

# Positioning LGI/OSI policy dialogue to support decentralisation in Ukraine

Final report on diagnostic consultations

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## LGI

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## Abbreviations & Acronyms

AAA	Accra Agenda for Action
ARC	Autonomous Republic of Crimea
AUC	Association of Ukrainian Cities
BSAL	Birks, Sinclair & Associates Llc
CoM	Cabinet of Ministers
CBIE	Canadian Bureau for International Education
CIDA	Canadian International Development Agency
CoE	Council of Europe
CPLR	Center for Political and Legal Reforms
DCN	Decentralisation Coordination Network
DFID	UK Department for International Development
EPT	Enterprise Profit Tax
EU	European Union
FoLSGU	Foundation for Local Self-Government of Ukraine
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
ICPS	International Centre for Policy Studies
LARGIS	Local and Regional Government Institutional Strengthening Project
LGI	Local Government and Public Reform Initiative
MCSD	Main Civil Service Department
MoE	Ministry of Economy
MoF	Ministry of Finance
MoRDC	Ministry of Regional Development and Construction
MP	Member of Parliament
NAPA	National Academy of Public Administration
OSI	Open Society Institute
PEM	Public Expenditure Management
PFR	Public Finance Review
PIT	Personal Income Tax
SCO	Swiss Cooperation Office
SIDA	Swedish International Development Cooperation Agency
SSC	State Statistics Committee
SUFTAR	Sustainable Finance for Territorial-Administrative Reform Project
US	United States
VAT	Value Added Tax
VR	Verkhovna Rada
WB	World Bank

# 1. INTRODUCTION

- Local Government and Public Reform Initiative of the Open Society Institute (LGI/OSI) is planning to expand its support to Ukrainian government in its reforms for administrative, political and fiscal decentralisation. LGI/OSI overall approach to this work is to provide analytical and technical support for policy development within the government. However, LGI/OSI is currently searching for direction to design detailed activities to achieve this goal.
- Fisco Inform team was commissioned to assist LGI in launching this work by organising a scoping field research to identify the key challenges and priorities in decentralisation reforms, possible scenarios for engagement and attached risks. Our approach to this research was to run consultations with as wide circle of engaged stakeholders as feasible, to reflect the complexity of political and institutional challenges behind decentralisation issues, and to cooperate effectively with other donors.
- During July-August 2008, Fisco Inform conducted bilateral meetings with representatives of major organisations (government officials and non-state actors) engaged in initiatives related to administrative and territorial reorganisation, intergovernmental finance, regional policy, taxation and political reforms. In addition, our team has conducted a desk study of key programmatic documents related to these reforms, including existing and draft legislation, draft reform concepts considered by the government and key non-state stakeholders, studies conducted by other sources, including sociological surveys and media coverage of related issues.
- In view of institutional and political complexity surrounding decentralisation reforms in Ukraine, this report presents generalised observations from individual consultations with representatives of the government and stakeholder organisations conducted by Fisco experts, without references to individual names and posts. Authors of this paper, Kateryna Maynzyuk and Yuriy Dzhygyr, are responsible for its content and recommendations.
- Consultations under this project coincided with the take-off of several new governmental initiatives for reforms in intergovernmental fiscal, administrative and political relations. One such initiative is the new concept for regional policy, which supersedes the strategy advocated earlier by the Ministry of Economy (with support from international community) and approved by the Cabinet of Ministers in 2006, and actively resurrects plans for a territorial reform. Another initiative includes proposed changes to Ukraine's Budget Code, backed jointly by the Ministry of Finance and Parliamentary Budget Committee. Finally, in early September, Verkhovna Rada considered a set of significant changes to legislation which redesigned political organisation of intergovernmental relations in Ukraine. At the moment when this report is produced, the future of these changes remains subject to political negotiations, and might require updates to evidence in this report.

## 2. CONTEXT

### 2.1. Developments in Key Systems for Decentralised Public Administration

#### *Intergovernmental Fiscal Relations*

- **Intergovernmental finance is an area which experienced most visible and most fundamental legislative change towards decentralisation.** Ukraine's Budget Code, introduced in 2001, brought in rules and principles of public expenditure management which implied a highly decentralised government system with considerable autonomy of oblasts, rayons and cities of oblast significance. The new rules were designed to serve as a fiscal platform for a system where major functions in healthcare, education and social care would

be delegated to local authorities. This platform included explicit legal and procedural distinction between state and local budgets, disjunction between general and earmarked transfers, introduction of an equalisation formula, and anchoring of this formula to variables of relative expenditure needs of communities compared to national average, rather than their absolute needs compared to national standards. This latter decision assumed that allocation of transfer funds based on relative needs would equalise opportunities between regions, leaving it to the local authorities to take these opportunities forward.

- **2001 Budget reforms were designed in a political environment highly hostile to the idea of decentralisation.** Consultations at the design stage of the 2001 Budget Code revealed considerable political disagreements on how political powers and public functions should be divided between levels of government. Despite growing exposure to evidence of decentralisation benefits, and examples of political origins of decentralisation in Central and Eastern Europe, Ukraine lacked a clear political vision and motivation for such reforms. Political interest behind reform was very strong, but represented by a narrow political segment and had to confront wide opposition. To a large extent, the opposition was represented by oblast level authorities, who expected to lose in political and financial influence over their jurisdictions if the central government stopped funding major social spending programmes through oblast budgets.
- **The reform strategy in 2001 did not aspire to political contract.** Given the strength of political conflict and the vagueness of public view on decentralisation, the reform has leaned to a hard-line strategy, grabbing opportunities for any feasible change, and leaving further reforms to the future. The chosen strategy of reform assumed taking forward those parts of the initial concept which would be politically acceptable - rather than developing a new politically acceptable concept, which would take much longer and represent a more visible risk. This was labelled, and much praised, as a necessary political compromise.
- **Rules developed by the 2001 Budget Code concentrated on fiscal changes and strongly relied on assumption that political decentralisation would later complement the new fiscal arrangement.** At the moment of reforms in Ukraine, unlike in Central and Eastern European countries, economic argument for decentralisation was much more convincing than political considerations. Deteriorating quality of public services, maintained by the post-soviet public finance, was a relatively safe political explanation to the need for new financial rules. As a result, the reform focused on clarifying the (previously almost entirely informal) rules for public financial management and on alleviating unfunded mandates at sub-oblast level. The latter was achieved (primarily) through clearer division of revenue and expenditure responsibilities between levels of government, and an introduction of a formula-based equalisation system for all rayons and cities of oblast significance directly at the central level, covering expenditures for major social programmes (health, education and social care). Because of political uncertainty around division of responsibilities among levels of government, the new equalisation scheme was introduced without actually defining expenditure responsibilities – either legally, or in terms of the necessary political and regulatory functions needed to administer these expenditures at the local level. Expenditure responsibilities were defined as the obligation to pay for respective budget lines.
- **Even in its trimmed scale, the 2001 budget reform is widely assessed as an aleatory event, conditioned by exceptional political circumstances.** On the one hand, the period around 2001 was (so far) unique in terms of how many representatives of the government and local associations exhibited strong will and enthusiasm for change. Supporters of reform were represented in the top ranks of the MoF and the Parliamentary Budget Committee. Moreover, the AUC provided a strong political support wing, given the expected benefits of reform for most cities. On the other hand, even despite this unique combination of will and interest, opposing interests, represented by oblast authorities, governors and Presidential Administration were counterbalancing the progress. In August 2000, when the reform-minded MoF submitted its first annual budget calculated with the help of a formula, Presidential wing initially reacted with a fierce rejection, prompting Ambassadors of Canada, UK and US write a formal appeal to the President to support prospects of local-self

government in Ukraine. However, political attention was swept away from these issues within the same month after the notorious turmoil around Melnichenko tapes. This circumstantial weakening of the Presidential authority was widely cited as a factor behind development of intergovernmental reform in the following year.

