sevastopol
Portion of the Personal Income tax	25%	25%	50%	100%
Portion of the Land tax	25%	25%	15%	-
Fees for licenses on certain business activities	X	X	X	
Fees for registration of business activities			X	
Administrative fines			X	

In addition to the revenues that are set by the Budget Code to be included in the calculations of the equalization transfer, the Resolution of the Cabinet of Ministers for 2002 (with explicit reference to the State Budget Law for 2002) determines the additional

revenues for the city of Kiev and the ARC that need to be included in implementing the formula (Table 4.)³⁹

Table 4: Additional Revenues that are taken into Account when Calculating Equalization Transfers for the year 2002

Type of Revenue	ARC	Oblast	Region	Kiev
Enterprise Profit tax	-	-	-	X
Excise Tax ⁴⁰	X	-	-	-

Note that the Resolution of the Cabinet of Ministers for 2002 (Article 6) states that a separate methodology will be used for calculation of these revenues. However, no reference to or explanation of this methodology were provided.

The estimate of the total amount of revenues allocated to each local government budget and included for the calculation of the equalization transfer⁴¹ is done on the basis of a relative fiscal capacity index –**K** computed for each local government. The relative fiscal capacity index **K** is calculated using the actual execution of the revenue basket for equalization purposes in the last three years prior to the budget preparation year.⁴² A more detailed calculation of the capacity index **K** is shown in Appendix 2.

For those local governments in which the forecasted “revenue basket for equalization purposes” in 2002 is more than 1.65 times higher than it was in 2000, the β coefficient is applied to reduce the estimated revenue amount.⁴³ The procedure is as follows:

$$\Delta D_i = D_i \text{ equalization 2002} - (D_i \text{ equalization 2000} \times 1.65)$$

$$D_i = D_i \text{ equalization 2002} - (\Delta D_i \beta_i),$$

³⁹ The State Budget Law (Article 33) defines which revenues are included in the local government general fund but there is no reference that these additional revenues should be included in the calculation of equalization transfers.

⁴⁰ Except 50% of excise tax on oil products and transportation.

⁴¹ As shown in table 3 and which further down in this document we call “revenue basket for equalization purposes” or first basket of taxes.

⁴² For the year 2002 data on real execution for the years 1998, 1999, 2000 were used.

⁴³ The ratio 1.65 was close to the average growth in Local government revenues comparing 2000 and 2002.

And where β_i is calculated for each local government separately as the average relative growth in revenues from 1999 to 2002.

$$\beta_i = (\beta_1/\beta_2) - 1$$

where $\beta_1 = D_i \text{ equalization } 2002 / D_i \text{ equalization } 2000$ and

$\beta_2 = D_i \text{ equalization } 2000 / D_i \text{ equalization } 1999$

Note that other revenues of local governments, those in the second basket, are not included in the estimate of D_i . Article 69 of the Budget Code defines which local government revenues are not included in the equalization formula. These revenues are thought to be used for the financing of the so-called own function financing. These revenues are also called the second basket and include:

- 1) Local taxes and fees payable to local budgets
- 2) Land tax – 100% for Kiev and Sevastopol, 75% for ARC, 60% for towns and villages;
- 3) Transport vehicle tax
- 4) Interest payable for use of budget surplus
- 5) Handicrafts tax
- 6) Dividends
- 7) Fixed agriculture tax
- 8) Enterprise profit tax payable by communally owned enterprises, and
- 9) Nine more different payments allocated to local government budget.

None of the revenues in this second basket is earmarked and, therefore, local governments can use them in any way they see fit. In fact, the same is true for the revenue sources in the first basket. Local government revenues are divided into these two baskets only for the purpose of the calculation and determination of the equalization transfer. Once the budgets have been approved and the level of transfers determined, local governments are entirely free to spend their funds from tax sources (the first and second basket and the equalization transfer) as they please. The significance of the second basket of revenues is that by excluding them from the calculation of grants, local

governments can increase their collections as much as they want to without fear of seeing their transfers reduced.⁴⁴

The philosophy of the Budget Code is that the Ministry of Finance at the central level needs to make sure that local governments have adequate funds to finance their delegated expenditure responsibilities (education, health, social welfare and so on) with a combination of revenue assignments and equalization grants. But, at the time of budget execution, local governments are free to spend these funds in activities other than the delegated expenditure responsibilities. This freedom or flexibility for budget execution has made many central government decision makers uncomfortable. For this reason, the central government (spearheaded by the Ministry of Economy) continues to explore the feasibility and desirability of minimum expenditure standards on local governments.

Expenditure

There were no changes in the methodology for estimating expenditure needs for the application of the equalization formula for 2002. According to Article 12 of the Resolution of the Cabinet of Ministers for 2002 the computation of total expenditure needs, V_i , for each local government for equalization purposes should include the following expenditures:

$$V_i = V_i \text{ administration} + V_i \text{ health} + V_i \text{ education} + V_i \text{ social protection} + V_i \text{ culture} + V_i \text{ sport} + V_i \text{ other} + V_i \text{ non distributed} + V_i \text{ special for ARC}$$

As for 2001, the estimated amount of expenditure needs is defined on the basis of unified norms of per capita expenditures for administration, health care, culture and sport, expenditure on per child or student basis in education, and per recipient of social services in social security and social protection.⁴⁵

⁴⁴ This absence of “clawback” for revenues in basket two is also shared with revenues in basket one, as long as the methodology used to estimate fiscal capacity (the relative index of fiscal capacity) does the job that it is intended to do: not to have any negative incentive effects on tax effort for the items in basket one.

⁴⁵ Recall that examples for the calculation of expenditure needs are shown in Appendix 1 of this report.

The Coefficient of Equalization α

Another innovation in the formula for 2002 is a scaling coefficient that calibrates the contribution of “surplus” local governments into the equalization fund.⁴⁶ According to Article 7 of the Resolution of the Cabinet of Ministers for 2002, those local governments whose calculated expenditure need V_i is smaller than calculated revenue capacity D_i contribute to the equalization fund an α amount of that difference. The simplified formula for this case can be rewritten as

$$T_i = \alpha (V_i - D_i)$$

For local governments contributing to the equalization fund in 2002, the coefficient α varies from 0.8 to 1.0. The individualized coefficient α is calculated taking into account the annual average growth rate of the “revenue basket for equalization purposes” or first basket for the last three years prior to the budget preparation year. That is: $\alpha_i = 1 - ((D_{i2002} / D_{i1999}) - 1) \times K_p$

To illustrate how the formula actually works let us assume that Oblast A has three regions (a); (b); and (c) with equal expenditure needs but different growth in revenues.⁴⁷

	Expenditure need	Revenue	Growth ($D_{i2002} / D_{i1999} - 1$)	$\alpha_i =$ $1 - ((D_{i2002} / D_{i1999}) - 1)$	Revenues after equalization
	1	2	3	4	2 - ((2-1)*4)
Region (a)	60	90	1.13-1=0.13	1-0.13=0.87	63.9
Region (b)	60	75	1.03-1=0.03	1-0.03=0.97	60.45
Region (c)	60	120	1.2-1=0.2	1-0.2= 0.80	72

This example shows that α_i or the equalization coefficient is smaller for those local governments which have experienced a higher rate of growth in D_i revenues, while the coefficient is larger for those local governments that have experienced a lower rate of growth in D_i revenues.

