

Chapter 3. Strengthening fiscal decentralisation in Ukraine

Chapter 3 presents the fiscal component of Ukraine's decentralisation reform. It highlights how the reform has developed and the implementation process. It offers an in-depth examination of the impact that fiscal decentralisation is having on subnational government revenue and expenditure, and equalisation systems, as well as the fiscal challenges that local communities are facing in light of the reform. Insight is provided into the management and public investment tools that could better support the delivery of public services, including the role of public enterprises, inter-municipal co-operation, and the need for more effective capital transfers for subnational investment. The chapter ends by exploring opportunities to reinforce human capital at the subnational level and the impact the decentralisation is having on the subnational government staff.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Introduction

Fiscal decentralisation is not new to Ukraine. It began at independence, was codified into the 1996 Constitution, the 1997 Law “on Local Self-Government”, and the Budget and Tax Codes that establish the basic rules for local government funding, budgetary relations and equalisation mechanisms. It is supported by the 1997 ratification of the European Charter of Local Self-Government. The principles contained in these instruments have not been fully implemented, however, despite important fiscal reforms to increase subnational government fiscal resources and improve the transparency and predictability of inter-budgetary relations. While fiscal decentralisation is at the core of the decentralisation process, it seems to have slowed, stagnated and even regressed, especially between 2010 and 2014.

The Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power, published in April 2014, took full measure of the importance of these challenges and set fundamental principles and ambitious goals for political, administrative and fiscal decentralisation (see Chapter 2). In terms of fiscal decentralisation, the Concept Framework addresses the need of sufficient resources to cover statutory responsibilities; a reform of the intergovernmental grants system, including equalisation; a reform of taxation, including the need to develop tax autonomy over rates and bases; easier access to borrowing; balanced state control on local finance; increased budget transparency and efficiency; and more ability to manage land resources (see Annex 3.A).

The implementation measures adopted to realise the fiscal component of the Concept Framework started in December 2014 with major changes to the Budget and Tax Codes.¹ Amendments were introduced to expand the revenue bases of several categories of subnational governments, change the tax-sharing arrangements, establish new local taxes and introduce a new equalisation system, modify the system of grants, relax borrowing constraints, and improve budgeting and financial management.

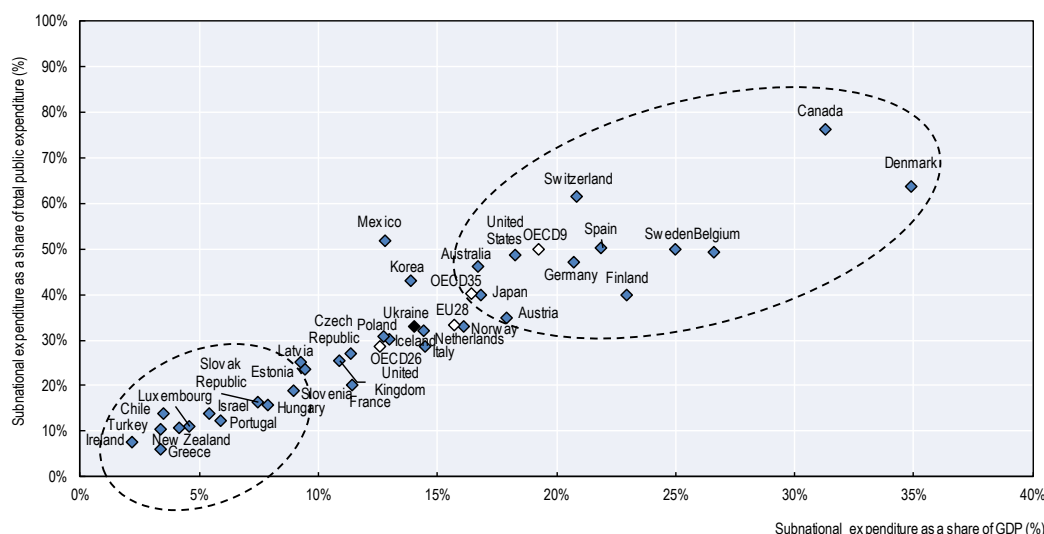
Reforms take time to translate into significant changes, but the impact of these measures gradually became evident beginning in 2015, and especially in 2016 and the beginning of 2017. The most significant changes thus far observed primarily concern a reallocation of powers and resources across subnational levels of government rather than a true transfer of competences and resources from the central government to lower levels of government. It should be noted, however, that the *oblast* (regional, TL2) and *rayon* (intermediate) levels function most frequently as territorial entities of the central government, which makes changes more difficult to identify and assess in terms of decentralisation. With the emergence of more powerful cities and communities, the situation could rapidly evolve if the central government effectively continues to deepen its decentralisation policy and addresses political, administrative and fiscal in a balanced way.

This chapter is comprised of two parts. The first part describes fiscal decentralisation in Ukraine as of end-2014, confirming the country’s still centralised nature in fiscal matters. It provides an analysis of the main reforms which have been adopted since late 2014 in numerous areas, including the reforms of inter-governmental grants and the equalisation system, the tax-sharing arrangements and own-source taxation, non-tax revenues, and borrowing and financial management frameworks. The second part is dedicated to assessing the progress of reform thus far. It provides recommendations for strengthening fiscal decentralisation in Ukraine, covering measures which could be adopted to improve the grants and taxation systems, the assignment of responsibilities, the delivery of local public services through transparent and efficient management tools, the level of public investments and its governance across levels of government as well as the quality and access to data on subnational government finance and assets.

Fiscal decentralisation in Ukraine: Contextual data and 2014-15 reforms

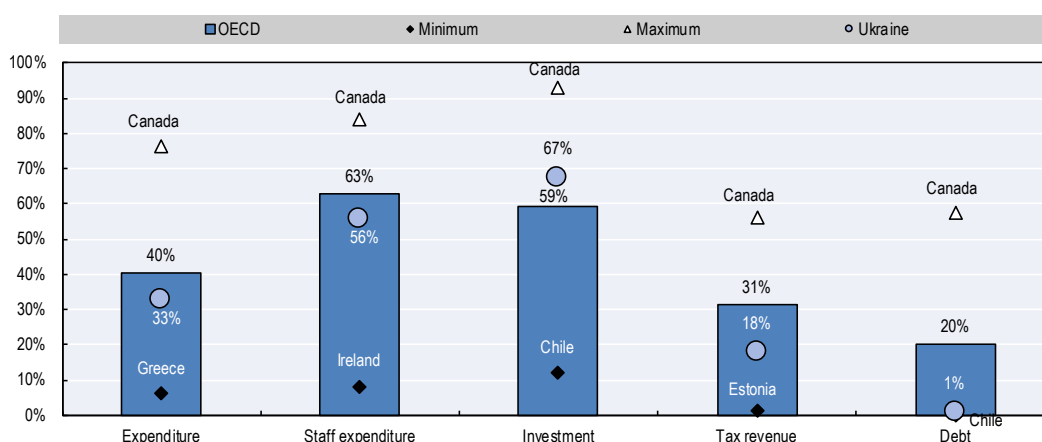
On paper, basic fiscal indicators suggest a relatively decentralised country. Ukrainian subnational governments represented one-third of public expenditure in 2015, in line with the EU-28 average and just 7 points below the OECD average of 40%. Ukraine compares with the Netherlands, Italy, Poland and Iceland, where subnational expenditure accounts for between 11% and 16% of gross domestic product (GDP) and between 27% and 33% of public expenditure (Figure 3.1).

Figure 3.1. **Subnational government expenditure as a percentage of GDP and general government expenditure in the OECD countries and Ukraine, 2015**



2. **Most local government accounts cannot be properly identified.** Data reported in the national accounts cover approximately 700 budgetary entities (*oblast* and Crimea, the cities of Kyiv and Sevastopol, *rayon*, and cities of *oblast* significance). This means that most municipal budgets, i.e. those of cities of *rayon* significance, towns, villages and rural settlements, are not individualised in the national accounts but managed according to the traditional *matrioshka* budgetary model and embedded in their *rayon*'s budgets, on which they depend for allocations. This “trickle-down” budgeting system is also open to political and economic games (OECD, 2003). The creation of unified territorial communities (UTCs), in the framework of the current administrative-territorial reform, is fundamentally changing the situation. The UTCs now have independent budgets, made of tax, grants and non-tax revenues, and have direct fiscal relations with the central government via their *oblast* administrations, although they can continue to receive subsidies from the *rayon*.

Figure 3.2. Subnational governments as a share of general government in the OECD and Ukraine (2015)



Notes: The general government sector includes central government, state and local governments, and social security sub-sectors. Investment for Ukraine is defined as acquisition of fixed capital. For OECD countries, the definition includes gross capital formation and acquisitions, less disposals of non-financial non-produced assets. Debt definition is based on that of the OECD. It includes, in addition to “financial debt” (currency and deposits, loans and debt securities), insurance reserves and other accounts payable.

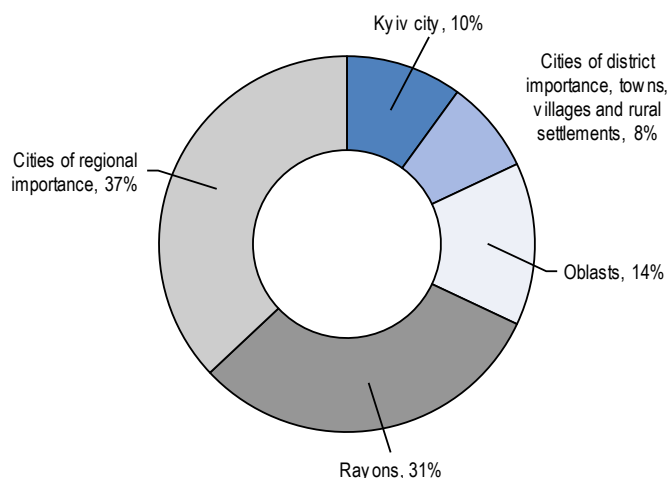
Source: OECD (2017a), “Subnational governments in OECD countries: Key data” (database), <http://dx.doi.org/10.1787/region-data-en>.

The ambiguity of the administrative and budgetary structure of subnational government explains why it is difficult to have a clear picture of subnational financial autonomy in Ukraine. Legally, there are two budget tiers: state (central government at national level) and local. The local tier is divided in two categories: regional (*oblast*) with very limited financial autonomy, and local budgets pertaining to *rayon*, cities of regional importance, cities of district importance, towns, villages, etc., whose financial status is not clearly defined (Standard & Poors, 2013).

The financial weight of each category of government is difficult to capture. It was not possible during the study to obtain data by tiers and categories of subnational governments, so figures were gathered from diverse, external sources (e.g. World Bank [2017a]; Levitas and Dkijik [2017]). A comparison of the data gathered reveals that the regional

level is weak, the intermediate level – i.e. *rayon* and cities of *oblast* significance – represents 68% subnational spending (78% if Kyiv city is included), and the local level (cities of *rayon* importance, towns, villages and rural settlements) represents only 8% of the total (Figure 3.3).

Figure 3.3. **Breakdown of spending by category of subnational government, 2016 (estimates)**



Source: OECD estimates based on World Bank (2017a), “Ukraine: Public finance review”, <http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review> and Levitas, T. and J. Djikic (2017), “Caught mid-stream: ‘Decentralization’, local government finance reform, and the restructuring of Ukraine’s public sector 2014 to 2016”, <http://sklinternational.org.ua/wp-content/uploads/2017/10/UkraineCaughtMidStream-ENG-FINAL-06.10.2017.pdf>.

Subnational government expenditure and investment are constrained

Subnational government spending power is restricted

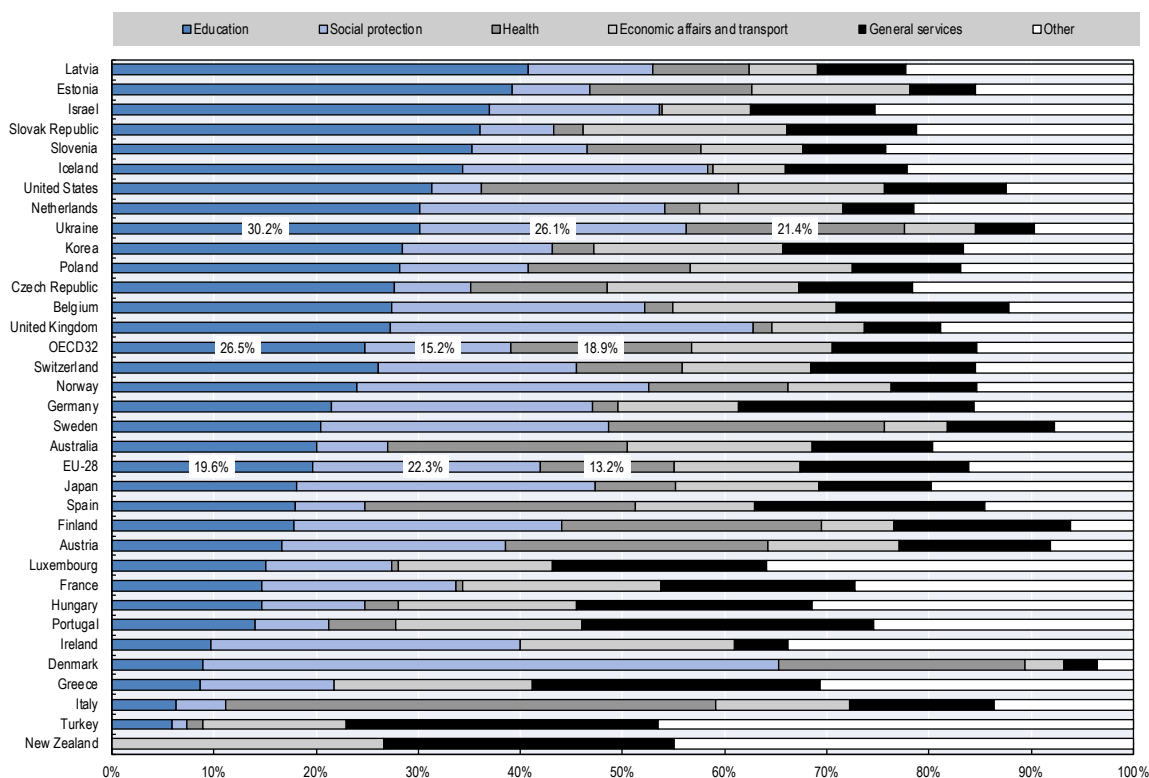
Subnational government functions are broadly described in numerous statutes and regulations (Annex 3.C)² and spending responsibilities are divided into delegated functions and exclusive or own functions. Delegated tasks concern the provision of public services such as education, health and social welfare. The central government is formally responsible for those functions and provides subordinate governments with targeted funds to carry out these tasks. They “transit” through local budgets but subnational government authorities have limited authority over them. Subnational governments also have limited autonomy in the management of their functions. Legal obligations, service organisation, financing, human resources, performance standards, etc., are all defined and monitored by the central government, leaving little or no discretion for subnational governments in the performance of delegated functions.

The ability of local governments to allocate expenditures between and within sectors is quite limited. The budget formation at the service facility level and its aggregation in the local budget are based on norms set by line ministries. For example, local governments are in charge of all of the functions of education except for higher education. However, the Ministry of Education retains full control over the norms that govern staffing, teaching hours, non-teaching personnel ratios and class sizes – based on an oversized network of schools instead of on the actual demand for the service, e.g. enrolled children or school-age population in the jurisdiction (OECD, 2014a). Delegated functions represent

the bulk subnational expenditure: education, social protection and healthcare amounted to 78% of subnational expenditure in 2015. This means that about three-quarters of all subnational spending are made on behalf central government. Most public expenditure for health and education is channelled through subnational governments: 83% for health and 74% for education, well above the EU and OECD averages.

By contrast, “exclusive functions” mainly concern local public goods such as utilities, housing and social protection for which subnational governments have more autonomy and which are financed from general transfers but also own resources. They are vaguely defined and represent a minor portion of subnational expenditure, particularly in comparison to OECD countries (Figure 3.4): 7% for economic affairs and transport, 6% for housing and community amenities and general public services (administration), 3% for recreation and culture, and 1% only for environmental protection. Almost all public spending on housing and community amenities (supply of potable water, public lighting, cleaning, urban heating, urban planning and facilities) also passes through subnational governments.

Figure 3.4. **Breakdown of subnational government expenditure by area (COFOG): OECD and Ukraine, 2015**



Note: 2015 COFOG data are not available for Canada, Chile or Mexico. 2014 COFOG data for Japan, Korea, New Zealand, Switzerland and Turkey. For the United States, data in the function “housing and community amenities” include the “environment protection” function data.

Source: OECD (2017a), “Subnational governments in OECD countries: Key data” (database), <http://dx.doi.org/10.1787/region-data-en>. For Ukraine, OECD calculations based on IMF database.

This breakdown of responsibilities also explains the weight of staff expenditure in public staff spending in Ukraine. Subnational staff expenditure accounted for 38% of subnational spending, slightly higher than in the OECD and the EU, on average, and close

to Sweden or the Czech Republic. Most of this expenditure is for the remuneration of teachers, medical staff and social workers (delegated functions). Thus, subnational governments act as paying agents on behalf of the central government.

There has been little progress in spending decentralisation

Progress in spending decentralisation is not fully reflected in figures. Rather, it appears that decentralisation has resulted in a reallocation of spending responsibilities across subnational levels (particularly from the *rayon* to cities and the UTCs) instead of a reallocation of charges between the central (ministry) and subnational levels. Between 2001 and 2016 in Ukraine, the growth of subnational government expenditure was quite significant, rising from 11.7% to 14.7%. However, the share of subnational government expenditure as part of total public expenditure hovered around 33% (Figure 3.5).

This analysis of local government expenditure at the macro level does not reflect a fiscal decentralisation process over the 2001-16 period. Since 2015, there seems to be movement towards more decentralisation in spending as the decentralisation of new responsibilities and charges progresses, although this remains to be confirmed.

Ukraine's subnational governments have low investment capacity

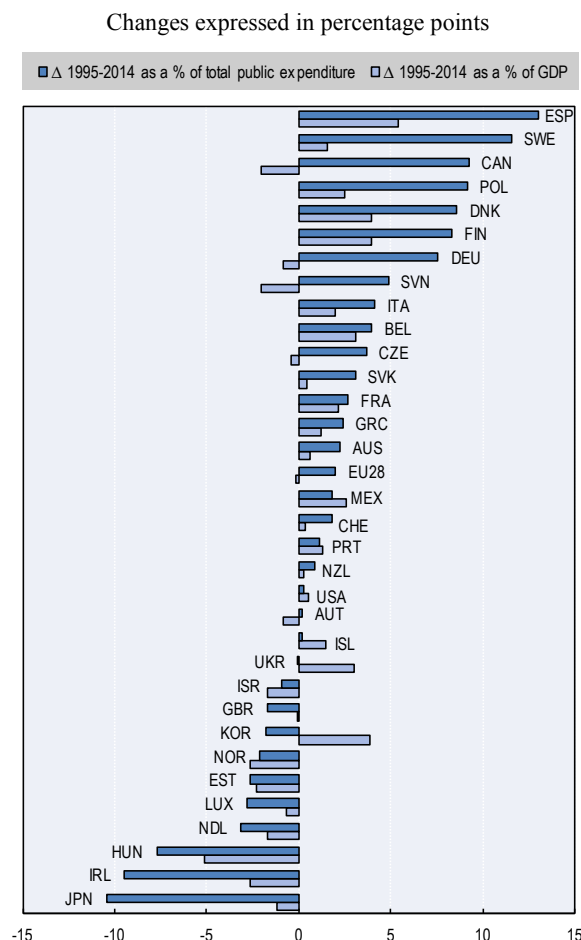
Public investment in Ukraine has fallen relative to GDP since 2000, despite temporary boosts in 2012 (due to FIFA/Euro 2012 and the parliamentary elections) (OECD, 2014a) and general agreement that infrastructure investment is a priority. As of 2015, it appeared to be on the rise, however, accounting for 1.8% of GDP in 2015 and 2.2% in 2016 (Figure 3.6).

The level of public investment of Ukraine is particularly low for a low middle-income country. In fact, Ukraine is well below the average of many other lower middle-income countries in the world, where investing heavily in public infrastructure is considered to be a key structural driver of growth. Many have recently found themselves boosting their public investment to fill the infrastructure gaps. In emerging markets and low-income developing countries, public investment rates peaked at more than 8% of GDP in the late 1970s and early 1980s, declined to around 4-5% of GDP in the mid-2000s, but have recovered since then to 6-7% of GDP (IMF, 2015). Public investment in Ukraine is also very low compared to OECD countries. In the Czech Republic, Estonia, Hungary and the Slovak Republic public investment exceeded 5% of GDP in 2015.

Ukraine's subnational governments do not have the fiscal capacity to heavily invest

Subnational government investment amounted to 1.2% of GDP in 2015, far lower than in most middle-income countries. On average, subnational governments in lower middle-income countries invest around 1.4% of their national GDP. In upper middle-income countries, the figure is 1.7% (OECD/UCLG, 2016). Subnational investment as a share of public investment is significant in Ukraine, at 67% of public investment in 2015 (Figure 3.7). This is significantly higher than the OECD average of 59% and the EU-28 average of 53%. This confirms that investment is a shared responsibility across levels of government, making its governance particularly complex as recognised by the OECD *Recommendation of the Council on Effective Public Investment across Levels of Government*.

Figure 3.5. **Subnational expenditure as a share of total public expenditure and of GDP, 1995-2014**

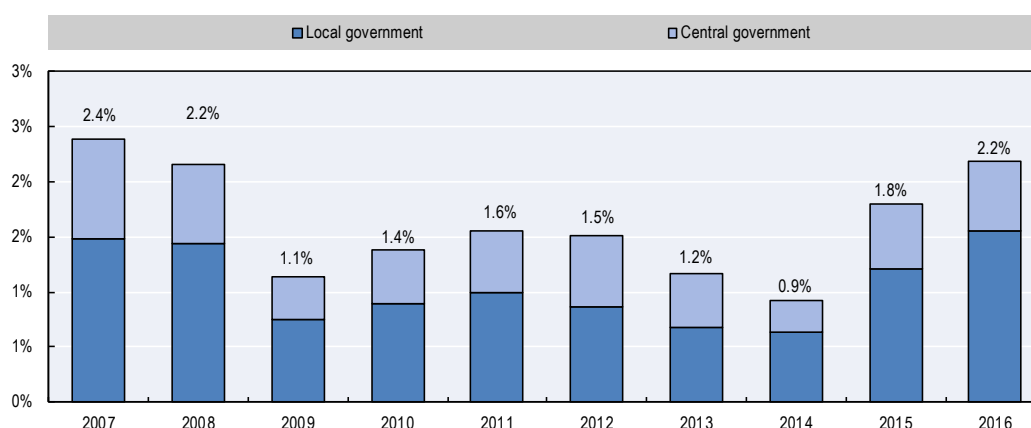


Note: 1995-2012 for Australia; 2003-13 for Mexico; 1995-2013 for New Zealand; 1998-2014 for Iceland; 1996-2014 for the Netherlands; 2005-14 for Ireland. No data for Chile and Turkey due to missing time series. For Ukraine, the series is more limited but ends in 2016, taking into consideration the last reform (2001-16, estimation).

Source: adapted from OECD (2016c), *Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en. For Ukraine, OECD calculations based on IMF, “Government finance statistics”, www.imf.org/en/Data and the State Treasury Service of Ukraine.

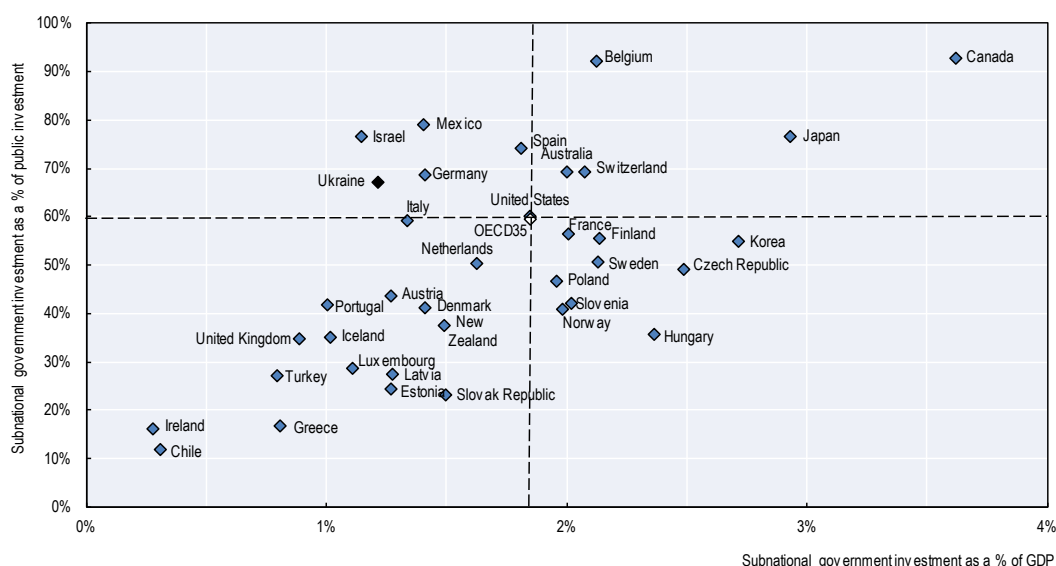
Despite the strong role that local governments play in public investment, they do not have the fiscal capacity to invest heavily: their self-financing capacity is limited by the weight of current expenditure. Meanwhile, capital transfers and investment subsidies are lacking and access to borrowing is limited. As a result, the share of direct investment in their total expenditure is low, despite recent improvement (from 4.5% of local expenditure in 2013 and 2014 to 10.5% in 2016). In addition, subnational governments lack financial stability and predictability – they cannot afford the large-scale multi-annual investment projects that are needed for building or renovating large infrastructure (EBRD, 2014). As a result, infrastructure is heavily underfinanced, and municipal infrastructure needs overshadow the size of local budgets.

