The Impact of the Economic Downturn on Local Government: What Can We do About It?

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What is this material and how it will be used?

It is assumed that economic down turn will have an adverse but varying impact on major sources of current revenue which local governments either levy or share. It may also increase expenditure on social welfare benefits, insofar as these fall on local budgets, and also on the costs of servicing any debt denominated in foreign currency. Normal capital budget revenues will also be reduced, although "fiscal stimulus" packages may offer opportunities to finance local infrastructural projects which can be activated quickly. State budgets will also be under equal if not greater stress and will be hard put to sustain existing levels of intergovernmental transfer, let alone increase aid to local budgets.

Clearly the full impact of the current crisis will take some time to materialise. Full statistical evidence will await the comprehensive financial reports produced by individual authorities and aggregated by national governments or associations. However, existing data might already produce far earlier evidence of the prevailing trends and should encourage rapid discussion of the steps which might be taken to mitigate any major long term deterioration in the ability of local government to sustain essential public services.

In consultation with Council of Europe, LGI has commissioned an international collaborative effort for analysis of:

- the actual impacts of the economic downturn on local budgets in the latter part of 2008 and the first half of 2009 derived from financial reports, nationwide or from sample LGUs, as they become available;
- the feasibility of the policy options for addressing the crisis including
  - improvements in efficiency
  - rationalisation of social expenditures to concentrate on support to low income households
  - cuts in the cost of territorial fragmentation through municipal consolidation or greater inter-municipal co-operation
  - relaxation of unsustainable service standards and expenditure norms
- the opportunities for access to "fiscal stimulus "investment funding, including prospective changes to structural fund flows.

The overall comparative analysis will be undertaken by a small editorial group of international specialists previously associated with LGI and Council of Europe programmes. It is hoped to produce a preliminary analysis of trends and policy options for discussion by international experts and the Council of Europe in September 2009, and in the light of their comment to submit it as a working document for the Council of Europe Conference of Ministers responsible for Local and regional Government, which is meeting in Utrecht in November 2009.

This material represents an input produced by FISCO Inform as a national observer for Ukraine in this research, based on a standardised international questionnaire.

Content

Acronyms and Abbreviations

ARC	Autonomous Republic of Crimea
BC	Budget Code
BYuT	Block of Yulia Timoshenko
CabMin	Cabinet of Ministers
CBC	Cross Border Cooperation
CMU	Cabinet of Ministers of Ukraine
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
ENP	European Neighbourhood Policy
EPT	Enterprise Profit Tax
EU	European Union
FDI	Foreign Direct Investment
GNI	Gross National Income
HUS	Housing and Utilities Subsidies
ILO	International Labour Organization
IMF	International Monetary Fund
KIIS	Kiev International Institute of Sociology
LGI	Local Government Initiative
LGU	Local Government of Ukraine
MinFin	Ministry of Finance
PIT	Personal Income Tax
PM	Prime Minister
PPP	Public Private Partnership
SME	Small and Medium Enterprises
UAH	Ukrainian Hryvnya
VAT	Value Added Tax
VR	Verkhovna Rada
WB	World Bank
WTO	World Trade Organisation

1. Revenues and Expenditures Assignment

1.1. Have there been any changes in response to the economic downturn in:

- The assignment of local government revenues and expenditures?
- The authority of LGUs over levy of taxes and charges?

- No actual change as of 30 June 2009. At this point, the government did not introduce any change into pre-crisis assignment of expenditure responsibilities, revenue sources or taxing authorities among levels of government.
- However, a complex, significant and highly retrograde reform is in the making. Although the government positions proposed changes as "anti-crisis" measures, their content actually developed gradually over the recent years[1]. The changes are proposed as significant amendments to the Ukraine's Budget Code combined with complementary amendments to other legislation (such as the Land Code, Law on Land Tax, and Law on Land Rent). Potential reform has several pillars:
    - Reduction of local budget autonomy, expansion of opportunities for manual decision-making and re-introduction of the budget "matryoshka" (in consideration since summer 2008 / first reading). Most of these changes represent legal validation to already existing practices. Major amendments include: an additional, parallel equalisation grant allocated through oblast budgets without clearly specified rules; fixating "protected articles" within the Budget Code; and an explicit requirement to allocate delegated expenditures based on central rules and standards.
    - Strengthening of sub-rayon budget revenues – without expanding their expenditure responsibilities – at the expense of revenue sources previously allocated to regional budgets (rayons and oblasts) (see Chart 1). The new Budget Code would allocate 100% of land tax to own revenues of local self-governments (to both – cities of oblast significance and sub-rayon communities (towns, villages and settlements)). At the moment, local self-governments share land tax proceeds with regional governments (sub-rayon communities keep 60%, transferring 15% to rayon and 25% to oblasts, and cities of oblast significance keep 75%, transferring 25% to oblasts). Moreover, overall size of the land tax proceeds is likely to increase considerably because reform package also includes other legislative changes which – as explained by their authors – would significantly extend the tax base and allow local government more flexibility and autonomy in establishing tax rates (by eliminating current legal collisions between the Land Code, the Law on Land Tax, and the Law on Land Rent)[2]. Apart from land tax, own revenues of local self-governments would include administrative fines and (a still non-existent) property tax. At the same time, proposed new Budget Code leaves expenditure responsibilities of sub-rayon communities at their current marginal level (kindergartens, basic medical care, local libraries and cultural activities) – which corresponds to their administrative capacity according to most studies[3].
    - Proposed change implies that cities of oblast significance and rayons – which have comparable expenditure responsibilities – will experience opposite changes in revenues (increase for cities; decrease for rayons). Currently – *and* according to proposed new Budget Code – the bulk of basic services in key delegated functions is assigned in equal amounts to rayons and cities of oblast significance.
    - More detailed itemisation of expenditure assignments, extending lists of concrete ways in which local governments should provide social services. Allocation of functions in social services as such is not changed. However, description of local expenditures included into calculation of equalisation transfers is extended to include a series of additional specific items such as: centres of social rehabilitation of disabled, centres of professional rehabilitation of disabled, centres of social services for youth.

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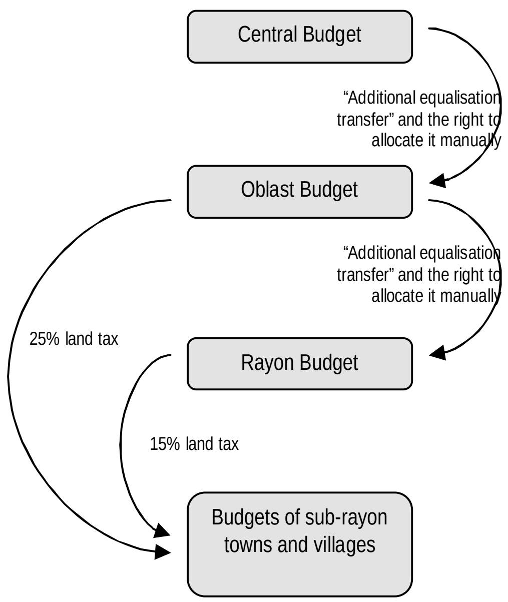
[1] As flagged, e.g., in *Positioning LGI/OSI policy dialogue to support decentralisation in Ukraine*, FISCO Inform, October 2008 (http://www.fisco-inform.com.ua/?module=an&action=preview&id=80)
[2] Based on an interview with MP Andriy Senchenko, Mirror Weekly, 14-20 March 2009, http://www.dt.ua/1000/1550/65669/
[3] *Improving Intergovernmental Fiscal Relations and Public Heath and Education Expenditure Policy: Selected Issues,* 2007, WB; *SUFTAR Project Final Report*, DFID / University of Birmingham, 2006

- Inclusion of programmes in housing & utility ("communal") development into expenditures taken into account in calculation of transfers ("delegated functions"). "Programmes for development of communal sphere" are listed as delegated functions in oblasts, rayon and city budgets. "Local" programmes in this sphere remain outside the formula for calculation of equalisation transfers (which means that increase in these expenditures does not affect the size of equalisation transfers).

Chart 1. Changes in revenue assignments in the Amended Budget Code



- Assumption of local government role by sub-rayon communities with population larger than 401 and direct equalisation of *all* local self-government budgets by the MinFin.

  The reform proposes direct calculation / allocation of equalisation transfers by the MinFin to all villages, settlements and sub-rayon towns with population over 401 *after the next round of local council elections*. Until that time, transfers would be calculated for *all* villages, settlements and sub-rayon towns regardless of their size.

- Re-introduction of sharing arrangement for Enterprise Profit Tax (EPT). 10% of EPT from private enterprises is now included into local budgets; moreover, it is included as revenues of the "development budget" (which is part of the local budgets which could be approved with deficit).

The reform has strong political backing and high likelihood of approval. Throughout the crisis and until the time of this note (June 2009), the reform was promoted by the current government (and personally Prime Minister Tymoshenko). The promise of land tax proceeds and direct transfers to sub-rayon communities was widely publicised and resonated very positively with rural population (at the time of upcoming elections). But although PM Tymoshenko presented the reform as a political challenge, it actually contains elements of policies promoted by all other political forces (including the scenario for territorial re-organisation backed by the President). Opposition (Party of Regions), which criticises the current proposal, subscribed to a back-up version which contains most of the same provisions; it also did not reject the draft at any stage but, in some cases, abstained from voting (at the background of limping negotiations between this party and the PM's BYuT). Amendments were voted by the Verkhovna Rada on 23 June 2009 and are expecting Presidential signature.

- Cosmetic changes are considered for local taxation - but were not yet approved. A several-year old process aimed at streamlining current contradictions in local tax legislation continues at regular speed. A draft law summarising latest proposals was submitted to the parliament. It eliminates local taxes whose administration costs are higher than proceeds[4] and acknowledges (a still non-existent) property tax as a local tax.
- The central government tries to administratively increase the proceeds from local and shared taxes& fees. Several measures and initiatives are directed at various local proceeds:

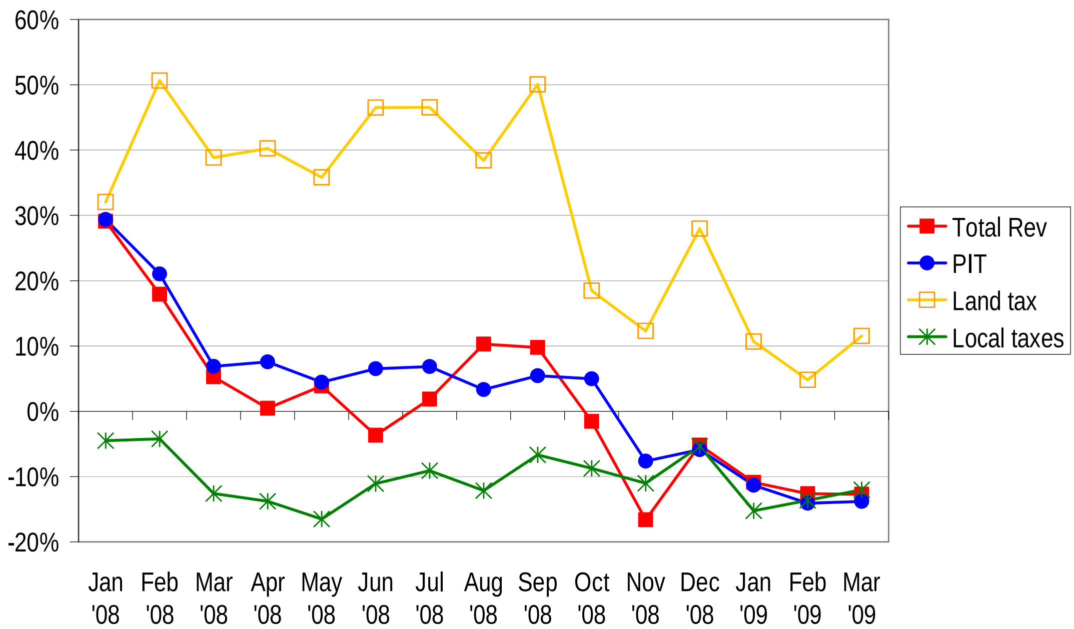
[4] Communal tax, horse racing participation and wins fee, dog fee, fees on using local symbols, fees on film shooting, fees on local auctions and lotteries, and fees for issuing property authorisation documents.