- **Observers agree that fiscal decentralisation since 2001 remained incomplete, naming similar ranges of lacking elements with varying views on priorities.** Widely shared concerns include: a mismatch between centrally imposed input norms and budget allocation rules, insufficient local revenue autonomy to maintain current expenditure mandates, insufficient administrative discretion at sub-national level, inefficiency of the current transfer formula (which is open to manipulation and stimulates spending inefficiencies), and the need to clarify and improve division of functions between government layers<sup>1</sup>. These studies also complain about continued weaknesses in regulation of capital budgeting and sub-national borrowing.
- **Studies of the *fiscal* dimension of Ukraine's decentralisation agree that it would be preferable to assign the core local government function to current rayons, without a major territorial re-cut.** According to these studies<sup>2</sup>, current rayons have the right size to effectively perform this function, while creating any different tier below rayon with significant expenditure responsibilities would be financially unsustainable. Respectively, these studies recommend gradual consolidation of sub-rayon units with the help of incentives for joint initiatives and other voluntary consolidation mechanisms.
- **The central post-reform debate and misunderstanding is on degree of decentralisation for core programmes in healthcare, education and social care.** Since the 2001 reforms allowed an uncertainty in political definition of delegated functions, they left the area open for multiple interpretations and vulnerable to manipulation.
  - Pro-decentralisation reading of the current legal framework sticks to the 2001 reform vision and implies that these core functions have already been delegated to oblasts, cities and rayons. To complete the process of delegation, Ukraine needs to create a matching amount of revenue and regulatory autonomy at appropriate sub-national levels to exercise the delegated policy function. Such regulatory autonomy would imply a revision of approaches to central expenditure mandates and standards, installation of a system for proper spending and efficiency controls, and development of proper administrative and political capacities at all levels to relate to each other in a manner assumed by delegation of power.
  - Pro-centralisation reading of the current legislation builds on a deconcentrated model for funding these sectors, leaving the core regulatory function to the central government. If the central government keeps giving detailed instructions on local service provision (even if these instructions would no longer be input-based as now), it would not be able to pay for this with the current transfer arrangement (a block grant and a rough formula) without creating unfunded mandates. Theoretically, transfers for such programmes should be targeted and calculated based on precise information on unit costs of centrally established services and expected numbers of users (as currently happens with social protection).
- **Uncertainty on division of powers in core expenditure functions is the root cause for the absence of other lacking elements to reform.** Commonly recognised weaknesses of the current system, listed earlier, especially the mismatch between regulatory and financial responsibilities at all levels, directly result from the lack of political decision on the degree of decentralisation that Ukraine is willing to assume.

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<sup>1</sup> *Improving Intergovernmental Fiscal Relations and Public Health and Education Expenditure Policy: Selected Issues*, 2007, WB; *SUFTAR Project Final Report*, DFID / University of Birmingham, 2006, *Financial Management for Better Results*, Malcolm Mercer, 2008, EU / Ecorys Research and Consulting; *Assessment of Public Expenditure Management: Developing a Technical Framework for the Financial Reform of Social Services*, Laurie Joshua, Yuriy Dzhygyr, 2006, DFID / BSAL.

<sup>2</sup> Ibid

- **The current uncertain and contradictory system creates major and growing stress to all levels of government, pushing them to develop coping strategies.**
  - The central government is stressed by disproportionate increase of responsibility for accurate calculation of transfers, which resulted after the core programmes were shifted to the block grant financing but without regulatory release. This stress was multiplied by eliminating the intermediary role of oblasts in transfer allocation.
  - The local governments are stressed by their inability to fund pre-defined services in pre-defined institutions with transfer funds which are, by definition, insufficient.
- **All participants of intergovernmental relations are prone to coping strategies which drag the system rapidly back to, and below, the pre-reform point.** Given the amount of areas left unregulated for proper delegation since 2001, pro-centralisation appeal has been strong from the beginning and increased exponentially because of multiplying stress factors associated with the unregulated environment. Coping strategies almost exclusively include actions which manipulate uncertainties in the system to establish pre-reform budgeting practices, such as:
  - Renaming institutions to match the existing division of responsibilities with expenditure responsibilities defined in the Budget Code;
  - Token reallocation of clients between institutions to change their legal status (e.g. mixing clients from different rayons to assign an oblast coverage to the service provider);
  - Using weaknesses in formula to match the results with existing practice of service provision on various territories;
  - Lobbying for changes in formula, especially in the revenue side;
  - Lobbying for the increasing share of targeted transfers.
- **Recently proposed changes to the Budget Code, backed by members of VR Budget Committee and the MoF, may legally secure the trend away from 2001 reform direction<sup>3</sup>.** Some of the proposed changes in this draft represent ways to de facto re-establish budgeting practices which ruled intergovernmental finance prior to reforms (see Box 1).

**Box 1. Recently proposed changes to the Budget Code which would reduce local budget autonomy and reverse the direction of 2001 reform**

- Introduction of an additional, parallel equalisation grant, which would be allocated through oblast budget without clear description of the allocation rules (Article 97, Article 108);
- Removal of the requirement for symmetric application of equalisation coefficient. The current Budget Code assumes that this coefficient is applied symmetrically to all local budgets, regulating the degree of overall horizontal equalisation (Article 98, p. 9, which would be removed). Removing this provision would open opportunities for influencing the sizes of equalisation transfers.
- Removal of the requirement to consider effective the sizes of intergovernmental transfers after the second reading of the annual State Budget law (Article 43). The idea of this provision was to give an opportunity to the local authorities to develop their budgets by the beginning of the budget year and to increase their autonomy in administering the block grant.
- Fixation of the list of protected expenditure lines directly in the Budget Code. This would remove opportunities for reconsideration of the role of protected expenditures in intergovernmental budgeting, significantly infringing on local budget autonomy.
- Introduction of an explicit rule to allocate delegated funds based on centralised norms and standards (Article 15, p. 3).
- Inclusion of excise duties into delegated revenues of Autonomous Republic of Crimea (which re-introduces selective treatment of this local budget and disbalance in their ability to fund local expenditures).

<sup>3</sup> Proposed draft Law of Ukraine “On amendments to the Budget Code of Ukraine”, Reg.No. 2709, 02/08/2008, submitted by MPs Mr. Derkach, Mr. Zhebrivskiy, Mr. Kyrylchuk. Major provisions of this draft



## **Administration of Key Social Sectors (Health, Education, Social Care)**

- **Ukraine's Budget Code imposes a high degree of functional decentralisation for major sectors of public service provision.** According to the Budget Code, sub-national budgets are responsible for the bulk of spending programmes in healthcare, education and social services to vulnerable population groups. Combined spending on these functions is around 85% of local budget expenditures. According to the WB PFR, local spending on education accounted to 64.1 % of total consolidated education expenditures in 2006, and local budget on healthcare in that year was 79.3%. Moreover, housing and communal services are funded almost fully from local budgets. Local spending is also critical to other sectors, such as transportation.
- **Equalisation transfers, allocated based on relatively simplistic criteria, remain key source of funding.** As discussed above, the Budget Code proscribed transfer allocation principles focused on equalising opportunities of access to services rather than actual outcomes. This assumed significant delegation of regulatory responsibilities to local authorities.
- **At the same time, there is a sharp mismatch between fiscal and administrative responsibilities in all social sectors, imposing considerable unfunded mandates.** Local governments have very low discretion in allocating funds and administering respective programmes. Administrative decision-making (including facility-level budgeting) is subject to a rigid vertical structure of input norms, dictated by central line ministries. One consequence is imposition on local governments of vertically protected recurrent spending, including half of the total public wages. Some decisions on local approaches to service provision are also stimulated by incentives built in the transfer formula: although most variables in the formula are linked to demographic variables, some other variables still allocate funding based on existing infrastructure of service providers. In particular, the formula allocates funds for social care based on the number of clients registered with particular residential institutions, reinforcing their domination.
- **Without a consensus on the degree of regulatory decentralisation for each of the sectors, stakeholders remain sharply divided about the role of service standards and unit costs.** Depending on which reading the stakeholders are taking of the current confusion between delegated and deconcentrated elements of intergovernmental relations, they suggest different ways of defining what the functional responsibilities might imply in the first place and how to remove unfunded mandates. One view on this uncertainty is that Ukraine needs a comprehensive system of service standards with precisely defined unit costs of each type of service provision, which would make it easier to hold the central government to account for the mandates it imposes sub-nationally. An opposite extreme view is that the central government should entirely revise its approach to service quality management, perhaps implying a revision of existing wide menu of declarative constitutional obligations of rights for access to services, delegating to sub-national governments certain discretion in how to match service provision to local expectations.
- **Existing analysis of social sectors finance note that it would be costly and inefficient to create / maintain core local self-government tier with significant expenditure functions at sub-rayon level<sup>4</sup>.** In particular, the WB PFR demonstrates that the current lowest tier of government is, in average, too small to effectively perform any policy function in healthcare and education. In the same vein, the DFID Assessment of Public Expenditure Management in Social Services shows that considerable policy autonomy in social service provision (in the form of developing a suitable balance of various types of services such as

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Law correspond to the content of the draft new Budget Code designed under the leadership of the Ministry of Finance and published on its website.

<sup>4</sup> *Improving Intergovernmental Fiscal Relations and Public Health and Education Expenditure Policy: Selected Issues*, 2007, WB; *SUFTAR Project Final Report*, DFID / University of Birmingham, 2006, *Assessment of Public Expenditure Management: Developing a Technical Framework for the Financial Reform of Social Services*, Laurie Joshua, Yuriy Dzhygyr, 2006, DFID / BSAL

residential or community-based) is feasible at the level no less than rayon, but potentially oblast. The study produced by the DFID SUFTAR project to analyse fiscal dimensions of the 2005 draft administrative-territorial reforms concluded that assignment of public competences is widely debated for reasons outside territorial reform, and that such assignment should not be driven only to maximize decentralisation, without considering how to make the arrangement sustainable and efficient.