⁴⁶ This innovation appears to have been the result of political pressure from richer cities on the Black Sea and other areas.

⁴⁷ For this example the coefficient K_p will be ignored. Essentially, the coefficient K_p was introduced to be able to withdraw additional funds from local governments for the equalization purposes.

For 2002, those local governments whose expenditure need was higher than the calculated tax capacity, the equalization transfer was calculated at 100% of that difference. That is, the coefficient α_i was equal to one for all “deficit” or subsidy dependant local governments. This is, of course the highest level of equalization that could be adopted.

Procedure for the Flow of Financial Means for the Equalization Purposes -2002

The actual transfer of funds is made on the basis of daily remittance rates that are calculated using the same methodology as in 2001.⁴⁸ The State Treasury is responsible for the financial flows required to fund the equalization grants (Article 35 of the State Budget Law for 2002.). The state taxes and fees in the third basket used for funding the transfers are:

- 1) Enterprise profit tax
- 2) VAT on imports only⁴⁹
- 3) Excise tax on goods manufactured in Ukraine (except for 50% of petrochemicals and transportation means manufactured in Ukraine)
- 4) Excise tax on goods imported to Ukraine (except for 50% of imported petrochemicals and transportation means manufactured in Ukraine)
- 5) Import and Export duty
- 6) Fee for the documents processing to get a visa
- 7) Fines for tax law violation,
- 8) and other different types of payments.

By comparison to the process in 2001 there has been an improvement in 2002 in ensuring the timely allocation and correction of the equalization transfer if the real execution of state taxes and fees that are used to fund the equalization transfers are smaller than forecasted. The State Budget Law (Article 35) states that every quarter, but not later than day 20 of the last month of the quarter, the State Treasury has to fill the gap

⁴⁸ The daily remittance rate is the ratio of the amount of planned transfers to the forecasted amount of collected state taxes and fees used to fund the equalization transfers within a particular oblast.

⁴⁹ The VAT on domestic transactions was excluded from the list because during 2001 there were many problems with its collection - in particular those arising from refunding VAT credits to businesses.

(using general central government funds) between the planned and actual amounts of the equalization transfer.

Those local governments that have to contribute to the pool of funds for the equalization grant have to make monthly payments of 1/12 the total calculated annual amount. These payments must be realized from the local governments' general fund to the central government's general fund. The actual contribution of the local governments cannot exceed the amount in the State Budget law. Therefore, local governments get to keep any over execution of local revenues. Conversely, if actual collections run short, local governments still have to contribute the amounts specified in the State Budget law.

The data available for budget execution during 2002 shows that the actual funding of the grants has not been smooth, which means lack of compliance with Article 35 of the State Budget law. (See Table 5). The real execution of equalization grants and transfers to local governments as of April 1, 2002 shows that for some oblasts real execution is smaller than the planned amount for the quarter. Of the 26 local governments that receive equalization transfers, approximately half received less than the quarterly norm. The highest deviation were for the Dnipropetrovska oblast, which received less than 15% of the amount forecasted for the quarter. Also of note, Donetsk came up short by 9%, and Khmelnytska by 12%.

Similarly, by analyzing local governments' contributions to the state budget it can be seen that there are large deviations from the quarterly norms: for example Lvivska oblasts transferred only 58% of its quarterly norm; Chernihivska oblasts –85%, and Khersonska oblast, Kyivska Oblast – 86% of their quarterly norms.⁵⁰ (See Table 5).

⁵⁰ First quarter' s norm is calculated in accordance to the State Budget Law on 2002, article 35, 36 which determine that equalization grant and contributions to the state budget at the first quarter should be 3/12 of the annual amount.

Table 5: Local Government Equalization Grant and Transfers to the State Budget
2002 Plan

Local Government	Equalization Grant				Transfers to the State Budget			
	Annual Budget Approved in 2002 Law	Planned as in Apr.1. 2002 Budget	Execution of as Apr.1. 2002	of Difference (%)	Annual Budget Approved in 2002 Law	Planned as in Apr.1. 2002 Budget	Execution of as Apr.1. 2002	of Difference (%)
CRIMEAN REPUBLIC	133,722.1	33,431	33,684	101	38,135	9,534	8,798	92
VINNYTSKA OBLAST	245,267	61,317	61,219	100	15,831	3,958	3,775	95
VOLYNKA OBLAST	167,863	41,966	45,023	107	2,285	571	507	89
DNIPROPETROVSKA OBLAST	113,819	28,455	24,256	85	233,989	58,497	55,936	96
DONETSKA OBLAST	117,698	29,424	26,818	91	243,997	60,999	57,794	95
ZHYTOMYRSKA OBLAST	223,396	55,849	56,715	102				
ZAKARPATSKA OBLAST	207,793	51,948	54,154	104	14,331	3,583	3,182	89
ZAPORIZKA OBLAST	88,539	22,135	22,104	100	138,036	34,509	30,653	89
IVANO-FRANKIVSKA OBLAST	210,300	52,575	58,184	111	4,086	1,022	1,022	100
KYIVSKA OBLAST	172,332	43,083	47,144	109	25,260	6,315	5,436	86
KIROVOHRADSKA OBLAST	142,503	35,626	34,379	97	3,114	779	797	102
LUHANSKA OBLAST	207,960	51,990	49,837	96	25,132	6,283	5,586	89
LVIIVSKA OBLAST	270,101	67,525	66,826	99	58,565	14,641	8,515	58
MYKOLAYIVSKA OBLAST	130,893	32,723	30,269	92	40,823	10,206	10,182	100
ODESKA OBLAST	173,640	43,410	43,660	101	122,048	30,512	27,620	91
POLTAVSKA OBLAST	139,658	34,914	32,694	94	74,698	18,675	18,236	98
RIVNENSKA OBLAST	201,830	50,457	46,757	93	11,407	2,852	2,852	100
SUMSKA OBLAST	134,683	33,671	33,170	99	17,707	4,427	4,427	100
TERNOPILSKA OBLAST	177,270	44,318	44,411	100	2,300	575	536	93
KHARKIVSKA OBLAST	150,938	37,734	37,634	100	98,686	24,671	24,897	101
KHERSONSKA OBLAST	158,737	39,684	39,367	99	2,091	523	449	86
KHMELNYTSKA OBLAST	206,215	51,554	45,396	88	7,162	1,790	1,702	95
CHERKASKA OBLAST	174,670	43,668	44,065	101	23,761	5,940	5,226	88
CHERNIVETSKA OBLAST	143,666	35,917	33,778	94	9,828	2,457	2,169	88
CHERNIHIVSKA OBLAST	153,370	38,342	36,874	96	17,428	4,357	3,714	85
KYIV				0	1,860,348	465,087	368,182	79
SEVASTOPOL	5,923	1,480.6	1,398	94				
Total	4,252,783	1,063,196	1,049,814	99	3,091,048	772,762	652,190	84