Figure 3.6. Public investment in Ukraine as a percentage of GDP



Source: OECD calculations based State Treasury Service of Ukraine, www.treasury.gov.ua.

Figure 3.7. Subnational government investment as a percentage of GDP and public investment in OECD and Ukraine, 2015



Source: OECD (2017a), “Subnational governments in OECD countries: Key data” (database), <http://dx.doi.org/10.1787/region-data-en>. For Ukraine, OECD calculations based on State Treasury Service of Ukraine, www.treasury.gov.ua.

The limited fiscal capacity of the subnational level is a concern given the large need for infrastructure investment. Fixed capital stocks in the public sector are ageing and of mediocre quality, and the country’s infrastructure needs are tremendous. In the area of transport, despite progress over the last three years, Ukraine has one of the lowest road network densities in Europe, together with a significant portion that is obsolete and does not comply with European standards (OECD, 2016b). Rural roads are state- or municipally owned. Their maintenance and modernisation are funded from the state and local budgets. According to the state agency charged with overseeing road development, Ukravtodor (under the Ministry of Infrastructure), in late February 2015, 88% of roads out of a total of 169 647 km required repairs or reconstruction, with almost 40% of them

failing to meet requirements for durability. Only 46% of the bridges and overpasses were in satisfactory condition with the rest being in poor to dangerous states due to their extreme age, with as many as 21% of bridges and overpasses being built prior to the Second World War and 51% built during the 1950s through the 1970s (OECD, 2015a; Ukravtodor, 2015). Municipal utilities, such as water and heating, have also suffered from decades of underinvestment. Estimates based on the household survey (World Bank, 2017b) indicate that in 2013, only 27% of the bottom 40% of the population had access to district heating and 23% to hot water, compared to 43% and 38%, respectively, of the top 60% of the population.

Subnational governments have access to various tools for delivering public services which are being improved

Subnational governments can choose between direct or indirect management to deliver a wide range of services, including waste collection, water provision, heating, maintenance of the housing stock, transportation, etc. Direct management means that the service is delivered by an internal municipal service (budgetary organisations). Indirect service provision is in the hands of public bodies or delegated to private actors or via public-private co-operation (Box 3.1).

Box 3.1. Forms of indirect service providers in Ukraine

- Public bodies: either local enterprises 100% owned and controlled by municipal or *oblast* administrations or an inter-municipal co-operation body that pools the material and financial resources of different communities in order to deliver or establish additional services.
- Joint ventures or joint stock companies in which the local government owns shares: subnational governments provide local services jointly with the private sector through an entity combining public and private capital, or partnerships with the commercial sector.
- Private actors: subnational governments may outsource service provision to private enterprises on a contractual basis (e.g. waste disposal), through licencing, concessions or consumer associations. Several laws define key legal principles applicable to municipal concessions, including the applicable sectors (e.g. urban public transport, water, sanitation, seaports, public catering, etc.). The most sophisticated form of public-private co-operation are public-private partnerships (PPPs); however, they are not frequently used at the subnational level in Ukraine.

The sector of municipal-owned enterprises lacks profitability and transparency

The municipal enterprises sector – still large in Ukraine despite shrinking in the past ten years³ – displays a low aggregate profitability. Municipal assets are less efficient (in terms of profitability) compared to other sectors of the national economy. This could be attributed mainly to the composition of municipal assets, but also to the low quality of local asset management. According to NISPACEE (2010), the collection of payments for

municipal services extended only to 50-60% of the payments due because of corruption, low qualifications and the poor discipline of managers. One of the many issues surrounding Ukraine's municipal companies is limited data to assess performance and a lack of transparency and accountability. While the law requires all local governments to publish their budgets and budget performance reports (not always done), reporting does not cover the financial transactions of government-related entities. Despite some technical progress in budget accounting and monitoring, transparency remains low (Standard & Poors, 2013).

Many municipal companies are also underfunded due to low tariffs and weak financial support from the mother municipality. It appears that public underinvestment also results from underinvestment in utility enterprises that provide services at subsidised rates despite needing to maintain an extensive infrastructure network. This contributes to the degradation of municipal physical assets.

Inter-municipal co-operation is still in its infancy but is being promoted

The promotion of inter-municipal co-operation (IMC), now supported by the 2014 Law No. 1508-VII on Co-operation of Territorial Communities (see Chapter 2) can help improve the efficiency of public service delivery when municipalities are too small, and/or have overlapping or redundant functions. There are various formats for IMC in the OECD, ranging from very informal agreements with no judicial framework to highly formalised arrangements. There are also different forms of funding (Box 3.2).

Box 3.2. Forms of inter-municipal co-operation and funding in the OECD

Most OECD countries have enacted regulations to encourage inter-municipal co-operation. IMC arrangements are now well developed and extremely diverse, varying in the degree of co-operation. They range from the softest (single or multi-purpose co-operative agreements/contracts, e.g. shared services arrangements or shared programmes in Australia, Ireland, New Zealand and England/the United Kingdom) to the strongest forms of integration, e.g. supra-municipal authorities with delegated functions in France, Portugal and Spain and even with taxation powers. For instance, in France, public establishments for inter-communal co-operation (*EPCI à fiscalité propre*) have their own sources of tax revenue and are based on a territorial development project. Between the two, there is a range of different forms of co-operation.

The dividing lines are between the public law model and the private law model: the private law model is based on the freedom of local authorities to pragmatically opt for the areas and forms of IMC based on the modalities and entities envisaged by this law, such as contracts, associations and commercial enterprises. The public model means that co-operation is regulated in some detail by public laws, including the contractual and financing arrangements, the type of delegated functions (with even mandatory functions), the governance structure, the supervision and control, etc.

In terms of financing, IMC structures are most often financed through contributions from municipality members. They usually complement these subsidies by other revenue sources related to the services they provide, i.e. they charge for local public services via user fees – transport, water provision, waste collection, etc. They can also receive grants from the central government, which is a way for central government to favour IMC. In fact, in some cases in the OECD, IMC has even privileged access to central government grant funding. IMC can also attract EU funds and private capital for public-private partnership initiatives between several municipalities and one or several private investors.

Figure 3.8. From soft agreements to more formalised forms of co-operation

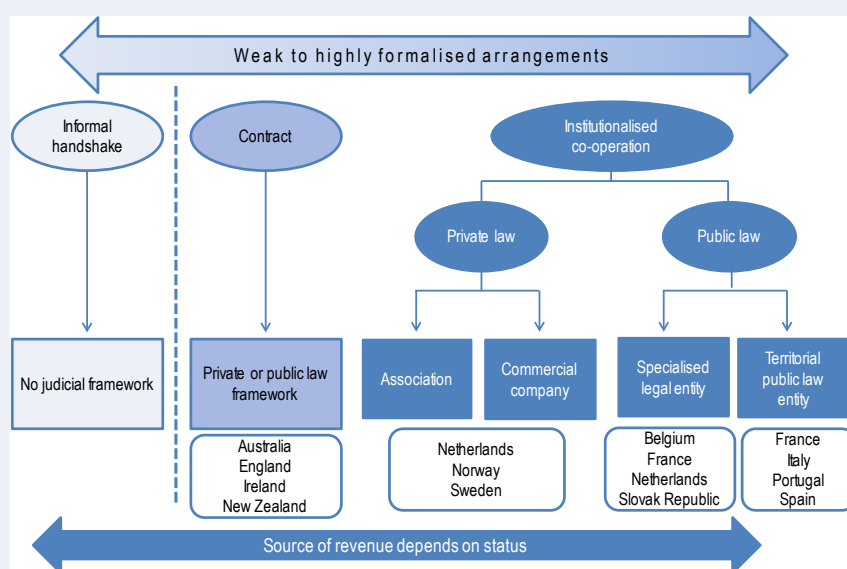


Figure source: Adapted and completed by the OECD based on www.municipal-co-operation.org.

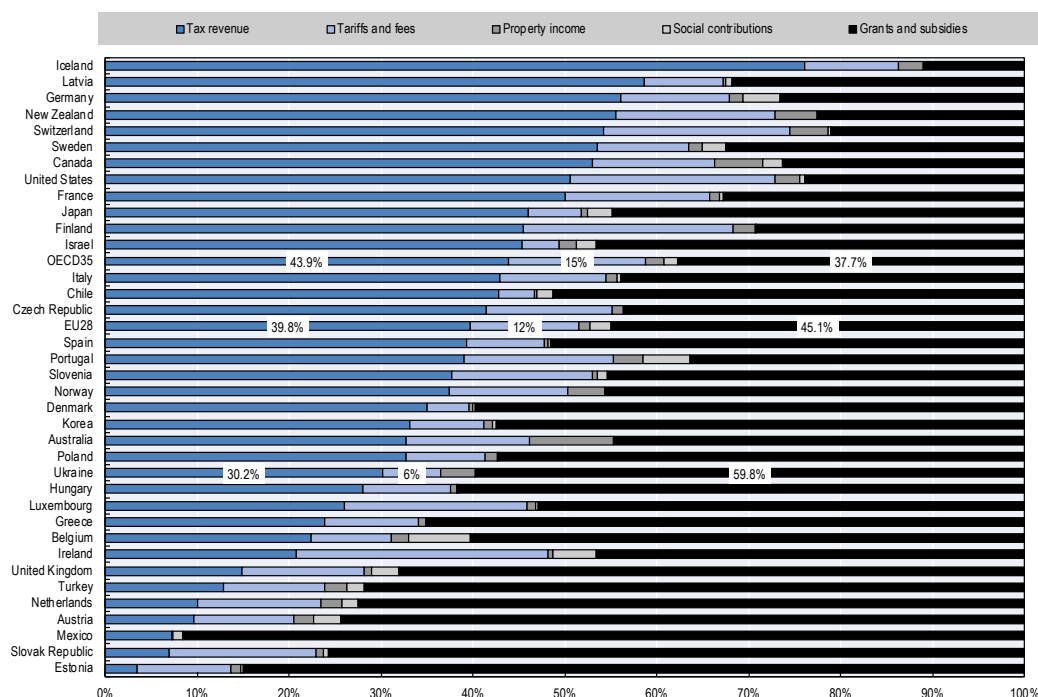
Box source: OECD (2017e), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, <http://dx.doi.org/10.1787/9789264272866-en>; www.municipal-co-operation.org

Subnational governments have a low level of autonomy in revenue management

The funding system is now dominated by central government transfers

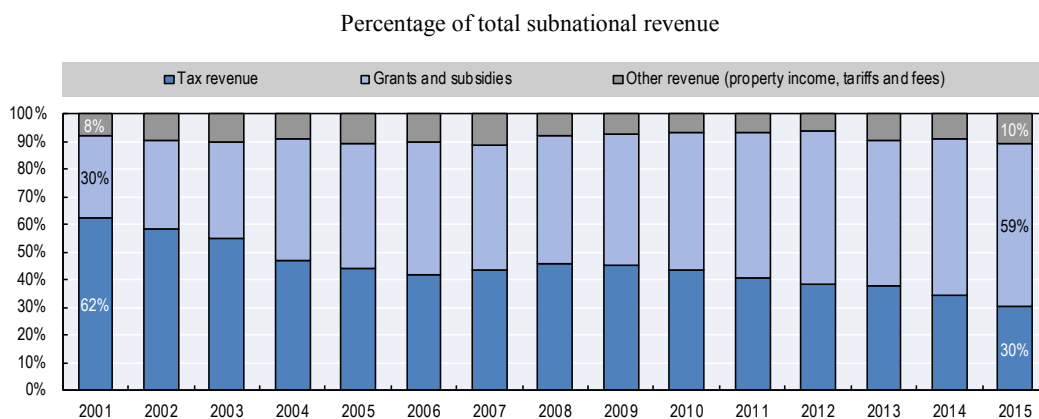
Sixty per cent of subnational resources come in the form of transfers from the central government. This is significantly more than the OECD (38%) and the EU-28 (45%) averages (Figure 3.9). Tax revenues represent 30% of subnational government revenues, compared to 40% in the EU-28 and 44% in the OECD. Over the last 15 years, the respective share of transfers and tax revenue has changed significantly. In 2001, tax revenues accounted for 62% of subnational revenue and grants 30% (Figure 3.10).

Figure 3.9. Structure of subnational government revenue:
OECD countries and Ukraine, 2015



Source: OECD (2017a), “Subnational governments in OECD countries: Key data” (database), <http://dx.doi.org/10.1787/region-data-en>. For Ukraine, OECD calculations based on IMF, “Government finance statistics”, www.imf.org/en/Data.

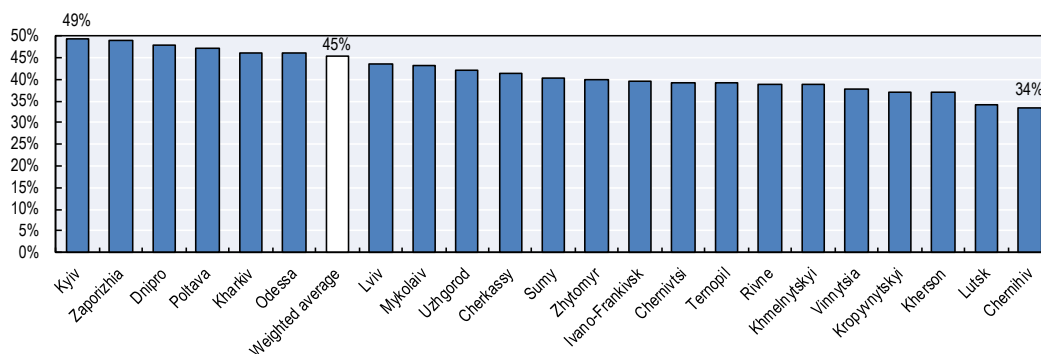
Figure 3.10. Change in the share of each source of subnational revenue



Source: OECD calculations based on IMF, “Government finance statistics”, www.imf.org/en/Data.

Local governments in rural areas rely most heavily on central government transfers, which represent more than 75 % of their revenues (World Bank, 2017a). By contrast, in cities, taxes generated 45% of revenues⁴ in 2015 (INEKO, 2017). In Kyiv, tax revenues represented almost 50% of the city’s total revenues in 2015 (Figure 3.11).

Figure 3.11. Tax revenue as a percentage of total revenue in 22 regional capital cities of Ukraine, 2015

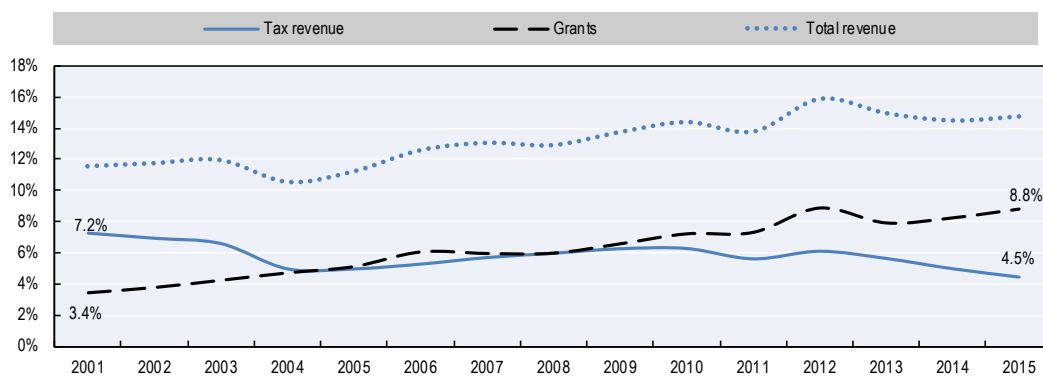


Note: No data available for Donetsk and Luhansk.

Source: OECD calculations based on data provided by INEKO, <http://budgets.icps.com.ua>.

Relative to GDP, central government transfers have strongly increased while tax revenues have decreased (Figure 3.12). The growing dependence of subnational governments on central government resources can reduce incentives to improve service delivery and strongly limits accountability at subnational level.

Figure 3.12. Changes in tax revenue and grants in relation to GDP



Source: OECD calculations based on IMF, “Government finance statistics”, www.imf.org/en/Data.

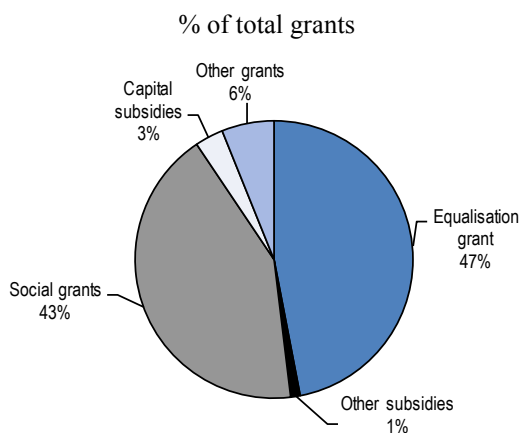
The inter-governmental system of grants was substantially reformed in 2014-15

Prior to 2015, the grant system was comprised of one equalisation grant and one social grant, together representing 90% of all transfers. This system had several important drawbacks (OECD, 2014a). These led the OECD to recommend reconsidering the equalisation system in terms of the amount of tax revenues that each local government could count on. It was also suggested to revise the allocation formula in order to make it simpler and less discretionary, by reducing the number of indicators and to use indicators based on the needs of the population in each area to determine resources allocated for the provision of local public services, instead of input indicators.

After the 2014 reform, there are still two main categories of grants, but their composition is very different than before. There is the equalisation grant and several formula-based central government transfers earmarked to fund sectoral expenditures, particularly in the education and health sectors. Capital grants and subsidies have also been established or

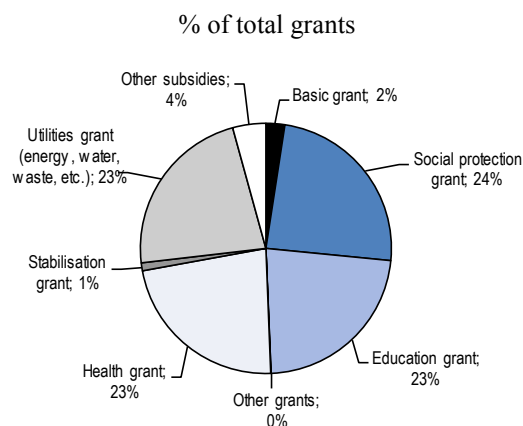
reformed to support investment projects aimed at fostering regional and local development and improving infrastructure (Figures 3.13 and 3.14). The new system of grants aims at ensuring more permanent and stable funding for key responsibilities, as well as enhancing the predictability and transparency behind the allocation of transfers through clearer allocation of rules. One major objective is to improve efficiency in the use of the resources.

Figure 3.13. **Inter-governmental transfers, 2013**



Source: Law of Ukraine “on State Budget of Ukraine 2013” No. 5515 dd, 6 December 2012.

Figure 3.14. **Inter-governmental transfers, 2016**



Source: OECD calculations based on State Treasury Service of Ukraine.

The grants remain very constraining. First, they are, for the most part, earmarked to finance delegated functions and pay staff. They are also associated with guidelines, norms and strict controls. While the intention is certainly justified – to avoid irregularities and inequities related to the provision of education, health and social services across the national territory – they also reduce subnational decision-making power, especially when norms and controls are excessive and not adapted to local specificities.

The equalisation reform

The December 2014 amendments to the Budget Code introduced an equalisation mechanism for subnational government revenues rather than expenditures, basing it on two taxes: the personal income tax (PIT) (for *oblasts*, *rayon*, regional towns and communities) and the corporate profit tax (CPT, only for regional budgets). The mechanism has simplified the calculation formula and now takes revenue performance into consideration when calculating the equalisation grants (Box 3.3).

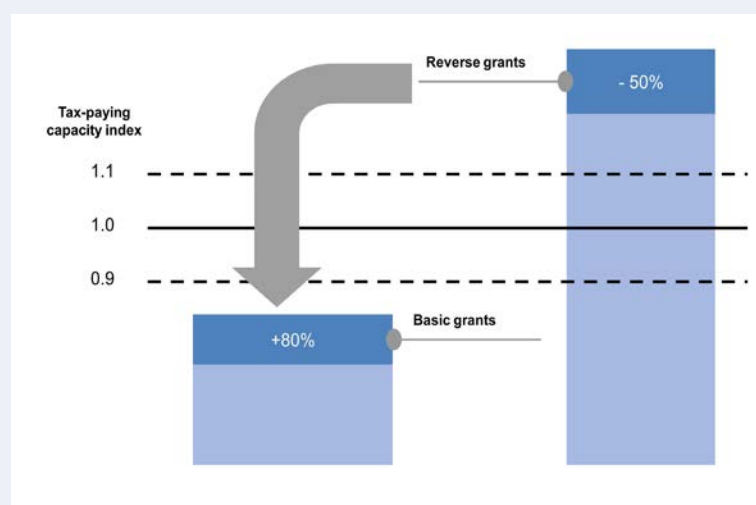
The basic grant amounted to 2.4% of inter-governmental transfers in 2016 and 1.3% of all subnational revenue. In 2015, in 18 regions, the difference between basic and reverse subsidies of all subnational governments was positive (they were net beneficiaries) while it was negative in six others (net contributors). Kyiv city is excluded from the system, despite its high level of PIT and CPT. By levels of government, cities were the biggest donors in 2015 and the *rayon* were the biggest beneficiaries of the equalisation process. The balance for regional administrations was slightly positive, meaning that, on average, they received more than they contributed. In 2016, it was foreseen that the UTCs would also benefit from the system (PwC, 2016).

Box 3.3. Ukraine's equalisation grant mechanism

The equalisation system's main elements are basic and reverse grants. The basic grant is a transfer from the national budget to the local budgets. The reverse grant is composed of funds transferred from the local budgets to the national budget to ensure horizontal equity. The equalisation mechanism is determined by the tax capacity index, which is the ratio between the tax capacity per person of a local budget and the average tax capacity per person of the same level budgets. This tax capacity index determines which local governments will receive basic grant, which will pay the reverse grant and which will be unaffected by the mechanism. The tax capacity index is also used for the calculation of the basic and reverse grants.

The mechanism is represented in Figure 3.15: 50% of revenue surplus is withdrawn from the budgets of local governments that earn more than they spend, but on condition that the tax capacity index is more than 1.1. The withdrawn funds are used to provide basic subsidies. The basic subsidy is only 80% of the required amount (provided that the tax capacity index is less than 0.9) for local governments that do not have sufficient revenue to cover their expenses.

Figure 3.15. New equalisation mechanism: Basic and reverse grants



Source: Reanimation Package of Reforms (2015), "Reforms under the microscope".

Said differently, local governments with tax capacity above the Ukrainian average by at least 10% will keep 50% of the revenue surplus. Poorer local governments, with tax capacity below 90% of the national average, will receive a basic grant which amounts to 80% of what is required to catch up with the average. Local governments with revenues between 90% and 110% of country's average will not be subject to either compensation or deduction.

Source: PwC (2016), "Local taxation diagnostic review of local revenues in Ukraine"; Reanimation Package of Reforms (2015), "Reforms under the microscope".

The reform of the education, health and social grants

The misallocation of resources in the education, health and social sectors resulting from the funding system is particularly problematic (Box 3.4). Prior to reform, the system of grants was not conducive to rationalising and improving the quality of the services, as it was based on expenditure gaps and historical data. In fact, any efficiency improvement would result in fewer resources for the local government.

Since 2015, there have been moves to reform the system. In 2015, a flexibility measure in education and health grant management was introduced, allowing for subnational governments to keep unspent funds from state grants at the end of the year for use in the following year to upgrade the material and technical base of educational and medical institutions. Previously they were withdrawn and sent back to the central government, which could encourage an inefficient use of funds. In 2016, four major sectoral grants were created or adjusted: the social protection grant, the education grant, the health grant and the utilities grants. These four funds are represented in the same proportion in total transfers and in total subnational revenues. Line ministries can allocate these grants directly to subnational governments, and new “principles” for the allocation of funds have been introduced. These principles are based on a formula-based calculation according to sectoral service delivery standards (for services guaranteed by the state) and norms per user. However, these principles have not yet been implemented. The allocation formula used in 2015 and 2016 has been in operation for over 15 years, initially as a part of gap-filling calculation, and for the last 2 years as a stand-alone formula allocating education/medical subvention.