- **Any further sector reforms are closely related to respective changes in intergovernmental finance.** (This conclusion is especially well illustrated in PFR p. 5-6, 1.14-15). Observers agree that increasing technical and allocative efficiency in providing most services in healthcare, education and social support to vulnerable will not be possible without connecting reforms in these sectors to sustainable changes in intergovernmental fiscal relations. At the same time, (as specifically mentioned by regional working groups of the SUFTAR project), further reforms in intergovernmental finance should be strongly led by reforms in administration of key social sectors.
- **Increasing fiscal envelopes for the key sectors, by itself, will not address their current poor outcomes and might harm the economy.** Recent evidence-based studies demonstrate that the root causes of current inefficiencies in healthcare, education and social care provision are linked to the fundamental distortions in the sector decision-making system, including a mismatch between levels of political, administrative and fiscal decentralisation. These studies also demonstrate that additional resources would not allow to address these distortions. Moreover, increasing these fiscal envelopes (e.g. through introducing health insurance schemes) would create an additional tax burden that would be wasted given the current systemic inefficiencies<sup>5</sup>.
- **Decentralisation at the level of institutions / service commissioning is hindered by lack of policy autonomy at local level.** Recent pilot projects to introduce comprehensive and sustainable local practices of service commissioning (in social care for vulnerable) showed that it would be problematic to increase decentralisation at the level of facility budgeting without removal of central regulatory barriers to local policy development. In particular, in social services, wide-scale pluralisation of service menu will not be possible without removal of central level barriers such as lack of marginal revenue flexibility at local level (since local governments do not influence the rates of taxes which they receive, any innovative decisions have to be funded from someone else's pocket (central funds) and there is no possibility to take financial risks / raise local taxes to fund local initiatives).
- **Current organisation of key sectors is bound to create intrinsic resistance to reforms.** Excessive centralisation and excessive reliance on input-based bureaucratic administration in all sectors diminishes local accountability. Without local accountability, and without appropriate systems for quality control, sector governance breaks down into resilient administrative enclaves, which are in a position to seek economic rents from manipulation with quality of services they are providing (such as out-of-pocket payments in healthcare and education).

## ***Regional Development***

- **Since independence, attempts to promote regional development in Ukraine have been interlinked with reforms to build the very institutional platform for design and implementation of regional policy.** Regional policy (defined as support to effective development of potential across territories) is intimately linked to, and dependent on, the nature of rules for relations between the levels of government and the country's territorial organisation. In particular, these rules proscribe which instruments could be realistically devised for regional policy implementation. Given that legal framework for

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<sup>5</sup>E.g. on healthcare see *Improving Intergovernmental Fiscal Relations and Public Health and Education Expenditure Policy: Selected Issues*, 2007, WB, para 33, p. xiv.

intergovernmental relations in Ukraine is still in the making, most concepts for a regional development strategy contained certain proposals on political, administrative and fiscal decentralisation needed for each of these strategies to work.

- **In 2006, the CoM approved a *National Strategy for Regional Development to 2015* crowning a five-year design process led by the Ministry of Economy.** The 2006-2015 Strategy was linked to a wider legislative package regulating regional policy issues, including a law on “Stimulation of regional development” (approved in 2005). The Strategy took up contemporary approaches to regional development and set out, as its major goal, to create conditions for the regions to increase their competitiveness and to achieve sustainable growth up to their full technological and human potential. The document broke this goal down to four objectives, one of which was to develop appropriate institutional and legal framework for the strategy to work. However, necessary institutional changes were described in terms of principles rather than concrete proposals. E.g., these included formation of local self-government (without specifying its exact make-up or level); harmonisation of territorial structure with the principles of European Charter of Local Self-Government, fiscally balanced equalisation of access to public services, etc. It also established that any re-shuffling of responsibilities between levels of government should be based on mutual consent with local governments, that territorial changes should be introduced gradually and with pre-emptive resolution of potential legal and political conflicts. The Strategy assumed that, provided a proper institutional framework is in place, regional policy would be implemented with the help of the following instruments:
  - Regional contracts
  - Programmes for reducing depressiveness of certain territories;
  - Targeted national programmes (“targeted solutions to systemic problems”);
  - Regional development strategies;
  - CoM’s coordinatory function, ensuring that regional development goals are respected by other central policies.
- **Most of the instruments designed (and approved) in 2006 remain were not realised to their full potential.** Implementing the new instruments for regional policy proved to be difficult and slow. By this time, only one regional contract was concluded with Donetsk Oblast (the second contract with the Lviv Oblast is in the signing stage). Many of the regional development strategies drafted by the oblasts are assessed by experts as weak and abstract. A draft procedure for allocation of capital grants (designed within DFID LARGIS II project) was not taken forward into a full-scale legislation.
- **The progress in signing the two first regional contracts, although incipient, is very important politically and requires stronger recognition.** Preparation, debates and overcoming the difficulties in signing the first contracts is reported as unprecedented experience for both the MoE and the two oblast administrations of building elements of operational partnership. Significance of agreements achieved through this work transcend the benefits of formal signing of the contracts. In the view of MoE, it is very important, politically, to maintain the momentum for development of this instrument and avoid its discrimination. Moreover, effective promotion of this work could strengthen intergovernmental relations with the oblast level, alleviating mistrust to central authorities and softening centrifugal sentiment.
- **Since March 2007, leading role in reforms “to ensure regional policy implementation” was assigned to a newly created Ministry of Regional Development and Construction (MoRDC).** Most interviewees agree that there is a degree of institutional duplication in division of responsibilities between the MoRDC and the regional development department of the MoE. But despite the fine institutional line between responsibilities of key ministries in regional development, they agree, in principle, on a sensible role scheme which assumes considerable inputs from each ministry. With the leading role of MoRDC in shaping core institutional framework for regional policy, the MoE continues to play a major role in implementation of the regional policy and its tools. At the same time, the MoRDC is

responsible for allocation of capital grants, which is one of the key instruments for regional policy implementation. The MoF remains responsible for fiscal sustainability of regional development and planning, including sustainability of the rules for intergovernmental fiscal relations on which regional development instruments rely.

- **MoRDC currently leads in a new reform initiative to amend approaches to regional development including considerable changes to political, administrative and territorial organisation at communal level.** Throughout 2008, MoRDC worked to design, discuss and promote a new Concept for State Regional Policy and a package of additional legislation to ensure implementation of this Concept (namely, a draft Law “On State Regional Policy”, a draft CoM Resolution “On approving a concept for upgrading the system of professional development for local civil servants and council deputies”, a Concept for Local Self-Government Reform, and a draft Concept of Administrative and Territorial Reform). This draft legislative package was designed under the auspices of the high level inter-ministerial working group by a working-level group of experts and MoRDC representatives, during away-days funded by the SCO. The package was presented at a series of events, mostly for the donor community and selected circle of experts. Observers note that the package still undergoes rapid changes, which they find challenging to trace. Details of this proposed reform are discussed in the following section, since, in the essence, it focuses primarily on administrative and territorial changes.

### ***Administrative and Territorial Structure***

- **Ukraine is a unitary state with three levels of local government.** The top tier includes 24 oblasts, the ARC and two cities of special status (Kiev and Sevastopol). The sub-regional level includes 488 rayons and 177 cities “of oblast significance”. The third tier of government includes over 12 000 villages, settlements and towns “of rayon significance”.
- **Current administrative and territorial structure has not changed since independence and is criticised for a widely recognised list of weaknesses.** Current spatial division reflects political principles of territorial organisation inherited from Soviet times, when territorial units were shaped in proportion to the number of party members residing in a region. An overview of problems arising from the current structure is provided in the new draft concept for regional policy developed by the MoRDC. It includes:
  - Excessive variety among units of the same level (e.g. in population, area size etc).
  - Mismatch between responsibilities and organisational capacities of various units;
  - Administrative enclaves, exclaves and overlaps, when territorial units include other units of the same administrative level;
  - Large amount of local governments (over 12 thousand) and rayons (around 500) which can be criticised as obstacle for effective management and control.

These problems make it difficult to effectively divide responsibilities and achieve cooperation between different levels of government, as well as between legislative and executive authorities at the local level.

- **History of “matryoshka” (quasi-feudal) type public administration left underdeveloped state’s capacity for partnership relations with regional governments.** In a quasi-feudal system of public administration, central authority is fragmented into pieces and traded down the vertical chain to regional authorities through individually negotiated agreements in return for political loyalty. Such arrangements, by definition, rely on very strict and static administrative hierarchy. Accordingly, the central government in a “matryoshka” type public administration system does not have effective tools for keeping regional governments to account for their policies with regard to local self-government units. One, most frequently cited, dimension of such system was fiscal “matryoshka” where budgets of

each level were defined manually by the upper level government. This fiscal arrangement was among the targets of 2001 reform, which established direct flows of equalisation funds from the central budgets to sub-oblast budgets. However, as discussed earlier, this reform did not cover the full range of rules in public administration and was therefore incomplete (it also left outboard fiscal equalisation rules within rayons). As a result, delegation of administrative and fiscal powers to regional authorities is still questioned by many stakeholders, mostly representatives of local-self government.