- About 20-fold overall increase in road fines (half of which stays in local budgets, and would be increased to 100% under proposed new Budget Code).
- Proposals for considerable reforms in land tax[5] which is estimated to increase proceeds by 4 billion annually.
- CabMin Resolution[6] which "recommends" local governments to charge maximum rates of single tax on private entrepreneurs who work abroad.

1.2. How far are efforts to concentrate shrinking financial resources on maintaining essential public services undermined by expenditure norms or service standards which are unsustainable in current economic circumstances? Are any measures to relax such requirements in progress?

- Mismatch between administrative and financial responsibilities imposed on sub-national governments has been the core problem of Ukraine's intergovernmental finance long since pre-crisis times. 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. These norms are contained in ministerial guidelines dictating the amounts of staffing and other resources based on existing infrastructure inputs, but also in constitutional prohibition of closing facilities in healthcare and education. These norms are also the key principle behind budgeting at the facility level and negotiating these budgets with local governments. 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 as described earlier. This input based budgeting, which permeates the system, creates strong negative implications for technical and allocative efficiency in key sectors, where the quality of service delivery is deteriorating at dramatic rates.
- Personal income tax – the key shared revenue in local budgets – shrunk rapidly during the post-crisis period, and this loss was not compensated by equalisation transfers. Chart 2 demonstrates that total revenues of local budgets have changed (fallen) synchronically with PIT throughout the crisis, which implies that equalisation transfers were not sufficient to counterweigh the effect of the falling revenues from this tax.

Chart 2. Monthly year-to-year % change in local revenues (in real terms)[7]



[5] Through changes to the Land Code, the Law on Land Tax, and the Law on Land Rent.
[6] CMU Resolution No 236, 05/03/2009
[7] Source: Treasury Budget Execution reports

- The government insists that local governments have sufficient funds to finance all social expenditures in a regular way. It also denies – or downplays – growing wage arrears and unemployment, which stand behind the plummeting PIT. The government's reports and statements on crisis-related labour market statistics describe trends in wage arrears and unemployment which are significantly more optimistic than existing sociological evidence and media reports – implying excessively optimistic prospects for PIT and local revenues.
    - Unemployment. The latest official statistics for unemployment released by the State Statistics Committee (average for 2008) was 6.9% (according to ILO methodology). According to this source, this indicator actually decreased throughout 2008 (from 7,6 in the first quarter). No official data was published for any month of the 2009. At the same time, sociological survey quoted earlier discovered that, in April, 10.6% of the sample reported having lost their job (11% in the February survey). On top of this, 3.4% reported having being sent to unpaid vacations (4.6% in the February survey).
    - Wage arrears. Throughout November 2008 – June 2009, the Government has reported that wage arrears in budget-funded organisations were non-existent[8] or incidental and diminishing[9]; and that wage arrears of other employers (including state funded enterprises) picked in April 2009 at UAH 1,7 billion but decreased afterwards (the latest published statistics is for 1 May 2009). The Government has repeatedly referred to strong administrative measures it plans to use to influence employers to decrease wage arrears (both in state[10] and private[11] ownership) – to surprise and protest of private employers[12].

      The size of overall wage arrears reported by the State Statistics committee differ significantly from evidence imputed from sociological survey. Table 1 demonstrates this comparison based on sociological survey by the Kyiv International Institute of Sociology, which found that in April, 10% of the representative sample reported arrears in wages or pensions[13] (already a drop from 13.5% in February). Based on official number of employed and pensioners, the minimum wage and average pension, arrears for only one month would represent UAH 2,3 billion – which is almost twice higher than the official number.

Table 1. Wage areas in April 2009: official statistics and estimates imputed from sociological surveys[14]

	Official Statistics		Imputed numbers		Official Statistics
				Arrears in wages and pensions	
	No of people (State Statistics Committee, 2008)	Min wage / Average pension as of April 2009	10% of each group (= no of people with arrears according to survey)	Imputed for one month, based on min wage and average pension	Reported by State Statistics Committee, as of 01/05/2009
Employed population (age 15-70)	20 972 300	625	2 097 230	1 310 768 750	
Pensioners	13 800 000	751	1 380 000	1 036 932 000	
Total			3 477 230	**2 347 700 750**	**1 404 600 000**
No of people reporting arrears in wages / pensions in KIIS survey (April 2009)			10%		

8 http://www.fisco-inform.com.ua/?module=news&action=view&id=2701
9 http://www.fisco-inform.com.ua/?module=news&action=view&id=2721
10 http://www.fisco-inform.com.ua/?module=news&action=view&id=2055, http://www.fisco-inform.com.ua/?module=news&action=view&id=2704, http://www.fisco-inform.com.ua/?module=news&action=view&id=2729
11 http://www.fisco-inform.com.ua/?module=news&action=view&id=2746, http://www.fisco-inform.com.ua/?module=news&action=view&id=2798, http://www.fisco-inform.com.ua/?module=news&action=view&id=2875
12 http://www.fisco-inform.com.ua/?module=news&action=view&id=2848
13 Press Releases, KIIS, Crisis Effects on Population of Ukraine, www.kiis.com.ua
14 Source of official data: State Statistics Committee of Ukraine

- The central government (the CabMin *and* the President) regularly appeals to local governments requesting them to honour expenditure responsibilities (and to organisations – requesting them to pay off wage arrears if/where they exist). The rhetoric on the issues related to the current problems in financing local expenditures (mostly, wages) is focused on declarative requests and browbeating of local governments rather than on finding ways to release their (centrally mandated) expenditure obligations. Examples include a statement of the Deputy Minister of Finance Mr. Matvijchuk in January 2009 about absence of reasons to have any arrears in regular financing of social expenditures[15]; a request of the President in June 2009 to the oblast governors to immediately pay off all recently accumulated wage arrears given that "the 2009 State Budget Law has not approved a single kopec of social arrears"[16].
- Disguised policies to address wage arrears in private sector: selective repayment of VAT refund arrears to defaulting enterprises. Since April 2009, the Government is working to develop a mutual settlement with private enterprises who have wage arrears to their employees: the Government would select these enterprises as primary candidates for receiving repayment of existing VAT refund arrears from the budget – but this repayment would be allocated immediately into accounts payable as wages to the employees, open in a state-owned bank[17]. Although this scheme would allow to repay some of the wage arrears to the population, and to generate a respective flow of PIT into local budgets, it promotes a highly opaque approach to VAT administration (which in itself is one of the core fiscal problems for Ukraine) and is also highly distortive since it establishes state support to least competitive enterprises.
- Disguised policies to address wage arrears in public sector: possibility of plans for mandatory sales of T-bills to public employees, with unclear implications for PIT. In April 2009, the Ministry of Finance announced plans to begin issuing T-bills (internal government bonds) for sales to general public. Annual rate of return for these bonds is set at 8%, which is considerably lower than even expected inflation rate. This leads observers to expect that the new T-bills would be placed through mandatory sales to public employees, as was practiced in the Soviet times[18]. At the background of growing arrears in the public sector, this tool could help to account wage arrears as internal public debt (rather than arrears). If this scheme takes place, its accounting will also matter for PIT liabilities (if T-bills purchases against wage arrears would be accounted as "voluntary" at the cost of received wages, that would imply regular tax liabilities on the PIT).

▪ The Government has reduced allowed maximum of staff in sub-rayon administrations; but increased their minimum salaries by 50%. In May 2009, the Government changed procedures for staffing sub-rayon administrations[19]. The maximum allowed size of staff was reduced from 20-27 to 15-18; the allowed limits (which were previously specified regardless of the community size) are now broken down into 7 categories and depend on the size of population. At the same time, the Government increased their salaries by 50% with simultaneous elimination of an extra allowance previously paid from rayon budgets[20]. This should make sub-rayon administration salaries less dependent on rayon-level decisions. The change is presented as the first step in gradual reformation of public administration salaries of local self-government[21].

▪ In other delegated functions, there is no action or intention to release expenditure norms or service standards.

▪ On the contrary: the government is increasing the centrally established thresholds of the subsistence minimum and minimum wage[22], which affect public wages within delegated functions. Without releasing the limits for firing staff in healthcare and education, that is a mandatory burden on local budgets. The 2009 State Budget Law left the subsistence minimum unchanged (UAH 626); but

[15] http://www.fisco-inform.com.ua/?module=news&action=view&id=2042
[16] http://www.fisco-inform.com.ua/?module=news&action=view&id=3188
[17] CMU Resolution No 312, 02/04/2009, *"On the issue of repaying in 2009 wage arrears and payroll payments which have accumulated as of 1 April 2009, at the cost of amounts of VAT refund from the budget".*
[18] http://www.fisco-inform.com.ua/?module=news&action=view&id=2839
[19] CMU Resolution No 494 of 23/05/2009 (becomes effective from 01/01/2010); *"On changes into Annex 5 of the CMU Resolution No 1349 of 03/12/1997".*
[20] CMU Resolution No 504 of 27/05/2009; *"On changes into CMU Resolution No 268 of 09/03/2006".*
[21] E.g., http://www.fisco-inform.com.ua/?module=news&action=view&id=3077
[22] Both thresholds are established by the annual State Budget Law.

established a schedule for gradual increase of the minimum wage over 2009 (see Table 2). Most recent increase became effective in April 2009. The opposition requests to increase both thresholds even further (by one estimate, to UAH 865)[23]. President has been critical of the increase and vetoed an attempt to start establishing the subsistence level through a separate law (which would make it easier to change) and a law which requires the minimum wage to be no lower than the subsistence level (which, however, is now effectively the case). The President explained his veto with an assessment that an increase would imply additional expenditures on wages at the level of UAH 50 billion[24].

- Overall tone of central rhetoric about local responsibilities over central functions remains highly irresponsible. Individual line ministries increasingly appeal to the need for pressuring local governments for participating in central programmes - on unclear terms. An example is a request from the Minister of Family, Youth and Sports Mr. Pavlenko to the President, asking him to request local governments to assist in providing housing for participants of Olimpic games and other important sportsmen.

Table 2. Changes in minimum wage in 2006-2009

	Nominal minimum wage (UAH)				% Increase over previous period			
	2006	2007	2008	2009	2006	2007	2008	2009
Quarter I	350	400	515	605	5%	0%	12%	0%
Quarter II	350	420	525	625	0%	5%	2%	3%
Quarter III	375	440	525	630	7%	5%	0%	1%
Oct-Nov	375	460	545	650	0%	5%	4%	3%
Dec	400	460	605	669	7%	0%	11%	3%
Increase throughout the year					14%	15%	17%	11%

Source: annual State Budget Laws of Ukraine

- Growing political standoff between key governmental structures creates contradictory legal decisions and increases overall weakness of the legislative mandates as such. One recent example is the Presidential ban on the possibility for the Prime Minister and the CabMin to give mandatory instructions to central or local authorities. The Prime Minister did not find the ban as having any implications on her routine approach[25].

1.3. What measures have been implemented or considered to improve the efficiency of local government expenditure by use of performance audit, benchmarking or other processes with similar aims?