Other Transfers in 2002

Other intergovernmental transfers for the year 2002 are shown in Appendix 4 to this report. The significant difference with respect to 2001 is the fast growth in the amount and types of special purpose transfers in 2002. Besides the equalization grant, in

2002 there were 14 special purpose allocations to local budgets in comparison to five in the year 2001. But this is still quite a manageable system in terms of number of grants.

4. An evaluation of the equalization grant system

The new approach to intergovernmental fiscal relations starting in 2001 with the adoption of the Budget Code and the introduction of an equalization system represents a formidable step forward.

While there has been much progress toward a more transparent, objective, predictable system of equalization grants, there is room for improvement. Below we review these issues.

Transparency

Ukraine's budgeting system and intergovernmental transfers in particular have gained significantly in terms of transparency. The Budget Code outlines the process for budget formulation and execution, while there is an explicit assignment of expenditure responsibilities and sources of revenues. In addition, local government equalization transfers are based on objective measurements of expenditure need and revenue capacity.

However, there are several aspects of the new equalization grant system where transparency could be improved:

- 1) The equalization system in general and the calculation of expenditure needs in particular is very complicated and quite difficult to comprehend. From many perspectives the basic document describing the methodology to be used for the calculation of equalization transfers, Cabinet of Ministers Resolution no. 1932 of December 29, 2000 "Procedure for Calculation of Inter-governmental transfers (Equalization grants, Subventions, and Contributions to the State Budget) for 2001" is an imposingly difficult document, even for specialists.⁵¹ One of the basic principles of transfer design is that equalization formulas should be transparent.

⁵¹ Several editorial features make this document harder to understand than it needs to be. For example, the many formulas used do not reflect relative indexes of need but rather absolute values of such needs. In addition, some of the formulas incorporate lump sum amounts for features or characteristics that should also be incorporated into indexes. In summary, there is little clarity in the Procedure document around the cluster of coefficients that in a combined way are supposed to capture the relative incidence of expenditure needs in the different functional expenditure categories.

Although term “transparency” can mean quite different things for different people, in the context of equalization grants it is usually taken to mean that by using the information that is stipulated by the legal acts including the formula and publicly available statistics, each local government should be able to recalculate its own and its neighbors’ transfers, including the measurement of revenue capacity and expenditure needs. This is practically impossible with the current system in Ukraine considering its existing complexity.

- 2) Another basic principle of equalization grant design is that the factors that enter the measurement of expenditure needs for each local government should be based on objective data and criteria, which local governments (or the central government) cannot influence directly. These factors may include different geographical conditions, different demographical profiles (more students than average, more potential social beneficiaries) or other social factors and costs of provision. This principle is not being respected in the actual computation of the equalization transfers. For example, expenditures such as the completion of construction of the main pipe line, or rebuilding water treatment plants that were used in 2002 for the expenditure needs of the ARC,⁵² should not be a part of a unified equalization system. The computations also made exceptions for Kiev and Sevastopol.⁵³ These kinds of expenditures should be financed separately through earmarked grants or block grants, completely outside the equalization grant system.
- 3) Transparency also requires that there be no especial treatments of hidden steps in the computation of the equalization grants. This basic principle is broken when the Resolution of the Cabinet of Ministers uses phrases such as “...using different or separate methodology...” without explaining this methodology or giving the reference where it is explained (see Articles 6 and 42 of the Resolution).
- 4) The Ministry of Finance should make public the expenditure norms in the annual State Budget.

⁵² See the last page of the Resolution of the Cabinet of Ministers for 2002.

⁵³ See Article 42 of the Cabinet Resolution.

- 5) The special treatment for the City of Kiev and ARC in revenue assignments and the calculations of the equalizations transfers (payments due in the case of the City of Kiev) has detracted from transparency. Rather than giving the City of Kiev an outright grant to compensate for its duties as capital city as done in 2001, the government allowed the City of Kiev in 2002 to keep one half of the enterprise profit tax receipts and also allowed for additional expenditure needs for Kiev in the calculations of the equalization formula.⁵⁴ In the case of ARC, the 2002 allowed the local retention of 50 percent of excise taxes on domestic goods paid in the territory. Transparency could be increased if the government used uniform rules for revenue assignments and formula calculations and in addition used outright explicit additional grants to address the special circumstances of the City of Kiev and the ARC.

Objectivity

The new equalization grant system represents a significant improvement vis-à-vis the previous system in terms of its objectivity. Nevertheless, the new system still relies in some cases on local government budget data. In particular, Article 75 of the Budget Code (section 2) states that Council of Ministers in ARC, local state administrations and executive bodies of relevant Radas shall provide the Ministry of Finance the necessary data for calculation of intergovernmental transfers. In reality, local government budget data are still used, for example, for checking how well assigned revenues cover expenditures. It would be much more desirable to obtain these data from a neutral institution like the State Statistic Office.

However, old ways of doing business still survive here and there. For example, the in the discussions of the 2002 at the Verkhovna Rada, the Ministry of Finance failed to substantiate by formula the amount the City of Kiev needed to contribute to the equalization fund.⁵⁵

⁵⁴ The allowed additional expenditure needs in the 2002 calculations were more than four times the direct grant the government gave the city in 2001 for providing capital city services.

⁵⁵ See *January-December 2001 Report, Budget and Fiscal Review*. Fiscal Analysis Office. Verkhovna Rada, Budget Committee. March 2002, page 22.

Objectivity of the formula is also being compromised by the willingness to introduce asymmetric treatments of local jurisdictions in the formula. Examples of this are the special treatment of the City of Kiev and the ARC in the calculation of revenue capacity and expenditure needs, and the asymmetric treatment provided by the coefficient α which is only applied to “donor” local governments to temper their measure of fiscal capacity.

Predictability

One of the areas where the new equalization system has improved local budgets is by making them more predictable. Increasing certainty or predictability of budgets is without doubt one of the most important benefits of a formula driven transfer system. Currently, the Budget Code determines the general principles for budget formulation and the calculation of intergovernmental transfers, then the Cabinet of Ministers using these general rules approves the actual calculations, and the final outcomes are approved by the State Budget law.