Introduction of new capital funds for regional and local development

Capital investment subventions, which are one of the key sources of funding for capital projects, have long been unpredictable and determined on an annual basis using non-transparent criteria and priorities (OECD, 2014a). This situation is changing thanks to the creation of the State Fund for Regional Development (SFRD) and the introduction of two new funds for subnational public investment: the subsidy for development of infrastructure and the subsidy for social and economic territorial development.

The SFRD was established in 2013 to support the State Strategy for Regional Development. It finances investment programmes and development projects prepared and submitted by subnational governments. Initially, the attributable funds were allocated to the regions on the basis of a simple formula: 70% was allocated among all regions, according to population, and 30% was allocated based on the proportion of the population falling below 75% of the country’s average GDP per capita. These proportions have changed recently to an 80/20 split.

In 2016, the state budget also introduced a subsidy for social and economic territorial development (UAH 3.3 billion, 3 711 projects) and the subsidy for development of infrastructure in the UTCs (UAH 1 billion, 1 383 projects) to finance development and infrastructure projects in targeted UTCs. Funds are allocated among the UTCs in equal proportions to their area and the size of the rural population, and are destined to fund the construction of administrative service centres, the renovation of social and educational infrastructure facilities, the construction and repair of roads, water supply facilities, the introduction of energy efficient measures, etc. In 2017, these two funds increased to UAH 1.5 billion and UAH 4 billion, respectively.

Box 3.4. An inefficient use of central government transfers in the social, health and education sectors

The health, education and social sectors are oversized and fragmented in Ukraine in terms of network size and staffing, as well as quite inefficient and deliver poor results. Ukraine has about 40% more hospital beds per capita than the EU average. Despite this over-developed infrastructure, only basic services are provided. Ukraine's score is among the lowest of all transition economies. A survey conducted in 2015 indicates that only 10% of Ukrainians had a good opinion of the quality of care in Ukraine. Eighty-five per cent consider the quality of healthcare services bad or very bad and deteriorating. In education, the school network is large but does not correspond to the pupil enrolment rates, which are declining, especially in rural areas. In the social sector, social assistance spending (cash transfers) is high – among the highest in the region – but Ukraine ranks low in terms of effectiveness of support. By contrast, social care services (support to old age, disability, child services, etc.) are underfunded.

While education and health networks have excess capacity, they lack equity. Schools and medical units in small communities are often understaffed and cannot provide quality services to the local population. Per capita expenditure on education and social services is not homogeneous across territories. The welfare system tends to increase inequities, and social assistance is insufficiently focused on the most vulnerable. Instead, the system tends to favour “categorical benefits” and a “privileged population” that is not, on average, poor.

Education, health and social assistance services are also inefficiently managed. The World Bank found over 70 local government welfare programmes and 39 central government programmes that lack monitoring, management and co-ordination. In the social care area, a significant share of resources is managed by *oblasts* but not in an efficient manner.

The grant system is partly responsible for the situation, as transfer levels are determined by norms and input-driven indicators based on historical data, rather than on demand-driven indicators based on assessed service needs. For example, the number of doctors is based on the existing number of beds in healthcare facilities and in schools, non-teaching staff is based on the number of square metres of a school facility. In addition, there is a high level of current expenditure that leaves very few resources for capital investments and quality-enhancing projects. Poor municipalities often do not have the capacity to maintain and repair their medical and education facilities, as all their resources are dedicated to operating expenditure. Only the wealthier municipalities can use their own-source revenues to cover financing and operational gaps, and renovate and invest in new infrastructures.

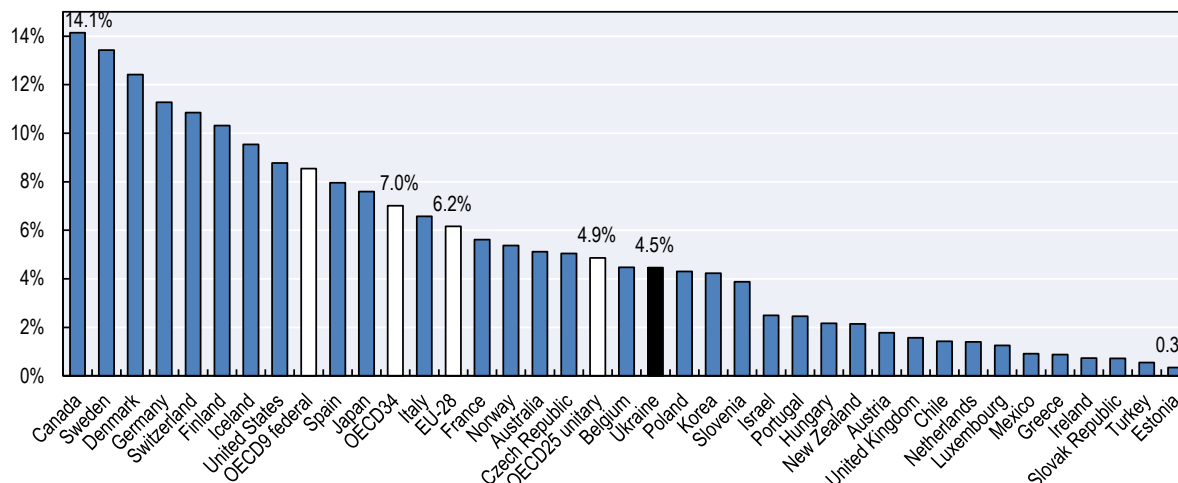
The consequences are paradoxical: a high level of expenditure but a low level of satisfaction in terms of access and quality of services.

Source: World Bank (2017a), “Ukraine: Public finance review”, <http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review>; OECD (2014a), OECD Territorial Reviews: Ukraine 2013, <http://dx.doi.org/10.1787/9789264204836-en>.

Tax reform has impacted shared and own-source taxation systems

Subnational government tax revenues are low and do not result from their exercise of taxing power. In 2015, subnational tax revenue in Ukraine amounted to 4.5% of GDP, below the OECD and EU-28 averages of 7.0% and 6.2%, respectively (Figure 3.16). Subnational tax revenue amounted to 18% of total tax revenue – compared to 38% in 2001 – well below the OECD average (31%) and the EU-28 average (23%).

**Figure 3.16. Subnational tax revenue as a percentage of GDP:
OECD countries and Ukraine, 2015**



Source: OECD (2017a), “Subnational governments in OECD countries: Key data” (database), <http://dx.doi.org/10.1787/region-data-en>. For Ukraine, OECD calculations based on IMF, “Government finance statistics”, www.imf.org/en/Data.

Tax-sharing arrangements are particularly important in Ukraine, as it appears that tax revenues are mostly generated from tax sharing with the central government. This represents a further limitation on subnational fiscal autonomy. Approximately 67% of subnational government tax revenue comes from the PIT. The allocation of shares to subnational governments is set in the Budget Code according to a fixed percentage of tax collected locally. Percentages vary according to the category of subnational government: subordinate governments are unable to adjust tax rates or bases. Own-source taxes are limited and all tax receipts are administered and controlled by the State Fiscal Service.

The reforms introduced in 2014 and effective in January 2015 affected shared taxes and own-source taxes. On the one hand, tax-sharing arrangements were modified between the central government and subnational governments and across subnational jurisdictions. Shared taxes now represent a lower share of total subnational government tax revenue. On the other hand, the list of local taxes was modified: some taxes were abolished while others were created or reformed. Furthermore, subnational governments were given more ability to modify tax rates and bases (Annex 3.D). Despite these reforms, it should be noted that globally the level of subnational tax revenues has diminished relative to GDP, to public tax revenues and to subnational revenues.

A new distribution for shared taxes

The reform has also modified tax-sharing arrangements between and across levels of government, especially with respect to the PIT, the CPT, the excise tax on retail sales of excisable goods, environmental taxes and rents for the use of natural resources.

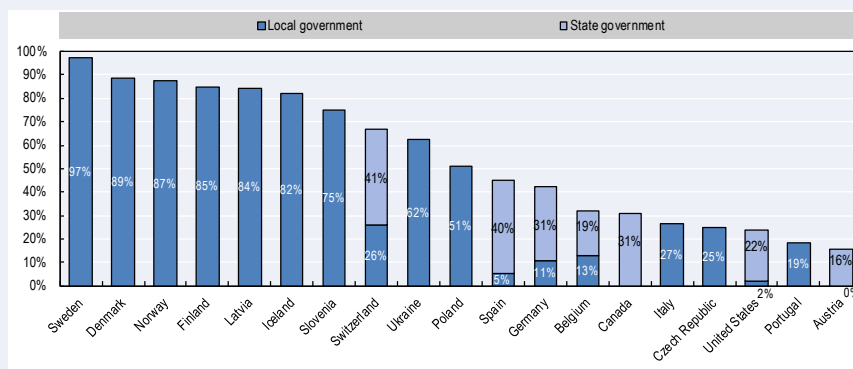
The 2014 amendments to the Budget Code modified the PIT vertically and horizontally. Vertically, the share attributed to subnational governments has decreased in favour of the central government. Prior to the reform, PIT receipts were fully redistributed to the subnational governments (except for Kiev). With this reform, the central government now receives 25% of the PIT as a general rule. Horizontally, PIT shares for each category of subnational government have changed. Overall, the weight of the PIT in subnational tax revenue dropped between 2014 and 2015, from 79% to 62%. Towns of *rayon* significance, villages and rural settlements which have not merged have lost their share of the PIT. Despite the share of the PIT redirected to the central government,⁵ in 2016 it still represented 54% of subnational tax and fee revenue, which is not unusual for some OECD countries (Box 3.5).

**Box 3.5. Personal income tax in OECD countries:
A significant source of revenue for subnational governments**

In OECD countries, the personal income tax (PIT) can represent a significant proportion of subnational tax revenue. In countries such as Denmark, Finland, Iceland and Sweden, where the share of PIT in subnational tax revenue ranges from 82% to 97%, it is a local own-source tax, not a shared tax. In Denmark, the local PIT is collected by the central government together with the national PIT. In Finland, the base of the local PIT tax is determined by the central government, but municipalities have full control over the rate. In Sweden, subnational tax revenues come almost entirely from the local PIT, which is an own-source tax, levied independently from the national PIT. Municipalities and counties have the same tax bases but decide independently to set their tax rate. In Norway, the revenue from the PIT on ordinary income is collected by the municipalities for the central government, the counties and the municipalities. The split of PIT revenues between the three levels of government is determined by parliament as part of the national budget. The tax level is set annually by the Norwegian parliament as the maximum level of municipal income tax. In principle, counties and municipalities can lower the income tax rate for their municipality, but in practice all use the maximum rates. In Portugal, the two autonomous regions enjoy a certain degree of tax autonomy. They are able to retain nearly all of the PIT generated within their territories, and exercise strong control over the rate and base. Portuguese municipalities receive a local PIT surtax capped at 5% of tax receipts collected from local residents, though municipalities can decide to reduce this percentage. In Italy, the PIT is a shared tax and an own-source tax. Part of the PIT receipts are shared and local governments can also choose to levy a surtax on the PIT.

Finally, in some unitary countries such as Latvia, Poland and Slovenia, the PIT is shared and accounts for more than 50% of subnational tax revenue. In Estonia, Lithuania, Romania and the Slovak Republic, until a reform of the System of National Accounts, the PIT was considered a shared tax between the central and subnational governments. With the new methodology, PIT receipts have been reclassified as central government transfers and no longer as tax revenue.

Figure 3.17. Personal income tax receipts as a share of subnational tax revenue in selected OECD countries and Ukraine, 2015



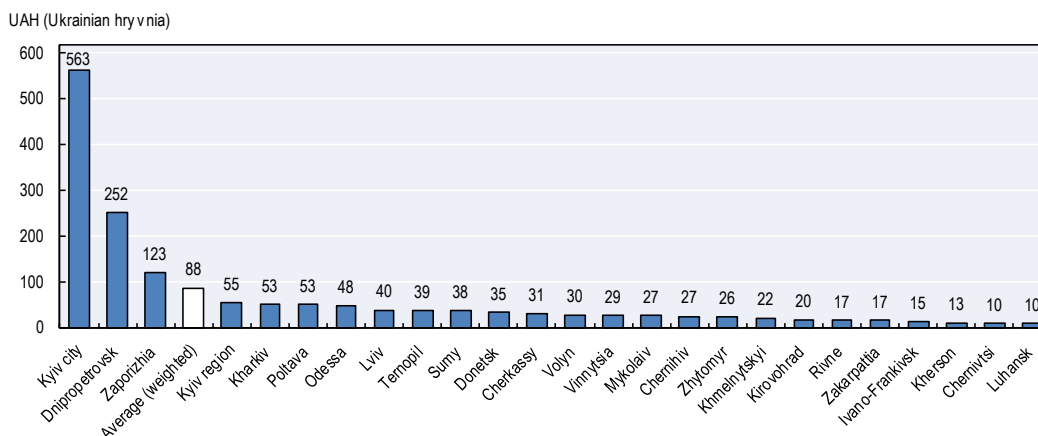
Source: based on OECD National Accounts and State Treasury Service of Ukraine, www.treasury.gov.ua. Execution of the budget (revenues). The definition used is “taxes on individual or household income including holding gains”.

Source: (OECD, 2018), OECD Tax Database, OECD, Paris, <http://www.oecd.org/tax/tax-policy/tax-database.htm> and <https://www.oecd.org/ctp/tax-policy/personal-income-tax-rates-explanatory-annex.pdf>.

Since January 2015, the corporate profit tax is shared, with *oblasts*, ARC and Kyiv receiving 10% of CPT receipts.⁶ The CPT is paid where a company is registered. This generates considerable disparities between regions, in particular a rather unfortunate bias in favour of larger cities, especially Kyiv (Figure 3.18). The CPT represented 4% of subnational tax and fees revenue in 2016.

As part of the reform, the retail excise tax on alcoholic beverages, tobacco, petroleum and gas was introduced in subnational budget revenue in January 2015. All receipts are allocated to local governments, including Kyiv. In 2016, it accounted for 7.9% of subnational tax revenue, 3.2% of total subnational revenue and 0.5% of GDP, which is quite significant. In addition, subnational governments receive a share of environmental taxes (i.e. ecological tax and pollution charges) as well as rents for the use of natural resources (water, forest resources, subsoil) whose shares were modified in 2015.

Figure 3.18. Corporate profit tax receipts per inhabitant per region and Kyiv, 2015

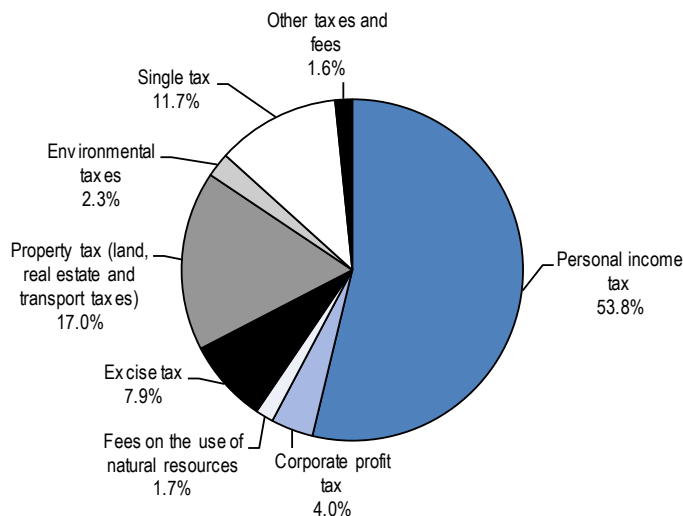


Source: Based on data from INEKO, <http://budgets.icps.com.ua>.

A renewed system of local taxes and fees with an increased taxing power

Some minor taxes were abolished in January 2015 and new local taxes were introduced by the Tax Code. In addition, the local government taxing power on local taxes and fees was enlarged, as they now have greater freedom to set rates and establish exemptions. The new system of local taxes and fees comprises four main local taxes: the single tax (also called the unified tax), the property tax, the parking fee and the tourist tax (Figure 3.19).

Figure 3.19. Breakdown of taxes and fees in total subnational taxes and fees, 2016



Source: Based on data from State Treasury Service of Ukraine, www.treasury.gov.ua, Execution of the budget (revenues).

However, local taxes and fees still represent a small share of subnational tax revenues and total revenues, respectively 29% and 12%. They also amounted to only 1.8% of GDP. In addition, rates remain capped and there are some other limitations concerning the ability to set rates and modify bases. For example, the tax rate of the single tax for individual

entrepreneurs is decided by local councils, but is capped, while for the other groups of taxpayers there is no taxing power: it corresponds to a fixed percentage of value-added tax (small businesses) or value of agricultural land (agricultural producers). The rate of land tax and the real estate tax other than on land are capped while the rate of the transport tax is fixed (Box 3.6).

Box 3.6. The reform of the property tax in Ukraine

In 2015, Ukraine reformed its property tax (Article 265 of the Tax Code of Ukraine), which is now composed of three different sub-taxes:

1. The land tax/rent: existing since 1992, it is a mandatory “local” tax or rent (depending on the legal status of the land plot) since 2015. It is levied on legal entities and individuals. The tax rate is set by local authorities but capped (between 1% and 5%), while the amount of the rent is also capped. The land tax/rent is the main component of the property tax, representing in 2016 around 93% of its receipts, 15.9% of subnational tax revenue, 6.4% of subnational total revenue and just under 1.0% of GDP.
2. The real estate tax other than on land, has been effective since 2015 in its new form. It is now paid by owners of residential real estate properties as well as by owners of non-residential properties, both individuals and legal entities, including non-residents. Cities may impose tax rates on properties based on location (locations bands) and type of real property, from 0% to 1.5% of the minimum wage per square metre of the taxable base as of 1 January. Local authorities can also decide on exemptions and reduced rates. In particular, they can determine the area of the property that is not taxed. Only “extra square metres” are taxed. Tax assessment is based on the state register of property rights, but since 2015/16 also on information collected through the certificate on property rights. This tax accounted for 5.7% of the property tax receipts in 2016, 1% of subnational tax revenues, 0.4% of total subnational revenue and 0.06% of GDP.
3. The transport tax was also introduced in January 2015. It is paid by individuals and legal entities who own cars registered in Ukraine. Cars not older than five years and with an average market value more than 750 times the minimum wage are taxed by UAH 25 000 per year. This tax is minor, accounting for 1% of the property tax receipts, 0.2% of subnational tax revenue, 0.07% of total subnational revenue and 0.01% of GDP.

The reform of the property tax, with the introduction of a real estate tax, is a positive step for Ukraine, and is aligned with both economic theory and tax practices in many other countries (Box 3.7).

Non-tax revenues are quite constrained but are increasing

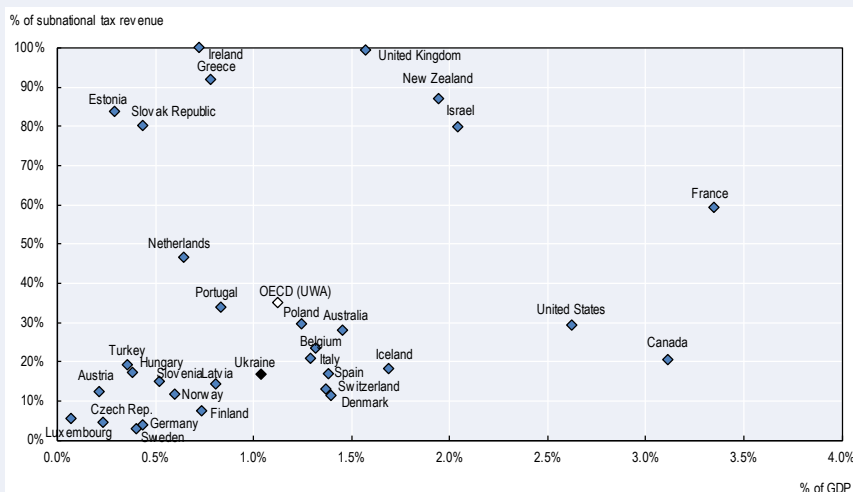
Non-tax revenues, which represent 10% of subnational revenues, are generated by property (6%), and administrative fees and revenues from “business activities” (4%). The share of non-tax revenues in total revenues increased from 6% in 2012 to 10.5% in 2015.

Box 3.7. The subnational property tax in the OECD

The property tax is a cornerstone of local taxation in many countries but its implementation and management face many obstacles. The merits of the property tax are regularly praised by economists: visibility, lack of tax export, productivity thanks to the stability of tax bases and solid return on tax collection, lack of vertical tax competition by exclusive or priority allocation to the municipal level, implicit progressivity (property values rise alongside the revenue of their owners), and horizontal equity (OECD, 2017b). These merits do not conceal the weaknesses and limits inherent in its practical application and management, which raise debates and encounter many difficulties. These obstacles explain that the significance of recurrent taxes on property in subnational tax revenue and GDP remains modest, although it varies considerably across countries.

In the OECD, recurrent taxes on property represent 35% of subnational tax revenue on unweighted average but between 90% and 100% of local tax revenue in Australia, Ireland, Israel, New Zealand and the United Kingdom, which are mostly Anglo-Saxon countries. At the other end of the spectrum, it is a minor local tax revenue source (less than 10%) in Nordic countries (Finland, Norway and Sweden), Estonia, Luxembourg, Switzerland and Turkey (OECD, 2016c). It represented 17-30% of local tax revenue in Hungary, Iceland, Japan, Korea and Poland. As a percentage of GDP, recurrent taxes on property range from 0.1% in Luxembourg to 3.1% in Canada and 3.3% in France, the unweighted OECD average amounting to 1.1%.

Figure 3.20. Subnational recurrent taxes on property in the OECD and Ukraine



Note: 2016 is the year of reference for Ukraine; 2013 and 2014 are the reference years for the other countries. Includes: taxes on land, buildings or other structures (D29a) and current taxes on capital (D59a).

Source: Based on data from OECD National Accounts for Ukraine and State Treasury.

Source: OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, <http://dx.doi.org/10.1787/9789264279049-en>; OECD (2016c), *Regions at a Glance 2016*, http://dx.doi.org/10.1787/reg_glance-2016-en.

Revenues from property⁷ tend to be increasing. For example, revenues resulting from the lease of public land could increase in the short term thanks to the June 2017 Cabinet Resolution on Land Resources Management System at the Local Level. The resolution provides that lands will be leased out through auctions only, and a period not to exceed seven years. The amount of land which may be transferred free of charge should not exceed a quarter of the land plots forming the object of the auction. The objective is also to reduce abuses and corruption related to lease of land, ensure more transparency and increase local revenues (Despro, 2017).

Another example of revenue generation from land is the introduction of a land value capture instrument called “shared participation in infrastructure development” allocated to subnational governments in the Urban Planning Law of Ukraine. The law has created a procedure for determining the amount of shared participation (contributions) that developers (investors) need to pay when they engage in construction, reconstruction, rehabilitation, overhauls, re-equipment, etc. of any property. These revenues are directed at developing city infrastructure. In Kiev, the shared participation is charged under the agreement with Kyiv based on the customer’s application and supporting documents. Between 2014 and 2015, the total value of shared participation agreements increased by about 190% in Kyiv.

The revenue from the administrative services fees has also been increasing since the amended Budget Law extended the list of services to be delivered by local governments⁸ instead of the central authorities. These local governments now collect the associated fees. A network of administrative service centres (ASCs) was created to help improve administrative service delivery. There were 713 ASCs functioning in 2017, 208 of which were created by local governments and 22 in the UTCs with the support of U-LEAD.⁹

Revenues from business activities are generated by the delivery of local public services, i.e. user charges and tariffs. Here, local governments can establish some charges and tariffs, but this ability is regulated by a complex system which includes legislated limitations to the local government’s powers. Significant reforms are ongoing, including that of local public service tariff setting. Specifically, in March 2017, when the National Commission for State Regulation of Energy and Public Utilities passed a resolution on the expansion of powers of local governments in tariff setting. Local governments can now set tariffs for heat energy production, transportation and supply. Of the currently operating licensees in this area, 74% will become subject to licensing by local authorities. The same will apply in the water supply and sanitation sector: 67% of the currently operating licensees will be supervised by local authorities.

Borrowing and financial management frameworks are becoming more flexible

Subnational government debt is very low and highly restricted

Local government borrowing is underdeveloped in Ukraine. In 2016, it accounted for 0.5% of GDP and 0.6% of public debt (Figure 3.21). Moreover, subnational debt has decreased regularly since 2007, both as a share of GDP and in relation to public debt. Compared with OECD countries, Ukraine has a very low level of subnational debt, close to that of Chile (where there is no official local debt), Greece, Hungary, Ireland and Slovenia.