- No actual change as of 30 June 2009.
- Most local governments have approved "anti-crisis action plans", in response to an instruction from the Prime Minister, but most of them are not aimed at making spending more efficient. Spending efficiency measures in most of these plans do not rely on analysis of service value and costs. Proposed measures are limited to closing as much public institutions and jobs as allowed by central regulations, cutting all possible administrative and entertainment expenditures, and shifting public services away from financing from the given local budgets (through transferring it to another budget, user-chargers or complete "self-financing")[26].
- The government announced some ad-hoc measures which may improve local budgeting processes in future:
  - Proposal to introduce a compulsory requirement for receiving capital subventions for local governments to have an approved "general layout" (a legally binding decision of the local council on future construction and development projects). According to Ministry of Regional Development and Construction, a strategy of local or regional development is not a sufficiently authoritative document to expect that all its aspects would be implemented, if it is not reflected in the

[23] http://www.fisco-inform.com.ua/?module=news&action=view&id=2697
[24] http://www.fisco-inform.com.ua/?module=news&action=view&id=1982на
[25] http://www.fisco-inform.com.ua/?module=news&action=view&id=3008
[26] E.g., see "Anti-crisis action plan for minimising the influence of financial and economic crisis on the economy of the Luhansk Oblast", approved by the Luhansk Oblast Council on 27/11/2008, No 25/12

general layout. Attracting legal arguments to illustrate the power and policy coherence of the local strategies (or lack thereof) is a debatable avenue (if there is no agreement between local players on the strategy, surely it will be violated – with or without a general layout). However, it is one way to voice the expectation that capital subventions should provided in response to serious strategic plans.

- The Prime Minister promised to request a moratorium on inspections of rural communities from the Prosecutor General. This possibility is presented as a significant administrative relief to rural authorities[27], and is received with much enthusiasm. The likeliest subject of inspections in the case of rural administrations is related to their authority over local land and property rights management.
- Proposed changes to Budget Code contain multiple provisions aimed at strengthening performance-budgeting at both central and local level, however many of these represent legal description of existing practices rather than a principally new approach. Proposed changes include requirements to make three-year spending forecast at all levels (including organisations), more detailed explanation of the budget programmes as a budgeting tool, a requirement to assess spending efficiency based on efficiency indicators.

▪ Most actual measures related to local and intergovernmental budgeting (and presented as attempts to assist local governments in providing public services) are not aimed at improving local expenditure (or overall budgeting) efficiency. Rather, they create loopholes for exerting additional out-of-pocket payments & user-charges, pressure tax authorities to increase collections through administrative measures and manipulate with political assets in the run-up to elections. Such measures include:

- Extending opportunities for charging citizens for services in education, healthcare and social services to vulnerable population groups. Most local governments made attempts to increase user-charges for services in delegated functions. Some local councils approved explicit instructions to all spending units to consider possible ways of charging customers for their survices[28].

  In April, Ministry of Healthcare issued a Resolution[29] formalising some of the existing user-charge for a wide range of services (starting from improved quality of hospital rooms and including utilisation of medical equipment in non-working hours and renting medical premises to other qualified organisations).

  The most notable case of such policies occurred in Kiev, which announced a draft Resolution[30] (in January 2009) establishing a plan to charge patients for all medical services provided by communal healthcare institutions. The details and probability of actual implementation of this Resolution remains unclear.

  Also in April, CabMin allowed higher education facilities to charge students for re-sitting failed exams, although it had to cancel this decision a month later after massive student protests.[31]

- Rapid unaccountable increases in user-charges for housing & utilities services (without changing the efficiency, transparency and accountability of the system of housing & utilities service provision, which implies that much of the new proceeds would be wasted) and introduction of loopholes for windfall rent-seeking in housing & utilites sector. Many local council and service providers approved rapid increases in tariffs for housing and utilities services (e.g. the latest increase in Kyiv – in June 2009 – was 50-85%[32]). Moreover, many providers approved new regulations which are dangerously close to explicit hijacking (e.g. a new requirement to approve installation of air conditioners by multiple authorities including local councils; with an urgent request to all current owners to provide appropriate documentation).

  Weak regulation of local monopolistic providers of housing and utilities services has been increasingly problematic in recent years. Local monopolistic providers and intermediaries (such as communal energy companies and local utility administrators) have maintained much higher arrears to generating

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[27] http://www.fisco-inform.com.ua/?module=news&action=view&id=3061
[28] E.g., see *"Anti-crisis action plan for minimising the influence of financial and economic crisis on the economy of the Luhansk Oblast"*, approved by the Luhansk Oblast Council on 27/11/2008, No 25/12.
[29] CMU Order (Розпорядження) No 420-р, 14/04/2009 *"On some measures for improving medical services to citizens"*.
[30] See Draft Order (Розпорядження) of the Kyiv State Administration *"On establishing tariffs for paid services provided by treatment and prevention healthcare facilities of state and communal ownership"* and its media coverage in, e.g., http://www.fisco-inform.com.ua/?module=news&action=view&id=2182, http://www.dt.ua/3000/3450/65118/
[31] http://www.fisco-inform.com.ua/?module=news&action=view&id=2974
[32] http://gazeta.ua/index.php?id=290131

companies compared to arrears they themselves have accumulated from the consumers. E.g., while (by most recent data) consumers have paid 85% of their bill for gas to local companies, the latter have paid only 30% of their bill to the national "Naftogas" [33]. This was combined with constant increases in tariffs approved by local councils, leading to allegations in collusions (through alleged kickbacks to local councils from accounts in locally controlled banks). In the face of crisis, the scale of this problem became even more palpable both socially and fiscally.

In mid-June 2009, Prime Minister Tymoshenko has proposed a massive administrative attack on potentially fraudulent providers and intermediaries. Her proposals include transferring all local payments for gas provision to special accounts in a state-owned bank (Oshchadbank), stronger control of the operations of local providers by the state tax administration, etc.

PM Tymoshenko also proposes to centralise the right to establish housing and utilities tariffs (which are currently established by local councils). However, a respective draft law would only be submitted after Presidential elections.

- Pressuring tax administrations to increase collections. Governments at all levels exert rigid administrative measures to increase collections. E.g., in April, the State Tax Administration explicitly announced firing managers and staff in local tax administrations which failed to ensure revenues against approved plan[34]. The local administrations react by more active inspections, administrative raids and arrests to potential non-payers[35].

- Using "spending efficiency audits" by control & revision authorities to create argument of wasting funds at all levels (rather than to improve it). Current capacity of control&revision authorities as well as Accounting Chamber for assessing spending efficiency is systemically low (there is no methodology and no basis for such assessment). However, in face of crisis, both have produced increasing number of reports alleging local governments in ineffective use of funds[36].

1.4. How far have measures been considered or implemented to reduce the costs of local administrative structures or increase economies of scale by increasing inter-municipal co-operation?

- Measures and initiatives to reduce costs of local administrative structures were described in previous sections and include:

    - Reduction in allowed maximum of staff in sub-rayon administrations; but increase in their minimum salaries by 50%, with simultaneous elimination of rayon-funded wage allowance.

    - A draft law which eliminates local taxes whose administration costs are higher than proceeds[37];

    - Approval of local and regional anti-crisis action plans which request all spending units to cut administrative expenditures (such as purchases of vehicles, mobile phones, furniture and equipment for administrative premises)[38].

- No measures were undertaken to save in local administration through inter-municipal co-operation. On the contrary, as described above, proposed changes to Budget Code support a version of administrative and territorial reform which introduces direct fiscal equalisation of sub-rayon communities (which is assessed by several studies as administratively costly).

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[33] http://4post.com.ua/economics/136137.html
[34] http://www.fisco-inform.com.ua/?module=news&action=view&id=2921
[35] http://www.fisco-inform.com.ua/?module=news&action=view&id=2369
[36] http://www.fisco-inform.com.ua/?module=news&action=view&id=2976
[37] Communal tax, horse racing participation and wins fee, dog fee, fees on using local symbols, fees on film shooting, fees on local auctions and lotteries, and fees for issuing property authorization documents.
[38] For examples see *"Anti-crisis action plan for minimising the influence of financial and economic crisis on the economy of the Luhansk Oblast"*, approved by the Luhansk Oblast Council on 27/11/2008, No 25/12 or *"On regional measures on strengthening financial and budget discipline and minimising the negative influence of the world financial crisis on the oblast's economy"*, approved by the Chernivtsi Oblast Council on 23/12/2008, No 301-25/08.

1.5. Is there any plan to consolidate (small) local government units?

- The government subscribes to (at least) two parallel current initiatives on territorial consolidation:
  - Continued plans for territorial-administrative reform which would amalgamate sub-rayon communities into a new basic unit of local self-government (gromada) no smaller than 1000 people. This reform, originating back from 2005, has been evolving under the leadership of the Ministry of Regional Development and Construction. Its latest addition (24 April 2009) exists as a draft law published for discussion at the Ministry's website[39]. The ministry stated that it considers financial crisis to be a proper and suitable time for this change[40].
  - A parallel initiative to change the Budget Code introducing direct fiscal equalisation of sub-rayon communities no smaller than 401 people, backed by the Prime Minister. This proposal was described in detail in previous sections. Direct equalisation of communities of this size would start from 2010, after elections to local councils. Theoretically, this assumes a complement political reform. At the moment, political/constitutional reform is in the centre of the standoff between key political forces, but no clear version of any scenario is clearly spelled out.
  - The government flagged the need to create a parliamentary coordination council to match any existing proposals on administrative and territorial reform, implicitly recognising the existing confusion. This proposal – by the Government's leading party, BYuT[41], - is, however, declarative and has not yet resulted in production of a single, well communicated reform strategy.

2. Stimulating local capital investments

2.1. Is any extra funding being made available to enable local governments to undertake investment projects with countercyclical effects? Are local governments well prepared to take advantage of it?

- The Government created a Stabilisation Fund, which should re-allocate about UAH 20 Billion of the State Budget to investment projects. The Government created a Stabilisation Fund in October 2008[42] as a tool to redistribute state budget revenues (mostly surpluses from planned privatisation and additional borrowing) towards loans and co-financing to "long-term infrastructure development investment projects of national scale".
- Despite declared focus of the Stabilisation Fund, it is allocated in a highly opaque way and is already used to finance wages in specific industries (coal mining).
  - Ways in which stabilisation fund is actually spent can be assessed only indirectly. Since expenditures from the Stabilisation Fund are accounted as a single line in the 2009 State Budget Law (at around UAH 20 Billion), subject to further distribution by separate decisions of the CabMin, the actual ways in which these funds are spent could be assessed only indirectly.
  - The Government announced that it would use the Stabilisation Fund on the following types of projects:

    Subsidisation of loans to agricultural sector;
    Support to coal industry; and
    Preparation to Euro-2012.
  - As of June 2009, the following indirect evidence indicates actual allocation of stabilisation fund resources:

    > Extra financing (UAH 600 million) to support 371 construction projects in healthcare, education and culture across Ukraine (based on a respective CMU Resolution which approves allocation of funds). These projects include construction and re-construction of schools, kindergartens, hospitals, stadiums etc. Prime Minister Tymoshenko explained this policy as a possibility to support jobs in construction as well as to develop public services in respective communities. It is unclear how these projects were selected.

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39 http://www.minregionbud.gov.ua/index.php?id=2066#
40 http://www.fisco-inform.com.ua/?module=news&action=view&id=2644
41 http://www.fisco-inform.com.ua/?module=news&action=view&id=2644
42 Law of Ukraine *"On primary measures against negative consequences from financial crisis and on amendments to some legal acts of Ukraine"*, No 639-VI, approved 31/10/2008

> Extra funding of UAH 1,05 billion to finance wage payments to coal miners in 2009. In March 2009, the CMU approved a resolution[43] which allowed to use UAH 1,05 billion of the Stabilisation fund, previously tentatively allocated as "subsidised credit and investment projects for coal mining safety", on paying wages to the coal miners.