There is some evidence indeed that the predictability of budgets may have increased as the result of the new budgeting approach. For example, the 2001 budget formulation process represented a clear break with the process of previous years.⁵⁶ For starters, the State Budget was approved before New Year's. Just the year before in, the 2000 State Budget had been approved on February 17 and published on March 13. By international standards, the achievements of 2001 in Ukraine to this respect may not look that distinguished but there is a marked difference for local budget predictability that 98 percent of all local budgets were approved as of April 18, 2001 and only 2 percent of local budgets approved by the same date of the previous year. This could be taken as evidence that both use of a formula and a substantially decreased possibility for additional adjustments in intergovernmental transfers simplified and facilitated the process of local budget planning.

However, there is ample room in the current system for increasing the predictability of local budgets. In general, too many decisions and details are left to the

⁵⁶ See *Intergovernmental Reform Monitor. Budget and Fiscal Review*. Fiscal Analysis Office. Verkhovna Rada, Budget Committee. June 2001, page 8.

State Budget Law or the Resolution of the Cabinet of Ministers. The following items need to be considered:

- 1) There is no good reason to leave it to the State Budget Law to determine which revenues should be allocated to which budget and the division of revenues between the special and general fund. The predictability of local budgets could be increased by stating those choices by means of a general rule in the Budget Code.
- 2) There may be good reasons for approving the total pool of funds every year in the State Budget but there is much less justification for leaving it to the State Budget to specify the division of means. In fact, many countries also use a rule to fix the pool of funds for equalization grants. This may take the form, as for example in Russia, of a fixed percentage of central government revenues. When greater macroeconomic stability is achieved in Ukraine it would be desirable to switch to this type of rule in Ukraine.
- 3) It may be possible for local governments to get a clear idea of the size of the positive (and negative) equalization grants sooner in the budget process, for example by August, with the issuance of the State Budget Resolution. For the last two years, local governments got a clear picture of the size of the equalization transfers when the central government delivered the State budget proposals to the Verhovna Rada in November.
- 4) It would also be preferable to move from the annual State Budget law to the Budget Code all provisions relating to methodology, timing, and responsible institutions for the transfer of funds for equalization purposes.
- 5) If the preference is not to clog up the Budget Code with details pertaining to the equalization grant system, an alternative would be to introduce a separate law on intergovernmental transfers. This law would state each step that should be followed in transfer calculation including:
 - How and when the total expenditure that will be used for equalization should be determined, within the context of a medium term expenditure framework for the central government.
 - The methodology and timing for the recalculation, again within the context of a medium term expenditure framework, of the relative division

of that total among different expenditure functions (for example local governments will know that 30 percent of the total will be allocated for education and so on)

- Equalization formula
 - Revenues that will be included in calculation of equalization
 - Mechanism for the transfer of funds
 - Who, when and in which way should submit the information and so on.
- 6) On the other had, the Cabinet of Ministers should approve the annual data (statistics) and calculation and the State Budget Law should contain the information on the approved state budget transfers and the final grants from and to the equalization fund. The two general principles are that general law should set all main parameters that influence the equalization outcome, while the technical calculations should be done annually by the Ministry of Finance and approved by the Cabinet of Ministers.

Equalization outcomes

The most fundamental feature of an equalization grant system is that it indeed equalizes horizontal fiscal disparities in both expenditure needs and fiscal capacity across subnational governments. It may come as a surprise but to judge from the international experience, equalization grant systems are not always equalizing. The problem may be some times in the design but more often is in the actual implementation of the formula.⁵⁷ Ukraine's new equalization transfer has strong equalization features in its design. Three particular features are noticeable in this respect. First, it uses a fraternal system of funding making the richer local governments contribute to the pool of funds. Second, it takes into account both disparities arising from expenditures needs and from capacity to raise revenues. Third, it can equalize, as has been the case so far, 100 percent of the difference between expenditure needs and fiscal capacity for poorer jurisdictions. See

⁵⁷ For example, the recent formula driven system of equalization transfers introduced in Indonesia in 2001 has not been equalizing over the last two years. The problem there lay in the actual implementation that tended to neutralize the effects of the formula.

Appendixes 5 and 6 of the report. The FAO (2001) report⁵⁸ used budgeted data for 2001 to analyze the coefficient of variation in the distribution of per capita expenditures before and after the equalization transfers and found a strong equalization effect.

Impact on tax effort and incentives

The previous system of gap-filling equalization grants in Ukraine was notorious for the perverse negative incentive effects on revenue mobilization and the efficiency of public expenditures. The switch to objective, formula-driven transfers based on measures of fiscal capacity and expenditure needs with the adoption of the new Budget Code should produce significant improvements in revenue mobilization and expenditure efficiency at the local level. Presently, we do not have the data that will allow a statistical analysis of these effects. Furthermore, since the new system was not really introduced until 2002, data from 2001 may yield some inconclusive results. This is precisely what the FAO found when they examine 2000 and 2001 data. There were still quite a few oblasts that continued to behave as in the old system of transfers and attempted to claw back good revenue performance⁵⁹ of cities and rayons in the previous period by reducing the level of transfers in the present period. Once data for 2002 become available it would be important to verify the expected improvements in revenue mobilization and expenditure efficiency.

Data and Upkeep

Currently there is no single agency in the Ministry of Finance that performs the entire calculation behind the equalization transfers nor is there a comprehensive data set and model that combines all the stages involved in the calculation of equalization grants. The measures of fiscal capacity are computed in the Revenue Department of the Ministry of Finance. Each line sector department, also within the Ministry of Finance, computes separate measures of expenditure needs for each local government. These different pieces of information are forwarded to the Local Budget Division in the Budget Department of the Ministry of Finance. The Local Budget Division assembles the pieces, and adds the α

⁵⁸ *Intergovernmental Reform Monitor. Budget and Fiscal Review*. Fiscal Analysis Office. Verkhovna Rada, Budget Committee. June 2001

⁵⁹ In this context, good revenue performance means revenues in excess of what had been budgeted.

and β coefficients to arrive at either a transfer or a contribution to the fund by each local government. This approach to administering the equalization transfers in Ukraine differs from the most common practices in other countries of having one specialized agency in the Ministry of Finance compute all the steps. Some countries have actually created an autonomous office or Grants Commission outside the Ministry of Finance as solely responsible for the collection of data, implementation and updating of the equalization grant system. The advantages of having a specialized agency administer the equalization grant include better data collection and more independence in implementation. It also facilitates the analysis of the performance of the current system and its future upgrading. Data and upkeep is an area that can be improved in Ukraine's equalization system.