- **Political and administrative relations between levels of government remain ambiguous, ineffective and create conflicts of interest, especially at regional and sub-regional levels.** As illustrated in the diagram, regional executive authorities are essentially subject to triple subordination. On the one hand, heads of oblast and rayon administrations are appointed directly by the President. At the same time, while the President approves candidates, they are nominated by the Prime Minister, so, in practice, appointments are subject to political bargaining between the two. Moreover, although regional councils cannot appoint heads of administrations, they can dismiss them by 2/3 votes. Sector departments of local administrations are also under effect of this arrangement. While heads of these departments are appointed by heads of local administrations, they have to be approved by the line minister (or oblast administration, for rayons). This means, first, that regional elected councils do not rely on locally accountable executive authorities. Secondly, local administrations are simultaneously responsible for execution of local policies and for representation of vertical control function over implementation of such policies. This intrinsic conflict of interest makes it difficult for administrations to effectively perform either function.
- **Ukrainian local councils are elected on proportional representation basis, which is a debatable arrangement<sup>6</sup>.** Ukraine's electoral system assumes proportional representation of parties and is a subject of wide criticism for a number of explicit and implicit reasons. However, since it was introduced for the first time in 2006, it proved to bring about a number of positive, as well as negative implications for the local governments.

On the negative side, the biggest disadvantage was that local councils elected based on party lists have weakened the links between the councils and their communities. Many local councils were filled with non-residents of respective communities, especially businessmen anchoring their interest in politically and economically powerful cities. Secondly, proportional system was introduced without a quota for all rayons in oblast councils (under the previous system, each rayon had a minimum quota of three seats). This created a significant obstacle for oblast councils to represent interests of all communities, since many rayons remained completely outboard without the quotas<sup>7</sup>. Thirdly, it should not be expected of political parties, by definition, to represent local issues and concerns in their programmatic appeals. Fourthly, with party lists, it became relatively more difficult for communities to relate to their councils and raise issues with their deputies (it was easier for them to contact a familiar name, rather than a party unit). Finally, the proportional system coexists with elections of mayors in one round, which often results in councils with political majority which differs from political standing of the mayor, which paralyses their activities.

At the same time, studies analysed for this research observe that proportional system has increased the overall level of political responsibility within the councils. In making political decisions on local issues, local deputies feel an additional accountability constraint forcing them to "keep the party's face". Furthermore, political affiliation (and membership in

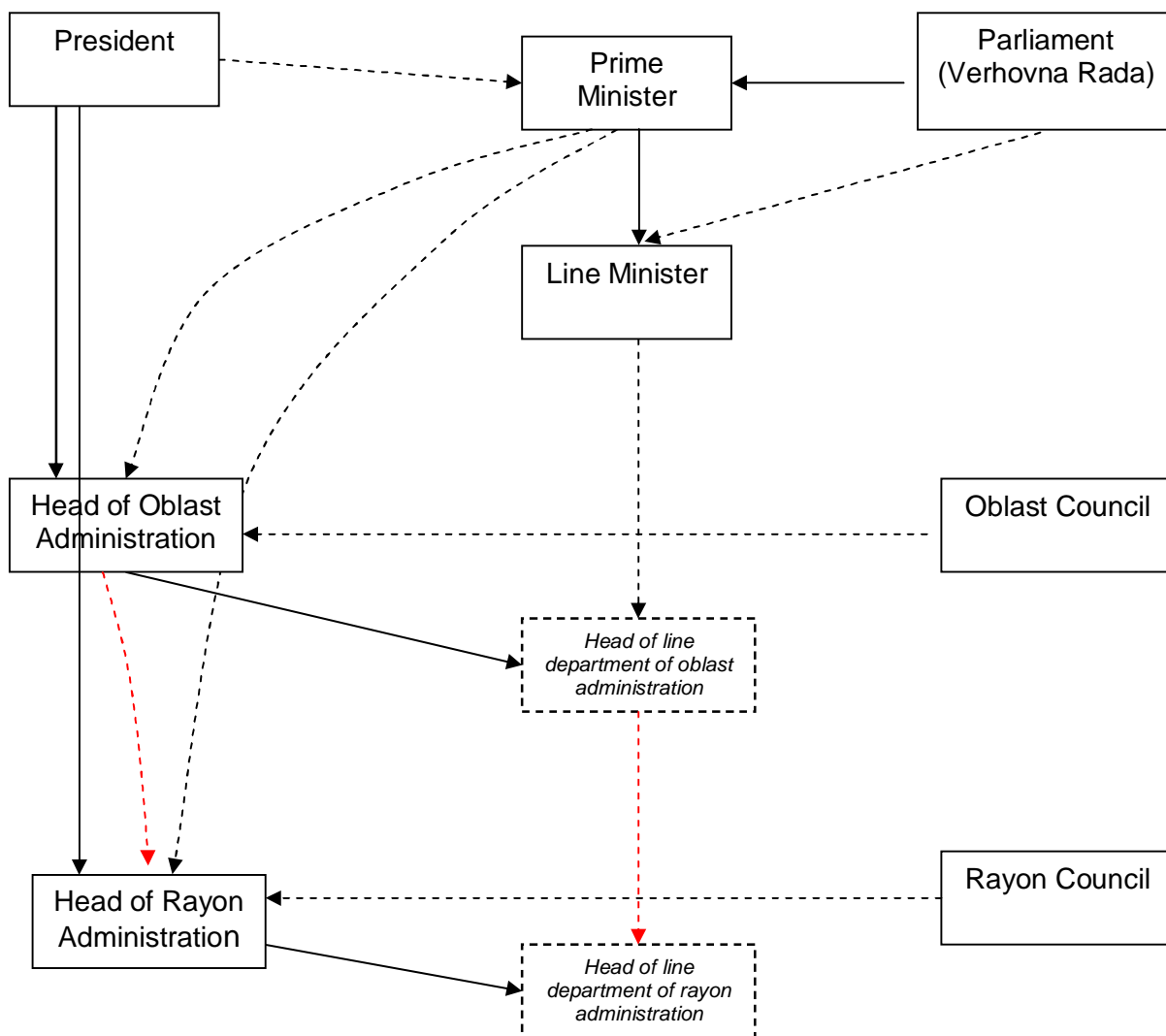
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<sup>6</sup> *Local elections in Ukraine: legal issues (2006)*; by D.S.Kovryzhenko, Agency for Legislative Initiatives; *Summary materials for the Conference "Interaction between civil society and authorities at the local level"*, Chasopys Parlamentu, №2/2006; *Ukraine: One Year After Elections; 2007*; Agency for Legislative Initiatives, Civil Network OPORA, Committee of Voters.

<sup>7</sup> For example, in Volynska Oblast, the oblast council does not include representatives from four rayons, Khersonska Oblast council – nine rayons; Cherkaska Oblast council – seven rayons. Moreover, oblast centres and big cities (of oblast significance) are overrepresented in most oblast councils: e.g., deputies from large cities represent 54% of Volynska Oblast council and 73% in Khersonska Oblast council.

respective council factions) made it easier for deputies to coordinate in marginal situations, where they would have normally been tempted to surrender in the face of individual benefits. Like in prisoners dilemma, when it is highly uncertain whether others would support a mutually beneficial decision, each individual decision makers is tempted to act to its own good. In such circumstances, a faction may help the deputies to unite. One positive consequence of this change was that many councils have shaped palpable oppositions to local majorities.

**Diagram of appointments within the executive authority on central and local levels  
(as of August 2008)**



- Reform champions differ in their views on fiscal implications of the current territorial inefficiencies and the desired shape and place of core local self-government.** All studies and reform initiatives agree that current basic level of self-government (villages, settlements and towns in their current setting) is inappropriately weak to continue performing this function. The amount of units at this level is too large, they are too diverse and, in average, too small to effectively administer basic sector functions. However, views differ on how to address this problem. One view, reflected in the current concept for administrative-territorial reform (and promoted earlier through 2005 reform initiative), is that an appropriate local level should be created through community amalgamation and a territorial re-cut. An alternative view (advocated, among others, by the WB PFR) is that the current rayons are more cost-effective candidates to perform the functions of lowest level of government, while creating a new sub-rayon layers would represent political and economic

risks. According to this view, it would be difficult to quickly upgrade administrative capacity of amalgamated communities enough to overcome current issues of administrative weakness and inefficient economy of scale for major sector functions. At the same time, the new layer would increase costs of administration.