- Given the uncertainty in future distribution of Stabilisation Fund proceeds, the CabMin is already preparing procedures for allocating these funds to extremely diverse spectre of projects (which is not clearly linked to their development potential). By June 2009, the Government has already approved 45 separate Resolutions with Procedures on allocating Stabilisation Fund proceeds to individual kinds of investment. These investment possibilities include very diverse possibilities such as: protection of libraries, museums and natural reserves[44], purchases of weapons[45], or national production of films[46]. There are also several procedures for projects in general regional and local development[47], loans to development of small and medium businesses[48] and introduction of energy-saving technologies in housing and communal sector[49]. Prospects for actual funding against these procedures remain unclear.

- The Government was trying to approve a new programme for investment into Housing & Utilities Infrastructure Modernisation – but so far failed. Since August 2008, the Parliament is considering a new programme for development of Housing and Utilities Sector for 2008-2012, whose requested funding is UAH 32 billion[50]. In Febuary, the Parliament approved this programme in first reading, but it remains at the draft law stage and is not reflected in the 2009 budget (i.e. is not effective or funded).

- In April, the Government started to utilise the World Bank's USD 140 million loan on municipal infrastructure development.[51] This project started to disperse in Odessa, Chernigiv and Ivano-Frankivsk, with 20 more cities in the pipeline. The project provides loans to municipal infrastructure development projects for 17 years with 4% interest rate and 5 year grace period.

2.2. Do the fiscal austerity measures cause decreasing public funds and consequently lower sub-national capital investments?

- Most traditional sources of funding for sub-national capital expenditures have steadily decreased since the beginning of crisis. Traditionally (in 2007-2008), Ukraine's sub-national capital expenditures were covered by about one third with available capital funds (capital transactions, loans, earmarked capital grants / subventions from central budget), with the rest funded out of current revenues (see Table 3). Also, it is evident from Chart 3 and Table 4 that of all existing earmarked capital grants, the only two palpable sources are transfers for capital projects in response to natural calamities or manually allocated transfers for various individual projects (support to construction of specific roads, airports, hospitals etc). The two capital grants allocated by transparent methodology – the transfer to support depressed territories (which existed in 2007) and tender-based capital grant – are relatively small.

  Apart from transfers for natural calamities – which are ad hoc – the key sources of funding for capital expenditures have contracted during the crisis:

  - The decrease in general fund revenues was discussed in earlier sections.

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[43] CMU Resolution No 281, 18/03/2009, *"On Ensuring wage payment to coal miners".*

[44] CMU Resolution No 441, 06/05/2009, *"On the procedures for using in 2009 the funds of the Stabilisation Fund on implementing measures to protect libraries, museums and national reserves"*

[45] CMU Resolution No 383, 22/04/2009, *"On the procedures for using in 2009 the funds of the Stabilisation Fund on creation, purchases and modernisation of weaponry, military and special equipment against state order for purchases from national producers to ensure state's defence".*

[46] CMU Resolution No 408, 28/04/2009, *"On the procedures for using in 2009 the funds of the Stabilisation Fund on producing films of national production".*

[47] CMU Resolution No 544-p, 13/05/2009, *"On approving the list of objects that will be funded in 2009 by the funds of the Stabilisation Fund and allocated to implementation of investment projects for social and economic development of regions".*

[48] CMU Resolution No 449, 15/04/2009, *"On approving procedures for using in 2009 the funds of the Stabilisation Fund for subsidising loans to small and medium businesses, in particular those which increase employment levels".*

[49] CMU Resolution No 327, 02/04/2009, *"On approving procedures for using in 2009 the funds of the Stabilisation Fund for implementing innovation and investment projects for energy saving in housing and utility sector".*

[50] Draft Law *"On National programme for reform and development of housing and utility sector in 2008-2012"*, Registration No 3063, 19/08/2008

[51] http://www.fisco-inform.com.ua/?module=news&action=view&id=2216

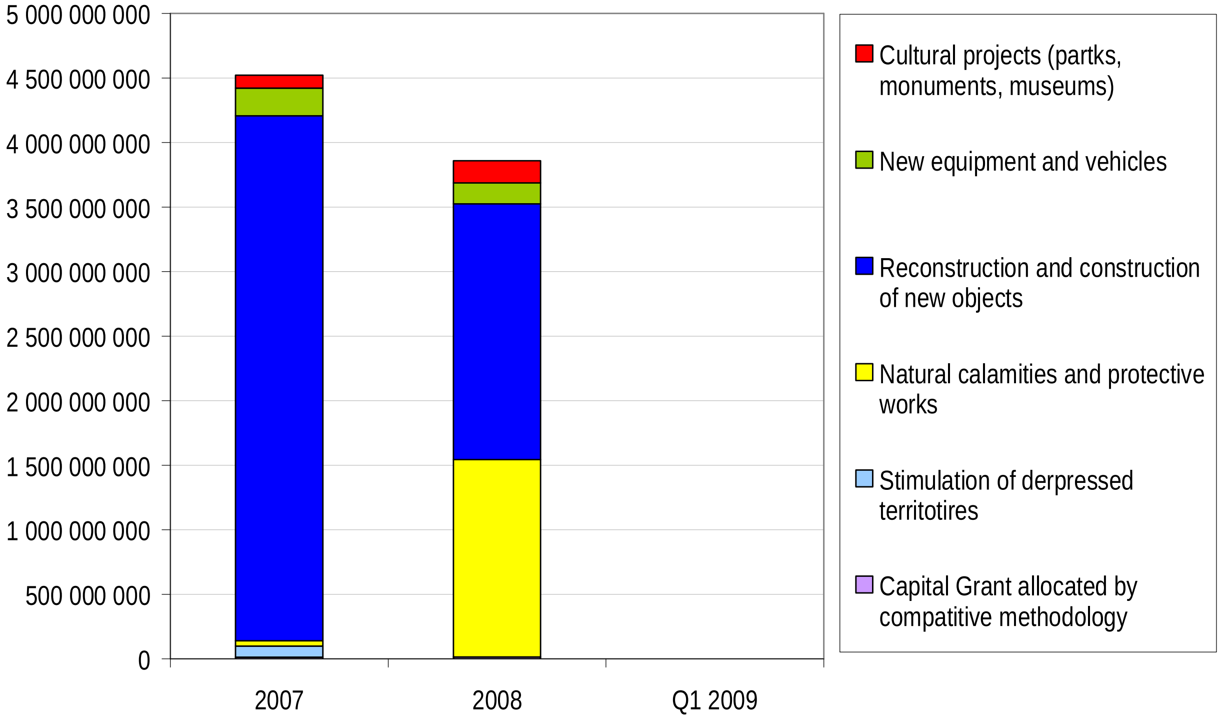
- Changes in earmarked capital transfers for reconstruction and construction of new objects are shown on Chart 5: it has steadily decreased. Apart from the crisis, the gradual contraction of this source could be explained by the notable change of policy towards this tool between the two recent governments. The considerable list of various capital subsidies in 2007 was decreased substantially in 2008, and further yet in 2009. This could be assessed positively; although it is not yet complemented with parallel expansion of the rules-based grants.

Table 3. Actual revenues available for capital investment
and actual capital expenditures of local budgets in 2007-2008 (UAH)[52]

	2007	2008
Funds for capital investments in local budgets:	**7 215 810 424**	**11 155 379 256**
- revenues from capital transactions	*4 603 526 471*	*4 577 060 588*
- capital earmarked transfers	*4 753 442 558*	*4 955 799 899*
- deficit financing:	*-2 141 158 605*	*1 622 518 768*
external loans	*1 485 249 549*	*-726 675 000*
internal bank loans	*390 000*	*8 647 710*
change in cash balances on accounts of budget spending units / organisations	*-162 691 726*	*-77 845 675*
net placement of secutiries and bank deposits	*-992 079 809*	*389 297 156*
change in balances on treasury accounts of local budgets	*-2 469 935 067*	*2 078 416 343*
other internal financing	*-2 091 551*	*-49 321 765*
Capital Expenditures	**22 498 419 933**	**25 901 878 099**

Source: Budget Committee of VR (State Treasury Reports)
http://budget.rada.gov.ua/kombjudjet/control/uk/index

Chart 3. Composition of revenues available to local governments for capital investment through earmarked subventions (by types of subventions), in prices of January 2007 (CPI)[53]

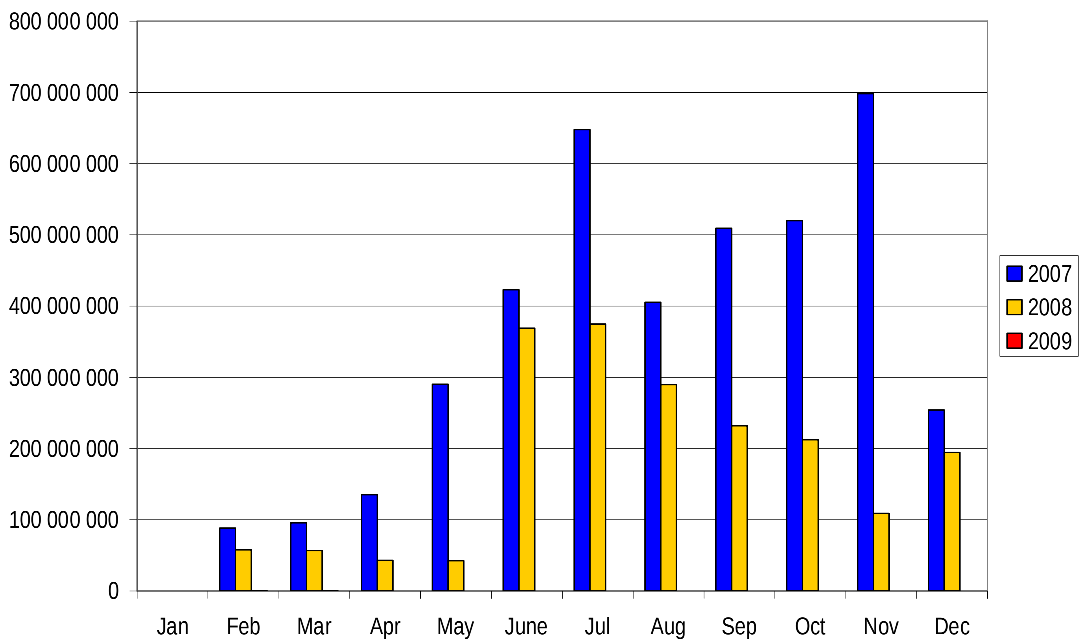


[52] Source: Treasury Budget Execution reports
[53] Source: Treasury Budget Execution reports

Table 4. Actual revenues from earmarked subventions on capital investment, in real terms, UAH, in prices of January 2007 (CPI)[54]