5. The way forward

Increasing coverage

The Ministry of Finance needs to examine how equalizing the system is when we take into account own expenditure and own revenues of local governments. This will require gathering data on the entire budgets of local governments. In the medium term, the Ministry of Finance needs to consider methodologies that incorporate in the formula the equalization for own expenditure needs and own fiscal capacity of local governments. There is a national interest, of course, as defined in the Budget Code, in providing adequate resources to all local governments for delegated functions (education, health and social welfare). However, there is also a national interest in making sure that there is some adequate degree of equalization among local governments for their "own" responsibilities. This latter is an issue that an amended Budget Code may take on.

Increasing predictability

Some basic steps can be taken to increase the predictability of grant flows for local governments. The Government's Budget Resolution could include information on the contribution of the central government to the equalization pool next year as well as information on the budget envelope for local governments and the breakdown of the envelope into the different functional expenditures (education, health, etc.).

Several additional steps could be taken to increase the predictability of grant flows for local governments. When a Medium Term Expenditure Framework is adopted by the central government, it would be feasible and desirable to introduce a general funding rule for the contribution of the central government to the equalization pool. Rather than determining this contribution on an annual basis, the central government would commit for a period of three years or longer a given percentage of its general revenues. Alternatively, the percentage can be with respect to a smaller but more stable over the business cycle basket of revenues. A second step would be to make the central government contribution to the equalization pool every year, once fixed as a percentage of revenues, as budgeted and opposed to how revenues are actually executed. The features above have been used in the Russia Federation for a number of years and have greatly contributed to the predictability of funds at the subnational level in that country.

Measuring fiscal capacity

The current system of measuring fiscal capacity, based on average revenue collection for the past three years, has served well, especially in the absence of data on tax bases and their proxies for different taxes. Using the index of relative fiscal capacity avoids the problem of inducing negative incentives to revenue mobilization only if the index is fixed for a “considerable period of time,” such as three or five years. From 2001 to 2002 freezing the index was not respected, although plans are to freeze it in the future. However, freezing the index aggravates the problem of the lack of flexibility in the methodology for local governments with downward revenue trends. The Ministry of Finance is manually correcting for these problems, which in turn may cause other problems.⁶⁰ It would be desirable to invest resources in data gathering and developing alternative methodologies, such as the modified representative revenue system used in Russia.

The division of revenue sources into the first and second baskets lacks a rationale and appears to be ad hoc. It would seem that at the time the Budget Code was written there was urgency to find an aggregate correspondence between the first basket and

⁶⁰ Other solutions to this problem have been suggested. See Kateryna Mainziouk (2001) *January-September 2001 Report, Budget and Fiscal Review*. Fiscal Analysis Office. Verkhovna Rada, Budget Committee. (November), pages 94-98.

delegated responsibilities and the second basket of revenues and own responsibilities. Provided that some aggregate correspondence is maintained, it would be preferable to assign fully the Personal Income tax and Land Tax to the first basket (for equalization) because the fiscal capacity implied by these revenue sources can be estimated using common methodologies. Fees, charges and so on would be left for the second basket as own revenues. Under this approach, the logic for the second basket would also be stronger. These are revenue sources from which it is hard to estimate fiscal capacity.

Simplifying the formula

As discussed in the previous section on the evaluation of the formula, there is room for its simplification, which in turn will have a positive effect on transparency and predictability of the equalization grants without sacrificing objectivity and equalization impact. Where the formula needs more simplification is in the methodology of estimating expenditure needs. In particular, the criteria or coefficient used to adjust basic expenditure norms up and down for different costs or different circumstances should be generalized and simplified.

Timely disbursement of transfers

The government should seek ways to improve the timely payment of the equalization transfers. The governments should use the new treasury system now in operation on the revenue side of the budget since January 2002, to implement the smooth allocation of funds to local government accounts on a monthly basis, and do that from the general fund of the central government, getting rid of the “third basket” arrangements. This recommendation can be implemented when all 622 local governments have their own local treasury offices. The applicability of this recommendation also assumes that the dual subordination of tax administration officials to the central authorities and to local government officials will no longer be an issue and that central authorities will not have to stimulate the collaboration of local officials to accelerate or improve central government collections.

Special purpose and conditional grants

Fiscal 2002 saw a significant increase in the number and amounts of conditional and special purpose grants with respect to 2001. This may have been the result of political pressures from various regions of the country and social pressure. But even if there is some alarm regarding the proliferation of special transfers, Ukraine still needs to develop an objective and transparent system of conditional grants that covers broader expenditure areas such as health and education. The ongoing efforts of the working group to define an objective system of capital transfers and other conditional grants should receive full support from the government.

Data and Upkeep

The sustainability and good performance over time of the equalization grant system can be improved by developing a specialized agency, which can be the Local Budget Division or a separate “Grants Committee,” to exclusively manage the entire equalization grant system. The current arrangement is too dispersed to really ensure that there is enough interest in collecting better data and improving the formula and overall performance of the equalization grants.

Appendix 1: The Calculation of Expenditure Needs

In order to illustrate how expenditure needs are calculated, let us go through numerical examples of the sequence of budgetary steps that are followed in arriving at the expenditure needs for each local government.

First, the central government sets the envelope or overall amount of expenditures for local governments that will be used for the calculation of needs in the following year. Next, the total amount of local expenditures is divided into separate aggregate expenditure functions (education, health, and so on) and, if desired, subdivided again into expenditure sub-functions (secondary education, primary health and so on). The process so far determines the notional amounts of that would be spent on the aggregate expenditure sub-functions. The next step consists of arriving at a basic expenditure norm for each main functional expenditure category by dividing the notional amounts by the objective criterion or number of clients in the entire country (population, or number of students and so on.)

Let us assume that the total amount of expenditures or the expenditure envelope for next year is 15,000 million that this is divided into expenditure functions in the following way:

Table 1-1
The Expenditure Envelope and its Partition

Type of Expenditure	Amount (mill)	Expenditure share	Objective Criterion
Administration (A)	375	2.5	Population
Education (E)	4,500	30	Weighted average of students
Health (H)	4,500	30	Health care coefficient
Social Protection (S)	4,950	33	Social protection recipients
Culture and Sport (CS)	675	4.5	Population
Total	15,000	100	

Second, we need to determine the basic statistics for each local government and for the country as a whole. Again for simplicity, let us assume a simplified scenario where the demographic profiles of a chosen Oblast A and for all Ukraine are as given in Table 1-2.

Table 1-2
Demographic Profile of Oblast A and Ukraine (millions)

	Population	General Students	Special Students	Social Protection Recipients	
Oblast tier			0.2	0.15	
City (a)	2	0.4		0.35	
City (b)	1	0.2		0.25	
Region (a)	0.5	0.1		0.1	
Region (b)	1.5	0.3		0.2	
Total, oblast A	5	1	0.2	1.05	
Ukraine		50	9	1.6	9
Cities		25	4.5		4.6
Regions		25	4.5		3.3
Oblasts		50		1.6	1.1

In addition to the demographic information, the calculation of expenditure needs requires estimation of relative health care needs as well as reliable data on the differential costs of educating different types of students.