Box 3.8. Local public service tariff setting in Ukraine

The system of tariff setting is regulated by several laws, in particular the Law “on Housing and Communal Services” No. 1875 of 2004, Law No. 2479 “on State Regulation in the Communal Services Sector” of 2010, as well as sectoral laws on heat supply, water and drinking water supply. In addition, the Tax Code is part of the framework for tariff setting of utilities as well as decrees of the Cabinet of Ministers and resolutions of the national regulatory commission.

The 2010 law in particular established a new system of state regulation in the sphere of municipal services, based on a new national regulatory body: the National Commission for State Regulation of Public Utilities. It took over from local governments the power for setting tariffs for publicly provided water supply and wastewater collection and treatment, transportation, and heating services. However, local governments are in charge of setting tariffs for utilities that are not regulated by the national regulator. These local tariffs must be approved by the Cabinet of Ministers of Ukraine.

In September 2016, a new long-awaited law was adopted setting up a new National Commission for State Regulation of Energy and Public Utilities. It shall become the independent public authority for state regulation, monitoring and control of the energy and public utilities sectors, for granting licences and for establishing tariffs.

In March 2017, the national government passed the resolution on the expansion of powers of local governments in tariff setting. These later will set tariffs in the areas of heat energy production, transportation and supply. Seventy-four per cent of the currently operating licensees in this area will become subject to licensing by local authorities. The same will apply in the water supply and sanitation sector. Sixty-seven per cent of the currently operating licensees in this area will be supervised by local authorities.

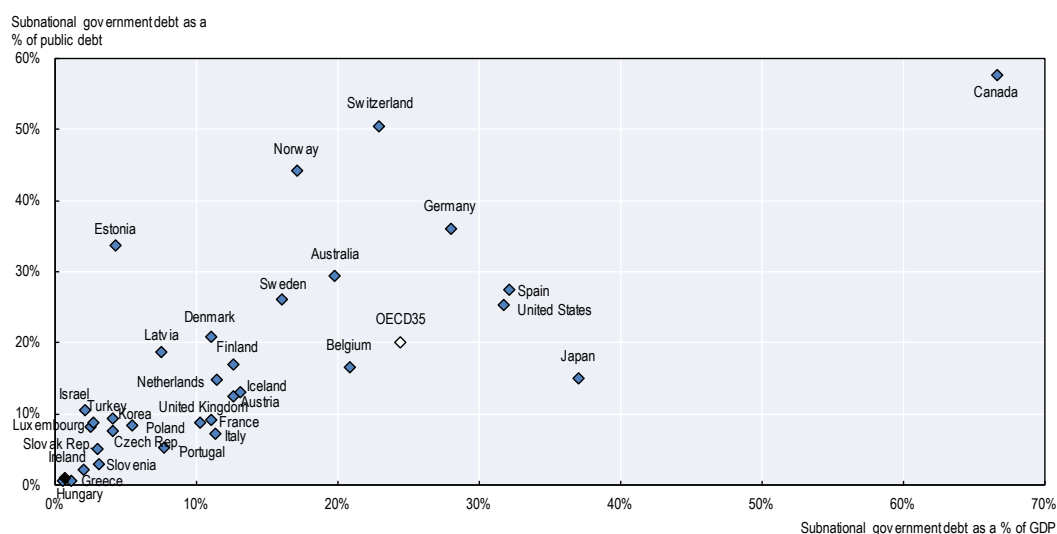
Source: Shugart, C. and A. Babak (2012), “Public private partnerships and tariff regulation in the water, wastewater and district heating sectors”, <http://ppp-ukraine.org/wp-content/uploads/2015/03/Tariff-Regulation-Report-ENG.pdf>; DESPRO (2017), “Decentralisation in Ukraine”, http://despro.org.ua/library/Decentralization%20Newsletter_March_2017_ENG.pdf.

Subnational government debt is composed of internal debt (77%) and external debt (23%). It composed mainly of loans, as the share of securities is very low (2% of debt stock as of 1 January 2017, a decrease from previous years). This is linked to debt restructuring and partial redemption of domestic bonds. Within loans, the share of banks and financial institutions is limited compared to the Treasury (26% vs. 74% in 2016). International financial institutions (e.g. the European Bank for Reconstruction and Development, the European Investment Bank, the World Bank, the Nordic Environment Finance Corporation, the International Finance Corporation, KfW Development Bank, etc.) are among the major investors in Ukraine’s municipal service sector,

including in transport, infrastructure, heat, water, waste management and energy efficiency measures (EBRD, 2014). Debt is very concentrated, with Kyiv representing around 40%. The debt per inhabitant reached UAH 2 269 in 2015 in Kyiv, ten times more than the weighted average of the other 21 regional capital cities (Figure 3.22).

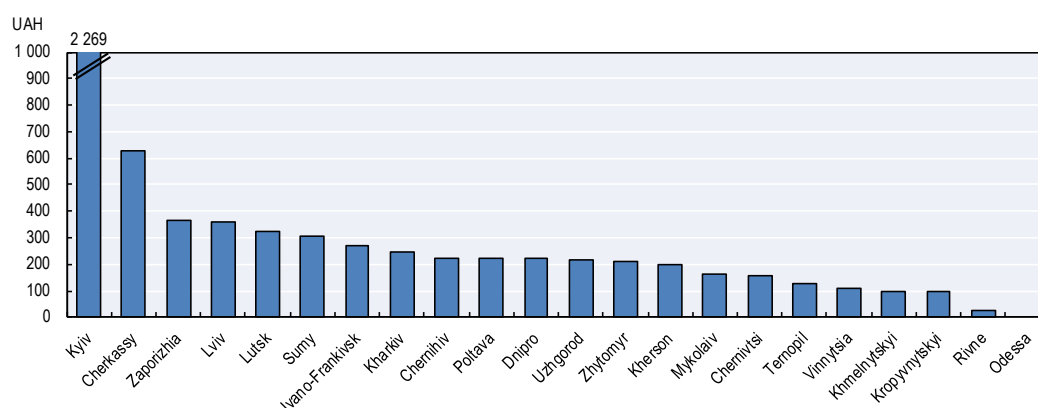
The low level of debt and its characteristics reflect the constrained legal framework that surrounds borrowing (Box 3.9). It also arises from a conservative stance in authorising municipal borrowings since 2013. Borrowing is strictly controlled and co-ordinated by the central government, and all decisions on municipal borrowing are taken by the Ministry of Finance. Most municipal bond applications have been rejected over the past several years, in response to international pressure on the Ukrainian administration to lower its public debt (Storonianska, 2013).

Figure 3.21. Subnational public debt as a percentage of GDP and public debt in the OECD and Ukraine, 2015



Source: Based on data from IMF database (Government Finance Statistics - www.imf.org/en/Data) and State Treasury Service of Ukraine, www.treasury.gov.ua.

Figure 3.22. Debt per inhabitant of regional capital cities, 2015



Source: Based on data from INEKO, <http://budgets.icps.com.ua>. No data available for Donetsk and Luhansk.

Box 3.9. Subnational government fiscal rules in Ukraine

The Budget Code provides a legal framework for the local government budget system. It includes the underlying principles, budgeting process and relationships between the state budget and local budgets. It is complemented each year by the Law “on the State Budget of Ukraine”. Local budgets are comprised of two parts, the General Fund and the Special Fund:

1. The General Fund is formed by the personal income tax, the property tax, the single tax (since January 2015), the corporate profit tax, some non-tax receipts and operating transfers from government. It is allocated for operating spending (e.g. salaries, maintenance, interest, etc.).
2. The Special Fund is formed by non-tax revenues (own revenues of budgetary entities, assets sales) and capital grants. Resources are earmarked going mostly to capital spending and debt repayment. It comprises the development budget (for capital expenditure and big repairs), the Special-Purpose Fund (special-purpose programmes, such as capital expenditure, repayment of borrowings, creation and rehabilitation of green belt areas, provision of urban amenities, etc.) and the Environmental Fund (environmental programmes) and others. The law allows for transfers from the General Fund to the Special Fund, but not vice versa.

Table 3.1. **Budgeting and fiscal rules applying to subnational governments in Ukraine**

	General Fund	Special Fund
Revenues	Taxes, including a share of personal income tax and operating subsidies.	Property taxes and earmarked fees, assets sales and capital grants.
Expenditure	Operating expenditures, including salaries and interest payments.	Development-related expenditures, including capital spending and debt repayment.
Deficits and surplus	Deficit is not allowed, unless it can be covered by free cash. Surplus is allocated to the development budget, repayment of outstanding borrowings and maintenance of the operating balance of budget funds at a predetermined level.	Deficit is allowed and must be financed by asset sales, borrowings, free cash or transfers from the General Fund. Any Special Fund surplus is allocated to repayment of municipal debt and/or acquisition of securities.
Direct debt plus guarantees	Not allowed.	Must not exceed 200% of the average forecast revenue in the development budget over the next two years (excluding multilateral loans guaranteed by the state). Must not exceed 400% for Kyiv.
Interest payments (as % of expenditure)	10%	Not allowed.
Borrowing	Must be authorised by the central government.	Must be authorised by the central government.
Borrowing in foreign currency	Not allowed.	Allowed. Bonds and loans allowed for cities of regional significance. Loans from international financial institutions allowed for all.
Budget payment	Via State Treasury for all budgets.	Via State Treasury for all budgets.
Default	No right to borrow for five years after default.	No right to borrow for five years after default.
Oversight	State Treasury, Ministry of Finance.	State Treasury, Ministry of Finance.

Source: Adapted from Standard & Poors (2013), “Public finance system overview: Ukraine local government system is volatile and underfunded”.

While still strict, the 2014-15 reform loosened the regulatory framework for subnational borrowing. It offers a simplified procedure for local government borrowing and guarantees based on the principle of “tacit consent”.¹⁰ In addition, the scope of borrowers has been extended: all cities of *oblast* significance are now allowed to borrow long term using both loans and bonds, as well as in foreign currency from banks and international financial institutions. *Oblasts* and *rayon* are still not allowed to borrow, with the exception of the Autonomous Republic of Crimea. It must be also noted that since 2011, all municipalities, regardless of population size, have the right to borrow, but only through loans and only from international financial institutions.¹¹ To ensure compliance with the threshold of the public (local) debt and government (local) guarantee, the central executive body keeps a Register of Local Borrowing and Local Guarantees – an information system that contains details on the local borrowing incurred and local guarantees granted.

Budgeting and financial management are being improved

Different local management reforms have been undertaken to improve administrative and executive processes. They cover diverse areas, including human resources management, financial management (i.e. budgeting, accounting and debt management), organisational management, optimisation of administrative process, e-government, quality management, open government, citizen participation, etc. which are beyond the scope of this report.

In Ukraine, subnational financial management is constrained by a number of restrictions and limits imposed by the national legislation, the Ministry of Finance and the State Treasury. Subnational government revenues are directly administered by the State Treasury. In addition, they have little ability to manage their own revenues, due in part to a degree of regulation, and in part to a lack of human, financial and technical capacity to administer resources, except in very large cities.

Several measures were introduced in 2015 that introduced greater flexibility to financial management and budgeting. For example, subnational governments are now authorised to open accounts in state banks, not only in the State Treasury, in order to deposit their own revenues derived from budgetary institutions and development funds. This has eliminated, or reduced, the prior dependence that subnational financial operations had on decisions of the government (EBRD, 2014). Subnational budgeting is being modernised as well. Local governments are now fully responsible for their budget planning, rather than having local earnings and expenditures planned by the Ministry of Finance (Kantor, 2015). The principle of budgetary autonomy was expanded, and deadlines for approval of local budgets have been clearly defined, irrespective of approval of the state budget. Finally, Ukraine is transitioning to multi-year budgeting and a medium-term expenditure framework, which offers the potential of greater predictability with respect to financing. This has been done at the subnational level in several OECD countries, including Belgium (Flanders), with its six-year strategic planning system and innovative digital reporting system. Subnational multi-annual budgeting will be trialled in 2018-20 (Ministry of Finance) in order to better develop medium- and long-term investment projects. The introduction of results-oriented budgeting is also foreseen.

The impact of fiscal decentralisation reform and challenges ahead

Though still in their early stages of implementation, the 2014-15 reforms have started to reap positive results. This process, however, has taken place in a differentiated way, which could rapidly become an issue for the success of decentralisation. Moreover, despite some real progress in terms of fiscal decentralisation, i.e. increased fiscal

autonomy in some areas, the reform still tends to promote a subnational financing model based on grants and subsidies more than own revenues. Transfers from the state budget are vital to financing devolved responsibilities, and they have steadily increased over recent years to become the main source of revenue for subnational governments. Paradoxically, this means that fiscal reform, which was meant to favour decentralisation, has led to greater dependence on the central government.

Fiscal decentralisation should be sustained and further deepened

Fiscal decentralisation is helping transform the governance system, but it may be at risk

Because of the difficulties in advancing decentralisation through political and administrative reforms as explored in Chapter 2, fiscal decentralisation has been used as a tool for transformation. It is inducing profound changes in the distribution of powers.

Fiscal decentralisation has paved the way for a new balance of powers among subnational governments. As already underlined, budgets of cities of *oblast* significance and the UTCs have increased substantially. *Oblast* administration revenues have shrunk while those of the *rayon* administrations have not shown any significant change for the moment (Levitas and Dkijik, 2017; World Bank, 2017a). Changes in the tax system and grant allocation have shifted subnational organisation and responsibilities.

This pragmatic method has produced some good results, allowing the “critically needed momentum to be maintained” (Levitas and Dkijik 2017). But it may also produce some undesired outcomes that will be difficult to correct in the future. The reduction in *oblast* administration budgets (and thus of their responsibilities) could contradict the decentralisation reform objective of creating full self-government entities at the regional and intermediate levels. This approach can also lead to some “improvisation and frustration” (Levitas and Dkijik, 2017). This may also generate instability and uncertainty among subnational governments, but for the central government as well, and especially for the population and business community, which is directly impacted by these permanent changes.

Fiscal decentralisation now needs to be better conceptualised in a strategic framework. The government could prepare, in association with representative associations of subnational governments at all levels and other key stakeholders, a fiscal decentralisation strategy, in particular concerning the allocation of powers and responsibilities.

On this basis, a road map and implementation plan for fiscal decentralisation should be prepared and discussed in a multi-stakeholder dialogue. A specific permanent “fiscal decentralisation committee” could be established involving key ministers, subnational government associations, business and citizens’ associations, universities, etc. (see below). At the central level, there should be also an inter-ministerial committee on fiscal issues more generally, to ensure consistency of reforms and regulations concerning subnational government finance.

The implementation plan should identify the necessary steps for the successful execution of fiscal decentralisation in terms of adjustments to make or new measures to take. It should also include tools and indicators to monitor the progress of the action plan and regularly assess the outcomes of the reform.

Subnational governments need more stable and autonomous revenue sources

Despite recent fiscal decentralisation measures, Ukrainian subnational governments are still strongly dependent on the state budget and state decisions for their revenues and expenditures. They have no control over more than 70% of their revenue, as it is comprised of grants and shared taxes. The remaining 30% can be considered own-source revenue (i.e. own-source taxes, fees, rents, property income, etc.), providing them with little flexibility. There is a wide gap between own-source revenues and operation and investment spending needs. This results in large fiscal imbalances. It is, therefore, still necessary to increase the share of own-source revenue in subnational revenues, including own-source taxes and non-tax revenues.

Subnational fiscal power should be reinforced through more flexibility in managing grants, and greater access to external funding. Subnational governments should enjoy more freedom in deciding how to allocate grants, without strict guidelines, norms and control from the central government, even if these are earmarked to specific sectors. The distribution of state transfers needs greater stability and transparency. To support subnational investment for local and regional development, access to borrowing should be facilitated with loosened borrowing rules and the strengthening and diversification of the credit market.

Spending responsibilities should be clearer

Delegated expenditure (i.e. in healthcare, education, social protection) amounts to almost 80% of subnational expenditure. Lack of flexibility in spending these funds leaves subnational governments with little spending autonomy. Many local authorities lack the resources to support their exclusive competences, in particular those necessary for the economic and social development of their territories. The weight of current expenditures on local budgets makes it highly difficult to generate self-financing capacity for investment.

Moving forward it will be necessary for Ukraine to (re-)evaluate the assignment of responsibilities across levels of government in order to ease the burden imposed by some functions on subnational governments and to enlarge their spending autonomy. A review of competences and functions among central, regional, intermediary and local levels should be undertaken to clarify the breakdown of responsibilities and to assess the relevance of delegating some functions to subnational governments. Decentralising does not necessarily mean transferring all functions from the centre to the lower levels of government. It means assigning the adequate function to the adequate level according to the principle of subsidiarity.

In Ukraine, numerous tasks are being transferred to the UTCs without a clear understanding of the impact in terms of charges and constraints. Apart from the fact that many small and/or under capacitated communities are ill-equipped to take on new responsibilities, the transfer of several functions to the local level is not always appropriate. This is particularly the case when it does not follow the subsidiarity principle, when it entails diseconomies of scale or when it involves significant current expenditure on behalf of the central government (e.g. paying teachers or doctors, managing hospitals or distributing benefits). This can be counterproductive to decentralisation reform if local governments are not able to effectively carry out the responsibilities entrusted to them by the reform.

On the basis of a comprehensive diagnostic of the distribution of responsibilities and functions across levels of government, Ukraine may want to consider “recentralising” some specific functions, leaving those which are “locally relevant” and best managed by

subnational governments at the local level. In the education sector, for example, some heavy current charges could be transferred back to higher levels of government while education investment functions and the associated costs (i.e. maintenance and repairs) as well as some operating expenditure (i.e. energy, extra-curricular activities, administrative services, canteens, pupils transport, non-teaching personnel, etc.) could be maintained at the local level. The idea is not to recentralise the entire sector, but rather to recentralise some functions (potentially more costly ones). In the social sector, the distribution of social benefits could be reassigned to the central level, since income distributional issues and assistance to vulnerable populations are traditionally the domain of the central government (Bogdan et al., 2017).

This reflection should be conducted for all sectors that the government intends to decentralise (and especially education, health and social welfare), in close co-ordination with ongoing reforms. For example, profound changes are foreseen in the health sector which would have a significant change on subnational governments' health responsibilities.

Assigning the right competences and the right functions among the different subnational levels is another challenge. There is no one model for breaking down responsibilities across subnational governments in the OECD. However, a general scheme based on OECD country experience, as outlined in Annex 2B could inspire Ukraine, as work still remains to be done with respect to assigning spending responsibilities and revenues.

Local communities are confronted with significant fiscal challenges

The future of non-amalgamated communities is also worrying in terms of resources. While fiscal incentives were used to encourage amalgamations, unless some action is taken to accelerate and consolidate the amalgamation process, this could create a large imbalance between the non-amalgamated communities and the UTCs.

The unified territorial communities: New budgetary entities with increased spending responsibilities and resources

The heterogeneity of the UTCs in terms of size, capacity and financial resources also raises concern. Many UTCs are still too small and are unlikely able to cope with their new responsibilities. Specific actions targeted at the UTCs are needed to face these challenges. Increasing the size of many UTCs to reach a minimum threshold for medium- to long-term sustainability will be important. Co-operation between the UTCs to deliver services and build new infrastructure should be also encouraged as a means to accomplish this. Furthermore, developing a special human resources plan that involves significant support in terms of training and capacity building in fiscal matters would also be of value.

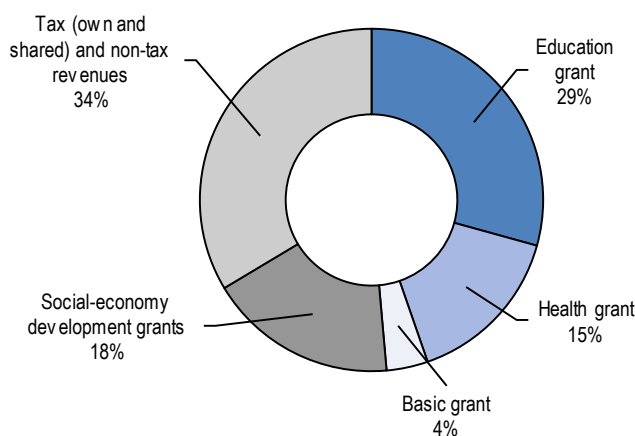
The incentive mechanism to promote mergers is an increase in financial capacity and fiscal autonomy attributed only to the UTCs. Thanks to the fiscal decentralisation reform, the UTCs are autonomous budgetary entities the direct inter-budgetary relations with the state budget, and can now negotiate their budget directly with the *oblast* (regional) government. With more fiscal capacity, however, comes more (transferred) responsibility, including the management of schools and nurseries; primary healthcare; culture, leisure and sports; social aid; and providing administrative services. The UTCs have received resources to cover these, including state funds, shared taxes and own-source taxes, putting them on par with cities of *oblast* significance.

The UTCs have been able to increase both central government transfers and own-source revenues. On the tax side, the UTCs receive 60% of the PIT collected on their territory,

100% of the CPT from local public enterprises, 25% of the ecological tax, 100% of the retail excise tax and 100% of the four main local taxes (i.e. property tax, single tax, parking fee, tourist tax). On the grants side, they receive direct inter-budgetary transfers from the state budget, including an equalisation grant (basic grant) and subventions, and sectoral grants (e.g. for education, health and social protection). They also receive a grant for having merged. Furthermore, they can access capital transfers funds, including privileged access to funds from the State Fund for Regional Development, a subsidy for social and economic territorial development, and dedicated funds for their development projects (subsidy for infrastructure development in the UTCs). Finally, they can benefit from non-tax revenue (previously reserved for cities), in particular payments for administrative services, user charges, revenues from the sale and leasing of assets, etc.

In 2016, grants represented 66% of the UTCs' revenues. Taxes (shared and local) and non-tax revenues accounted for 34% of their revenues (Figure 3.23). Grant funding is 7 points higher for the UTCs than for all subnational governments, highlighting a higher dependence of the UTCs on the central government. This dependence can be even higher: grants represented more than 75% of UTC revenues for 45% of the UTCs, and more than 90% for 7% of the UTCs. By contrast, these UTCs received very few tax revenues (World Bank, 2017a).

Figure 3.23. Revenue structure for unified territorial communities, 2016



Source: Adapted from World Bank (2017a), "Ukraine: Public finance review", <http://documents.worldbank.org/curated/en/476521500449393161/Ukraine-Public-finance-review>.

Some government sources estimate that the General Fund of the UTCs (including transfers from the state budget) increased almost seven-fold between 2015 and 2016. In reality, if one eliminates the transfers, they increased by more than three times. In 2017, of the 366 active UTCs, the own-source revenues of local budgets more than doubled, totalling UAH 3.2 million in 2017.

The UTCs are using this increase in own-source revenue to address gaps in social and other infrastructure (e.g. schools, heating, roads, health/dental clinics). In 2016, capital expenditures made by the UTCs reached UAH 52.5 billion, compared with UAH 32.1 billion in 2015 (Ministry of Finance). In 2016, investment expenditure represented 30% of total expenditure – the highest rate for all categories of subnational governments (Levitas and Dkijik, 2017). There is anecdotal evidence that they are also successful in promoting greater economic development and growth. Other positive results associated with the

reform is the perception that this new funding structure can improve tax compliance, as mayors have a vested interest in ensuring that taxes are paid, improving the climate for business and innovation, and helping fight corruption.

However, some issues have emerged. First, numerous UTCs are still too small (although no threshold has been defined). Among the 665 UTCs registered in October 2017, covering 28% of the national territory and 13.4% of population, 35% have fewer than 5 000 inhabitants, while the average is 8 565. There are, on average, 4.7 communities amalgamated in one UTC (Ministry of Regional Development, October 2017). Small UTCs are unlikely to achieve economies of scale in service delivery. This could undermine efforts to rationalise education, health and social healthcare networks and facilities (World Bank, 2017a).

Although they have received transfers and tax revenue, the transfer of former *rayon*-owned assets has yet to be completed and personnel have yet to be reassigned. As a result, the UTCs have to transfer funds from the state budget to their former *rayon* to pay for services the *rayon* is still providing (World Bank, 2017a).

The UTCs do not all have the same financial capacity. A 2017 study undertaken for the Ministry of Regional Development showed that UTCs with a low number of residents had limited capability to provide all of the required services to their residents, and limited capacity for sustainable development. By contrast, those UTCs with a larger number of residents had higher indicators of earned revenues per individual community resident.¹²

The UTCs also face a lack of technical capacity to manage new responsibilities and funding. In the social sector, providing social care is a completely new function, for which they are unprepared. According to a 2017 World Bank report, many UTCs have handed this responsibility back to the *rayon* together with the associated funds. The emergence of the UTCs as direct beneficiaries of sectoral subventions thanks to the decentralisation process has resulted in an increase of the total number recipients of sectoral grants. This represents progress, as they now receive direct funding to carry out their tasks. However, it has also deepened the fragmentation of budget resources, which was already high, increasing duplication and risks of inefficiency in the use of resources. This raises the more general issue of the relevance of decentralising health and education to the lower level of government, and underscores the need to review the overall budgeting process, in particular how grants are transferred from the state to local budgets.