- **There is a considerable anxiety and divergence in views among stakeholders regarding the sequencing and implementation of territorial changes.** Spatial shifts in administrative functions raise a number of concerns among political stakeholders, civil servants and general public. One concern is protection of interest of small communities whose position would be changing. Another concern is access to public services, in terms of both quality and distance. While some initiatives were rather straightforward in terms of potential sequencing (e.g. the 2005 reform was presented to the stakeholders as a set of draft legislation), others opted for a more gradual approach (such as the 2006-2015 Strategy for Regional Development, as discussed earlier). In the absence of a strong political demand for amalgamation either at local or at central level, some observers note that Ukraine's territorial reforms are driven "neither bottom-up nor top-down, but rather from outside, which often skews them to addressing specific issues without acknowledging the more complex general picture". After the first communication of the recent territorial reform initiative, the reaction in the media was predominantly anxious or hostile<sup>8</sup>. Interview with AUC revealed that there is a considerable anxiety over amalgamation among small communities, who fear the uncertainty and tend to oppose change.
- **Recent proposals for administrative-territorial reform, led by MoRDC, cover a wide range of changes (territorial, administrative, political), but stakeholders still assess them as incomplete.** The reform initiative under discussion includes, apart from the Concept and a draft law on Regional Policy, legislative proposals on the following reforms: local self-government reform, administrative-territorial reform, and improvements to professional development for local civil servants and elected deputies. These proposals are subject to continuous revision by the MoRDC. Assessment of the draft concept by CoE experts in May 2008<sup>9</sup> noted that the reform remained alarmingly vague in defining links between regional policy and local self-government, as well as its fiscal dimension.
- **At the time of production of this report (September 2008), VR approved new rules for appointments of local administrations, canceling their subordination to the President and local councils – but these may be soon vetoed.** One of the key milestones during the recent political stress was a sweeping parliamentary approval to the draft law No 3112 "On amendments to some laws" (including the Law "On acting heads of local state administrations"). Essentially, this law transfers the right to appoint the heads of local state administrations to the Cabinet of Ministers. Earlier, the President could veto governmental candidates for this post; from now on, if a candidate is vetoed, the Cabinet of Ministers receives the right to appoint an acting head. Moreover, the new law abolishes the right of oblast and rayon councils to impeach heads of administrations by 2/3 no-confidence vote. All they could do from now on is submit an appeal to the Cabinet of Ministers proposing a dismissal. At the time when this report was produced, political negotiations remained at their peak, with this legal change being one of the central contested issues. The President declared that he is planning to veto this law, although the amount of votes behind it (350) is enough to overcome it.

## ***Taxation and Revenue Sharing***

- **Unclear intergovernmental division of responsibilities is mirrored by a revenue sharing scheme which does not compensate local governments for central policies.** Local government revenues almost exclusively depend on central transfers and shared PIT,

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<sup>8</sup> For an illustrative example see Delovaya Stolitsa, #23/373 7.07.2008, p.12 ("Tymoshenko to 'form-up' the regions: Cabinet of Ministers will be changing mayors as gloves").

<sup>9</sup> Appraisal Report on the Draft Concept Paper on State Regional Policy for Ukraine, CoE, May 2008

with meagre possibilities for levying local taxes. Given the combination of rigid input-based norms for expenditure policies dictated by line ministries combined and the output-based transfer system, the absence of local marginal revenue autonomy makes it, by definition, impossible for local authorities to balance their budgets without softening some of the constraints (e.g. by breaching some of the norms, raising funds locally through off-budget channels, underperforming substantially on major services, or all of the above). Furthermore, central decisions on shared revenues such as PIT systemically fail to compensate local budgets for the implications, despite the specific requirements for this in the Budget Code (examples include PIT rate reduction in 2003 and centrally imposed tax exemptions).

- **On-going discussions on ways to compensate for unfunded mandates converge on the goal to strengthen local revenue autonomy through introduction of a property tax, although views on its technical design differ.** A tax on property has been a permanent element of all versions of draft Tax Codes and all three versions of Concepts for Tax Reform ever considered in Ukraine. At the moment, there are two existing legislative scenarios which remain under consideration. One is the draft Tax Code championed by *Nasha Ukraina* deputy Mr. Katerynychuk, which describes property tax as a central tax and without sufficient technical detail. Based on stakeholder and media comments, despite specific PR campaign, this proposal did not raise sufficient political support. The second scenario is a Tax Code currently developed by the government (championed by MoF Mr. Pynzenyk) and not yet released for consultations.
- **The biggest risk is lack of coordination between activities to design the tax reform and the general debate on the desired direction of decentralisation processes in Ukraine.** In the absence of clear vision and political agreement on preferred degree of fiscal decentralisation, proposals for a new property tax do not always rely on comprehensive assessment of either local capacity to administer local taxes, or macroeconomic feasibility of increasing the overall tax burden. The idea of keeping property tax at the national level is one example of misguided motivation for introducing this tax. Moreover, lack of a widely shared vision of how existing revenue sharing is linked to the division of responsibilities has recently started to inspire proposals for returning to sharing schemes for such taxes as EPT, VAT and Excise. Such arrangements were common practice in Ukraine in early 90s, proved to be dramatically detrimental (as would be predicted by international practice and economic theory) and were removed by the Budget Code in 2001. In particular, sharing indirect taxes, especially VAT, is distorting by definition: it results in tax export (when residents of one territory consume services paid for by residents of other territories), uncertainties for local budgeting (because such local receipts are difficult to forecast), and horizontal fiscal disproportions.

## 2.2. Political Regionalisation: Magnitude, Factors, Forecasts

- **Ukraine suffers from strong social insecurity over its ability to maintain state unity, but it rests on misguided historical analysis.** A wide-spread concern over state integrity often refers to historical evidence, showing repeated failures to create a nation state on the territory of modern Ukraine. This analysis also refers to the considerable share of ethnic Russians in Ukraine's population, implying that the country is historically predisposed against forming a sustainable state, leaning towards the influences of its bigger neighbours with older state history.

However, the reference to historical roots of national states in this analysis is misguided. In reality, while some of the world's national states do date far in history (like Portugal or Japan), most of the Europe's current national states did not exist until nineteenth century. Most of the states which existed until that time were either multi-ethnic empires (the Austro-Hungarian, Russian, Ottoman, French and British Empires) or smaller states which now represent a "sub-national" government layer. Furthermore, the current ethnical division in Ukraine into two almost equal halves was not shaped until the end of the World War II,



when this territory was subjected to ethnic cleansing, territorial re-allocations of ethnic groups, massive urbanisation of ethnic Ukrainians and significant inflows of ethnic Russians. Prior to late twentieth century, the territory of modern Ukraine was considered one of the most ethnically diverse in Europe<sup>10</sup>.

Therefore, neither the lack of empire-state record, nor the presence of significant share of citizens with ethnical and cultural self-identification similar to those of neighbour countries, do not, by themselves, represent historical grounds to doubt Ukraine's chances to preserve state unity in the modern times (despite popular believes).

- **Sensitivity over state disintegration is not rooted in current differences on major economic, social or political issues, where Ukraine's population is overwhelmingly united.** Since 1994 up to 2006, surveys around major elections showed that voters throughout Ukraine had very similar attitudes to political freedoms, civil rights, market economy, private property and private business<sup>11</sup>. In the surveys conducted by Kyiv International Institute of Sociology, responses to these questions were very close and of no statistical significance to voting preferences.
- **The only factor which has statistically significant influence on difference in political choices is degree of linguistic heterogeneity.** Sociological research suggests that there is one specific factor which creates two distinct groups of diverse attitudes among Ukraine's population: linguistic heterogeneity of Ukraine's regions<sup>12</sup>. In particular, there is a distinct regional segmentation between territories populated predominantly by monoethnor Ukrainians (those who identify themselves exclusively as Ukrainians, regardless of their family background and nationality), and territories populated by a mix of bi-ethnors (who identify themselves as both Ukrainians and Russians) and Russian monoethnors.
- **Significance of linguistic factor for self-identification is widely utilised by all political parties, contesting around the role of Russian language and Ukraine's foreign policy.** All political parties readily focus their campaigns on issues related to linguistic heterogeneity and impose on voters a political choice between two extreme scenarios – compulsory linguistic unification versus ostentatious recognition of the Russian language as official alternative to Ukrainian. This divisive approach spills over to sharpen the divide in regional preferences for foreign policy objectives (in terms of relations with Russian Federation), which is not immediately linked, but could be easily associated with self-identification on linguistic grounds.
- **Weak political dialogue and public communication over central policies (including foreign policy) blurs distinction between policy decentralisation and political regionalisation.** In political debates over the country's cultural divides, political leaders increasingly apply decentralisation arguments (such as the need for stronger local accountability in public service provision) in one line with possibilities for regional takeover in areas related to foreign policy, national defense and security, and other state-defining central functions. A specific term "regional opposition" appeared recently to label counteraction to national policies by opposition parties which declare their protests through support to declarations approved at the regional level (where opposition dominates local councils) in contradiction to central decisions. Without effectively consulting and communicating with the electorate on central issues, without linking these consultations to statistical evidence and feedback analysis, the central government, regardless of its political affiliation, remains vulnerable to such potential pressures.
- **Risks of political regionalisation are not systemically addressed, and are therefore legitimate and growing.** If factors outlined above are not alleviated, a degree of legitimate risk exists in delegation of considerable political power to sub-national level. Without sufficient research and consultations, it is not immediately clear whether deeper political decentralisation would provide a sustainable equilibrium to the current tensions. Moreover,

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<sup>10</sup> *Kleine Eschichte der Ukraine*, by Andreas Kappeler.

<sup>11</sup> *How do politicians manage to divide Ukraine?*, V.Khmelko, *Mirror Weekly*, #24 (603) 24-30/06/06.

<sup>12</sup> *Ibid*

it would be difficult to address these tensions without dealing with their origins, which related to current political policies and weak capacity of the central government.