On the basis of inter-oblast comparisons of the use of different kinds of health care facilities, assume that Oblast A has been assigned a health care coefficient of 0.98. This means that the demand for health care in Oblast A is estimated to be two per cent below the national average.

In the case of education, assume that analysis of the costs of supplying education in different areas and to different types of students indicates that the cost of educating a special student is twice as much as educating a general student and that students attending

a general school in mountainous regions cost fifty per cent more per student than the cost of educating a general student in a city. Finally, assume that general students in regions cost thirty per cent more to educate than general students attending school in cities. See Table 1-3.

Table 1-3
Coefficients for Calculation of Weighted Average of Students

	City	Mountain region	Region
General student	1	1.5	1.3
Special student	2		

To calculate the number of weighted students in oblast A and for Ukraine as a whole, we multiply the number of students in each category by the proper coefficient.

For oblast A, this calculation appears as:

$S_i = 1(0.4)+1(0.2)+1.3(0.1)+1.5(0.3)+2(0.2)=1.58$ million. A similar calculation for Ukraine yields a value of $S_u = 13.55$ million.

Recall that in our example the overall expenditure envelope is divided by the functions as :-**Administration (A) -0.025; Health (H) -0.3; Sport and Culture (SC) -0.045; Education (E) -0.3; Social (S) -0.33**. And let us calculate a single basic expenditure norm, as opposed to separate expenditure norms for each category. We call this basic expenditure norm the **average per capita spending (APS)**. This is equal to 300 for the entire country and is calculated as the ratio of the total expenditure envelope for the country (15,000 million) divided by total population (50 million). Now by recalling that the weighted number students in Oblast A is S_i and that for Ukraine this number is S_u we can calculate the per capita expenditure needs for oblast A as follows:.

$$APS (A +H k + SC + E (S_i/P_i :S_u/P_u)+S(R_i/P_i :R_u/P_u) \quad [1]$$

Where P_i and P_u are the population of Oblast i and Ukraine respectively, and R_i and R_u are the numbers of social protection recipients in the Oblast i and Ukraine. Substituting the values in the example, we have

$$300(0.025 + 0.3(0.98) + 0.045 + 0.3(1.58/5 : 13.5/50) + 0.33(1.05/5 : 9/50)) = 330$$

Thus for Oblast A per capita expenditure needs exceed the national average by ten per cent. Or put in an alternative way, oblast A has an index of relative budgetary need of 1.10.

It is important to emphasize that all of these formulas for calculating expenditure needs go to considerable lengths to reflect the regional, location, environmental and social factors that differentiate, in terms of expenditure needs, local governments from each other. In the interest of simplicity, however, most of these other factors that produce variations in expenditure need have been ignored in these calculations

Appendix 2: Calculation of the Index of Relative Fiscal Capacity

The estimation of fiscal capacity (in the calculation of equalization transfers) is based on revenue basket one (revenues considered for equalization purpose). In order to arrive at fiscal capacity (revenue for equalization purposes for local government “i”) it is necessary to compute an index of relative fiscal capacity for each local government.

According to Article 6 of the Resolution of the Cabinet of Ministers for 2002, total revenues from basket one for Ukraine (the aggregate of local revenues for equalization purposes), D_{u4} , is calculated as an aggregate forecast, which incorporates the macroeconomic conditions for Ukraine. Thus, the revenues for equalization purposes of local government “i” is given by:

$$D_i = K_i (N_{i1} + N_{i2} + N_{i3}) \times D_{u4} / (N_{t1} + N_{t2} + N_{t3})$$

Where:

D_{u4} - Aggregate forecast for Ukraine of revenues in basket 1

D_i - Revenue basket for equalization purposes for “i” local government

K_i - Index of Relative Fiscal Capacity

N_i, N_t – Population in local government “i” and for Ukraine as a whole,
and where

$$K_i = \frac{(D_{i1} / D_{u1}) \times N_{t1} + (D_{i2} / D_{u2}) \times N_{t2} + (D_{i3} / D_{u3}) \times N_{t3}}{(N_{i1} + N_{i2} + N_{i3})}$$

The Index of Relative Fiscal Capacity K_i measures the historical average of its per capita revenue basket for equalization purposes relative to the national average per capita revenue basket for equalization purposes.⁶¹ For example, if this index has a value of two, it means that the local government has a revenue capacity to generate from revenue basket one twice as much revenues per capita as the national average.

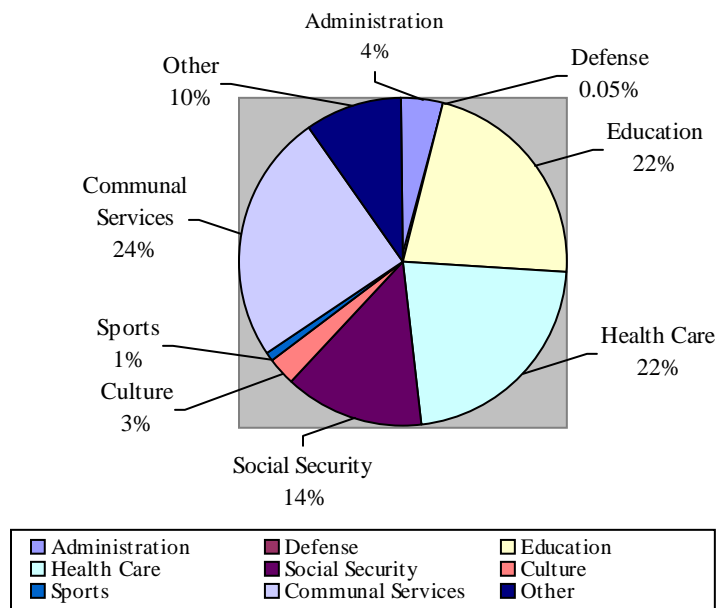
⁶¹ For 2001 the calculation included revenues for 1998, 1999 and the first ten month of 2000. For 2002 the calculation used real executed data for 1998, 1999, 2000.