A new problem arose in 2017 concerning unspent funds at the local level. These are being accumulated in treasury and bank accounts, instead of being used for maintenance or infrastructure development. Prior to the 2015 reform, unspent funds had to be returned to the state budget. Now, they can be kept and put in treasury accounts or banks accounts. This measure constitutes progress for subnational governments, as they can now keep their funds, accumulating savings for future large projects, and strengthening financial strategies and planning. The practice, however, is now criticised by the government, which is concerned about the increase in unspent funds. According to the Ministry of Regional Development, unliquidated local budget balance funds in treasury and bank accounts are constantly growing. As of January 2017, they amounted to UAH 49 billion, compared to UAH 31 billion the previous year – an increase of 35% in real terms. Significant investment needs are not being covered while subnational governments still claim additional funds. This may, however, reflect the difficulty subnational governments face in designing and implementing projects, due to capacity gaps and/or lack of territorial strategic planning. It is recommended conducting an in-depth survey (possibly by the inter-municipal associations) to understand the reason for such an accumulation.

Improving fiscal dialogue between central and subnational governments

The dialogue between central and subnational governments, in particular through their associations, could be reinforced. At the central government level, there are no formal (or informal) mechanisms of systematic and permanent consultation and co-ordination with subnational governments. A positive step was taken in December 2015 with the creation of the Parliamentary Office of Local Self-Government, which provides information and advisory assistance to representatives of local self-government bodies, and helps to resolve organisational issues regarding their co-operation with parliament.

As far as financial issues are concerned, the influence of subnational governments on the central government is modest, except for some large cities. The government has its reform agenda and takes decisions unilaterally, which translates into limited predictability in terms of changes to the institutional framework. Although the law requires the state to make the draft state budget available to local governments for the purpose of consultation, the vast majority of financial decisions are taken solely by the central government with no reference to other tiers of government (Standard & Poors, 2013). Representative associations of subnational governments are not consulted on the calculations of annual grants or tax-sharing arrangements, contrary to practices in a number of OECD and European countries.

Fiscal decentralisation reform needs to establish, or reinforce, co-ordination mechanisms in fiscal matters across levels of government. Ukraine could set up a permanent state-local government fiscal co-ordination committee which would meet regularly each year. This committee should have a permanent secretariat and a budget to ensure its effectiveness and sustainability. To ensure credibility with government institutions, it should be placed under the prime minister and chaired in a bipartite way, i.e. by a representative of the Ministry of Finance/Regional Development and a representative of an association of subnational governments.

Box 3.10. Select OECD experiences with multi-level dialogue and co-ordination

OECD experience shows that countries with well-developed co-ordination arrangements have a comparative advantage for the introduction and implementation of future reforms (OECD, 2013a).

Co-ordination is well-developed in Australia, Germany, Italy and Spain, where dedicated permanent policy exchanges, forums or “conferences” have been set up at the central and/or regional levels. Co-ordination mechanisms are also widespread in Nordic countries, where co-ordination is ensured through regular formal meetings held between representatives from central and local governments. Subnational government associations are consulted on legislative changes and participate in the dialogue and negotiations with the central government. They can be also associated upstream in drafting legislation that concerns them through precise consultation procedures, but also via multiple informal interactions and exchanges of information, built on mutual trust. There is a genuine “culture of negotiation”, based on transparency and respect for all stakeholders, aimed at consensus-building.

In France the government introduced a “Conference of Territories” (*Conférence des territoires*) and reactivated the Observatory on Local Finance and Public Services in July 2017. The first body, chaired by the prime minister, is composed of members of the government, representatives of local and regional authorities, the parliament and the existing territorial co-ordination bodies. The aim is to ensure that subnational governments are involved upstream in decisions that affect them, to build a “trust pact” between levels of government, and to establish a new mode of functioning and distribution of roles between the state and the subnational governments. The second instrument is a bipartite body aimed at favouring information, dialogue and negotiation concerning new measures that impact local government finances.

Sources: OECD (2017e), *Multi-level Governance Reforms: Overview of OECD Country Experiences*, <http://dx.doi.org/10.1787/9789264272866-en>; OECD (2013a), *Investing Together: Working Effectively across Levels of Government*, <http://dx.doi.org/10.1787/9789264197022-en>.

Box 3.11. Recommendations for sustaining and further deepening fiscal decentralisation: General principles

- Better conceptualising fiscal decentralisation in a shared strategic fiscal framework, implemented according to a clear road map that includes monitoring tools and indicators.
- Setting up a permanent sub-commission dedicated to fiscal decentralisation issues. This could be part of the decentralisation committee or council recommended earlier.
- Acting on the side of revenues, in particular by increasing own-source revenues, but also on the expenditure side by undertaking a review of competences and functions to clarify the breakdown of responsibilities across levels of government and to assess the relevance of further delegating or recentralising some tasks.
- Avoid creating a “two-speed system” between dynamic unified territorial communities and the other local communities which continue to resist amalgamation; increase UTC fiscal capacities.
- Improve fiscal dialogue between central and subnational governments through appropriate co-ordination mechanisms, including a permanent state-local government fiscal co-ordination committee.

The system of inter-governmental grants needs further improvement

Preliminary look at the impact of the new equalisation system

It is difficult at this early stage to assess the performance of the new horizontal equalisation system, as it has been in place only since 2015. Such an exercise should be undertaken over a longer period of time. In addition, it should be assessed in conjunction with the equalisation components of other grants, for example in education, social protection and health, once their allocation mechanisms are determined and stabilised. What can be said, however, is that the regional variation in per capita revenues (taking into consideration *oblasts* and all their subordinate jurisdictions) was very low pre- and post-2015 reforms, except for the city of Kyiv. This indicates that the equalisation system was, and still is, effective in equalising subnational government revenues. Significant per capita tax revenue disparities are offset by variations in per capita budget subsidies (World Bank, 2017a).

However, a deeper analysis is necessary. Contrary to appearances, there is a significant change before and after the reform, underlined by a 2016 study by PwC. There is a clear correlation at the regional level between the amount of the net equalisation grant (the difference between basic and reverse subsidies) and regional GDP, which was not the case with the previous equalisation mechanism. That means that the wealthiest regions in terms of GDP transfer the largest amounts to the state budget, while the poorest receive the most. Other positive results are the increased transparency and simplicity of the new system.

Nevertheless, some issues need to be raised. First, the basic grant remains modest, representing 1.3% of subnational revenue in 2016. Second, the basket of taxes taken into consideration for horizontal equalisation is limited to the PIT and the CPT. This basket could be enlarged to include other shared taxes (e.g. excise taxes) or even some local taxes. Third, the exclusion of Kyiv from the equalisation mechanism is questionable, as the city receives a large portion of the shared PIT and CPT (38%), while accounting for only about 7% of the population. Fourth, the new horizontal equalisation system is essentially a “Robin Hood” system based on the redistribution of tax resources across subnational governments from the “richest” to the “poorest” and seems efficient in terms of “solidarity”. But it should be closely monitored for its incentive effects in the medium term, especially if the basket of taxes is enlarged to include own-source taxes. Additional time will be needed to identify side effects, any counterproductive effects or fiscal incentives, especially on local and regional development. If it is too focused on horizontal solidarity, a compensation system such as this one can favour “inequity” or “unfairness” and be economically inefficient in the end. It can undermine subnational government efforts to increase their own tax bases and boost regional growth (OECD, 2013b). The experience of several OECD countries in this respect is illustrative. Several OECD countries tend to combine vertical transfers (from the central government to financially weak subnational governments) and horizontal transfers (from wealthy jurisdictions to the poorer ones), as well as arrangements based on revenue equalisation (to reduce differences in tax-raising capacity) or charges equalisation (to reduce differences in the cost of providing public services). In Ukraine, some adjustments could be needed in the future to find a trade-off between solidarity, equity and economic efficiency principles. Implementation of the new allocation mechanisms for sectoral funds will have an impact on territorial disparities. They may include vertical equalisation instruments, based on population needs (i.e. “charges”).

The reform of education and health grants should be completed and ensure sufficient and stable revenues

The new system of grants has improved the financing of delegated functions, in particular in education and healthcare: there are more funds and they are better allocated. The flexibility measure concerning education and healthcare grants allows subnational governments to keep unspent funds for the following year in their budgets. In addition to encouraging the rationalisation of funds, it supports investment in local infrastructure.

However, some issues remain and new issues have emerged, becoming more and more sensitive as responsibilities are progressively transferred and taken over by local governments. Underfunded mandates remain. Despite a significant increase in grants, central government transfers are still insufficient to cover all of the delegated functions prescribed by law and to be secured with sufficient revenues (OECD interviews). Thus, subnational governments use other subsidies and own-source revenues to fund delegated functions. This leaves little room for maneuver to cope with the transfer of additional responsibilities and to finance exclusive responsibilities. According to Kantor (2015), 20% of public services are still underfunded. In particular, funding for education and health delegated expenditure is insufficient (e.g. vocational schools as the Vocational Education Grant, created in 2015, was abolished in 2016). Specific funding for capital investment is insufficiently considered in funding allocations.

Furthermore, instability in funding and a risk of inconsistencies between the new expenditure obligations of local governments and the revenue sources assigned to them persist. The reform was intended to promote stability and predictability of financing but it

has not done so. Fund allocation rules have been changed every year since 2015, which generates great uncertainty. Until 2016 local budgets had to cover the financing needs of schools and polyclinics, and hospitals predominantly via central budget transfers, including maintenance, repairs and utilities (energy and water bills). In 2017, subnational budgets had to take on a significant part of expenditures for schools and medical institutions, as central government transfers were earmarked exclusively for teacher remuneration and hospital costs, without including utilities and maintenance costs. Local governments are using their local revenues to finance these operating expenditures at the expense of investment, which had to be cut.

The “principles” of grant allocation were determined by the reform based on the switch from an input-driven approach to a demand-driven one – which is more focused on users’ needs. These measures, however, have yet to be implemented. The allocation formulas remain the same as those used for 15 years, with some difference: rather than being part of a gap-filling calculation as in the previous equalisation grant, they are “stand-alone formulas” allocating education or medical subventions. This means that the current allocation mechanisms are still based on input indicators and historical data, not output indicators, population needs or performance indicators. Further political commitment and work are needed to address these challenges. The revision of grant allocation mechanisms according to a demand-driven approach should be accelerated in order to encourage an efficient use of resources, ensure the equalisation of resources across subnational governments to improve territorial equity, and increase transparency. This will require developing a list of services and standards in each sector, entailing the commitment of the various ministries responsible for developing new capacities, procedures and data-collection mechanisms. The international donor community could support this, as it is doing in the case of the education sector.

Ukraine needs a comprehensive assessment of the quality of public services

Healthcare, education and social systems still lack a comprehensive assessment of service quality. There are few to no criteria for evaluating the quality of public services in Ukraine and there is no a single methodology for calculating the cost of providing them. This makes it difficult to determine whether local budget revenues will match spending needs or whether local governments use their funds efficiently. Measures should be put in place to gather information about the actual effect policies have on the quality of such services. This information is essential in making the service more respondent to the needs of the population, thereby generating a more efficient use of resources (OECD, 2014a).

Box 3.12. Recommendations for improving the system of intergovernmental grants

To improve the system of intergovernmental grants, the OECD recommends:

- Closely monitoring the impact of the new equalisation system on solidarity, equity and economic efficiency to be able to correct potential adverse effects. Envision some adjustments, for example an enlarged tax basket, the inclusion of Kyiv, an increase of the basic grant.
- Designing and implementing new allocation mechanisms of sectoral grants according to a demand-driven approach, based on output indicators and quality standards.
- Supporting line ministries to increase their capacities, procedures and data-collection mechanisms to manage their new responsibility as fund managers.
- Developing a comprehensive assessment of the quality of local public services.
- Guaranteeing the level, stability and predictability of funds to adequately finance delegated functions and avoid underfunded mandates and inconsistencies from one year to another.
- Integrate capital funding in sectoral grants.

The tax reform needs to move to a new stage

Overall, the tax reform has modified the distribution of national tax receipts across and within levels of government. It has also introduced new local taxes and increased the power subnational governments have over tax rates and bases. The impact on subnational tax revenue taken globally is not evident, however, as subnational tax revenue decreased in 2015 in relation to GDP, public tax revenue and total subnational revenue.

Tax-sharing arrangements

The personal income tax needs adaptation

The PIT reform is a positive measure: its redistribution is better balanced across subnational governments. In particular, it has been a major, and effective, incentive for amalgamations. In addition, the reduction of the PIT weight in subnational tax revenues was welcome, because it reduced the reliance of subnational government budgets on one unique tax and on a revenue source which is very cyclically sensitive.

However, the PIT reform raises several concerns. First, the suppression of the PIT for non-amalgamated local communities is understandable, as it formed part of the incentive mechanism for mergers. However, this deprivation of resources can become problematic for non-amalgamated communities, raising the question of their sustainability.¹³ Second, the current PIT collection system is criticised, even if it can be justified. The PIT is collected where people work (i.e. payable at the place of company registration) instead of where they live. As a result, there is a disconnect between the place where local services

are consumed and the place receiving the benefits of PIT revenues. Most of the PIT paid by the residents of a given municipality may benefit another municipality, that where the company is registered, generally a neighboring city, but also often Kyiv. This situation leads smaller communities to often indirectly “subsidise” larger cities, while they lack resources to finance their own services and infrastructure.

The justification for the system is mainly technical. Today, there is no universal declaration of income by individual taxpayers, rendering residence-based taxation challenging. Therefore, the PIT is collected at the source – where the companies are registered and PIT administration is the task of employers and the tax administration, with no taxpayer intervention. In the medium to long term and in the perspective of a wider national tax administration reform (including the introduction of mandatory PIT filing by taxpayers), it could be envisioned to change the system of PIT collection to the place of residence instead of the place of work.

Excise tax should be stabilised as a tax targeted at subnational government

Finally, the introduction of the retail excise tax on alcoholic beverages, tobacco, petroleum and gas into subnational budgets represents a positive change. Excise taxes are quite common in the OECD, generally as a surcharge of national tax, but even as a local tax. In fact, there are easily linked to local services or infrastructure such as the tax on petroleum products (redirected to supporting roads) or the taxation of alcoholic beverages and tobacco (used to support healthcare services).

One major issue since the reform has been the change to the retail tax on petroleum. Originally abolished as a local tax because of management problems, as of 2018 it will be used to finance a new Road Fund. It will receive 50% of the proceeds of the excise tax on petroleum products in 2018, 75% in 2019 and 100% in 2020. Sixty per cent of the Road Fund will be channeled to construction, reconstruction, repair and maintenance of roads of general use; 35% will be spent for local roads; and 5% for road safety.

Developing own-source tax revenues

Despite recent progress, the revenue structure remains unbalanced, as own revenues are still under-developed, especially own-source taxes. Ukraine could undertake a comprehensive analysis of its local tax system to identify the main options for reform and a road map for their implementation. The objective would be to develop a mix of own-source taxes. A basket of taxes applied to different taxable basis can provide subnational governments with more flexibility to cope with economic, social or political changes. There are several general principles or guidelines of good subnational taxation that could inspire Ukraine in this reflection. First, it upholds the link between taxes paid and public services received (the “benefit principle” or “pay for what you get”). Property values are, to a great extent, influenced by the actions of local government (quality of infrastructure and services, etc.), so it makes sense that the beneficiaries of rising property values (a rent) should be taxed on some of that benefit. Secondly, local governments need to rely on taxes that are relatively non-mobile and non-redistributive (to avoid base erosion via the movement of firms and households). And finally, local taxes should be designed so that the local tax burden cannot easily be “exported” to other jurisdictions (e.g. via very heavy reliance on sales taxes).

One major obstacle in this process is the difficulty in creating new local taxes (e.g. local business tax on non-wage income tax, business licences imposed on businesses for the services and infrastructure provided by subnational governments, waste collection tax,

cleaning tax, street lighting tax), as it increases the pressure on local taxpayers. Fortunately, there are other alternatives. The first is to transfer some national taxes to local governments, by providing them some margin on the rates and/or the base. A review of the Ukrainian overall tax system should take this into consideration. Such transfers should be made in relation to the transfer of new responsibilities and functions, according to the “benefit principle”. There are different possibilities in this area and Ukraine could look at international experience to see which taxes could best fit local Ukrainian characteristics.

A second approach is to optimise existing local taxes (bases and rates), in particular the property tax, in its three components: the transport tax, the real estate tax other than land and the land tax. The 2014-15 reform of the property tax, mainly the land tax and the introduction of the real estate tax in 2015, is a large step forward for Ukraine, but there is still a long way to go. The property tax represents a relatively small share of subnational revenue. The low ratio for Ukraine is the result of a narrow tax base, numerous exemptions, and the limitations of the current cadastre and real estate property register, despite recent improvements.

Optimising the transport tax

In 2016, the transport tax generated very few resources for Ukrainian local governments in comparison to OECD countries, where it is generally a significant source of revenue for subnational governments. This tax, called the “motor vehicle tax”, “road tax” or vehicle registration tax”, paid by owners of a vehicle, has a strong link with local infrastructure provided by subnational governments, in particular road construction and maintenance. If the tax is used to finance roads and other transport needs, it can match payment for the service to the benefit from the service. It has many other advantages: a potentially large tax base; a relatively fair tax, especially if tax is based on the value of the vehicle and there are alternatives to owning a car; a non-exportable base; a simple tax that is relatively easy to pay and collect; a relatively balanced distribution across subnational governments; and a tax that is compliant with environment goals as it can counteract the negative externalities associated with local traffic congestion and air pollution (PwC, 2016).

Boosting the real estate tax

The new real estate tax applied to property other than land is still a minor source of revenue, explained by a very limited tax base and under-utilisation by subnational governments. The thresholds for taxation are very high (tax is not charged for properties under a certain area), exempting a large number of (smaller) properties. The tax rate is not linked to the size of the property, constituting another limitation. Industrial and commercial properties are also excluded, further limiting the property tax. There is a long list of exemptions, determined by the Tax Code but which can be extended by local governments. The local level, however, tends to make little use of its taxing power. Tax rates set by subnational governments are often below what is permitted by the law, making them quite low overall. Meanwhile, gaps between nominal rates and effective rates can be significant. In 2016,¹⁴ the rate was 0.5% in L’viv, Rivne and Kropivnicki; 1% in Kyiv, Chernihiv, Cherkasy, Ternopil, Khmelnytskyi, Chernivtsi, Lutsk, Uzhgorod, Kherson and Mykolaiv; and 2% in Kharkiv, Dnipro, Zaporizhia, Odesa, Sumy, Zhytomyr, Vinnytsia and Ivano-Frankivsk.

Finally, property registration is incomplete, despite the 2004 Law “on State Registration of Proprietary Rights to Real Property and their Encumbrances” that went into effect in 2013. The law aims at creating a single and more integrated, consistent and efficient system of state registration of real estate rights, covering both lands and buildings (Registration Law). The law introduced certificates to confirm right to ownership of real property (instead of previous state acts) and it is now possible to register through administrative service centres. Currently, only about 20% of taxable properties are on the tax rolls. The other properties are not taxed at all (World Bank, 2017a).

Improving the land cadastre, valuation methods and land market

The absence of an efficient and reliable unified cadastre remains a significant issue, despite several important advances. Implementation of the 2011 Law of Ukraine on State Land Cadastre (Land Cadastre Law) got underway in 2013, bringing some important changes to the availability and quality of cadastre data. The data will include boundaries of administrative territorial units and land plots, cadastre numbers and purpose designation of land plots, limitations in use of lands and servitude, normative monetary value of lands, etc. These data are now available on the official website of the State Agency of Land Resources to facilitate the access of individuals and companies to available land plots. However, the process is still ongoing.

The other issue is the absence of an explicit land market, which makes evaluation particularly difficult. The difficulty in this area is related, more broadly, to the unfinished land reform and moratorium on the sales of agricultural land enacted in 1992 and extended in 2005, 2008 and 2012, prohibiting the sale, purchase and transfer of private agricultural land. The result is an undervaluation of agricultural land and imperfect land valuation – both of which have an impact on tax collection. In addition, because of the lack of data about sale prices for land, the evaluation method used to calculate land taxes and land lease payments, the so-called “normative monetary evaluation of land”, is based on numerous normative documents rather than on market data (USAID, 2016).

Box 3.13. Recommendations for improving the subnational tax system

- Improve tax-sharing arrangements:
 - Change the system of personal income tax collection to the place of residence instead of place of work.
 - The excise tax should be stabilised as a tax targeted at subnational government.
- Increase revenues from own-source taxes:
 - Undertake a comprehensive review of Ukrainian's own-source tax system to identify the main options for reform and create a balanced "basket of local taxes": creating new taxes, new transfers of national taxes, optimisation of existing local taxes (e.g. transport tax and the real estate tax other than land).
 - Reform the tax on real estate other than land in order to enlarge its base. Several options can be envisioned: abolition or lowering of areas' thresholds; reduction of the cases of exemption; integration of industrial and commercial buildings into the tax base as well as of state-owned lands and property, as both categories also benefit from local public services and infrastructures; bundling various fees into the property tax to raise additional revenues related to local services (e.g. street lighting, cleaning of public spaces, waste collection) and setting up a minimum tax rate to avoid under-taxation.
 - Accelerate the reform to build a modern unified cadastre and property register to better define land and property rights, facilitate transactions, help to resolve land/property disputes and improve tax/rent yields. In particular, a significant effort should be made to complete the registration of lands and properties to enlarge the tax base while reducing inequalities in this area.
 - Improve the valuation methods of lands and real estate properties based on market value, taking into consideration various criteria.
 - Encourage reluctant local governments to fully use their taxing power, in particular by rewarding local government tax effort, as some can be reluctant to exercise this power for political reasons (unpopularity).

Delivering better local public services through more transparent and efficient management tools

Reforming the sector of municipal enterprises for more transparency and effectiveness

The municipal enterprise sector is poorly known and assessed, and has low profitability. This raises several questions regarding transparency and accountability, and their difficulties in terms of funding. Ukraine could undertake a thorough analysis of the "municipal economy" in order to stake stock of municipal companies (including joint

stock companies) and the challenges they face, in particular with respect to decentralisation. This would constitute the starting point for reforming the sector in order to improve its funding, profitability, the quality of services provided and overall accountability. Reform in this sector should go hand-in-hand with an overhaul of public service tariffs. Municipal companies should also become a tool for better public investment at the subnational level. If well managed and profitable they can provide significant dividends to their shareholders.

Ukraine could look at international experiences in this field, in particular in Europe where there are about 25 000 local public companies, with particular prevalence in Austria, France, Germany, Italy, Poland and Spain. Local public companies are common and typically used to manage municipal services in sectors such as water and sewage, energy, waste collection and treatment, local public transport, social services, healthcare, but also urban planning and development, etc. Local public companies are very often active in basic infrastructure services where market failures or high transaction costs are present (OECD, 2017b).

Supporting further inter-municipal co-operation for the delivery of public services

At its introduction, Law No. 1508-VII of 17 June 2014 on Co-operation of Territorial Communities, supporting inter-municipal co-operation (IMC), did not generate a high level of co-operative agreements for this form of service delivery, but the situation seems to be evolving positively (Chapter 2). The government should reinforce its support to inter-municipal co-operation, for example by encouraging the creation of joint co-operation bodies, which are permitted by law. Additional regulations could be prepared to favour the establishment of such entities based on private or public law, with clear responsibilities and associated funding. In fact, more formal structures would ensure more financial stability and sustainability, allowing IMC bodies to plan over a longer period of time.

Optimising revenues generated by the delivery of local public services

Today revenues generated by local public service delivery are quite small, with tariffs kept low for social and political reasons. Despite an increase observed over the last years, Ukraine still has among the lowest tariffs in several sectors (e.g. the water sector) compared to other countries in the region (DANUBIS, 2015). As is the case elsewhere, tariffs in Ukraine do not cover operational costs. In addition, the system of privileges allocated to low-income households and to other categories of users further reduces revenues generated by the provision of public services. Numerous sectors are underfunded in Ukraine, in particular housing, municipal utilities and urban public transport. Therefore, services must be subsidised by the national budget, which is insufficient and unpredictable.

The existing legal and regulatory framework for tariff setting is multi-layered and complex. Many of the documents that define rules for calculating utility-specific norms are outdated or inadequate for application to real practice (Shugart and Babak, 2012). The creation of the National Commission for State Regulation of Energy and Public Utilities has not yet led to a clarification of roles or to a simplification.

The decentralisation of tariff setting in the heating and water sectors launched in March 2017 by a resolution taken by the National Commission for State Regulation of Energy and Public Utilities could improve the funding of utility services, but it is too early to draw conclusions. The resolution expanded the powers of communities to set tariffs of heat-energy production, transport and supply, as well as in the area of water supply and sanitation. In both sectors, local authorities will be responsible for approving operating

licenses (for 74% of licenses in the heating sector and 67% in the water sector). However, this reform should be accompanied by a significant programme of capacity-building in order to disseminate modern management, and monitoring tools and practices within local governments.