- **Political parties are united on core arguments for policy decentralisation and strengthening local-self government.**<sup>13</sup> All core parties agree on general arguments for fiscal and administrative decentralisation, including better quality of service provision and stronger local accountability. They also agree that the current size of lowest tier of local government is, on average, far too small to effectively perform this function. At the same time, representatives of all parties expressed concerns over preserving the rights and interests, and addressing concerns, of smaller communities, whose current responsibilities would be more effectively performed by covering a larger catchment area (either through an amalgamated unit or through centralising these functions under reformed rayons). Furthermore, representatives of all political parties agree that meaningful local self-government is not possible without establishment of executive authorities accountable to local councils elected by majoritarian voting; with oversight from a prefecture-type system of central control. To summarise, political accord on these ideas is very expressive.
- **Political parties are, however, divided on the role for local-self government in addressing risks of political regionalisation.** There are, broadly, two general strategies for decentralisation reforms in terms of the role assigned to stronger local-government in supporting national unity. One view suggests that while local governments should become operational and much stronger, Ukraine also needs to address larger tensions in the form of inter-regional divides by delegating sufficient administrative and political powers to regional authorities. Proponents of this view do not necessarily insist on legal federalisation, but insist that federalism should be observed as a principle of voluntary agreement and cooperation between central and sub-national authorities. An alternative view is that risks of political regionalisation are too high, and should be offset by taking political decentralisation as far as economically and administratively possible, so that strong local self-governments would dissolve centrifugal tendencies of regional magnitude. In other words, this implies that decisions on fiscal and administrative decentralisation should be made not only based on the usual set of efficiency considerations, but also based on political grounds, to offset the possible role of regions, leading to higher degree of local autonomy (for cities and sub-regional communities) than would be expected by purely economic argument.
- **However, given the origins of disintegration risks, they could be addressed at the central level, without implications for decentralisation policies.** As explained above, existing evidence (which should be expanded) suggests that there is no factor behind existing separatistic tendencies that could not be addressed by central level policies (or, in fact, by discontinuing counterproductive current policies). If this hypothesis is correct, the risk of state disintegration has origins which are different from any given structure and degree of regional or local autonomy. Accordingly, this risk should not be addressed by choosing appropriate degrees of autonomy (which could be left to economic reasoning), but through targeted campaigns to embrace linguistic heterogeneity and through appropriate regional consultations with all parties concerned.
- **Political parties agree that overcoming current divisions will take much time and energy. At the same time, expected political costs of any existing initiatives implying political decentralisation are too high for any government to be willing to take them.** Interviews with representatives of major parties, quoted earlier, show that all major parties (and observers) view administrative decentralisation reforms as the biggest challenge Ukraine has been facing since independence, and feel unsure about its prospects and feasibility. They agree that all previous steps, such as certain legislative changes, approval of concepts and programmatic statements, remained purely declarative. Delegated from all three core parties at the time of the interview emphasised the complexity of the

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<sup>13</sup> This and further observations on programmatic views of core political parties are based on pre-election analysis in 2007 led by Mirror Weekly, including an interview with representatives of key parties published in #31 (660) 24-31/08/07 *How shall we set up Ukraine; or what to do with the administrative-territorial reform?* By Y. Mostova and S. Rahmanin.

decentralisation challenge and the risk of focusing on only one of its components, including territorial component. One view during the consultations of this project was that any government who would go forward with a meaningful decentralisation reform (including an administrative territorial reform) would unavoidably lose political scores because of how unpopular this reform will always be.

### 2.3. Evolution of Approaches in Academic and Donor Community

- **Contemporary analysis of multi-tier government systems recognise constant changes in vertical distribution of authority and combine ideas from economics and political science.** Current thinking on federalism and decentralisation recognises that most countries are constantly under pressure for upward and downward power shifts (including risks of disintegration and delegation of power to supra-national bodies).<sup>14</sup> This calls for extending pure economic reasoning for most efficient decentralisation arrangements to embrace political and institutional analysis of centrifugal and centripetal pressures in the system. It also requires looking specifically at political and social sustainability of any intergovernmental distribution of economic and fiscal responsibilities in a multi-tier system.
- **The new paradigm of complexity economics suggests that it is impossible to design an equilibrium model for intergovernmental relations and that any multi-tier open system will always continue to evolve.** The new complexity economics utilises analogies with thermodynamics. It could be demonstrated that traditional economics is based on the first law of thermodynamics, which assumes that systems are closed and can settle around equilibrium. As the first law of thermodynamics, this approach is incomplete: the second law of thermodynamics shows that any closed system will always tend to increase its entropy (the degree of randomness and chaos) and an equilibrium is therefore not possible. By viewing economic systems as complex, open and adaptive, complexity economics accepts that they may not necessarily settle at an equilibrium and does not attempt to devise optimal models for any given economic situation. Instead, it tries to understand and guide evolutionary processes, influence their sustainability and direction.
- **Major donor organisations are increasingly appreciative of specific support to policy dialogue to implement reforms (as a tool distinct from support to design of the content of reforms).** Country strategies and concrete projects of most donors increasingly complement “technological” support to Ukraine’s government with activities related to long-term knowledge transfer for policy implementation. This corresponds with the general trend in improving aid effectiveness through support to country systems and ownership, and building more effective partnerships for development.<sup>15</sup> In the decentralisation area, such plans of key international players are listed below.
  - **The World Bank (WB)’s** country strategy for 2008-2011 identifies weak public financial management and administration among the key development challenges for Ukraine. This new strategy acknowledges that for some of the key reform areas Ukraine has not yet arrived at a national consensus on desired priorities and directions for change. Therefore, the WB will shift its support towards non-lending instruments and extend activities to promote strategic change and share knowledge – in particular, in the area of more effective public finance and administration (which will be one of the two major vectors of WB’s activities). The major principle in this work will be to concentrate financial support on those areas where there is a clear interest and implementation potential within the government; while on other, less distinct goals activities would be focused on advice and knowledge sharing.

One of the key inputs of WB into current decentralisation debate was its recent Public Finance Review (PFR), which created a strong evidence-based platform for considering

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<sup>14</sup> Based on overview by Jonathan Rodden, MIT

<sup>15</sup> Accra Agenda for Action, 2008

policy options in fiscal equalisation and sub-national spending on health, education and capital investment. Although this report took into account political economy factors behind current decentralisation initiatives, it did not describe them in detail and concentrated on technical analysis and recommendations.

- **Council of Europe (CoE)** has been a keen observer of Ukraine's decentralisation processes. The recently approved Action Plan for Ukraine 2008-2011 includes benchmarks related to stronger local democracy and good governance at local and regional levels. The Action Plan assumes that this will be supported through four major projects, which cover a comprehensive range of issues for sustainable decentralisation:
  - Project 1. Local and regional democracy (€ 23 000 secured, on-going);
  - Project 2. Developing local government legislation and balanced distribution of powers (proposed for 36 months, € 1 170 000 (not secured) (MoRDC, Parliamentary committees; FoLSGU, associations of local authorities);
  - Project 3. Strengthening the capacity of local authorities (proposed for 36 months, € 630 000 (not secured); (MoRDC, FoLSGU, associations of local authorities);
  - "Project 4. "Sustainable spatial development and regional planning" (proposed for 2009-2010, € 100 000 (Ukrainian contribution: € 50 000) (MoRDC).

This plan is assessed by other stakeholders as one of the most promising initiatives, given its political appeal, comprehensive thematic coverage, the emphasis on balanced distribution of powers and local capacity. However, there are also concerns about the need to ensure institutional sustainability of this support. This includes a concern about methods by which future projects will operate, and whether there will be sufficient ownership of inputs provided by international experts by the country as a whole and other parts of the government outside MoRDC.

- **European Union (EU)**. The major methodological direction of the current EU initiatives is the gradual transfer of its programme into direct budget support to Ukrainian government, according to the ENPI priorities. The EU supports two major current projects: an on-going project "Support to Local Development" and a currently launched project "Sustainable Regional Development". While the former project looks primarily into housing and communal infrastructure (through for pilot cities and in partnership with MoE), the new project will work more broadly on regional development and on creation of the National Regional Development Fund which could become the future instrument for EU direct budget support.
- **The Swiss Cooperation Office (SCO)** runs a nine-year project (2007-2015) "Support to Decentralisation in Ukraine". Considerable part of planned work under this project will focus on capacity building for policy implementation and knowledge management. After the first activities at the build-up phase (which included funding for drafting the recent MoRDC reform package by an expert group during away-days in Pushcha Ozerna), the SCO noted the need for wider coordination with other experts and stakeholders working in this field, and a stronger emphasis on fiscal decentralisation issues (which are overlooked by most donors). To achieve this, the project will work on the following:
  - Extend the current working group under MoRDC to form a wider Decentralisation Coordination Network (DCN), which will meet regularly (e.g., monthly), include non-state experts as well as ministerial representatives, and look into concrete technical issues which will come up in the process of implementing reforms. One of the hopes for this work is to stimulate stronger debate with MoRDC around current reform issues (as discussed earlier, at the moment critical comments to this reforms are rather blurred; there is no distinctive counter-argument, especially in terms of fiscal decentralisation)
  - Continue support to NAPA for development of specialised courses for senior public servants;