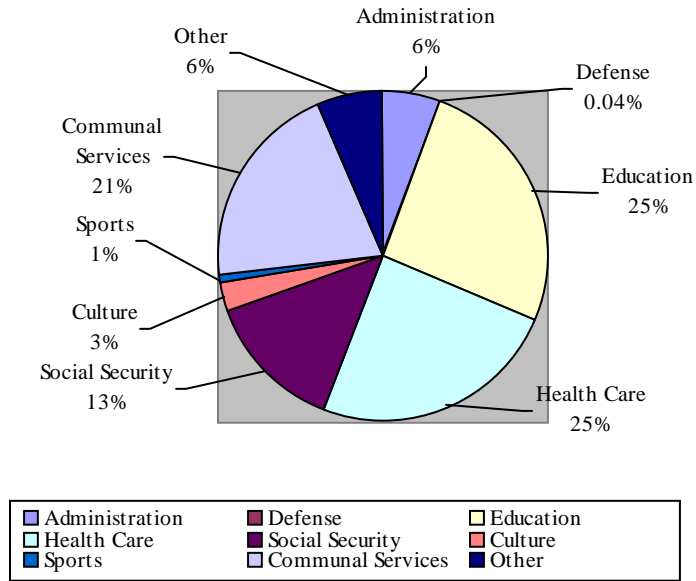
Appendix 3: Other Transfers to Local Governments in the Year 2002

The State Budget Law for 2002 (Article 34) introduces the following types of special purpose transfers and funded amounts:

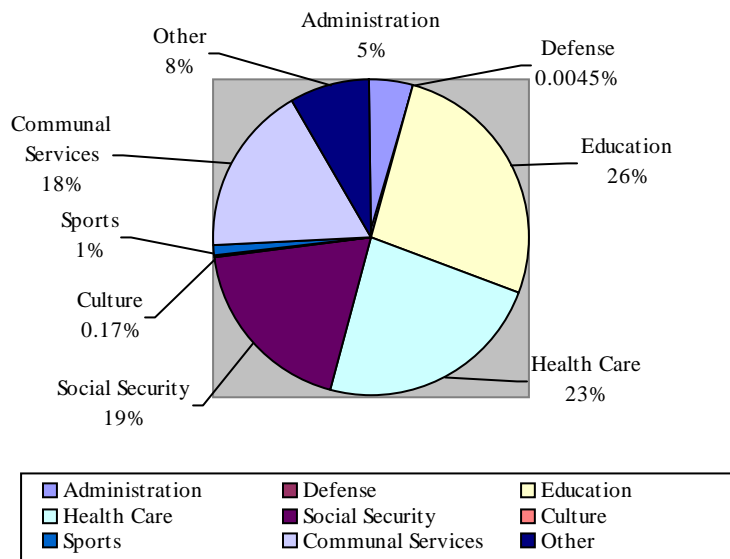
- 1) Special purposes grant for the families with many children, disabled from birth and disabled children – in the amount of UAH 1,076,743.4 thousand;
- 2) Special purpose grant to the population for payment of electricity, natural gas, heat, water supply and disposal, and communications services - in the amount of UAH 2,295,000 thousand;
- 3) Special purpose grant to the population for payment for hard and liquid household fuel, condensed gas, rent, and disposal of garbage and household waste in the amount of UAH 634,510 thousand;
- 4) Special purpose grant to war and labor veterans (besides exemptions for payment for electricity, natural and condensed gas, hard and liquid stove fuel, utility and communications services) and compensation for the use of public transport by some categories of citizens - in the amount of UAH 285,382.4 thousand;
- 5) Special purpose grant for construction and purchase of apartments for military servicemen, participants in war in Afghanistan and military conflicts in other countries, members of families of military servicemen who died in the course of duty, as well as the servicemen retired or discharged due to health status, age etc - in the amount of UAH 170,445 thousand;
- 6) Special purpose grant for the liquidation of consequences of the natural disaster in Zakarpatska oblast - in the amount of UAH 20,000 thousand;
- 7) Special purpose grant for repayment of the principal of the debt on the loan issued in 1999 by the open joint stock company *State Savings Bank of Ukraine* to Zakarpatska oblast State Administration for liquidation of consequences of the natural disaster-in the amount of UAH 32,000 thousand;
- 8) Special purpose grant to the city of Kharkiv for liquidation of the aftermath of breakage at wastage works in the amount of UAH 27,750 thousand;
- 9) Special purpose grant for the Ivano-Frankivska oblast for the liquidation of the aftermath of the natural disaster in Ivano-Frankivska oblast in the amount of UAH 7,000 thousand;

- 10) Special purpose grant to Odesa oblast for the integrated reconstruction and renovation of Odesa State Opera Theatre in the amount of UAH 5,000 thousand.
- 11) Special purpose grant to the budget of the city of Sevastopol for social and economic development of the city in the amount of 25,300 thousand;
- 12) Special purpose grant to the Zaporizka oblast for financial support to the state communal enterprise Vodokanal in the city of Zaporizhzhia according to the Agreement of Guarantee between Ukraine and European Bank for Reconstruction and Development in the amount of UAH 8,000 thousand;
- 13) Special purpose grant to the Kirovohradska oblast for the liquidation of the aftermath of the natural disaster in the oblast in the amount of UAH 4,000 thousand;
- 14) Special purpose grant for partial execution of Article 57 of the Law of Ukraine *On Education* in the amount of UAH 155,000 thousand.

Appendix 4: Local government expenditures by functions, 1999-2001**1999****2000**



2001

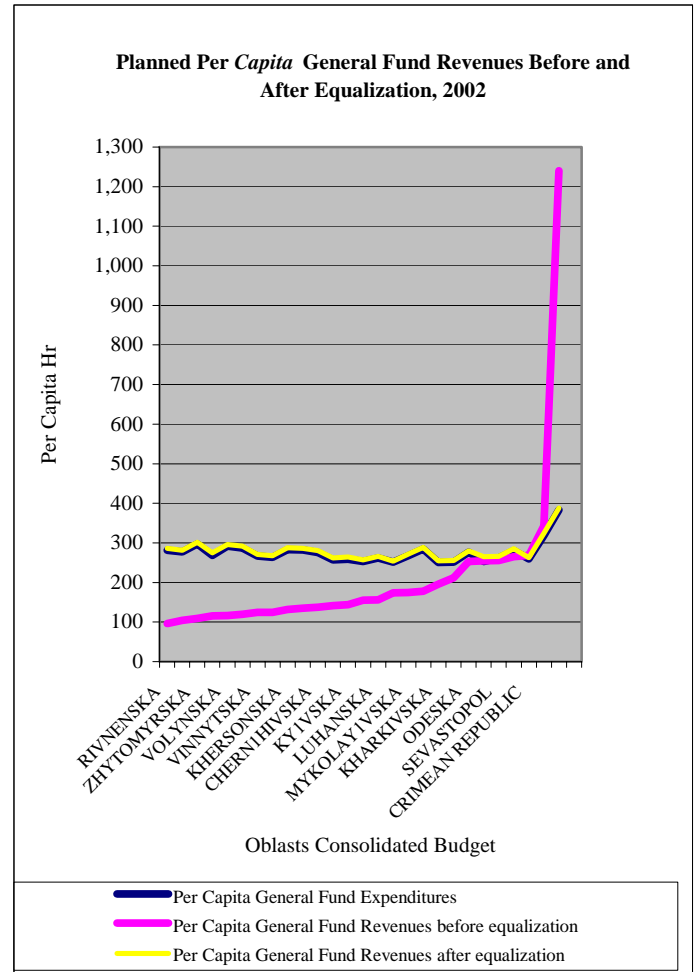


Expenditure in thousand of Hr	1999	2000	2001
Administration	672.5	996.3	1013.7
Defense	8.4	7.0	1.0
Education	3470.6	4334.5	5898.5
Health Care	3449.7	4165.9	5133.0
Social Security	2166.4	2286.8	4229.3
Culture	404.1	500.6	39.1
Sports	132.6	143.0	209.9
Communal Services	3973.2	3491.4	3964.6
Other	1538.3	1068.5	1868.9
Total	15815.8	16994.0	22358.0

Source: Expert Group's "Evaluation of Intergovernmental Finance in Ukraine," 2002.