The system of privileges should be also revised beyond their implications for tariff regulation. There is a tendency to shift central government obligations on social protection, transport, housing and municipal utility privileges to local governments while the state budget does not compensate these with the corresponding funds. Beyond the issue of “fair compensation”, the reform should aim at providing subnational governments with more powers to apply differentiated user charges and tariffs according to local characteristics, not social needs defined by the national level.

Developing revenues generated by the use and improvement of public domain

Complete the demarcation of local public domain and strengthen the role of subnational government in land management

To develop income from assets, it is necessary first to properly and thoroughly identify these assets and second to have the right to use them. In Ukraine, the issue of municipal land ownership and use is becoming more and more sensitive, in particular in the context of increased decentralisation. Registration of the boundaries of towns, villages and other settlements is still incomplete. According to the Land Governance Monitoring (implemented in 2015 by the World Bank), only 50 communities out of 29 772 had formally registered their boundaries as of end 2015. This undermines the legitimacy of decisions taken by local governments concerning the assignation of land plots. This also lays the ground for land conflicts in several regions. In addition, the low level of municipal land registration in the cadastre tends to encourage non-transparent activities, to reduce economic development and investment, and to diminish potential local revenues. This also weakens the rights of the tenants and land users, making lease relations non-transparent and the local authorities unaccountable for the decisions taken (USAID, 2016). This problem is part of a wider unresolved debate on the land reform.

This issue of property and land-use rights has also become one of the biggest sources of pressure between the UTCs and state administrations – be it at the central, *oblast* or *rayon* level. In fact, the UTCs should have received property and land-use rights for the entire territory formed by the amalgamation of the communities (i.e. land within the individual administrative boundaries, and the land in between them), including the revenues they generate. This has not been the case because of the lack of a legal basis for a transfer of rights by *oblast* or *rayon* administrations, or for a claim to rights by the UTCs. The result is unclear property rights, fragmented land management in the UTCs, and limitations on own-source revenue and decision-making capacity by local authorities.

Several reforms are ongoing in this area to accelerate the definition of boundaries and decentralise land management to subnational governments, but they are facing a lot of resistance. For example, the 2014 draft Law No. 1159 on “Some Measures to Strengthen Territorial Community Role in Land Management” which aimed at reducing the monopolistic power of the State Agency of Land Resources by decentralising land management to independent local councils, was finally abandoned. A new draft Law No. 4355 “on Introducing Amendments to Certain Ukrainian Legislation Concerning Increasing the Local Government Authority in Land Management and Strengthening the

State Control Over the Use and Protection of Lands” was first approved by the parliament in April 2016 but its adoption is still pending. It proposes:

- transferring to local councils the authority to manage state-owned and municipally owned lands located beyond the boundaries of populated areas as the type of the delegated authority (except for the lands of the Ministry of Defence, natural reserve and environmental preservation lands, or other lands of high importance for the state)
- establishing a mechanisms for the UTCs to transfer state-owned lands located beyond the boundaries of populated areas to communal ownership
- providing local governments with the power to exercise oversight over the use and protection of lands.

It appears urgent to complete the registration of boundaries of towns, villages and settlements. A clarification of the responsibilities of central and subnational governments concerning land management is also necessary in order to promote efficiency, reduce corruption and increase revenue from land. In this perspective, Ukraine could envision increasing the role of local governments in land management and accelerate, to this end, the adoption of the draft Law No. 4355 on the Decentralisation of Land Management. As far as the UTCs are concerned, a new draft Law No. 7118 was approved by the Cabinet of Ministers and registered to the parliament in September 2017, which grants them the right to manage state-owned lands that are located within and beyond the boundaries of populated areas, and transferring the ownership of these lands to them.

Develop land value capture instruments

Ukraine could consider developing further land value capture instruments, in particular the system of “shared participation in infrastructure development”, already well developed in Kyiv. Such a betterment levy paid by land, building and housing developers (and also from homeowners) is particularly suited to local financing needs and establishes a direct link between an increase in property value resulting from public works and services improvements (e.g. road paving, sidewalk, street lighting, etc.) and an increase in local revenues paid by the beneficiaries of such works and improvements. In addition, betterment levies provide funds which are reinvested almost immediately.

To develop further these instruments, Ukraine could also draw inspiration from international practice in land-based financing instruments. Colombian cities are Latin America’s leaders in this area, but there are also interesting arrangements in North America, Europe and New Zealand (Box 3.14).

Box 3.14. Land-based financing instruments: Focus on several international practices

Several Colombian cities are leaders in land-based financing instruments. Inspired by the Constitution, which stipulates that one of the state's duties is to capture the added value generated by public actions, Colombia created two interesting revenue-raising mechanisms aimed at financing urban development by capturing the capital gains from property and land generated by public infrastructure projects. The *Contribución de valorización* (1921) is a betterment levy (also called a special assessment). The *Participación en Plusvalías* (1997) aims at recovering part of the increased land values resulting from the change in land-use regulations (e.g. changing zones, change in the designation of the type of land, change in density regulations, etc.). These instruments are primarily used by large cities, such as Bogota, Barranquilla, Bucaramanga and Cali.

Some of most common fiscal instruments to manage land development in OECD and non-OECD countries are: brownfield redevelopment incentives, historic rehabilitation tax credits, transfer of development rights, use-value tax assessments, development impact fees and betterment levies (OECD, 2017d). Examples of land value capture tools in the OECD include “development charges” in Canada and the United States or tax increment financing districts in the United Kingdom. In New Zealand, councils require development rights or development contributions from developers as part of granting consent for development so that developers bear the costs of new infrastructure (i.e. roads, water and wastewater infrastructure, and community facilities). They account for about 2% of revenues.

Sources: OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, <http://dx.doi.org/10.1787/9789264279049-en>; OECD (2017d), *The Governance of Land Use in OECD Countries: Policy Analysis and Recommendations*, <http://dx.doi.org/10.1787/9789264268609-en>; OECD (2016a), *Making the Most of Public Investment in Colombia: Working Effectively across Levels of Government*, <http://dx.doi.org/10.1787/9789264265288-en>.

Box 3.15. Recommendations for delivering better local public services

To deliver better local public services through more transparent and efficient management tools, the OECD recommends:

- Taking stock of the situation of the “municipal economy” and municipal companies, considering the challenges faced with decentralisation, and designing a reform for more transparency, accountability and effectiveness.
- Reinforcing further inter-municipal co-operation to make it a common and efficient tool for delivering public services through increased incentives, the promotion of “joint co-operation bodies” and the development of inter-municipal co-operation in metropolitan areas with dedicated funding.
- Optimising revenues generated by the delivery of public services to better cover the costs of services, decentralising tariff setting accompanied by a capacity-building programme at the local level to carry this out in a modern and efficient manner; and revising the system of privileges.
- Developing revenues generated by the use and improvement of the public domain:
 - completing the demarcation of local boundaries over the national territory
 - strengthening the role of subnational governments in land management by accelerating the adoption of draft Law No. 4355; adopt draft Law No. 7118 concerning land management in the unified territorial communities.
- Further developing land value capture instruments.

More effective public investment across levels of government for regional development in Ukraine

The governance gaps of public investment are one of the major bottlenecks for efficient public investment in Ukraine. The quality of investment strategy, planning and co-ordination, the project selection procedures, the project’s implementation, evaluation and audit, are particularly weak.

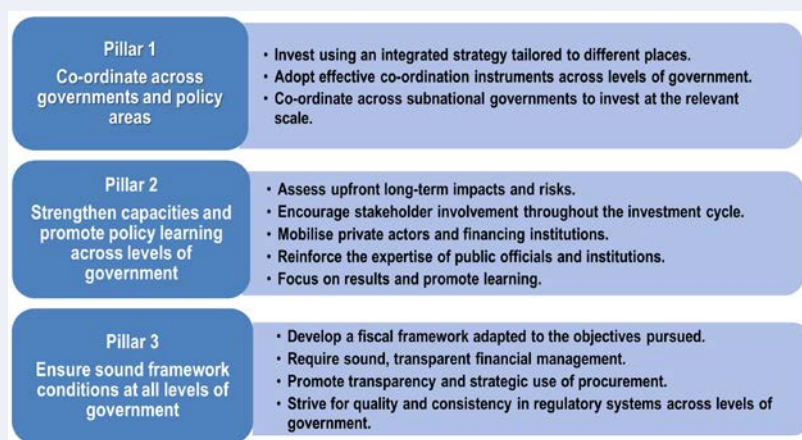
The strong involvement of subnational governments in public investment confirms that investment in Ukraine is a shared responsibility across levels of government. But it also confirms the complexity of its governance. In Ukraine, more than in many other countries, managing inter-dependencies is crucial for strengthening the efficiency and effectiveness of public investment. There is a need for effective co-ordination among levels of government in order to help identify investment opportunities and bottlenecks, manage joint policy competencies, ensure adequate resources and sufficient capacity to undertake investment, resolve conflicts, or create trust (OECD, 2014a). OECD member countries have acknowledged the importance of better governance for public investment by adopting the *Recommendation of the Council on Effective Public Investment across Levels of Government* in March 2014 (OECD, 2014b) (Box 3.16).

Box 3.16. Recommendation of the Council on Effective Public Investment across Levels of Government

The OECD Council Recommendation groups 12 principles into 3 pillars representing systematic challenges for efficiently managing public investment: co-ordination challenges, subnational capacity challenges and challenges in framework conditions.

An implementation toolkit has been developed to provide basic guidance and help policy makers at all levels of government implement these principles in practice, providing concrete examples and best practices for countries at any stage of decentralisation.

Figure 3.24. OECD Recommendation of the Council on Effective Public Investment across Levels of Government



Sources: OECD (2014b), *Recommendation of the Council on Effective Public Investment across Levels of Government*, www.oecd.org/regional/regional-policy/Principles-Public-Investment.pdf; OECD (2015b), *Implementation Toolkit of the Recommendation on Effective Public Investment Across Levels of Government*, www.oecd.org/effective-public-investment-toolkit.

The OECD Recommendation could help Ukraine to address systemic challenges for public investment in the context of the ongoing decentralisation reform. In Ukraine, all areas covered by the Recommendation are instrumental to ensure effective public investment across levels of government for regional development: clear responsibilities and political power, in particular adequate assignment of responsibilities at different levels of government for investment; stable, sufficient and sustainable financial resources, including autonomous revenues; appropriate human resources and local management capacity; efficient strategic development planning at local and regional levels for public investment; effective horizontal and vertical co-ordination among the various levels of government, but also between the private and public sectors; identification of investment priorities and appropriate estimations of costs and risk assessments; adequate system of evaluation, selection and monitoring of projects; preparation of financial plans, etc.

In particular, co-ordination mechanisms and sound framework conditions are fundamental for subnational governments when investing in a multi-level governance context. The following part will focus on some principles of the OECD Recommendation:

- How to ensure that capital transfers, in particular the SFRD, are used properly for effective public investment?

- What other financial instruments can be mobilised to support investment? The borrowing framework and PPP schemes will be analysed.
- How to promote transparency and strategic use of public procurement at the subnational level?
- How to develop a sound and transparent financial management at all levels of government?

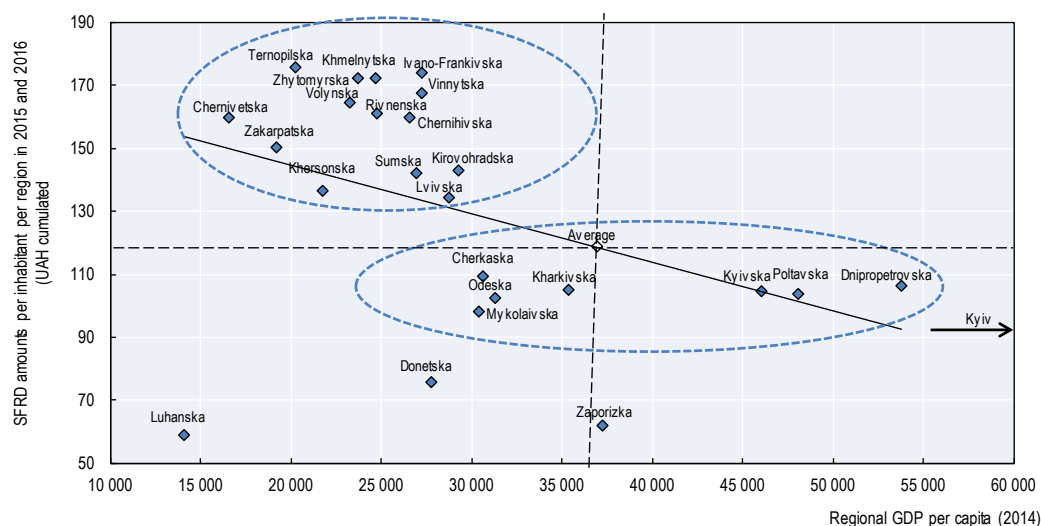
More effective capital transfers for subnational investment

In 2015, the SFRD financed 728 projects (UAH 2.37 billion) out of 1 267 submitted projects. In 2016, the SFRD amounted to UAH 2.69 billion, financing 810 projects. In total, the SFRD amounted to UAH 119 per inhabitant on average in Ukraine in 2015-16 (cumulated).

The amounts allocated per region show significant regional variations, which is quite normal, as the fund is supposed to support regional development, in particular for lagging regions. If we compare the SFRD allocation per region in 2015 and 2016 and the regional GDP per capita, there is a negative correlation. This means that the SFRD funds have been allocated to the least favoured regions of Ukraine. There is, however, a strong discontinuity. Two groups are clearly identifiable: that of regions below the cut-off at 75% of average per capita GDP (i.e. around UAH 27 700) and that of regions for which the GDP is over this threshold but without correlation between their wealth and the amount of subsidy they received. There are, however, some outliers: Kyiv, which received UAH 101 per inhabitant while its regional GDP per capita amounted to UAH 124 163 in 2014; and the three Eastern regions of Donetsk, Zaporizka and Luhansk. Overall, the SFRD has served its purpose, i.e. “extending regional development funds to all regions, while concentrating resources in the places of greatest need” (Figure 3.25).

Despite the 2017 modification shifting the 70/30 split to a 80/20 split (with a cut-off at 75% of average per capita GDP), there is still significant discontinuity in the distribution, i.e. regions just above and just below the threshold have been treated very differently.

Figure 3.25. **Correlation between regional GDP per capita and SFRD allocations per inhabitant, 2015 and 2016**



Note: No data available for the Autonomous Region of Crimea and Sevastopol.

Source: Based on data from the State Treasury (SFRD executed budgets) and the Ukrainian Bureau of Statistics.

Overall, the fund could be better integrated with other inter-governmental grants to ensure that the overall pattern of transfers corresponds to priorities in terms of reduction of interregional inequalities and use similar sets of territorial and socio-economic criteria. This approach would also help reduce the risk that the uncoordinated actions of different ministries result in central government transfers that reinforce interregional disparities.

In addition, the SFRD only covers development and capital expenditures – funds cannot be used for other categories of expenditure (e.g. educational and consulting services that can help prepare and execute investment projects). Nor does it cover maintenance and repair expenditures. A debate surrounding the definition of investments that can be financed with the SFRD has emerged. A broad definition of investments could fill the financial gap in terms of general purpose local investments, but it could also undermine the purpose for which the SRRD was created: financing regional development plans. This restriction could be loosened when expenditures are closely linked to the investment project. Article 103.1 of the Budget Code on subsidies to construction, reconstruction, repair and maintenance of local roads of municipal property is a step in that direction, but there is a need for a more global solution to support subnational investments.

Finally, establishing new funds for regional and local development projects is a very positive step towards ensuring more effective regional development. These projects answer real and concrete needs for basic equipment and infrastructure, such as the reconstruction of first aid stations, refurbishment of hospitals, replacement of windows in schools and kindergartens, road surface maintenance, etc. The implementation of these new instruments has, however, faced several challenges. Projects are very fragmented and, although they are useful for the communities, they do not contribute to the implementation of the State Strategy for Regional Development or regional strategies. They do not generate added economic value and do not contribute to regional development. They also reflect the low capacity of local governments in terms of preparing development projects, stressing the need of technical assistance and training to support local staff during project preparation and implementation.

Developing access to external funding for investment

Developing subnational borrowing should be a major component of fiscal decentralisation in Ukraine, providing more financial autonomy to subnational governments. The current restrictions on municipal borrowing are questionable from an economic point of view, in particular for investment. Borrowing is an essential means to increase subnational financial capacity to invest in municipal infrastructure and create an environment conducive to inclusive economic growth at the regional and local levels.

A working group could be established that includes central government entities (Ministry of Finance, State Treasury, Central Bank of Ukraine, Ministry of Regional Development, etc.), subnational government association representatives, commercial banks, international financial institutions and the donor community, rating agencies, etc. to reflect on a new borrowing framework for subnational governments, with a set of fiscal rules that contributes both to favour investment in infrastructure and to ensure economic stability and sound fiscal management. Among the measures which could be assessed are reviewing prior authorisation of the Ministry of Finance; enlarging the subnational borrowers' categories (the regions in the future, the UTCs, medium-sized cities); developing a credit market for subnational borrowing (i.e. creating a more diversified local debt market); and changing the fiscal ratios thresholds.

Transparency and reporting requirements are essential to monitor and control municipal debt levels. Implementing a central evaluation system for municipal public debt management is a best international practice. In Ukraine, this monitoring exists through the registry for local public debt management provided by the Budget Code. This registry should be made public in order to promote transparency and monitoring and detect the municipalities that are at risk so corrective measures can be implemented in a timely manner, as is the case in several OECD countries such as Mexico (*registro publico único* and warning system called *Sistema de alertas*), Norway (ROBEK, Register for Governmental Approval of Financial Obligations), Portugal or Korea (OECD, 2017b).

Cautiously developing the use of public-private partnerships at subnational level in Ukraine

Public-private partnerships (PPPs) can attract much-needed investment, especially in large cities that have capacity to manage a complex financing tool. The use of PPPs is incipient in Ukraine. The first Law “on Public-Private Partnerships” was passed in 2010 and considerable hope had been placed on it as a way to attract investment, though it did not live up to expectations for a variety of reasons ranging from the formulation of the law itself to a lack of government and sector capacity (Arzinger, 2015).

To improve the legal framework, a new PPP Law entered into force in May 2016 introducing amendments to “Some Laws of Ukraine to Eliminate Regulatory Barriers for Development of Public-Private Partnership and to Stimulate Investments in Ukraine” (Law of Ukraine No. 817-VIII). The PPP Law better defines the scope of a PPP project. The areas for the application of PPPs were widened to include housing, energy-saving technology and social services. In addition, in order to increase certainty and protect investors, the law provides new rights and security and establishes a clearer institutional framework and governance structure for PPPs through a dedicated PPP Unit in the Ministry of Economic Development and Trade.

The law is still too recent to have had a significant impact on subnational PPPs. In general, if Ukraine is to develop PPPs at the subnational level, some points to remember are:

- PPPs present particular risks in the context of high levels of corruption, such as are observed in Ukraine. It is still necessary to improve the public procurement framework, and to take into consideration subnational specificities in this area (see below).
- The use of PPPs in specific sectors also depends on the progress of economy-wide reforms, e.g. tariffs policies in the housing and utilities sphere. The state will have to take on some kind of guarantor’s role even in PPPs concluded with regions or cities.
- Developing subnational PPPs requires considerable capacity building. Regional or local officials must be capable of: identifying strategic opportunities at the local level; planning complex technical, legal and financial projects; co-ordinating numerous actors with different cultures and knowledge and over long periods of time; building local support for PPP projects; monitoring and evaluating projects and liabilities; reporting and auditing, etc.
- PPPs are useful to finance large-scale or complex infrastructure projects, but cannot substitute for public investment efforts, in particular to address needs in remote and lagging regions. PPPs can only be a useful, but partial, response to investment needs as, by definition, private actors are looking for bankable projects which might or might not be the case in the poorest regions. In most

OECD countries, PPPs account for less than 10%, or even 5%, of overall infrastructure investment (Burger and Hawkesworth, 2013; OECD, 2016a).

Despite these risks and limitations, developing subnational PPPs remains an option for Ukraine to address its large infrastructure investment needs. Several recommendations can be made to maximise the likelihood of success of subnational PPPs:

- Ukraine should proceed with caution in rolling out subnational PPPs. Pilot projects should be undertaken, monitored and evaluated carefully and only then scaled up. In addition, it will probably make sense to focus in the first instance on projects where the technical and other risks are relatively low and well understood – basic infrastructure, for example. In the same way, PPP projects should be restricted to regions and big cities. PPP projects are technically, legally and financially complex, and imply a high-level of resources and expertise that is not available outside large subnational governments. Subnational governments should have enough creditworthiness to support the financing of PPPs.
- The PPP Unit created under the Ministry of Economic Development and Trade should be mandated to help subnational governments in dealing with PPPs. To this end, the PPP Unit should be strengthened and trained to subnational specifics. Several PPP units at international levels have developed their activities in this perspective (Box 3.17).
- All national, regional and municipal PPP projects – including those in the planning phase – should be made as transparent as possible, including for tender procedures. A comprehensive central registry of PPP projects involving central and subnational governments and public satellites (e.g. municipal companies) should be maintained and publicly accessible on the Internet. It would allow a monitoring of PPPs based on reliable and comparable data; more transparency on the different PPP arrangements; and exchange of methodologies, expertise and good practices across territories. The PPP Unit could develop and maintain this database. Today, there are no accurate data on the number of PPPs and concessions underway in Ukraine. International practices could be useful (Box 3.17).
- The government could launch a dedicated PPP training programme to build and reinforce municipal sector capacity to effectively engage with the private sector in PPPs. Training programmes for regional and local officials could include topics such as project finance, appraisal methodologies, risk assessment and other subjects relevant to PPPs. The PPP Unit could be involved in this process.
- An important step forward would be the standardisation of PPP subnational projects, an approach taken by several countries (Box 3.17).
- The government could provide financial resources to subnational governments to access technical support dedicated to PPP projects, such as in the Philippines through the Project Development and Monitoring Facility funds.
- A legal framework adapted to local projects should be established to regulate, secure, facilitate and stimulate PPPs at metropolitan levels.

Improving the public procurement framework

In Ukraine, public procurement remains one of the most challenging areas in general, and for its subnational governments in particular. Due to non-transparent and uncompetitive procedures, state and local budgets are losing a significant share of their resources which otherwise could be directed to important activities requiring investments (EBRD, 2014).

An efficient and transparent public procurement system is needed to strengthen integrity, enhance accountability and thus support decentralisation.

In 2014, a new Law “on State Procurement” was adopted that was expected to cut the channels of corruption. However, the law does not yet appear to have yielded the anticipated results. A 2014 report of the Ministry of Economic Development and Trade indicated that while funds of local budgets represented around 29% of public procurement in 2015, the Treasury issued 225 warnings on identified violations of the procurement requirements towards local budgets’ funds; the Antimonopoly Committee of Ukraine received 1 342 complaints of violations of the legislation on public procurement (44% more than in 2014), out of which 494 complaints were satisfied. It is expected that the introduction of “ProZorro”, the electronic public procurement system, will help reduce corruption at the local level. The Law “on Public Procurement”, adopted in 2016, approved the full transition of public procurement to the new electronic platform, requiring that all public procurements be carried out through electronic means.

These changes represent substantial progress with respect to openness, transparency and procedural fairness. Institutions such as the Council of Europe, the European Union and the World Bank have welcomed the new legislation, which brings greater alignment with good international practices in public procurement (OECD, 2016b). They should be continued and a focus on the specificities of subnational procurement could be further given to better assess the challenges and needs of the subnational public sector. Ukraine could pay more attention to the provision of guidance to subnational governments for procurement. The government could also encourage and support subnational governments willing to collaborate (through purchasing alliances, framework agreements, central purchasing bodies). It is also essential to professionalise procurement through training programmes and recognition of procurement officials as a specific profession. In fact, the experience in EU countries shows that corruption – estimated to cost EUR 120 billion per year according to the European Commission – is not primarily linked to fraud but more to incompetence. In the EU, 55% of public procurement spending occurs subnationally – and many subnational governments lack the capabilities to conduct procurement in terms of knowledge and specialised staff. As a result, 41% of quantifiable errors for absorption of EU funds in 2006-09 were associated with procurement and the vast majority of problems are errors, not fraud (OECD, 2015b).