- Launch a large separate initiative for better knowledge management for decentralisation. This work will help to consolidate a comprehensive database of information in this area which currently exists in Ukraine, and assist central ministries in developing skills for better information management.
- **Swedish International Development Cooperation Agency (SIDA)** is at the start of extending support to decentralisation and regional development, and is currently at the stage of diagnostics and planning (including inputs by international experts commissioned for this task). One of the concerns for SIDA is ensuring that decentralisation activities that it would support bring results which are institutionally sustainable. This is why SIDA is looking into perspectives for implementation of the recently approved CoE Action Plan for Ukraine as a promising political driver of institutional consolidation for reforms.
  - **Canadian International Development Agency (CIDA)** aims to provide flexible and diversified support to enhance good governance at all levels of public administration. Most of its efforts are anchored to sub-national projects, such as municipal service delivery in five pilot oblasts and joint regional development initiatives with UNDP. However, the agency also makes inputs and remains open to deeper cooperation with the central ministries. Its current work on improved economic forecasting with MoF, MoE and SSC, as well as on civil service reform with the MCSD, are examples of cross-cutting support to more effective policy-making in multi-tier government systems.
  - **Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ)** has provided active support in the area of fiscal, administrative and territorial amalgamation at communal level since 2006. It worked with the CoM secretariat, MoRDC, the AUC, and selected thinktanks (ICPS and CPLR) to fine-tune their reform initiatives, develop alternative models for administrative-territorial reform, issue related publications and articles. One of the lessons suggested by GTZ experience in the area is that reform designers strongly rely on the changes for political will to receive a green light for their initiatives. They also observe that perhaps the only current strategy within the ministries to increase sustainability of reforms is a “*public presentation*” of the recent reform concepts – which underlines the weakness of the government’s communications and influencing skills, and lack of donor support to cover this gap.
  - **UK Department for International Development (DFID) has closed its bilateral programme** in Ukraine, but much of its graduation lessons remain relevant and have been frequently quoted at interviews for this research. One of the major conclusions of DFID support in decentralisation was the need to work through partnerships, including expert networks and informal working groups. Interviewees of this research quoted DFID SUFTAR project (Sustainable Finance for Territorial-Administrative Reform, 2005) as one of the most successful initiatives in this area, since it managed to combine fiscal and administrative aspects of decentralisation, took the courage to look into weaknesses of proposed reforms (and therefore helped to strengthen the debate), and worked through a multiple partnership which included several ministries, the CoM, and regional authorities.

### 3. SUMMARY OF MAJOR CHALLENGES

As described in previous sections, despite much work and active legislative developments, Ukraine’s public administration suffers from excessive centralisation, and attempts to decentralise it have systemically failed. Historical record also shows that all previous reforms and policies in this area have faced a set of similar, often identical, obstacles to change. This suggests that it would be difficult to expect progress in the future without addressing these route causes of failures in the policy process. This section suggests a summary of these primary challenges, building on historical analysis by individual policies.

In line with insights from most interviews, most of key challenges relate to weaknesses that should be addressed, first of all, through central policies. Quoting Anatoliy Chemerys, vice-

president of NAPA, “in order to properly decentralise, Ukraine needs to first properly centralise”, so that the power delegated to local authorities is a meaningful and effective instrument. The challenges implied by today’s context converge to the overall need for Ukraine to build a “national compact”<sup>16</sup>, between the government and the society, around the benefits of central state functions. Without such compact (achieved through strategic evidence-based communications, consultations and planning), it would be difficult to achieve an agreement on delegation of public function to sub-national governments, and avoid political abuse of decentralisation slogans. Because of its centrality and importance to state unity and effectiveness, this one issue could be labelled the one millennium challenge for Ukraine, with footprint implications for the neighbouring countries.

There is also an overwhelming agreement among all interviewees that at this stage, the needs of decentralisation reform in Ukraine are less “technological”, and more “political”. While most stakeholders have access to information on theoretical principles of decentralisation and its best international practice, their capacity to cooperate for implementation of these principles is lagging behind.

### ***Lack of strategic, two-way communications***

- **Practically all interviewees in these consultations believed that poor communication of previous (and current reforms) is a major risk (failure) factor.** Most stakeholders are convinced that something is very wrong with policy communication.
- **Most stakeholders see policy communications as awareness raising and advertising, rather than influencing.** Stakeholders widely agree that success of implementing reforms strongly depends on perceptions of desired changes among participants. However, a popular conclusion from this is that designers of reform initiatives should aim to influence perceptions by promoting their ideas, explaining them to others and «educating» others to accept the change. These approaches lack contemporary features of public communications, which focus on feedback analysis and understanding the audiences.
- **Communications expertise is not a recognised competence within the government, and respective skills are weak.** There is no equivalent within the current structure of the civil service to communication specialists.

### ***Lack of policy dialogue***

- **Despite the recent fashion for policy dialogue within the government and donor community, this concept is often confused with PR.** Legal passage of all reform initiatives assumes that every document designed within the government travels through multiple agreements and approvals: first, within the government and, if it requires parliamentary consideration, through negotiations in Verkhovna Rada. With increasing frequency, legislative initiatives are revealed for comments to non-state stakeholders (including through publications on official web-sites, organisation of conferences and workshops, etc). However, such activities are usually designed as promotion of existing ideas, and not as an attempt to resolve conflicting interests and agree on shared ideas. Respectively, consultations might trim the content of reform proposals but they almost never effect is in substance.
- **Formal government working groups rarely assume substantial negotiations among parts of the government or with non-state stakeholders.** Both government officials *and*

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<sup>16</sup> In this paper, we define compact as a term originating from a diplomatic concept of a *pact*, or a multi-party agreement, and widely used to describe an agreement between a government and civil sector, aimed at improving their relations for mutual benefit.

representatives of donor community note that formal inter-ministerial working groups, composed of highest rank representatives, almost never actually function. Typically such groups are either a formality or a top-level formal cover to activities of an auxiliary expert group working to draft certain legislative changes. Usually, despite the inter-ministerial umbrella of the assignment, such expert groups build upon expertise of a single ministry, sometimes relying on a circle of non-state experts with a proven record of cooperation. E.g., during consultations under this project, all interviewees explained that the working group in charge of developing the recent legislative package for administrative, territorial and local government reform, consisted of a top rank inter-ministerial platform, with most actual work conducted by a group of experts and MoRDC specialists with support of SBC.

- **It proved difficult for Ukraine to develop green and white papers on key policies.** In 2006, a partnership of the MoF, National Security Council and ICPS (a thinktank), with financial support from CIDA and CBIE, undertook a specific project to design and implement a government communication strategy for fiscal decentralisation, including development of green and white books. These documents have been duly produced and presented at regional and central level workshops, as well as on the ICPS website. However, interviews suggest that none of the papers led to substantial shifts in positions and attitudes, as would be expected with policy papers. Two years on, there has also been no practical follow up with actual implementation of these ideas. This episode is illustrative of how it is difficult for stakeholders in Ukraine to design policy consultations and commit to their results.

***Lack of comprehensive policy process (with strong diversified viewpoints, a full spectrum of policy roles such as gatekeepers, facilitators, associations etc)***

- **Stakeholders note that the decentralisation debate became weak and unbalanced.** Although the amount of organisations and donor activities related to local self-government and decentralisation increased rapidly in recent years, there is very little diversity in opinions on most issues, and existing opinions are rarely evidence-based. Furthermore, although many observers and media voice general dissatisfaction with such proposals as recent initiative for administrative and territorial reform, there is no palpable and expressive source of intellectual opposition to proposed changes.
- **Theoretically, all roles in the policy process are filled up by appropriate organisations, but policy process would benefit if these functions are strengthened further.** This study lists two examples of policy agents although the list is certainly not exhaustive.
  - **Cabinet of Ministers secretariat.** CoM acts, predominantly, as a gatekeeper for initiatives designed by various ministries. At the moment, it represents one of the few sources of alternative opinions on the MoRDC reforms (even though the new Concept for Regional Policy was formally agreed within the government).
  - **Local government associations.** Associations, and in particular Association of Ukrainian Cities, played a critical role in lobbying for fiscal reforms in 2001. Since that time, number and scope of associations increased, and they continue to remain keen participants of the reform dialogue. The recent research paper “A Concept for Local Budget Reform” designed by AUC contains a comprehensive analysis of the current situation, with recommendations that correspond to best contemporary principles of intergovernmental finance. At the same time, some stakeholders expressed concerns that local demand for dialogue and reform is weakening. Outputs of major associations become increasingly academic (mainly research and books). Some interviewees reckon that lobbying efforts by key associations for practical policy change have decreased.

### ***Lack of a comprehensive vision for decentralisation***

- **Committed and shared decision on division of decentralisation responsibilities between tiers of government is central to further reforms.** History of changes in all policy areas described in previous section shows that all of these processes were obstructed by lack of political decision on the desired degree of decentralisation, including place, size and role of local self-government and regional layers. Intergovernmental fiscal reform is being reversed because of ambiguities in delegation of spending programmes to sub-national budgets. Sector reforms have reached an impasse because of the difficulties in releasing the rigid vertical chain of command and in installing accountable and fiscally sustainable relations between authorities of different levels. Regional policy is restricted in choice of instruments because most of them (such as, e.g., regional agreements) require a new institutional framework for relations with the local and regional governments. Administrative and territorial reforms face wide anxiety because of differences in views on the role of local-self government, amalgamation process and fiscal sustainability of changes. New tax initiatives, often isolated from decisions on desired degree of local revenue autonomy, risk to create macroeconomic inefficiencies and distortions.