**Appendix 5: Planned Per Capita Local Government General Fund Expenditures
and Revenues, 2001⁶²**

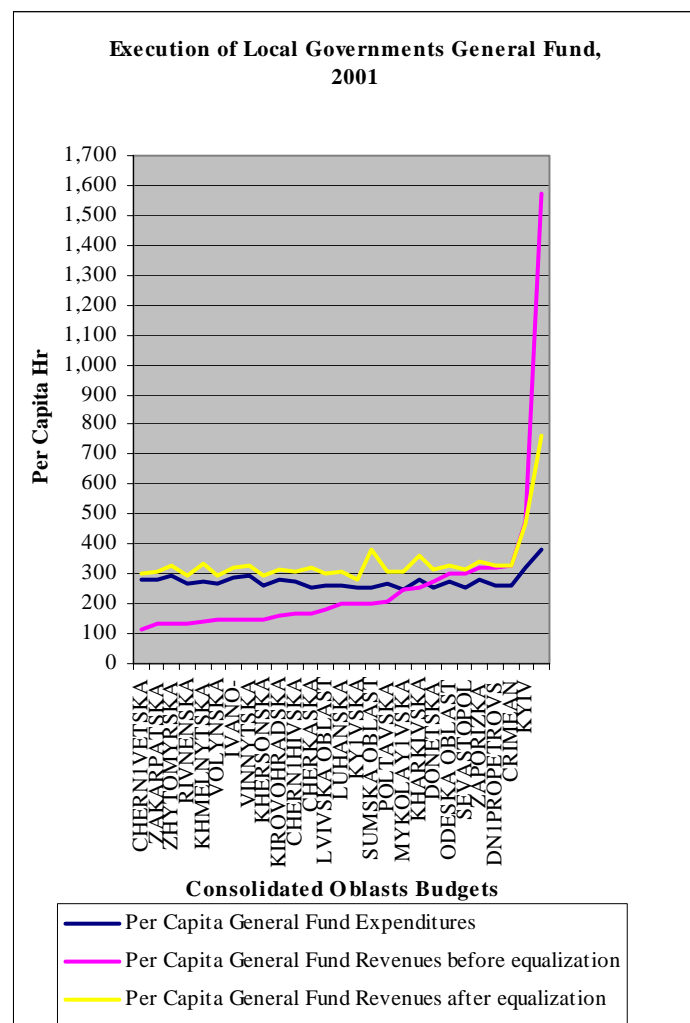
Local Government	Population 01.01.2001. (Thousands)	Per Capita General Fund Expenditures in Hr	Per Capita General Fund Revenues before equalization in Hr	Per Capita General Fund Revenues after equalization in Hr
TERNOPILSKA	1,151	281	96	286
CHERNIVETSKA	929	277	105	281
ZAKARPATSKA	1,282	297	109	302
ZHYTOMYRSKA	1,421	268	115	275
RIVNENSKA	1,184	292	117	296
KHMELNYTSKA	1,447	287	119	292
VOLYNSKA	1,054	266	124	271
IVANO-FRANKIVSKA	1,454	263	125	267
VINNYTSKA	1,799	283	132	288
KHERSONSKA	1,213	282	135	286
KIROVOHRADSKA	1,153	276	137	280
CHERNIHIVSKA	1,268	257	141	262
CHERKASKA	1,435	258	144	264
LVIVSKA	2,703	253	155	257
LUHANSKA	2,607	262	156	266
KYIVSKA	1,811	251	174	254
SUMSKA	1,319	268	175	272
POLTAVSKA	1,660	284	178	288
MYKOLAYIVSKA	1,287	251	196	255
KHARKIVSKA	2,941	252	212	255
DONETSKA	4,894	276	253	280
ODESKA	2,492	253	255	265
SEVASTOPOL	388	262	256	266
ZAPORIZKA	1,984	280	265	285
DNIPROPETROVSKA	3,678	259	269	263
CRIMEAN REPUBLIC	2,101	318	342	324
KYIV	2,637	383	1,240	388
Total	48,140	275	249	280



⁶² Data source: Per capita General Fund Expenditures- Resolution of the Cabinet of Ministers for the year 2001, Per Capita General Fund Revenues Before and After Equalization – State Treasury of Ukraine (FAO- website)

Appendix 6: Per Capita Local Government General Fund Expenditures and Revenues Execution, 2001⁶³

Local Government	Population 01.01.2001. (Thousands)	Per Capita General Fund Expenditures in Hr	Per Capita	Per Capita
			General Fund Revenues before equalization in Hr	General Fund Revenues after equalization in Hr
TERNOPILSKA	1,151	281	114	304
CHERNIVETSKA	929	283	134	307
ZAKARPATSKA	1,282	297	136	328
ZHYTOMYRSKA	1,421	268	136	296
RIVNENSKA	1,184	277	141	337
KHMELNYTSKA	1,447	266	145	292
VOLYNSKA	1,054	287	148	320
IVANO-FRANKIVSKA	1,454	292	148	327
VINNYTSKA	1,799	263	149	292
KHERSONSKA	1,213	282	164	315
KIROVOHRADSKA	1,153	276	167	311
CHERNIHIVSKA	1,268	257	168	318
CHERKASKA	1,435	258	180	301
LVIVSKA	2,703	262	198	309
LUHANSKA	2,607	251	201	281
KYIVSKA	1,811	253	201	378
SUMSKA	1,319	268	210	307
POLTAVSKA	1,660	251	247	306
MYKOLAYIVSKA	1,287	284	251	362
KHARKIVSKA	2,941	252	273	316
DONETSKA	4,894	276	304	331
ODESKA	2,492	253	304	316
SEVASTOPOL	388	280	319	339
ZAPORIZKA	1,984	262	319	329
DNIPROPETROVSKA	3,678	259	327	329
CRIMEAN REPUBLIC	2,101	318	476	467
KYIV	2,637	383	1,571	765
Total	48,140	275	311	349



⁶³ Per Capita General Fund Expenditures (except for expenditures funded from the State budget in the form of Subventions).