Box 3.17. Selected examples of tools supporting the development of public-private partnership projects at subnational level

- Establishing dedicated public-private partnership (PPP) units. In line with the OECD on *Principles for Public Governance of Public-Private Partnerships*, dedicated PPP units exist in most OECD countries. France and the United Kingdom have enlarged the scope of their PPP units to include subnational projects.
- Developing databases of subnational PPPs. Such registries have been developed in several countries. In Colombia, the National Planning Department has set up and manages a database to register PPP projects. In the Philippines, the PPP unit has developed a comprehensive database.¹ In the United Kingdom, HM Treasury has compiled a database of signed Private Finance Initiative (PFI) projects by over 100 different procuring authorities, covering over 20 sectors.² In India, the state of Gujarat, which developed the first ever PPP legal framework in India in 1999, has developed a database of PPP projects.³ In Canada, the Canadian Council for PPPs provides information on PPPs and maintains a Canadian PPP Project Database called *P3 SPECTRUM*.⁴
- Standardising subnational PPP projects. Colombia has carried out this work in order to reinforce expertise in the preparation of projects among subnational governments. The United Kingdom has also developed standardised contract documents and standardised guidelines for PFIs to help to attenuate some of the risks presented by the complexity of PPP contracts and the administrative capacity constraints of the public sector, especially at the local level. This has led to relatively uniform PFI contracts in England and likely reinforced a minimum level of local capacity (OECD, 2016a).
- Providing financial subsidies to finance technical assistance. In the Philippines, the Project Development and Monitoring Facility funds are administered by the PPP Center and may be utilised to finance consultancy services for the preparation of project pre-feasibility and feasibility studies; project structuring; preparation of bid documents and draft contracts; transaction advisory; assistance in the tendering process, including bid evaluation and the award of the PPP contract.

Notes: 1. https://ppp.gov.ph/?page_id=26068. 2. <https://www.gov.uk/government/publications/private-finance-initiative-and-private-finance-2-projects-2016-summary-data>. 3. www.gidb.org/ppp-ppp-project-database. 4. www.p3spectrum.ca.

Sources: OECD (2014a), *OECD Territorial Reviews: Ukraine 2013*, <http://dx.doi.org/10.1787/9789264204836-en>; OECD (2016a), *Making the Most of Public Investment in Colombia: Working Effectively across Levels of Government*, <http://dx.doi.org/10.1787/9789264265288-en>; OECD (2016b), *OECD Investment Policy Reviews: Ukraine 2016*, <http://dx.doi.org/10.1787/9789264257368-en>; OECD (2012), *Recommendation of the Council on Principles for Public Governance of Public-Private Partnerships*, www.oecd.org/gov/budgeting/PPPnoSG.pdf.

Towards a renewed fiscal responsibility framework

In the context of the decentralisation agenda, a significant amount remains to be done in Ukraine with respect to fiscal discipline, despite the progress achieved so far. Looking at

all dimensions of fiscal health and the responsibility framework is beyond the scope of this report. The following developments point out some issues that were identified as crucial during the study process.

Improving municipal budgeting rules to avoid unfunded and underfunded mandates

The Ukrainian government should ensure that decentralised responsibilities are financed with sufficient resources to avoid structural deficits. In fact, any fiscal rule will be ineffective if there is a structural problem of unfunded mandates. Structural mismatch between subnational spending obligations and the allocation of revenues is a common source of subnational government deficits and debts, with the risk of fiscal distress and insolvent (OECD/KIPF, 2016).

The presence of underfunded mandates in Ukraine is real. It is also increasing with the delegation of new functions and the lack of regulatory and funding stability, including in the case of grants but also for tax revenues (e.g. abolition of the excise tax on petroleum). Compounding this situation is the tendency to shift the financial burden of privileges relating to housing and municipal utility services, guaranteed by the state, to local budgets (Association of Ukrainian Cities). This leaves subnational governments with the difficult choice of whether and how to continue services: by cutting them or reducing their quality. This also results in little or no leeway for investment, leading to a downgrading of local assets and higher costs to upgrade them when repairs are absolutely needed.

Some OECD countries have introduced reforms to mitigate or even reverse the use of unfunded or underfunded mandates and regulations in systems, such as in Denmark. This type of regulation could be introduced in Ukraine, setting the basic principle that there is no transfer of charges without the adequate transfer of funding and that the compensation should be consistent over time.

Establishing audit mechanisms adapted to the decentralisation context

As far as budgetary and financial supervision and control are concerned, they are essential in a context of increased fiscal decentralisation and greater autonomy. Financial audits are necessary to assess the quality of financial reporting and the reliability and accuracy of financial information and management. However, this control should be done in accordance with the principle of local autonomy, in particular laid down in Article 8 of the European Charter of Local Self-Government on “administrative supervision of local authorities’ activities”.¹⁵

Financial audits can be done externally, internally or both. Internal audit tools should be better developed. Currently, only *oblasts*, *rayon* and large cities are able to implement such internal procedures of fiscal audit. Internal audits should be an obligation set by regulation for all subnational governments and supported financially by the central government. Such financial support would allow subnational governments to equip themselves with a specific team or external support (consultants, inter-municipal expert team) and an adequate information system, also reducing the technology gap at the local level. With respect to external audits, state financial supervision and the control system over subnational governments should be adapted to the new decentralisation context. The budgetary control should be done *a posteriori*. In the perspective of the creation of the prefect function, it could be carried out by this new “body”. However, it should be done in accordance with the principle of local autonomy and in liaison with an external audit institution. In Ukraine, such an institution exists through the Accounting Chamber of Ukraine (ACU), but it does not have the mandate to audit subnational governments

(Box 3.19). The Ukrainian authorities should consider an extension of the remit of their supreme audit institution to subnational governments, and in the longer term to develop an ACU network of regional or interregional chambers such as in France or Italy. Such a process of independent financial process covering the entire public sector could improve the quality of public finance accounts as a whole. In the case of Ukraine, it is recommended to apply both internal and external approaches.

Box 3.18. Avoiding unfunded mandates at the local level: The Danish example

In Denmark, there are two long-established basic principles on unfunded mandates. These principles guide decisions about how much the central government should contribute to the local government system when devolving new tasks to subnational authorities or when additional costs arise from a change in national legislation.

The Expanded Total Balance Principle (*Det Udvidede Totalbalanceprincip*, DUT principle), requires the central government to compensate local authorities with extra grants whenever new national legislation has an impact on local expenditure. Conversely, resources must be refunded where new national legislation has the opposite effect.

The Budget Guarantee Scheme compensates local authorities for additional expenditure resulting from external factors which are outside of local government control. Some areas are particularly sensitive to changes in market or social conditions, such as social security benefits, cash assistance for the unemployed, early retirement pensions, integration of refugees or immigrants, etc.

These principles, adopted by agreements between the Danish central and local governments, are intended to safeguard an equitable relationship between them and establish effective budget co-ordination.

Sources: OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, <http://dx.doi.org/10.1787/9789264279049-en> based on CoR (2001), *Regional and Local Government in the European Union: Responsibilities and Resources*, <https://publications.europa.eu/en/publication-detail/-/publication/d681ca99-788f-49d9-bb04-40b74a9acc06/language-en>.

Reinforce democratic oversight and accountability

The oversight role of regional and local councils on budgetary issues is critical to promoting fiscal transparency and accountability. It should be developed in particular by reinforcing the capacity of councillors in the budget process, which is often low. This is particularly the case in the UTCs. Each member of regional, *rayon*, city and local councils should be trained on fiscal financial management techniques and ethics when taking office, to understand how the budget process works and how, as a councillor, s/he may have a role for effective budget scrutiny. Permanent specialised councillors on financial issues could be nominated.

Box 3.19. The role of the Accounting Chamber in subnational government fiscal auditing in Ukraine and OECD countries

Established in 1996 with a constitutional status, the Accounting Chamber of Ukraine (ACU) is the country's supreme audit institution. The organisation and activities of the ACU are regulated by the Constitution, the Law on the Accounting Chamber of Ukraine, the Budget Code and other secondary legislations. The ACU is only subordinated and accountable to the parliament. It operates independently of any other state authority.

Historically it has focused on the control of expenditures of the central budget, reporting its audit in public reports. In 2014/15, the scope of its control was extended to the revenue side of the central budget. It also provides public advice on the budget law submitted by the government to parliament and issues reports on budget execution. In addition, the ACU audits the preservation and use of state property.

The new Law on the Accounting Chamber of Ukraine adopted in July 2015 has strengthened the independence of the ACU in a range of areas. For example, it requires the ACU to publish all its reports and decisions, and the ACU has an option to apply to the Budget Committee for consideration of proposals on ACU funding in the state budget in cases of disagreement with the government. Other changes have been introduced which will align the ACU with a modern supreme audit institution (World Bank, 2015).

However, local finances are still not included in its mandate, which is not the case of several OECD countries where the supreme audit institution can audit both state and local government budgets, on the expenditure and revenue side. This is the case in France (*Cour des Comptes*), Germany, Italy (*Corte dei Conti*), Poland (NIK) and Portugal, for example. Some national supreme audit chambers have a network of regional chambers, as the *Chambres régionales des comptes* in France. In France, the Decentralisation Law of 1982 created the regional chambers of audit. These public bodies are responsible for an *ex post* auditing of subnational governments' accounts, and must also review the management of local governments and related entities.

Sources: World Bank (2015), *Ukraine: Public Financial Management Performance Report*, <https://openknowledge.worldbank.org/handle/10986/11898?locale-attribute=en>; Accounting Chamber of Ukraine, www.ac-rada.gov.ua/control/main/en/index; OECD (2017b), *Making Decentralisation Work in Chile: Towards Stronger Municipalities*, <http://dx.doi.org/10.1787/9789264279049-en>.

Beyond regional and local councils, increasing citizen and civil society participation to the financial management of the city and their role of oversight is instrumental for the success of the decentralisation process as acknowledged by the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power, involving further citizens and the civil society. Fiscal decentralisation challenges are to ensure that citizens understand the issues and how the changes will take place and how they can contribute and take benefit. Not only must fiscal reforms be communicated and explained to citizens, their social acceptance must be underpinned by awareness, and citizens must buy into and participate in the creation of reforms well before they are implemented. There is a need for an inclusive and participative approach to develop citizens' willingness to pay taxes. To this end, efforts to educate taxpayers would be welcome, with a view to attenuating the hostility resulting from taxpayers' misunderstanding of the logic behind the taxation process (OECD, 2017b). More citizen participation provides

effective control over the way budgets are spent. It may also develop trust in government and reduce corruption.

Today, there is low citizen engagement in many local jurisdictions of Ukraine as the current system does not promote the accountability of local budgets to local residents, although there are cities, such as Zhytomyr, that are beginning to implement participatory budgeting. Citizens and civil society should be involved further in the budgeting process and financial oversight. This involves more transparency and public access to the budget process as well as setting up specific tools to support the involvement of citizens and civil society. There are different ways to develop social accountability in financial issues:

- Making budget information more easily accessible and understandable to the public (a “budget for citizens”) and developing capacity-building meetings with the population and associations in order to develop their financial skills and understanding.
- Developing citizens’ monitoring committees on fiscal issues.
- Publishing a yearly (or half-yearly report) on budget execution in a friendly format, accessible by the public.
- Favouring participatory budgeting experiences through which citizens can express their demands in terms of allocation of budget. They can become active participants in community problem-solving and influence the provision of local services. Participatory budgeting can also improve the efficiency of the budget by better targeting it to citizens’ needs. There are already some interesting experiences in Ukraine, such as in Zhytomyr, Bergdiansk or Chernihiv, which could be promoted and shared among municipalities.

Box 3.20. Recommendations for improving the multi-level governance of public investment

To improve the governance of public investment across levels of government for regional development in Ukraine, the OECD recommends:

- adhering to the *OECD Recommendation of the Council for Effective Public Investment across Levels of Government*
- reviewing how the SFRD and funds for territorial development and infrastructure are distributed to better support regional development and decentralisation
- consider developing state-region contracts for regional development
- developing subnational borrowing by loosening borrowing rules and developing a more diversified local debt market (loans and bonds)
- developing cautiously subnational PPPs for regions and large cities with adequate capacities and with special support
- promoting transparent and strategic use of public procurement, especially at subnational level, through specific guidelines and strengthening human resources
- improving the budgetary and fiscal rules framework:
 - introducing a budgeting rule forbidding unfunded or underfunded mandates
 - making internal audit compulsory and developing tools and financial support to help local governments to this end
 - improving external audit by extending the remit of the Accounting Chamber of Ukraine to subnational governments.

Improving quality and access to data on subnational finance and assets

There is no adequate indicator system for monitoring, evaluation and control of subnational government finance and assets. Both macro and micro data are insufficient, and not properly provided and disseminated. The lack of access to systematic and comprehensive data limits the scope of the analysis and overall assessment of the fiscal decentralisation reform and also underscores the need for transparency in inter-budgetary relations.

The clear allocation of roles and co-ordination between institutions is lacking

Monitoring the responsibility for collecting, processing and disseminating statistics is not clear, despite a clear allocation of roles on paper. According to the Budget Code, the Ministry of Finance regulates the accounting and reporting methodology on budget execution. The State Treasury Service is responsible for summing up, drawing up and budget execution reporting and assures the reliability of this information. Budget reports (monthly, quarterly and annual) on consolidated state and local budget execution on revenue, expenditure, lending/borrowing and financing provide information on budget execution which is available on the official website of the State Treasury Service.¹⁶ The Ministry of Finance is responsible for the dissemination of fiscal information. The information exchange between the Ministry of Finance and the State Treasury Service is regulated by a specific order of 2009. The Ministry of Finance also has information exchange agreements with the State Statistics Service (www.ukrstat.gov.ua) and the National Bank of Ukraine as well as with other data-producing institutions (IMF, 2017). Despite this system, it is still very difficult to have access to data and co-ordination

between the different institutions seems to be lacking. Providers of data do not seem to be willing to disseminate the appropriate data, preferring to shift responsibility back and forth between them.

Lack of appropriate data on subnational government finance and local assets

While there has been significant progress in budget classification, particularly since 2011, data are not fully harmonised according to international standards. This explains some differences between IMF data and data provided by the State Treasury Service. For example, consolidated data applied to the state and local government, but do not include social security. Local tax revenues include fees which normally should be excluded. Local debt does not include commercial debts and arrears.

While information on budget execution is public and shall be published, it is not possible to access data for any breakdown by level of subnational government or by source of revenue and destination of expenditure (at *oblast* level for all subnational governments and then by category: *oblasts*, districts, cities, communities). At any rate, the OECD Secretariat was unable, despite repeated requests over a period of months, to obtain this information from the different authorities (Ministry of Finance, State Treasury). This lack of macro data at a disaggregated level is a major obstacle for analysing subnational finance and progress of fiscal decentralisation reform in a detailed manner. Data are also lacking on an historical basis (series), which makes comparisons over time difficult.

In addition, it is not possible to access micro-data of individual subnational governments' budgets. To obtain information for a specific local budget, one has to approach the respective local financial authority or a local office of the Treasury Service (Council of Europe, 2015). At the local level, although the law requires all local governments to publish their budgets and budget performance reports, this requirement is not always followed (Standard & Poors, 2013).

Such data are instrumental in the context of decentralisation and the need to bring more transparency, consultation and accountability towards citizens and civil society in Ukraine.

The same difficulty applies to subnational government financial and non-financial assets. An inventory of financial (municipal companies and company shares, financial investments, savings, cash deposits, loans and other liabilities, etc.) and physical assets (facilities and equipment, natural assets such as water, land and forest) owned by subnational governments is missing in Ukraine while the Constitution and the Law on Local Self-Government stipulate that local self-government units have the right to use their assets to settle the important issues of local life. There is no comprehensive data on these different assets in Ukraine where it is a particularly complex issue because of the huge transfer of state properties to regional and local governments since independence. In fact, before 1991, subnational assets in Ukraine were very small in volume and did not play a significant role in economic and social development. After independence, local property formation began with the delineation between state and local property, the transfer of properties to the different levels of government. In parallel, a process of privatisation of local property was undertaken. While this process of delineation and transfer is not terminated, in particular concerning land, better knowledge of subnational assets is urgently needed.

Such asset inventories are lacking in many OECD and non-OECD countries. But they are critical for improving assets management and for designing performant fiscal management frameworks. Such a diagnostic allows an assessment of the potential for

making better use of these financial and non-financial assets and increasing revenues they may generate (taxes, fees, rents, dividends, land value capture instruments, sales, etc.).

Dissemination of data could be improved

There is still major progress to make in Ukraine in the dissemination of appropriate information in an appropriate manner. Very often existing data are disseminated in an inadequate format as a list of excel sheets, which limits the ability to extract and analyse data over a time series. This could be overcome with a database format.

However, there are a number of laws related to the dissemination (and protection) of public finance data, including the “Law on Information” of 1992, the “Law on Access to the Public Information” of 2011, the “Law on State Statistics and the “Law on Open Use of Public Funds” of February 2015. The latter requires, in particular, that all central and subnational government bodies, including municipal and state-owned companies, disclose their budgets and transactions on an online portal. To implement the law, a test portal has been set up. In November 2016, the Cabinet of Ministers approved the Procedure for Maintaining the Unified State web-portal of open data (<http://data.gov.ua>). Another initiative has been launched with the support of SlovakAid under the auspices of the project “Transparent, Financially Healthy and Competitive Local Governments in Ukraine”, implemented by the Institute for Economic and Social Reforms (INEKO, Slovak Republic), in partnership with the International Center for Policy Studies (ICPS, Ukraine). The project provides budget data and comparative analysis for the 24 oblasts and 24 regional capital cities (<http://budgets.icps.com.ua>). These initiatives are a very positive step towards more transparency and efficiency. However, only 50% of governmental bodies and 20% of state and municipal companies had published their information by the end of 2016 (IRF, 2016).

There are some good practices among countries which have developed portals or observatories on local finance macro and micro data with the aim to increase the dissemination of information, transparency, accountability and citizen engagement thanks to verified, comparable and harmonised sets of indicators. One can cite Austria (*Transparenz Portal*), Chile (SINIM),¹⁷ the Czech Republic (MONITOR),¹⁸ France (*Observatoire des finances et de la gestion publiques locales*), Portugal (*Portal de transparência municipal*)¹⁹ and South Africa (Municipal Money).

Box 3.21. Recommendations for improving quality and access to data on subnational finance and assets

To improve quality and access to data on subnational finance and assets, the OECD recommends:

- continuing to harmonise Ukrainian data to international standards and improving data availability by category/level of subnational government for every budget item, including debt and over time
- developing an easy-to-use database with government statistics (revenue, expenditure, lending/borrowing and financing) covering all levels of government over a long period of time, accessible on line
- establishing a web portal with micro-data with individual accounts
- undertaking a comprehensive, clear and updated inventory of local assets and developing monitoring tools for them.

Subnational government human capacities

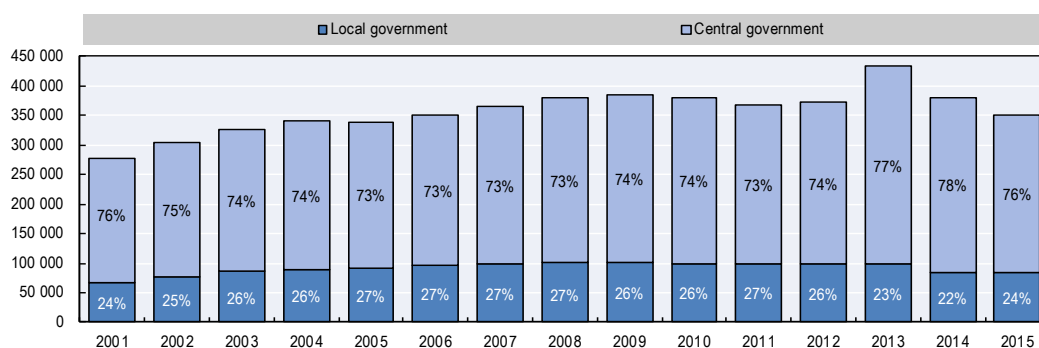
Having adequate human resources at subnational level is one of the primary conditions for the success of decentralisation reform. In fact, it is not efficient to assign the provision of a service at the local level without the necessary capacity. Bardhan (2002) argues that lower levels of government typically have less administrative capacity, and Bird (1995) points out that while the central government might not know what to do, the local government may not know how to do it (OECD, 2014a). At the same time, the lack of human capacities at subnational level cannot be used as a pretext for not decentralising or for limiting local autonomy. Capacity development often comes from learning by doing and sharing the results.

The lack of human capital and capacity in Ukraine

One of the most critical challenges facing decentralisation reforms in Ukraine is the lack of human capital and capacity to effectively administer the duties of governance at the local level (USAID, 2014).

In January 2015, there were 84 500 officials in local governments and 268 000 in central government. Included in local government officials are those who work in councils and executive committees; not included are civil servants working for the state territorial administration (regions and districts) as well as education and healthcare workers. Overall, the number of civil servants decreased in 2015, but the drop was higher at the central government level than at the local level. As a result, although the share of local government officials in total civil servants has decreased over the last years, it has increased compared to 2014 to reach 24% (Figure 3.26). Seventy-seven per cent of local government officials are women, a high ratio that is also found at the central government level (76%). The majority of local government officials (48%) are in towns, villages and rural settlements while 45% work in cities. Officials of districts and regional councils and Kyiv and Sevastopol councils represent only 7% of the local public workforce.

Figure 3.26. Number of civil servants at the central and local government levels, 1 January 2016



Sources: OECD elaboration based on National Agency of Ukraine on Civil Service (2015), “Civil service in figures 2015”; State Office of Statistics of Ukraine (2017a), Statistical Bulletin on “The number of civil servants and officials of local government on December 31, 2015 year”.

The breakdown by region of the number of inhabitants per local government official and per central government official shows significant differences between local and central governments as well as within local and central government sectors. The (unweighted) average rate for the local government is 141 inhabitants per official while it is 426 inhabitants for the central government (without Kyiv city, Donetsk and Luhansk *oblasts*, which have extreme values). Within the local sector, the number of inhabitants per local government official ranges from 116 (Chernihivska) to 178 (Dnipropetrovska).

The regulatory framework for local government staff is obsolete

According to Kantor (2015), the 2001 Law on Service in Local Self-Government Bodies has several drawbacks, number one being the lack of control mechanism of its application. In theory, the selection and appointment of officials are based on an open competition, but in practice the procedure is complicated and lengthy and therefore bypassed. In 2015, only 35% of local staff were recruited according to open competition while 57% were appointed with other procedures, the remaining coming from internship or staff reserve. In some regions the proportion of staff recruited through competition is even significantly lower (less than 25% in five regions in 2015). Promotions through unjustified managerial decisions and from political pressure are not uncommon as well as cases of corruption and abuse of power in the process of recruitment (Kantor, 2015). These uncompetitive conditions of recruitment combined with low salaries and a lack of prestige explain why the number of applicants is limited and that the local government sector struggles with attracting people. The level of staff turnover has been quite high – around 10% in the last couple of years (Kantor, 2015). This situation also explains why the proportion of management staff is disproportionate compared to specialists/technicians: 44% vs. 56% in subnational government, much more than in the central government sector where managers account for 26% and specialists/technicians 74% (State Office of Statistics of Ukraine, 2017a).

Beyond these drawbacks, one of the fundamental issues concerning the Law on Service in Local Self-Government Bodies is its *raison d'être*. The fact that officials of local self-governments are not subject to the Civil Service Law has been criticised, considering that local self-government officials should be included as civil servants (Parrado, 2014). The difference of regulatory framework is all the more problematic as the Law on Civil Service has now been profoundly amended in order to comply with European standards of good public administration (Box 3.22).

Box 3.22. The new Civil Service Law in Ukraine and its impact on local governments

Central and subnational government civil servants are not regulated by the same legal framework. The status of local government civil servants is regulated by the Law on Service in Local Self-Government Bodies of 2001 (employees are called “officials”), while that of the central government is regulated by the Law on Civil Service (employees are called “civil servants”).

In principle, both laws are close and the Law on Service in Local Self-Government Bodies is intended to take into account specific characteristics of the local government sector. It regulates legal, financial and social conditions of the employees (not elected people) of local governments (procedure of appointment, staff categories, salary and retirement conditions). It also stipulates the scope of authority of local officials and their legal protection. According to the law, local councils and their executive bodies are responsible for determining the number of local officials, and thus have some autonomy to manage their staff.

However, the Law on Civil Service was amended in May 2016 as part the Strategy for Public Administration Reform and Strategy for Civil Service Reform, while the law concerning local self-government bodies has not yet been modified.

In fact, at the central level, profound changes have been introduced to set up a modern and transparent civil service in Ukraine, in particular to create a professional civil service in the state administration. It improves the status of civil servants (introduction of three categories instead of seven and salary scales), strengthens the individual responsibility of civil servants and provides for more transparency. Appointments will be based on an open competition with oversight by a special Senior Civil Service Commission as far as top managers are concerned, composed among others of representatives of the civil society. Civil servants will be prevented from lobbying the interests of political parties. High-level civil servants are forbidden to combine civil service and mandate in a local council. A new position of “state secretary” has been introduced to manage ministerial administration, who will be a civil servant chosen through a contest instead of a political figure. Thus, there will be a difference between political and administrative positions. In addition, top officials will no longer enjoy unlimited terms in office but will be appointed for a five-year term and can serve no more than two consecutive terms. Salaries will be more stable and resistant to handling as bonuses will only make up 30% of the salary (instead of 70-80% previously).