		Capital Grant allocated by compatitive methodology	Stimulation of derpressed territotires	Natural calamities and protective works	Reconstruction and construction of new objects	New equipment and vehicles	Cultural projects (partks, monuments, museums)
2007	Jan '07	0	0	0	0	0	0
	Feb '07	0	0	0	88 400 263	0	0
	Mar '07	0	0	3 968 207	95 748 888	385 908	0
	Apr '07	4 918 394	0	6 101 118	135 160 205	58 027 881	0
	May '07	4 904 147	0	6 212 650	290 223 733	8 163 224	608 840
	Jun '07	4 854 833	0	5 114 007	422 880 010	4 911 569	9 712 560
	Jul '07	0	0	5 424 033	647 862 499	83 918 830	9 341 136
	Aug '07	0	46 184 683	5 675 456	405 441 787	9 930 250	10 290 547
	Sep '07	0	16 679 102	5 830 948	509 316 429	7 200 943	14 890 482
	Oct '07	0	12 821 213	5 396 777	519 969 259	24 589 964	39 374 075
	Nov '07	0	12 548 386	2 024 231	698 142 930	17 515 146	9 563 173
	Dec '07	-2 363 206	-2 038 850	-4 250 899	254 187 873	-916 408	5 934 802
2008	Jan '08	0	0	0	0	0	0
	Feb '08	0	0	59 137	57 901 957	0	0
	Mar '08	0	0	56 972	56 852 863	0	16 895 143
	Apr '08	5 562 787	0	1 718 744	43 066 627	0	22 246 726
	May '08	5 100 972	0	1 881 028	42 580 835	50 787 761	21 859 504
	Jun '08	4 420 491	0	1 791 455	369 001 822	559 830	29 352 176
	Jul '08	0	0	3 747 203	374 834 981	26 256 675	17 471 492
	Aug '08	0	0	1 017 284 135	289 824 203	29 662 195	25 371 390
	Sep '08	-371 386	0	247 591 999	232 029 814	4 456 627	22 328 593
	Oct '08	0	0	238 039 901	212 291 929	1 300 032	0
	Nov '08	0	0	2 327 669	108 956 805	7 036 028	7 195 617
	Dec '08	-481 628	0	14 485 672	194 499 217	42 159 441	8 210 404
2009	Jan '09	0	0	0	0	0	0
	Feb '09	0	0	0	335 425	0	0
	Mar '09	0	0	0	211 750	0	0
	Totals						
	2007	**12 314 167**	**86 194 534**	**41 496 527**	**4 067 333 876**	**213 727 308**	**99 715 615**
	2008	**14 231 237**	**0**	**1 528 983 914**	**1 981 841 052**	**162 218 589**	**170 931 044**
	Q1 2009	**0**	**0**	**0**	**547 175**	**0**	**0**

Chart 5. Real change in the monthly amounts of capital transfer on reconstruction and construction of new objects (in prices of January 2007 (CPI))[55]



[54] Source: Treasury Budget Execution reports
[55] Source: Treasury Budget Execution reports

- Respectively, since November 2008, capital expenditures of sub-national budgets significantly decreased in year-to-year comparisons. As shown on Chart 6, since the beginning of the crisis, monthly capital expenditures of local budgets were considerably lower compared to same months of previous years, in real terms. They also remained a trivial contribution to the overall local investment, which only decreased compared to investment by domestic enterprises and foreign investors, as illustrated by Chart 7.

Chart 6. Real change in monthly amounts of capital expenditures of local budgets (in prices of January 2007 (CPI))[56]

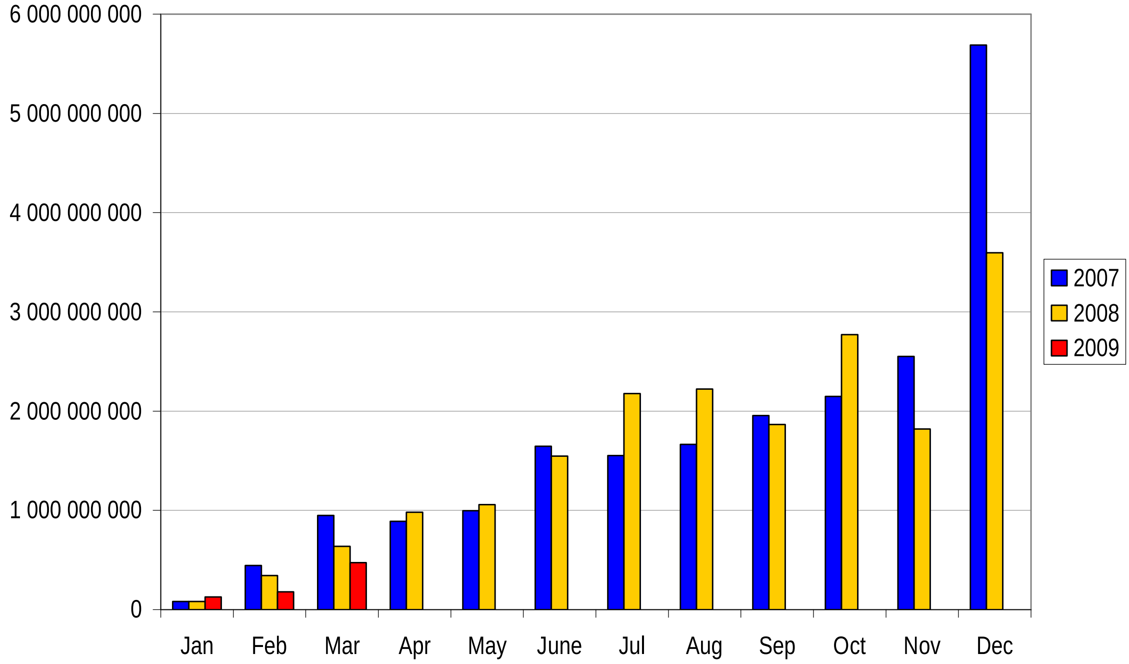
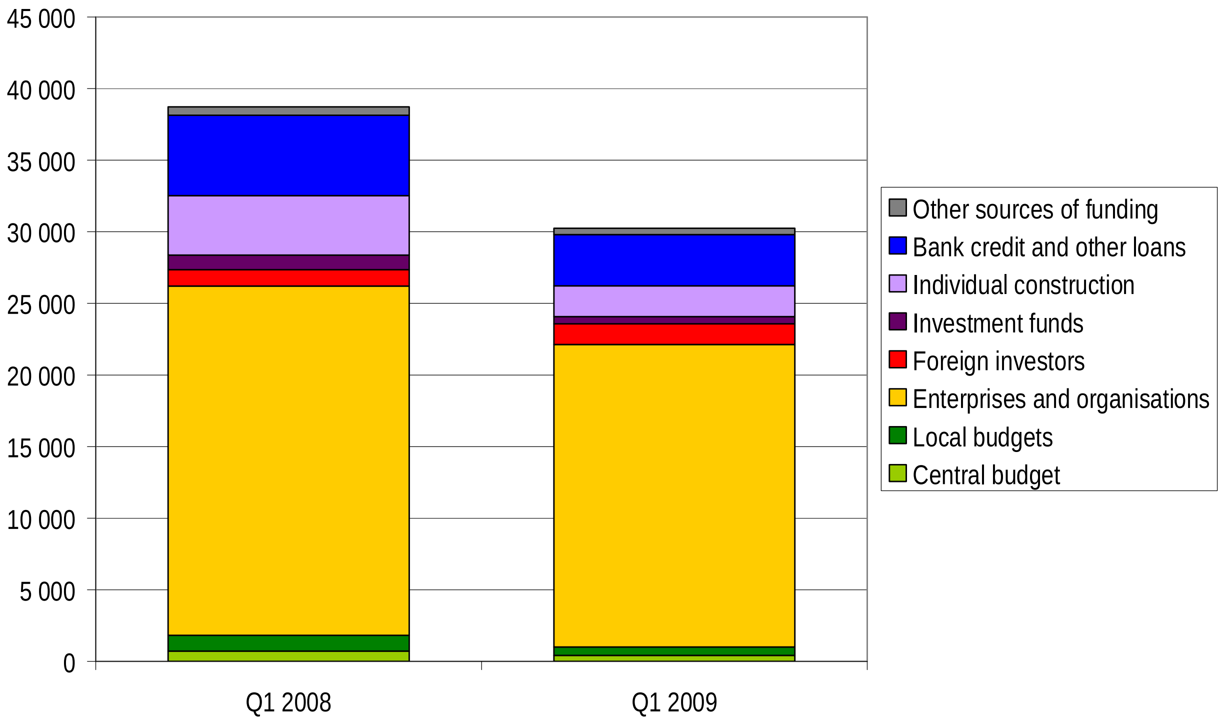


Chart 7. Capital investment by types of investors (Q1 2008 compared to Q1 2009), nominal prices, UAH mln[57]



[56] Source: Treasury Budget Execution reports
[57] Source: State Statistics Committee of Ukraine

2.3. How the measures listed below to enhance municipal investments are accepted and used? Which are the most preferred ones?

2.3.1. Increase access to external sources:

 improving local awareness of EU structural and pre-accession fund; easing project requirements, increase EU co-funding share;

- Although Ukraine's access to EU structural funds has increased in wake of EU Enlargement, and further on through growing partnership within the European Neighbourhood Policy, these funds remain relatively limited: compared to EU member and candidate states, with respect to policy goals declared in the ENP, and against Ukraine's project absorption capacity.
  - The Box below[58] provides an overview of overall possibilities for Ukraine for financial cooperation with the EU. It shows that the most significant infrastructure-development component of EU support is represented by bilateral funding through EBRD. The local authorities are also eligible to cross-border cooperation structural funds, allocated through several multi-country programmes.
  - In terms of structural funds, throughout implementation of the 2004-2006 programme cycle, funded through the INTERREG IIIA/Tacis CBC instrument, Ukraine participated in seven CBC programmes. Most of these programmes disbursed successfully, and reported a higher demand by high quality proposals than was available within the budgeted framework. E.g., in the latest round of the Poland-Belarus-Ukraine programme, with the overall TACIS-funded budget at EURO 8 million, and a project ceiling at EURO 1 million, Ukraine participated through 17 projects, which fully absorbed existing funding capacity. The next programme cycle (2007-2013) is starting its first round of implementation this summer (with two years of delay), and the amount of proposals and enquiries is already much higher than in previous years.
  - Co-funding requirements for CBC projects were decreased from the initial 25% level to 10% during the 2004-2006 cycle. In implementation of the projects so far, this 10% co-funding requirement was not found problematic. Since the next round of programme implementation for the 2007-2013 is commencing only this summer, most proposals contain co-funding amounts which were budgeted within local budgets prior to the crisis, and it is therefore unclear whether these commitments will be viable. However, no specific action (or, indeed, any research or enquiries) was undertaken into these risks so far.
  - The project requirements within the next programme cycle (2007-2013) have been released significantly compared to 2004-2006 cycle, but this is not related to the crisis in any way and is merely a coincidence in timing because of implementation delay. The release includes wider circle of eligible applicants (e.g. it now includes authorities of all levels and communal enterprises), acceptance of harder co-funding contributions, etc.
- Albeit Ukraine managed to absorb available CBC funds rather well so far, it suffers from a number of legislative weaknesses compared to its European CBC partners, which may complicate access to these funds in the future – and is not currently addressed by the Ukrainian Government:
  - Unlike in previous programme cycle, when Ukraine was eligible to an individual budget ceiling within the CBC programme budget, the next cycle will be based on the common project implementation budget with other countries. This will place a much stronger demand on the quality of Ukraine's participation – given the possibility to re-allocate funds towards the better prepared European partners.

[58] Based on http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/217&format=HTML&aged=0&language=EN&guiLanguage=en, http://www.central2013.eu/working-with-central/about-central.html

- The Budget Code does not contain sufficient details for accounting and utilisation of structural funds, making it problematic for local recipients to manage their CBC project funding (which has to comply with Ukrainian legislation).
- Ukrainian local governments are often unwilling to budget for co-funding expenditures, because if the local government reserves revenues for co-funding and the proposal loses in the competition, the current legislation requires local government to return any leftovers to the State budget at the end of the budget year. Taking time and effort to amend the local budget to reflect the changed circumstances is not always possible (or reliable) option, given the unpredictable schedule of EU competition rounds.