### ***Distorted and conflicting views on political regionalisation***

- **The challenge of making a political choice on intergovernmental division of responsibilities is tainted by conflicting views on the role of the regional tier.** Economic argument behind debates of decentralisation is increasingly dominated by concerns over the role of oblasts in the overall balance of political and fiscal power. Origins of these concerns differ, and are not always explicit. One factor is the post-soviet tradition of “matryoshka”-type (quasi-feudal) public administration, with the risk that the central government would not be able (or willing) to preserve interests of local-self government and hold regional authorities to account in how they exercise the delegated functions. Another factor is anxiety of growing political regionalisation and the risks to state unity. Finally, it is impossible to exclude other additional considerations behind contra-regionalistic views.
- **Risk aversion towards regionalisation based on current regional divisions is disproportionate to existing evidence.** As explained in section 2.2, although risks of disintegration are legitimate and growing, these risks originate from central level policies rather than local demand for autonomy. These central policies utilise existing regional differences, which are scarce, to strengthen political appeal in national electoral campaigns. Moreover, these limited differences are differences in ethnic self-identification, rather than in social or cultural attitudes. However, these differences in self-identification *could* transcend into divergence in attitudes to major national priorities such as foreign policy and international trade, if political campaigns capitalise on such links.

### ***Lack of evidence behind policy process***

- As already mentioned repeatedly, most decentralisation initiatives so far were designed based on rather conceptual arguments. Since these proposals did not refer to statistical and sociological evidence as argument for change, it made it difficult to explain and promote them to other stakeholders and general public.



## ***Weak systems for civil service professional development***

- Despite significant increase in the availability of training programmes and general information on decentralisation, regional policy and intergovernmental fiscal relations, there is no systemic provision of basic knowledge in this area to a wide circle of civil servants, as a matter of professional induction.
- The National Academy of Public Administration (NAPA) is the official provider of continued professional development services to central and local governments. Despite significant support from various donors (especially, CIDA), the scope and depth of training in NAPA in the areas of decentralisation remains incipient. Starting from this year, NAPA plans to expand it in three major ways.
  - First, it works to strengthen two new specialised master programmes: *Local Self-Government* and *Regional Administration*, and an earlier launched MPA programme in *Public Administration*, which focuses to a large extent on decentralisation issues. All these programmes need to be extended by specific short courses (up to 16 hours) related to decentralisation, local administration, development and finance.
  - Second, short courses in decentralisation and local finance, developed for the master programmes, would be included into curricula of formal professional development training for civil servants (“qualification upgrade courses”).
  - Third, NAPA is working on developing a general civil service induction course, to address the overall considerable gap in general knowledge among civil servants, especially given their rapid turnover. According to estimates shared during the interview, 36% of Ukraine’s civil servants do not have higher education, and much more have graduated in fields not related to public administration or finance. The new induction course will include topics on decentralisation and local self-government. Another induction course, for senior civil servants, is currently under development with support from SCO.

## **4. RECOMMENDED OBJECTIVES AND PRINCIPLES**

To address the challenges described above, future activities can build on the following key objectives:

- Assist Ukrainian government and non-state stakeholders to gain in-depth understanding of root causes of current challenges in decentralisation.
- Facilitate policy dialogue and stronger balance in the debates around priority issues;
- Transfer knowledge and skills to upgrade approaches in policy development and implementation.

At the same time, based on lessons from experience of previous projects and the nature of the current priorities, it seems practical to consider the following operational principles for the future work:

- Avoid focusing activities on a single stakeholder and aim to work with collaborative structures;
- Avoid providing technological support and blueprints on issues where institutions are not yet created;
- Avoid providing support to initiatives which do not account for the full range of decentralisation issues: fiscal, administrative, and political implications.

## 5. EVALUATION OF OPTIONS FOR ENGAGEMENT

This section lists options for assistance, along with brief comments. These options are not mutually exclusive and could be usefully combined.

### 5.1. Possible methods and partnerships for assistance

#### ***Assistance to MoRDC in public communication (training; advice; analysis)***

- The MoRDC considers it central for the success of reforms to focus a considerable effort on public communications. During the meeting, the ministry suggested that this is an area where they would benefit from support and advice.
- Our analysis supports the view that government communications should urgently improve to become more strategic and feedback oriented.
- An option for engagement would be a specific help to MoRDC, consisting of professional training in strategic communications, with a pilot case built on current reforms in administrative and territorial structure. This training, coupled with support to development of concrete outputs, should be targeted at transforming the view on communications as advertising reforms or pure education towards absorbing marketing techniques, utilising sociological surveys to understand expectations of stakeholders, shaping convincing messages etc.

#### ***Analytical and training support to Decentralisation Coordination Network (DCN)***

- As discussed in the report, one of the current weaknesses in implementation of decentralisation policies is lack of productive dialogue between stakeholders. Current initiatives are criticised for weak ownership by other reform agents, even where their opinions have been formally incorporated. These initiatives would also benefit from relying on stronger statistics and sociological data, which would make them less abstract and easier acceptable to others.
- SCO proposes a tentative plan to extend activities of the current Working Group for Administrative-Territorial Reform under MoRDC in order to organise a wider and more sustainable Decentralisation Coordination Network, which would support the ministry in its reform initiatives on a constant basis. This Network will meet regularly to raise on-going issues on the reform agenda, requiring ad-hoc training, technical analysis and organisation of wider debates and information exchange.
- An option for engagement is support of a number of technical discussions within the DCN, by provision of related training and expert analysis. A list of possible topics for such support is provided in Section 5.2.

#### ***Commissioning of wide independent study on decentralisation challenges Ukraine***

- Government representatives suggested that one aspect of current complexity related to decentralisation reforms is that stakeholders and donors tend to treat the various issues separately, without a comprehensive analysis of how they relate to a bigger picture. One reason for such approach is that the bigger picture would not be complete without looking into political economy issues, and without accepting some of the lessons about previous reforms which were not as successful as initially planned.
- However, such a study would become an important first step in the right direction. The study should be evidence based, using concrete statistics, content analysis of documents, surveys and qualitative data.

### ***Assistance in development of training programmes on decentralisation with NAPA***

- As discussed in the text, NAPA is in the process of developing a set of basic induction courses in decentralisation, local self-government, and intergovernmental finance for Ukraine's civil servants. This is an area where LGI/OSI has a considerable comparative advantage and much to share for strengthening the content and approaches of this training.

### ***Analytical and training support by individual technical themes for the CM secretariat***

- Because of its gatekeeper function in the policy process, CM secretariat is a critical agent for strengthening policy dialogue and making it more balanced and objective.

## **5.2. Thematic topics for analytical support and training (applicable for all partnerships)**

- Service unit costs, standards of service provision, methods of service quality control in decentralised service provision;
- Risks of territorial amalgamation and their management (such as approaches to protection of rights and communicating reform initiatives to amalgamating communities), including fiscal risks;
- Sustainable options for size, place and responsibilities of local-self government in Ukraine;
- In-depth analysis of options, risks and international experience in the area of regional self-government;
- Regional self-government versus regionalised “matryoshka” type public administration (specific analysis of the international experience and post-planned economy context);
- Political regionalisation: concepts, facts, current issues, options for reforms;
- Revenue sharing in the context of decentralisation reforms and macroeconomic constraints (brush-up of key principles, best practices and linkages between policy variables);

## Annex 1. Interviews conducted in the course of this research

Anatoliy Maksyuta	Ministry of Economy	First Deputy Minister
Oleksandr Babych	Cabinet of Ministers Secretariat Regional Policy Department Unit for Territorial Organisation and Local Self-Government	Deputy Head
Nina Bidna	Ministry of Regional Development & Construction Territorial Reform Unit	Head
Anatoliy Chemerys	National Academy of Public Administration	Vice-President
Volodymyr Vakulenko	National Academy of Public Administration	Head of the Regional Administration, Local Self-Government and Urban Management Department
Myroslav Pitsyk	Association of Ukrainian Cities	Vice-President
Katya Petrina	World Bank	Senior Social Protection Specialist
Yulya Smolyar	World Bank	Social Protection Specialist
Olena Lytvynenko	Swiss Cooperation Office	Programme Coordinator
Olga Tymoshenko	Swedish International Development Cooperation Agency	Project Coordinator
Taras Zhuravel'	GTZ	Project Manager
Tetyana Korneeva	EU Sustainable Local Development project	
Olga Mrinska	Institute for Public Policy Research North	Research Director
Dmytro Lutsenko	Centre for Institutional Development (Центр Інституційного Розвитку)	Executive Head
Andriy Lobach	The Foundation for Effective Governance (FEG)	
Ihor Kogut	Agency for Legislative Initiatives	Director
Doris L. Wong	CIDA	Counsellor, Head of Technical Cooperation Section