The law is being implemented. In 2016, 30 subordinated regulations were adopted, in particular those related to the Senior Civil Service Commission, the procedure for competitive selection for civil service positions, the standard qualification required for the new civil servant categories and to the remuneration scheme. Currently, one urgent issue is to harmonise the Law on Service in Local Self-Government Bodies with the Law on Civil Service. To this end, draft Law No. 2489 was presented to the parliament in April 2015 and should integrate a major part of these new provisions but, as of September 2017, adoption was still pending.

Source: National Council of Reform (n.d.), “Reforms Progress Monitoring: 2016”, National Council of Reform, Kyiv, Ukraine, <http://reforms.in.ua/en/news/reforms-progress-monitoring-2016-past-2-years-ukraine-has-made-greater-progress-implementing>

It is expected that the Law on Service in Local Self-Government Bodies will be also revised to be synchronised with the Law on Civil Service and integrate these fundamental principles, in particular the clear distinction between political and administrative functions in order to help depoliticise the civil service at the local level. According to the National Agency on Civil Service, 53% of local government officials are such dual “jobholders”. Draft Law No. 2489 on Service in Local Government Bodies was introduced by the government in 2015 and adopted in first reading in the parliament. The final adoption is still pending.

The aim of the proposed law is to establish a new legal and institutional framework for service in the local self-government bodies which guarantees the separation between political and professional activities without interference. The draft law aims at enhancing the “prestige of service” in local government, defines the status of local officials and ensures equal access to local civil service based on merit and not on arbitrary and partisan appointments.

Impact of the decentralisation process on subnational staff

It is expected that the decentralisation reform will reduce the number of central government civil servants by about 30% as numerous functions will be transferred to subnational levels. Local governments will not be able to assume such responsibilities with their current staff.

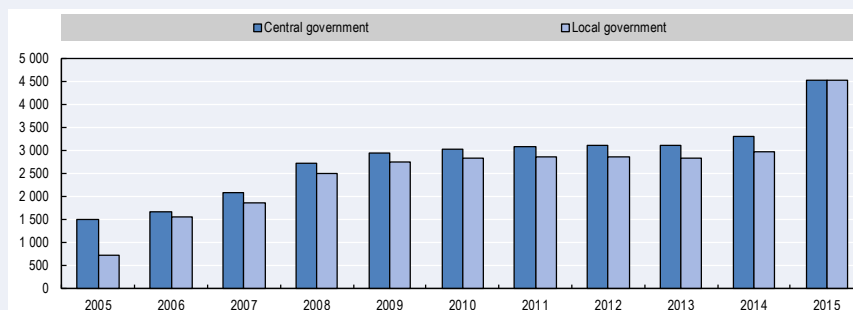
Quantitative and qualitative impacts

On a quantitative side, subnational governments will have to recruit new staff. Transfers of staff from the state territorial administrations (*rayon* in particular) will probably take place. Several *rayon* have progressively fewer and fewer responsibilities, which are being transferred to the UTCs. These transfers of staff pose specific challenges because they imply changes in terms of status and remuneration as well as geographical movements. This can constitute a major obstacle. Recruitment of human resources is another issue. As already underlined, the local government sector has difficulties attracting and retaining highly skilled people because of low salaries (despite catching up over recent years) (Box 3.23), difficult working conditions in remote areas and limited career opportunities in some areas. The shortage of staff can be problematic in some regions. Moreover, many subnational governments, especially the UTCs, do not have human resources departments able to organise recruitment contests, run panels, etc. Another obstacle is to find candidates with adequate capacities to manage the competences which are transferred or to exercise specialised functions, such as local budgeting or strategic planning.

**Box 3.23. Wages in central and local governments:
Higher and more harmonised**

Salaries in Ukraine's central government sector have always been higher than salaries in the local governments. However, there was a significant catching-up effect in 2005 between central and local government average salaries. The average pay for civil servants in the central government was more than twice the average salary of local government officials. In 2006, the difference was only 8% and it remained quite stable during the period. In 2015, there was a significant revalorisation for both the central and local governments. The gap between both sectors is now very modest. As a comparison, in 2015 the average monthly nominal wages of a full-time employee amounted to UAH 4 195, three times above the level of the minimum wage while it amounted average UAH 3 480 in 2014.

Figure 3.27. Average pay of civil servants in central and local governments, Ukraine



Sources: OECD elaboration based on National Agency of Ukraine on Civil Service (2015), “Civil service in figures 2015”; State Office of Statistics of Ukraine (2017a), Ukrstat (2015), “The Number of Civil Servants and Officials of Local Government on 31 December, 2015”, *Statistical Bulletin*, Ukrastat, Kyiv, Ukraine, <http://www.ukrstat.gov.ua/>.

On a more qualitative side, although the level of human capital is quite high in Ukraine compared to other low-income countries, it can be challenging at subnational level. The level of education of civil servants is higher in central government than in local government: in 2015, 92% of civil servants in central government had completed a higher education vs. 74.5% in local government. Moreover, local government capacity varies a lot by the nature of the territorial-administrative units in question. In *oblasts* and cities of regional significance, the capacity of government officials is quite adequate. The capacity on the *rayon* and *hromada* level, however, is currently very low. Many towns, villages and settlements, in particular those which are depopulated, even lack executive bodies, which can perform governmental functions. They have no fiscal responsibility as they do not manage their budget, which is embedded in the upper-level budget (USAID, 2014).

This is a critical issue as far as the UTCs are concerned. Many do not have the minimal human capital and technical capacity to implement self-governance. In UTCs formed with villages and settlements, the lack of human capacity is significant, much more than

in the UTCs formed around a town or a city of *rayon* significance, which can count on human resources.

Improving skills in subnational governments

As a result of the decentralisation reform and the reallocation of responsibilities, there is a particularly massive need for improving skills at community level, especially in the UTCs. As stressed by a recent survey of the Council of Europe, a substantial effort for capacity-building work should be undertaken in areas such as management of the new responsibilities, regulation and procedures, budgeting and accounting, management of property assets, strategic planning, formulation of local development policies, public procurement, engaging citizens, etc. (Box 3.24).

Box 3.24. The educational needs of members of local government bodies in unified territorial communities

A study carried out by the Kyiv International Institute of Sociology in February-March 2017 at the request of the Council of Europe Program “Decentralization and Territorial Consolidation in Ukraine” in co-operation with Council of Europe experts and in collaboration with the Ministry of Regional Development and the National Agency of Ukraine on Civil Service, provides interesting key findings. People interviewed were heads, deputy heads, members of local councils, secretaries, employees of executive bodies and village headmen from 159 communities.

Among the expanded responsibilities, the most difficult areas for respondents in terms of skills, qualifications and organisation of service are healthcare and education facilities management, land plot and property registration, and the allocation of housing subsidies. Respondents were also asked to evaluate to what extent spheres need an improvement in competence. Most often, unified territorial community heads, deputy heads and local council members mentioned financial and tax legislation and public procurement, then financial management, planning and use of budget funds, local development and infrastructure development, strategic planning, and communication with citizens.

The absolute majority of heads, deputy heads and local council members think that all kinds of instruments/events are effective for professional development. By far, exchanges of experience with colleagues from other territorial communities rank first (69% of respondents), followed by participation in exchanges of experience with foreign colleagues (24%), consultation with experts (24%), study visits (20%), studying best practices (15%), participation in seminars and training (14%). Online training ranks last.

Nearly all UTC heads and their deputies had participated in educational events at least once in the past year. However, when asked about regular educational activity (at least every two months), 47% of heads and 36% of deputy heads said that they studied regularly. In the case of council members, the indicator of educational activity is considerably lower; only 43% participated in at least one educational event, including only 6% who studied regularly. The vast majority of those who have participated in any educational events (85%) think that these events are rather or very beneficial.

Seventy-one per cent of respondents among chief UTCs’ officials were satisfied with the level of access to educational events offered in their territorial community. The majority of UTCs’ heads, deputy heads and local council members trust all kinds of institutions in the context of education. The relatively least trustworthy for them are non-governmental organisations while the most trustworthy are international organisations (technical assistance projects), the Association of Ukrainian Cities, regional training centres (retraining and advanced training of employees

of state agencies, local governments, state enterprises, institutions and organisations), the National Academy of Public Administration and its regional institutes, individual consultants and the Ukrainian Association of Village and Town Councils and the National Agency for Civil Service of Ukraine and its territorial bodies.

Source: Council of Europe (2017), “Survey of training needs of local self-government officials in amalgamated territorial communities: Results of sociological research”, <https://rm.coe.int/report-survey-training-needs-of-amalgamated-communities-representative/168072b8ec>.

Mechanisms are in place to support subnational capacity building, but they need to be substantially strengthened (OECD, 2014a) to meet the challenges brought by the decentralisation process and to adapt the Ukrainian training system to European standards.

The national training system is co-ordinated by the National Agency of Ukraine on Civil Service, set up in 2011 by presidential decree with the mission to ensure the modernisation and further development of the civil service and the service in local self-government bodies (Vyacheslav, 2012) as well as by the National Academy of Public Administration under the President of Ukraine (NAPA). Funding is provided by the state budget, but also partly by local budgets. In 2014 around 8 000 local civil servants participated in training in state-owned institutions (Kantor, 2015).

Created in 1995, NAPA is an essential element of the training system for public servants. It is the main higher educational establishment in the system of training, in-service training and advanced training of civil servants and local self-government officials in Ukraine. NAPA has established four regional institutes in Dnipropetrovsk, Lviv, Odesa and Kharkiv as well as an Institute of Public Administration and Local Self-Governance which is a scientific and methodological institution which accounts for the challenges of formation and implementation of comprehensive practice-oriented system of training of civil servants and local government officials. Among its missions is the development of professional competences of civil servants and local self-government officials. NAPA has developed a draft Concept of Reform and Development of the Academy for 2016-2020 but the current concept is for the moment very general and does not seem to take into proper account the challenges resulting from decentralisation. A national strategy for reforming the training system in relation to subnational governments’ current and future development challenges seems to be missing, and more largely a national strategy for human resources management at subnational level. NAPA should work to train staff in the local authorities (Lviv OECD seminar).

In this regard, the experience of the French National Local Civil Service Centre (*Centre National de la Fonction Publique Territoriale*, CNFPT) is instructive. It is now a worldwide best practice in terms of implementing an efficient single vocational training system for local government workers to cope with the needs brought by successive decentralisation reforms. Today, the CNFPT is very deconcentrated, based on a network of 29 regional “delegations”, their antennae in each department, 18 poles of competences and 5 institutes, allowing proximity with decision makers as well as with trainees. Among the five institutes is the National Institute of Local Government Studies, based in Strasbourg, which is responsible for the initial and continuing training of senior local government managers. The regional network is the pillar of the CNFPT’s functioning and

effectiveness. The CNFPT participates in the Observatory of Public Employment and has also developed a directory of local civil service professions based on the National Employment Agency (ANPE) directory, which lists 231 jobs divided into 35 professional groups reflecting the diversity and efficiency of local public services. This *Répertoire des métiers* became a job management and employee training tool for local governments.

Other countries such as Chile, Colombia, Greece, Italy, Lithuania and Spain have also set up dedicated public schools of government, programmes or academies for municipal and regional training, whose experience can be helpful for Ukraine.

Among other main actors, we find regional training centres, associations of local government (Association of Ukrainian Cities and the Ukrainian Association of Village and Town Councils), the Ministry of Regional Development, non-governmental organisations, individual consultants, and international organisations through dedicated programmes and technical assistance such as the Council of Europe's Programme on "Decentralisation and Territorial Consolidation in Ukraine"²⁰ and the "U-LEAD with Europe" initiative "Local Empowerment, Accountability and Development Programme". Managed by GIZ, this programme aims at setting up, in co-operation with the Ministry for Regional Development, local government development centres in all *oblasts* of Ukraine. Launched in April 2017, local government development centres are non-profit entities to build the capacity and enhance the management and leadership skills of local government authorities. They provide direct support to local government bodies, primarily those of amalgamated communities.

Box 3.25. Recommendations for improving human resource capacity

To support decentralisation with improved human resource capacity, the OECD recommends:

- Designing a subnational strategy for human resources management.
- Significantly stepping up support for training regional and local officials:
 - Enlarge the National Academy of Public Administration's mission to develop training programmes targeted at subnational governments.
 - Support the establishment of the national consultation platform on reforming the training system for local authorities.
 - Request and technically support subnational governments to build an annual training plan. This should be accompanied by dedicated funding from the central government, with significant allocations at least for the coming years.
 - Establish specific training actions for senior managers in local government.
- Set up an observatory of local employment, remuneration and competences.
- Reinforce the human resources management function (HRM) in subnational governments with HRM professionals. In smaller local authorities this could be accomplished through inter-municipal co-operation (i.e. a municipal association and shared back offices).
- Favour mobility across levels of government (central and subnational governments) and within subnational governments and create incentives to attract qualified professionals and students to subnational governments.

Notes

1. The Tax and Budget Codes represent the main the legal bases for regulating intergovernmental fiscal relations and managing subnational government budgets (Annex 3.B).
2. Subnational government functions are broadly described in Article 143 of the Constitution, and detailed in a series of laws, including “on Local Self-Government in Ukraine” (Chapter 3, Articles 27-41) and “on the capital of Ukraine – Hero City of Kyiv”, as well as in the Budget Code and in sectoral legislation (e.g. the Land Code, the Forest Code and the Water Code).
3. According to Ukrainian Statistical Committee, in 2016 there were 11 438 municipal companies, compared to 16 700 in 2006.
4. On average in 22 *oblast* capital cities.
5. In 2015 the PIT represented around 11% of central government tax revenue.

6. The CPT also includes the tax on profits of municipal enterprises and several taxes on the profit of companies with foreign investment, foreign legal entities, insurance entities, banking organisations, etc.
7. These are derived from receipts from capital transactions (proceeds from property privatisation, sale and lease of land), from transactions with assets from own revenues of budgetary entities and from municipal enterprises' dividends.
8. These include: registration of legal entities and individual entrepreneurs, registration of real estate property rights, registration of place of residence, construction permits, cadastre information, preparation and issuance of national ID cards and passports for travelling abroad, etc.
9. Source: presentation to the Council of Donors on the Decentralisation Reform, July 2017.
10. If the Ministry of Finance does not provide objections within a month, a local government can proceed with a loan (Article 74).
11. This limitation dates to 2011 when it was felt that Ukrainian commercial banks were unwilling to lend to municipalities, or lend responsibility to municipalities. Thus the state felt it prudent to "pave the way" with lending by International Financial Institutions in order to build the capacity of municipalities in managing commercial borrowing (EBRD, 2014).
12. This analysis is based on the first 159 UTCs, which formed in 2015; 27 indicators were processed to determine the financial capacity of the amalgamated territorial communities, classified into 4 demographic groups (less than 5 000 inhabitants, 5 000-10 000, 10 000-15 000 and more than 15 000 inhabitants).
13. It appears, however, that PIT receipts represented a very small to non-existent portion of revenues in the case of small rural communities due to the collection system.
14. In 2016 when the maximum tax rate was still 3%, i.e. before the reduction to 1.5% because of the minimal wage reform.
15. Signed by Ukraine in 1996 and in force since 1998.
16. www.treasury.gov.ua/main/uk/doccatalog/list?currDir=146477.
17. www.sinim.gov.cl.
18. <http://monitor.statnipokladna.cz/en/2017>.
19. <https://www.portalmunicipal.pt>.
20. www.slg-coe.org.ua.

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Annex 3.A.

Financial dimension within the Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power

The Concept Framework provided for the establishment of appropriate material, financial and organisational conditions as well as adequate human resources for the implementation by local self-governments of their own and delegated responsibilities.

In that perspective, the Concept Framework established several principles to be followed:

- Providing local governments with the resources necessary for the exercise of statutory responsibilities.
- Calculating intergovernmental transfers on the basis of unified standards for the provision of public services.
- Allocating transfers from the state budget directly to every local budget.
- Determining the financial basis for the implementation of local governments' own powers in terms of taxes and fees related to the territory of the respective administrative-territorial unit.
- Consolidation by local budgets of part of the proceeds from the payment of income tax of newly created legal entities, within five years from the date of investing in the legal person.
- Giving local governments the right to regulate the rates of local taxes and fees.
- Preventing other bodies of local self-government and executive bodies to provide tax benefits that reduce own revenues of local budgets. Such fiscal privileges may only be established by the local self-government body, whose budget includes such local taxes and fees.
- Providing local governments with access to credit resources for their investment projects. Borrowing procedures of approval and local guarantees should be simplified. These procedures should be balanced with state control methods aimed at preventing bankruptcy of municipal property rights.
- Increasing the transparency and efficiency in the use of budget funds by introducing a programme-target method for all local budgets.
- Determining the material basis of local self-government, including land owned by the territorial communities of villages and settlements, towns/cities and commonly owned assets by territorial communities of villages and settlements, towns/cities, *rayon* and *oblasts* as well as determining the proper tax base.
- Providing the territorial communities with the right to dispose land resources within their territories, to pool their assets and resources within the framework of inter-community co-operation to implement joint programmes, and to provide public services in a more efficient manner to the population of the adjacent territorial communities.

Source: Concept Framework of Reform of Local Self-Government and the Territorial Organisation of Power.

Annex 3.B.

Key regulations impacting intergovernmental fiscal relations

Besides the Constitution and the Law on Self-governments, the main regulations governing the financing of subnational governments in Ukraine are the Tax Code and the Budget Code. These regulations stipulate all stages of the budget process, monitoring and audit, the structure and functioning of the fiscal information system, accounting rules, as well as local budgets' reporting system and the availability of fiscal data (Council of Europe, 2015).

The first Ukrainian Budget Code was adopted in 2001, and addressed some issues of fiscal decentralisation, including the distribution of revenues and expenditures between different levels of government, and introduced the formula for the equalisation transfers. It was reformed in 2010 to improve the transparency and predictability of inter-budgetary relations, which entered into force 1 January 2011. Several changes were introduced, including:

- the reassignment of tasks (removal of primary healthcare functions from lower level communities, introduction of more detailed lists of social tasks for the *rayon* level – *rayon* and cities of *oblast*/republican significance)
- the provision of a list of resources taken into consideration for the calculation of the tax potential index
- tax-sharing arrangements between the central and subnational governments.

The Tax Code was also modified in 2010, reducing the number of local taxes from 15 to 5 (tax on immovable property other than land, unified tax, license for special entrepreneurial activities, parking tax and tourist tax). New reforms of the Tax and Budget Codes were introduced in 2014, and came into force in 2015.

Table 3.B.1. **Key regulations impacting intergovernmental fiscal relations**

Title	Date of enactment and reform	Function
Constitution	1996	Defines the basic functions of local self-governments, the central government, its executive bodies and their responsibilities.
Law of Local Self-government	1997	Provides the basis for functioning of local government finance.
Law on Local State Administrations	1999	Outlines the duties of central government bodies at <i>oblast</i> and <i>rayon</i> levels.
Budget Code of Ukraine	2001, with significant amendments in 2010/11 and 2014/15	Regulates relationships in the process of preparation, consideration, approval, and execution of budgets and reviewing reports on budget execution, as well as controlling the execution of the state budget of Ukraine and local budgets. It also determines the structure of tax allocations across levels of government and the system of inter-governmental transfers.
Tax Code	2001, with significant amendments in 2010/11 and 2014/15	Divides all taxes collected into national taxes and local taxes and fees.
State Budget Law	Annual	Defines intergovernmental transfers. The state budget annual Law of 2001 refined the division of responsibilities between the central and local governments.

Source: adapted from OECD (2003), “Multi-year investment planning for the city of Lutsk”, <https://www.oecd.org/countries/ukraine/35177698.pdf>.

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Annex 3.C.

Subnational government responsibilities

Subnational government responsibilities are described in broad terms in Article 143 of the Constitution. They are detailed in the Law “on Local Self-Government in Ukraine” (Chapter 3, Articles 27-41), “on the Capital of Ukraine – Hero City of Kyiv”, in the Budget Code, and in sectoral legislation including the Land Code, the Forest Code and the Water Code.

In terms of functions, subnational governments are in charge of the following key assignments:

- ensuring integrated social/economic and cultural development of the territory of the community
- planning
- adopting the local budget, accounting and financial management
- municipal property management
- creation of municipal enterprises
- licensing and registration
- regulation of land relations.

Subnational governments must meet the needs of the population in the areas of housing, transport, trade and communal services, social protection, health, education, culture and sports, and environmental protection.

In practical terms, subnational governments provide the majority of their services in the sectors of education, public health, housing and public utilities. They are in charge of: running schools and hospitals; providing social protection, including social benefits; constructing and maintaining local roads and housing; providing municipal utilities (water and sanitation, waste collection, heating, etc.); and local transportation, as well as developing cultural and leisure facilities and activities.

Table 3.C.1. **Breakdown of spending responsibilities between the state and subnational budgets**

	State budget	Subnational budgets
Public administration	Legislative and executive branches, president of Ukraine, holding elections and national referendums.	Maintenance of local government bodies.
Education	Specialised state-owned schools and extracurricular activities (designated by the Cabinet of Ministers), vocational, higher and postgraduate education.	Preschool, general primary and secondary (including specialised educational institutions), extracurricular activities.
Healthcare	Specialised hospitals and polyclinics, military hospitals, national sanatoria, sanitary and epidemiological stations.	Outpatient clinics, polyclinics, hospitals, maternity homes, primary medical care centres, first and emergency aid stations.
Social protection and social security	State programmes of social aid, payment of pensions to military servicemen, state support to public organisations, compensation for deficit of the Pension Fund of Ukraine.	Support of children and low-income individuals.
Culture and arts	National and state libraries, nature reserves, national museums and exhibitions, national theatres and philharmonics, support of cinematography, TV, radio broadcasting, the press, state archives.	Local libraries, museums, exhibitions, theatres, clubs, philharmonics of local significance, zoos.
Physical culture and sports	State programmes in the area of physical culture and sports, maintenance of central sports schools for sport excellence, national centres for physical culture and sports.	Sport schools for children and youth, centres for physical culture and sports, maintenance of sports facilities.
Economic activity	Economic development, development of transport, road infrastructure, postal service, telecommunications and information technology, conservation of architectural monuments, building of national monuments.	Construction, reconstruction, repair and maintenance of local roads.
Other expenditures	Basic and applied research, and information links of state significance, international activity, judiciary, national defence, law enforcement, national security, creation and replenishment of state stocks and reserves, state debt servicing.	Local programmes for development of housing and municipal utilities. Municipal improvements in localities.

Source: Presentation by the Council of Europe.

Annex 3.D.

Shared taxes and own-source taxes before and after the 2014/15 reform

Table 3.D.1. Shared taxes and own-source taxes before and after the 2014/2015 reform

	Before the 2014/15 reform	After the 2014/15 reform
Regions (<i>oblasts</i>), Autonomous Republic of Crimea	25% of the personal income tax (PIT) 100% of the corporate profit tax (CPT) from local public enterprises 10% of the ecological tax 50% of the rents for the use of natural resources (except oil and gas)	15% of the PIT 10% of the CPT 100% of the CPT from local public enterprises 55% of the ecological tax 50% of the rents for the use of forest and water resources 25% of the rents for the extraction of minerals
Kyiv	50% of the PIT 100% of the CPT from local public enterprises 35% of the ecological tax 50% of the rents for the use of natural resources (except oil and gas) 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	40% of the PIT 10% of the CPT 100% of the CPT from local public enterprises 80% of the ecological tax 50% of the rents for the use of forest and water resources 25% of the rents for extraction of minerals 100% of the excise tax on retail sales of excisable goods 4 local taxes*
Sevastopol	100% of the PIT 100% of the CPT from local public enterprises 35% of the ecological tax 50% of the rents for the use of natural resources (except oil and gas) 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	100% of the PIT 100% of the CPT from local public enterprises 80% of the ecological tax 50% of the rents for the use of forest and water resources 25% of the rents for extraction of minerals 100% of the excise tax on retail sales of excisable goods 4 local taxes*
Districts (<i>rayon</i>)	50% of the PIT 100% of the CPT from local public enterprises	60% of the PIT 100% of the CPT from local public enterprises
Cities of regional importance	75% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	60% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the excise tax on retail sales of excisable goods 4 local taxes*
New amalgamated communities		60% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the excise tax on retail sales of excisable goods 4 main local taxes*
Other local communities (cities of <i>rayon</i> importance, towns, villages and rural settlements)	25% of the PIT 100% of the CPT from local public enterprises 25% of the ecological tax 100% of the land tax 100% of the fixed agricultural tax 5 local taxes*	100% of the CPT from local public enterprises 25% of the ecological tax 100% of the excise tax on retail sales of excisable goods 4 local taxes*

Note: Before the 2014/15 reform, the five local taxes were: the tax on real estate other than land, the single/unified tax, the license for special entrepreneurial activities, the parking tax and the tourist tax. Since the reform, there are four local taxes: the property tax (land tax/rent, tax on real estate other than land, transport tax), the single tax, the parking fee and the tourist tax.

Source: OECD elaboration based on diverse sources



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