<u>Box. What EU funding is available to Ukraine?</u>

Ukraine currently benefits from a range of EU funding possibilities within the European Neighbourhood Policy (ENP), recently extended through the Eastern Partnership initiative. Both policies are funded within the European Neighbourhood and Partnership Instrument approved for 2007-2013 budget cycle. However, Ukraine is also eligible to benefit from other EU programmes on top of ENP as listed below.

- ENPI Bilateral technical assistance programmes. For 2007-2010, bilateral funding for Ukraine within the ENPI is budgeted at EURO 494 million[1]. The ENPI envelope for 2010-2013 is under revision as it will be increased by additional funds allocated for the Eastern Partnership initiative (a total of EURO 350 million for the six benefiting countries). The approval of the Eastern Partnership will also result in reallocation of funds within the current ENPI but its outlook is not yet announced.
- Multi-country and regional programmes:
  - The EU Neighbourhood Investment Facility (NIF) which helps to leverage funding to investment projects in the Neighbourhood Area. In 2008, three such projects were approved for Ukraine, committing EUR 6.6 million in technical assistance, and expected to leverage EUR 608 million in loans of European Finance Institutions in the transport energy and social sector.
  - Governance Facility, which provides EUR 50 million annually combined for all ENP countries.
- Trans-national framework, which replaces the ENPI CBC component.
  - Under the CBC Component of the ENPI, three cross-border cooperation programmes to which Ukraine's participate were adopted in 2008, notably the Romania-Moldavia-Ukraine EUR 126.718 million for the period 2007-13), Poland -Belarus-Ukraine (EUR 186,201 million for the period 2007-13) and the Black Sea CBC Sea basin programme (EUR 17.306 million for the period 2007-13).
  - The CBC East under the new trans-national framework was approved at EUR 25 million for 2008, for all eastern neighbours combined.
  - Programmes of European Grouping and Territorial Cooperation which engage Ukraine (e.g. Central Europe1).
- Bilateral cooperation with the EBRD and EIB.
  - As of January 2008, 22% of EBRD's commitment in Ukraine (EUR 2,96 billion) was in infrastructure and municipal development projects. After the crisis, EBRD has increased its overall 2009 commitment in Ukraine by a third, but it is unclear how much of the increase would be directed to municipal projects.
  - The EIB signed a framework agreement with Ukraine in 2005. Since that time, the major project it has approved for Ukraine was EUR 200 Million for the M-06 road from Kiev to Chop in 2007. However, it declares continued openness to new projects of key common interest (one new area under consideration is infrastructure development for Euro 2012.

- special national funding schemes and public investments programs focus on local governments;
  - No special funding schemes at the national level, as described in 2.1.
- local borrowing: interest rate and lending policy; special subsidised credit lines; restructuring municipal borrowing (from loan to bonds); issuing local government guarantees; easing national control over local borrowing decisions;
  - UAH 25 million in 2009 Budget to subsidise local borrowing on energy-saving technologies in housing and utilities sector. CabMin's Resolution[59] which guides the disbursement process specifies that projects should be selected on a competitive basis but delegates the details of the process to the Ministry of Housing and Utilities.

[59] CMU Resolution No 514, 13.05.2009, *"On the guidelines for using the funds allocated in 2009 State Budget Law to subsidising interest payments on credits received to introduce energy-saving technologies in housing and communal sector"*.

- CabMin expands opportunities for local governments to borrow for covering the costs of subsidisation of housing & utilities tariffs.

  Local governments typically and significantly subsidise local tariffs for housing and utilities services. That results in liabilities of local governments to communal service providers. After the beginning of the crisis, local governments' arrears against these liabilities to communal service providers have significantly increased (some aspects of regulatory problems arising between local councils and communal service providers were already described in Section 1.3.).

  In April 2009, the CabMin approved a Resolution[60] which made it easier for local governments to borrow for covering such arrears. This allows local governments to issue exchange notes payable to commercial banks to attract funds for repayment of arrears to local housing and utilities service providers. One ambiguity of this decision is that by borrowing from commercial banks against all existing arrears to service providers, local authorities take up not only the costs of their own decision to subsidise services, but also any existing arrears for services on behalf of the population, as well as rising prices for gas and electricity.

  An illustrative case in point is Kyiv city's attempt to borrow for covering its subsidised housing and utilities services. Kyiv city administration has recognised UAH 1,2 billion debt to Kyiv Communal Energy Providing Company (KyivEnergo)[61]. In the beginning of 2009, Kyiv administration used a borrowing scheme explained by these debts to attract funding from commercial banks using as collateral a range of the city's most famous historical buildings (allegedly, planning to default on those loans, thus transferring these assets into private ownership). Eventually, with the help of CBU's special resolution, the city attracted the needed funding from two commercial banks at 21,5% annual interest rate[62]. Several other cities have already voiced interest in following the same scheme. In the meantime, Kyiv administration reports being in negotiations with the National Bank of Ukraine to receive UAH 300 million loan for further re-financing of its arrears[63].

- Amendments to the Budget Code have formalised the opportunity for local governments to buy, sell and exchange their debt liabilities (through operations with respective securities) within the specified limits. This possibility was previously open only to the Ministry of Finance with regard to the State Budget debt and is now extended to local governments.[64]

- Amended Budget Code have also significantly expanded the allowed limits of local debt. The allowed limit to local debt was increased as explained below:

Article 18-2. Marginal amount of local debt =	
[Previous edition]	[Amended edition]
= 150% of	= 200% of
average annual forecast for the *NEXT* 3 years	average annual forecast for the 3 years *AFTER* the planned period
of revenues in "development budget"	of revenues in "development budget" extended by 10% revenues from EPT and 15% revenues of PIT

- Amendments to the Budget Code have reduced the threshold of population size for cities to be able to borrow in foreign currencies, expanding their access to foreign loans. In the new BC, borrowing in foreign currency is allowed to ARC and cities of population larger than 500 thousand, while earlier it was 800 thousand people[65].

[60] CMU Resolution No 392, 22/04/2009, *"On some issues in financing the payments for natural gas by economic agents which generate heating energy consumed by population".*

[61] According to KyivEnergo, the debt was higher - at UAH 1,4 billion, and commentators alleged that this debt was only part of overall arrearas of Kyiv administration to a wide ranger of other service providers, the overall amount of which was not disclosed by the authorities: http://www.fisco-inform.com.ua/?module=news&action=view&id=2716

[62] http://www.fisco-inform.com.ua/?module=news&action=view&id=2882

[63] http://www.fisco-inform.com.ua/?module=news&action=view&id=2857

[64] Article 16-6 of Amended Budget Code of Ukraine.

[65] Article 16-2 of the Amended Budget Code of Ukraine.

- sources from PPP schemes: do they decline; were there delays or cancelation of PPP projects; how stable is the revenue stream for PPP projects;
  - PPP in Ukraine are negligibly small. Based on the most recent available data, the size of PPP projects in Ukraine is negligibly small compared to most Central European countries (see Table 5). Also, the bulk of these projects is concentrated in the telecom sector, and is therefore of distant relevance to local budgets and local economic development. PPP in transport infrastructure are non-existent.
  - Neither the crisis, nor the expectation of hosting the Euro-2012, have resulted in principal expansion of this instrument. Most infrastructural projects considered or implemented within the recent years have been clear-cut cases of state, communal or private investment.
  - The Government continues to develop legislation regulating PPP, but it is unclear whether that will be sufficient to bring out the existing potential for such projects. In June 2009, the VR approved a draft law on PPP[66], which will become a framework document, unifying existing legislative norms contained in other laws (On concessions, On concessions for the construction and operation of roads, On agreements on product distribution, On financial leasing, On leasehold of state property, and On management of state property objects). Observers assess this development as only one step in resolving the limitations which hinder development of PPP in Ukraine. [67]

Table 5. Total Investment in Projects by Primary Sector (US$ million) 1990 - 2007

	Ukraine	Hungary	Poland	Slovakia	Romania	Croatia
Energy	160	6 371	2 981	4 657	3 986	376
Telecom	6 561	14 715	26 957	3 889	8 002	4 585
Transport	0	6 025	1 845	42	140	1 615
Water and sewage	100	0	71	0	157	299
Total	6 821	27 111	31 854	8 588	12 285	6 875
Total per 100 thous population	**14,7**	**269,6**	**83,7**	**159,1**	**57,0**	**154,9**
Population	46 382 836	10 055 580	38 060 823	5 396 198	21 546 874	4 438 310
GNI per capita (US$)	2 550	11 570	9 840	11 730	6 150	10 460

Source: The Private Participation in Infrastructure (PPI) Project Database
http://ppi.worldbank.org

2.3.2. Improve project preparation and management: develop a bank of small scale infrastructural construction and repair projects which might qualify for fiscal stimulus funding.

- In recent years, the government has maintained several initiatives to create databases of investment projects which are available for additional funding.
  - One such initiative is development of investment projects and programmes under Ukraine's State Agency of Investment and Innovations[68].
  - The Ministry of Economy and the Ministry of Regional Development and Construction have been also working to develop methodologies for producing investment proposals to be funded by earmarked capital transfers from the central budgets (as discussed in other sections, the size of these transfers is small and is decreasing after the crisis).
- No additional action was undertaken to extend these databases specifically in terms of counter-cyclical fiscal stimulation. However, this is not likely to be the major factor in overall weakness of government's counter-cyclical investment given the scale of other limitations described earlier.
- It is unclear which database of projects was used by the government in allocating the resources of the latest (and only) disbursement of the Stabilisation Fund.

[66] The Law of Ukraine *"On general principles of public-private partnership"*, approved 25/06/2009 (the draft law number N 3447-д, of 14,04.2009 – not yet registered in the VR database, awaiting a presidential signature).
[67] http://www.feg.org.ua/ua/news/foundation_news/102.html
[68] http://www.invest.gov.ua/

2.3.3. Promote indirect measures for improving local investments

Local economic development

Business promotion, attracting/keeping inward investments

- Inward investment is slowly recovering; shrinking production has not resulted in major outflow of investors so far. Through the recent years until the end of third quarter of 2008, Ukraine's financial account remained in surplus, as illustrated on Chart 8. However, in the next two quarters, the outflow of short-term capital created a sharp deficit, exacerbated by outflow of portfolio investors. The FDI also decreased compared to previous periods, but remained positive. Moreover, given its seasonality, the FDI year-to-year dynamics in the first quarter of 2009 was relatively buoyant. The strongest recovery occurred in investment from regional sources – the Russian Federation and Cyprus which intermediates most of Ukraine's off-shore investment.

Chart 8. Capital Account Balance and its Composition[69]

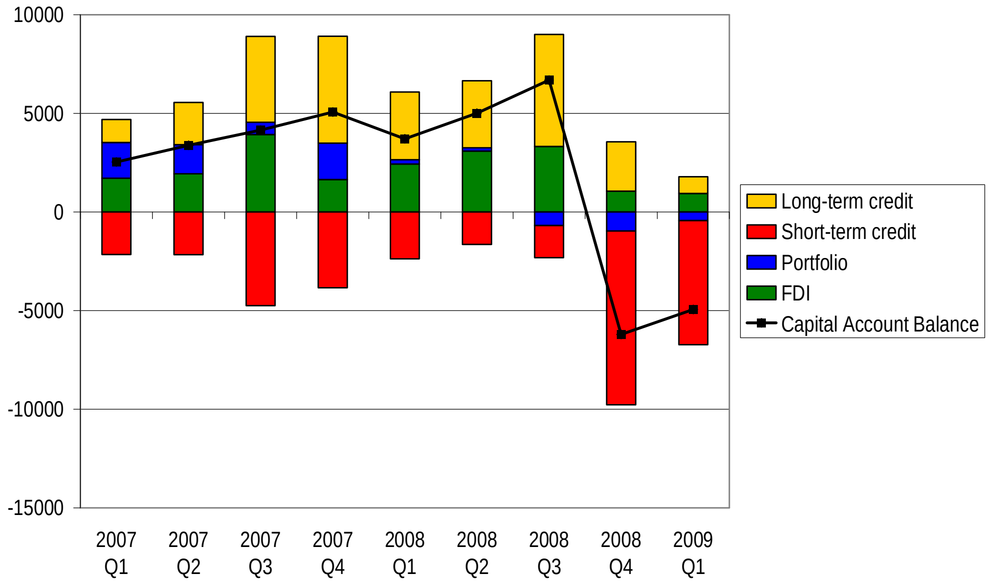
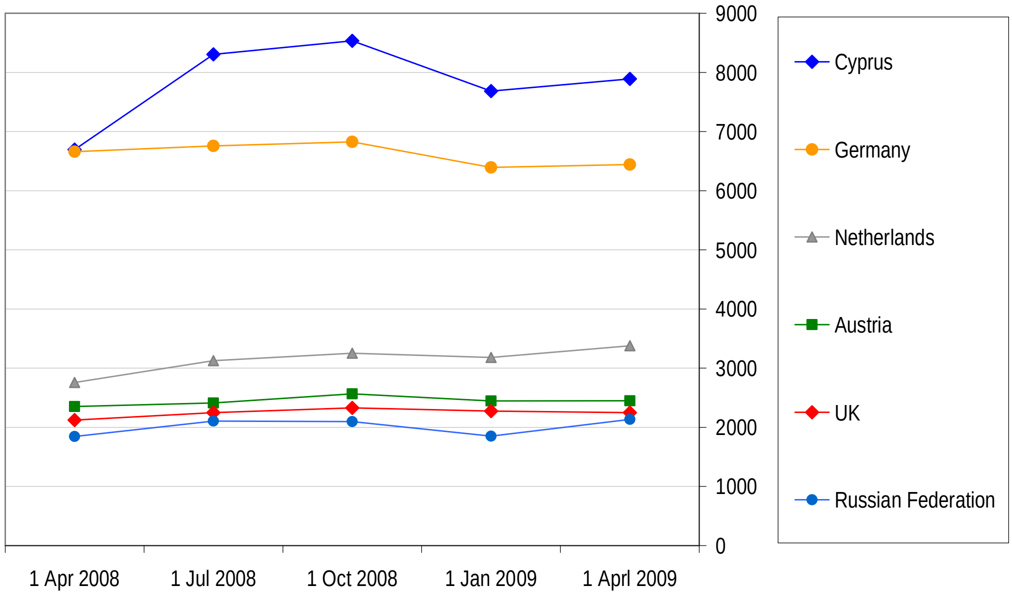


Chart 9. FDI increase by country of origin[70]



[69] Source: National Bank of Ukraine
[70] Source: State Statistics Committee of Ukraine

- Local level policies for investment promotion are focused exclusively on lobbying for central level support to specific investors operating on their territories. Most anti-crisis action plans approved by local administration contain "recommendations" to the central government regarding targeted support to major enterprises in their regions.

- Central level policies to support investors through the crisis are mainly distortive and do not enhance competitiveness and transparency of the overall business climate. Non-distortive measures are either marginal or declarative. The key latest central policy decisions affecting entrepreneurship and investment activity – including the failures to implement some of the initiatives – are described below.

  - Taxation.

    Proposals for Tax Amnesty. The CMU approved a draft law[71] which would allow taxpayers to declare untaxed incomes during a period of 6 months, to be taxed by a state duty of 4-8% and secured with a set of guarantees from further investigation.

    Proposals for a Single Social Tax. Ukraine's payroll taxation is fragmented across four off-budget social insurance funds (Pension Fund, Unemployment Fund, Temporary Disability Insurance Fund and Work Injuries Insurance Funds), suffers from complex administration, and has relatively high average rate (estimated at 42%[72]). This raises costs of compliance and discourages private investment. Since January, Ukrainian government has debated a contradictory proposal to unify these taxes under a single social insurance tax. The point of disagreement was allocation of responsibility for administration of the combined funds to a newly created central agency. As a result, a respective law approved by the VR was vetoed by the President and failed to either override the veto or evolve to eliminate the conflict.

  - Subsidies to private sector. In October 2008, the CabMin introduced a series of indirect subsidies to support enterprises in metallurgical and chemical production: a moratorium on increases in railway transportation tariffs and a decrease in prices on coking coal, gas and electricity for such enterprises[73]. The subsidies were introduced as temporary, but were repeatedly extended since that time.[74]

  - Trade barriers. In December 2008, the Government attempted applying a 13% increase on all import duties except "critical import" items (explaining this measure by the plummeting current account). In March 2009, after multiple internal and external concerns over its compliance with Ukraine's WTO obligations, the duty was cancelled for all items – except automobiles and refrigerators.

  - Bureaucratic re-organisation. The Government has created a special Agency for Foreign Investment, which will take over the supervision of the Ukrainian Centre for Investment Promotion "InvestUkraine" (which was earlier reporting to Ukraine's State Agency for Investment and Innovation). The government also promised to meet every Thursday specifically to discuss investment-related issues, and to open direct hotline for investors to be able to make proposals to Ukrainian government[75].

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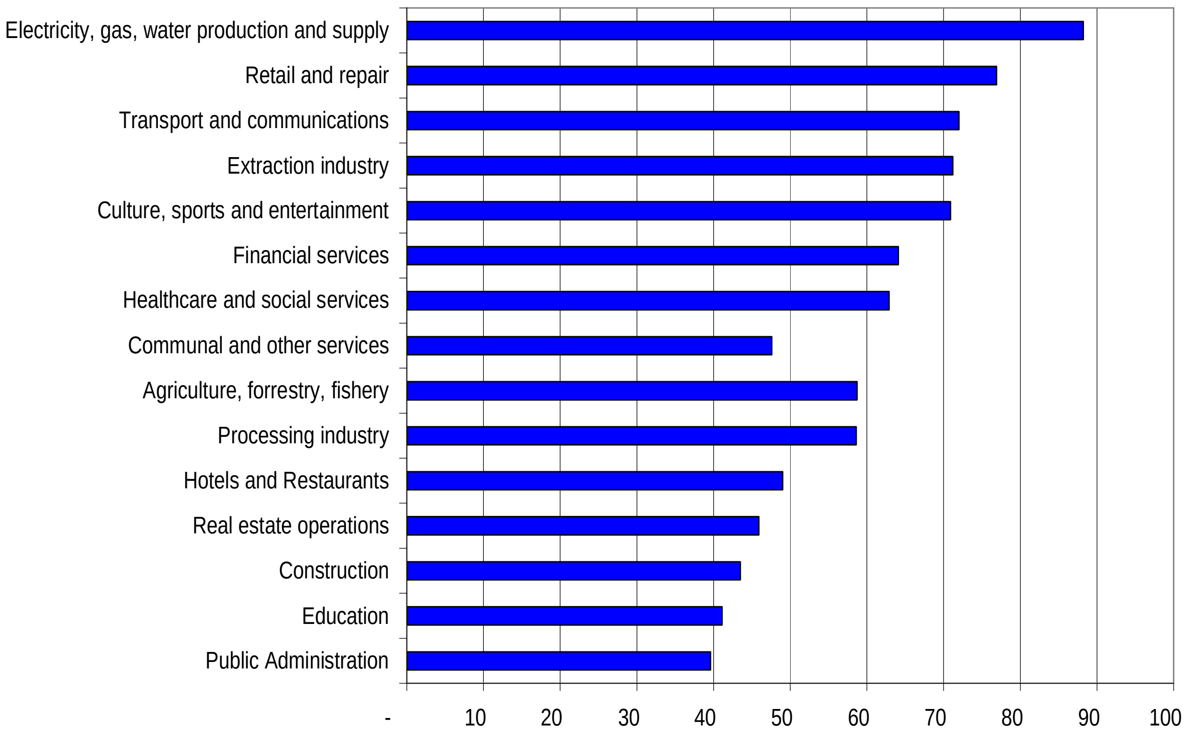
[71] Draft Law *"On special procedures for declaring revenues on which there was no payment of taxes/ fees to the budgets of state off-budget funds"*, approved by CMU on 28/04/2009. http://www.minfin.gov.ua/control/uk/publish/article?art_id=211584&cat_id=53608; see comments at http://www.fisco-inform.com.ua/?module=news&action=view&id=2975.
[72] *Ukraine – Public Finance Review: Creating Fiscal Space for Growth*, Chapter 1, "Why is fiscal space needed for Ukraine?", Para 1.9., World Bank, September 2006.
[73] CMU Resolution No 925, 14/10/2008.
[74] http://ua.korrespondent.net/business/880572/print
[75] http://www.epravda.com.ua/news/49896b4fb47e5/

Chart 10. Capital investment in the sector in Q1 2009 as % of Q1 2008[76]



SME development

- No specific extra funding was allocated on SME development either at national, or at local level. Although the government declared plans to direct a share of the Stabilisation Fund to small business support, no actual disbursement against these programmes were registered so far.
- Most local regulatory policies with regard to SME since the beginning of the crisis were focused on pro-cyclical fiscal tightening. Squeezed by the need to finance protected delegated expenditures, on the one side, and by administrative pressure from the central tax authorities to maintain tax collections, on the other, local administrations are reported to use most available leverages to extract additional funds from local businesses.
- Central government regulatory policies have mixed implications for the SME. They included:
  - A pro-cyclical increase in the single tax for private entrepreneurs. Faced with the continued fiscal contraction, and after much debate and protest, the government has increased the single tax on private entrepreneurs by an additional amount payable to the Pension Fund (representing a 62% increase to the maximum tax rate). The single tax, operating in Ukraine since 1999, had been levied at rates established by local governments within centrally specified maximum of UAH 200, and was not increased or indexed since the time of introduction. A portion of this tax (42%, UAH 84) was payable to the Pension Fund, and would be now increased to a minimum of UAH 207,5 – implying an additional UAH 123,5 to a maximum rate.
  - Reported administrative pressure on local tax authorities to maintain tax collections.
  - Administrative actions to support certain categories of small businesses vis-à-vis their landlords and larger suppliers. E.g., in March 2009, the CMU approved a resolution banning any increases in market space rents[77] (it was reported earlier that local market owners have significantly increased rent levels after the crisis).

[76] Source: State Statistics Committee of Ukraine
[77] http://www.rbc.ua/ukr/newsline/2009/03/05/513486.shtml

- Transparent regulations on local debt and insolvency; special measures for debt recovery, support to smooth cash flow
- Compensation of local budgets for lost financial investments in defaulting banks.

- By 1 March 2009, deposits of local governments in commercial banks equaled to UAH 1,6 billion. By that time, local governments already encountered difficulties in recovering a quarter of that amount - UAH 400 million (equal to about 5% of total monthly local revenues)[78].
- The Government implemented a series of administrative measures to assist local governments in recovering their deposits.
  - At CabMin's request, the NBU requested commercial banks to ensure primary repayment of deposits to local government authorities[79].
  - The CabMin has also instructed local governments to stop placing funds on deposits of commercial banks, relocating them to state-owned banks[80].
- Measures to assist local governments encountering increasing amounts of municipal debts were described in earlier sections.

3. Targeting social expenditures

3.1. Have any measures been taken or proposed to local governments for reducing the costs of social expenditures by modifying the system of social benefits or services?

- Most post-crisis measures related to social protection focused on social insurance programmes, social benefits, subsidies, and privileges - which are financed through deconcentrated central transfers – and therefore do not directly affect local budgets. Since the beginning of the crisis, the government has considered or implemented the following measures in social protection – all of which are primarily linked with social protection expenditures financed from the central budget:
  - Attempts to amend elements of the pension system, faced by a growing deficit;
  - Release of a strategy to reform social assistance privileges;
  - Release of plans for reform in social benefits;
  - Multiple ad-hoc amendments to the system of social benefits, subsidies and privileges, trying to respond to crisis-related and elections-related pressures (fiscal, social, and political).
- Note: measures on central programmes of social assistance do have a range of indirect affects on local budgets:
  - Changes in minimum wage and subsistence levels influence delegated responsibilities and central mandates on local governments (as described in 1.2);
  - Changes in non-cash subsidies and privileges to population (such as a discount on payment of housing and utilities services to low-income population or other subsidised service tariffs for other population categories) are also funded through deconcentrated earmarked transfers to local budgets. However, given the difficulties in estimating the monetary equivalents of these non-cash privileges, it becomes difficult to ensure full and transparent compensation of these costs to local governments;
  - Increase of pension fund contributions for private entrepreneurs is pro-cyclical and bears risks of re-shadowing of small local businesses (with resulting losses to local budgets);
  - Changes in social benefits strongly affect household income and, therefore, its social vulnerability, increasing the risks of additional pressures for provision of social services which – as a financial responsibility – are delegated entirely to sub-national budgets.

[78] http://delo.ua/news/103448/
[79] NBU Telegram No 40-212/839-1957
[80] CMU Resolution No 52, 28/01//2009, http://www.fisco-inform.com.ua/?module=news&action=view&id=2197

- The changes considered or implemented for modification of the system of social insurance and assistance are described below.
    - Release of a strategy to reform social assistance privileges; In June 2009, the Government has approved and released a "Strategy for Streamlining the System of Social Privileges". Taking steps to sort out existing social privileges by the end of 2009 was requested by the IMF within its crisis-related stand-by agreement. However, the resulting step is assessed by both parties as a rather long shot. The strategy is a policy paper for 2009-2012. Its aims to reduce the amount of categorical privileges (keeping only a few caterogories which are politically sensitive but probably small in the long-run such as war veterans), and to link privileges clearly to income levels. However, the strategy assumes that it will take 2009-2010 to prepare necessary legislation, and that actual changes will be implemented in 2011-12. To a significant extend (and as acknowledged by the IMF), expecting a more immediate action on the highly politically sensitive topic of privileges is not feasible in the run-up to elections[81].
    - Development of plans for reform in social benefits. In parallel, the Government reports of new plans to reform the system of social benefits as a whole, co-operating closely with the WB and the EU. Specific content of the reform is not yet released. However, the Government and the WB report that changes aim to focus the system on the poorest and most in need. Proposals under discussion include a variety of methods of income verification and inspection. The WB advocates a combined approach of income inspection and imputation, given the high share of informal sources in household incomes (experiments with this model were implemented in five oblasts during April-June 2009).[82] Earlier, the EU proposed support to development of a new system based on institutionalised tax-benefit micro-model (and disbursed funding to a respective 2.5 year project[83]). However, the likelihood of accepting this approach and micro-modelled tax-benefit system is still unclear.
    - Multiple ad-hoc amendments to the system of social benefits, subsidies and privileges, trying to respond to crisis-related and elections-related pressures (fiscal, social, and political). In the post-crisis months, the Government implemented a significant amount of minor amendments to the current approaches to calculation, administration and funding of social benefits, described below.
        - > Risk management in social insurance payments.
            - → The CMU introduced new rules for inspecting claims of social insurance against temporary disability and work injuries based on a set of criteria assessing the risk of fraudulent claims. The criteria include ranged riskiness of professional activities, diligence in payment of insurance contributions, and diligence in ensuring work safety on enterprises.[84]
            - → According to new rules on public works, two refusals to take up proposed public works by unemployed without education and qualified work history will be taken as ground to disqualify such citizens as unemployed.[85]
        - > Extension of the coverage and level of social insurance schemes to incorporate extra social distress after the crisis
            - → The CMU released some of the existing legal obstacles for receiving temporary unemployment benefits. Earlier, employees fired under "redundancies based on joint agreement of the sides" were not eligible to the benefits, which was sometimes used manipulatively by employers. The new rule will allow redundant employees to claim benefits starting from the 8th day of unemployment. [86]

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[81] http://www.fisco-inform.com.ua/?module=news&action=view&id=3191, http://www.fisco-inform.com.ua/?module=news&action=view&id=3114
[82] http://www.fisco-inform.com.ua/?module=news&action=view&id=2626
[83] http://socialbenefits-ua.com/
[84] http://www.fisco-inform.com.ua/?module=news&action=view&id=3139
[85] http://www.fisco-inform.com.ua/?module=news&action=view&id=2691, http://www.fisco-inform.com.ua/?module=news&action=view&id=2608
[86] http://www.fisco-inform.com.ua/?module=news&action=view&id=3181

- → New rules for defining eligibility of households for low income support will base calculations of household income for families with a newly unemployed member on three months of their choice (compared to six latest months, applied earlier). This will allow such households to access social protection much faster and in larger scale.[87]

- → New rules will apply to calculation of social benefits for newborn children and for mothers of many children, linking these payments to official subsistence level; earlier, these payments were specified in absolute nominal UAH terms.[88] (this implies that from now on the payment will incorporate any future increases in the subsistence minimum).

> Income verification for social benefits and subsidies.

- → New rules for allocating subsidies on housing and utilities payments for low income families will base on more elaborate procedures for income verification. These will include inspection for major household expenditures (durables costing more than 10 subsistence levels), precedents of detecting undeclared sources of income, and diligence in payment of the unsubsidised share of the due payments.[89]

- → New rules will disqualify households from eligibility for low income support in cases if a household includes a member of working age who is not employed, is not registered as unemployed, and is not studying.[90]

> Linking categorical social transfers to income levels:

- → New rules will introduce an extra amount of child attendance benefits to families with low income[91]

> Further extension of privileges – despite declared policies:

- → In parallel with attempts to rationalise social transfers and privileges, the menu of privileges continues to grow – albeit only incrementally. In June 2009, the VR further extended the status of war invalids to people who served in the military during 1941-1945 despite being of minor age, and those who later became disabled because of a general illness received during their military service.[92]

- Attempts to address the growing deficit of the Pension Fund. Official statistics on the Pension Fund budget execution is not publicly available, and is subject to acute political controversy and allegations. At the same time, shrinking labour market and shrinking payroll tax revenues create obvious additional pressures on the Pension Fund balance, which depends almost exclusively on the pay-as-you-go funding. In April, the Government has increased Pension Fund contributions for the private entrepreneurs operating under a simplified tax system (as described earlier in 2.3.3). A discussion about raising the minimum pension age, which resurrected in March 2009, did not lead to any policy decisions. Also in March, the VR approved a specific law, strengthening administrative control over payment discipline for contributions into the Pension Fund[93].

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[87] http://www.fisco-inform.com.ua/?module=news&action=view&id=3147, http://www.fisco-inform.com.ua/?module=news&action=view&id=3007
[88] http://www.fisco-inform.com.ua/?module=news&action=view&id=2220, http://www.fisco-inform.com.ua/?module=news&action=view&id=2215
[89] http://www.fisco-inform.com.ua/?module=news&action=view&id=3190, http://www.fisco-inform.com.ua/?module=news&action=view&id=3054, http://www.fisco-inform.com.ua/?module=news&action=view&id=2967
[90] http://www.fisco-inform.com.ua/?module=news&action=view&id=2507, http://www.fisco-inform.com.ua/?module=news&action=view&id=2505, http://www.fisco-inform.com.ua/?module=news&action=view&id=2508
[91] http://www.fisco-inform.com.ua/?module=news&action=view&id=2963
[92] http://www.fisco-inform.com.ua/?module=news&action=view&id=3110
[93] The Law of Ukraine *"On Amending some legislative acts of Ukraine on repayment of arrears to the Pension Fund and on strengthening responsibility over violation of legislation in the area of mandatory state pension insurance"*, No 1074-17, approved 05/03/2009.

3.2. Is the cost to local government of social benefits and services rising as a result of the economic downturn? Which of such cost increase has been the most prominent?

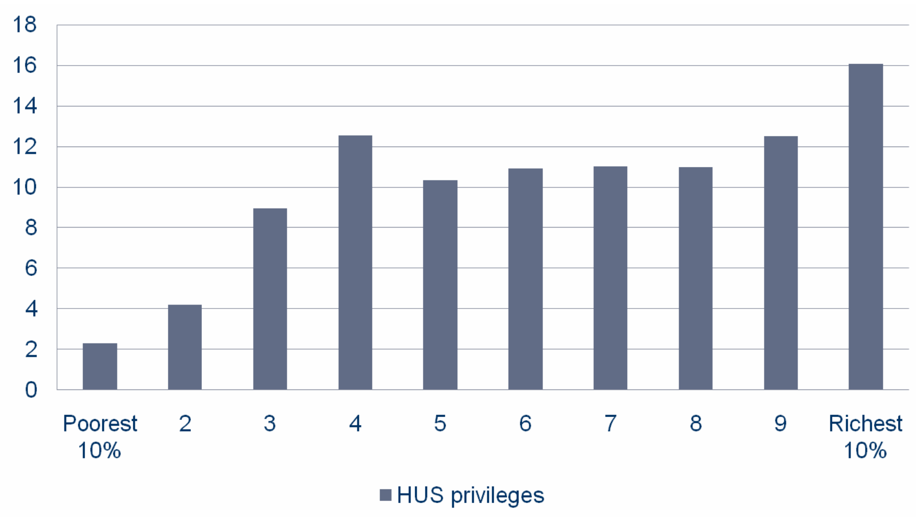
- No direct costs of social benefits. As was explained in 3.1., social benefits in Ukraine are fully funded from the central budget, and therefore local governments to not directly bear any costs related to social benefits.

- No clear evidence of rising costs or demand in social services - yet. The local governments are, however, fully responsible for funding social services to vulnerable population groups and should therefore absorb the costs of any increases in crisis-related vulnerabilities. Since household incomes have dropped considerably after the crisis, it could be reasonable to expect a deterioration in social vulnerability indicators related to (low) household income – and thus a rise in demand for social services. During the economic downturn of the 90s, rapid deterioration of household incomes was indeed found to correlate with increases in consumption of addictive substances, family breakdown, domestic violence, loss of homes etc. However, no objective evidence or research is available to judge whether income drops affect social vulnerability in the same fashion as in the 90s, and how strong is the influence, if any. No official statistics on the levels of social vulnerability – or sociological survey data to this point – is available in public access. In one of the speeches in November 2009, the Minister of Family, Youth and Sports has referred to the growing amount of claims of domestic violence and suicide attempts, but no statistics was quoted[94]. Increases in social vulnerability are also reported by media – albeit also with weak evidence base (e.g. one quoted outcome is increase in abortion rates based on interviews with pharmacy sales specialists and increase in *yandex* (internet search engine) search for "abortion" which raised ten times in first quarter of 2009 compared to same period of last year)[95].

3.3. If so, does the method of allocation give sufficient priority to the needs of the poorest households?

- The current system of allocation of low income support is not well targeted; in fact, most benefits and subsidies are regressive. According to the research presented by the World Bank[96], in 2006 only 24% of all types of social assistance were received by the poorest decile (10% of population ranked by income level), and 37% were received by the poorest 20%. By 2007, the latter dropped to 34% (of all assistance received by the 20% poorest population). The failure to reach the poorest is especially pronounced in the largest support programmes such as subsidies for housing and utilities services: in 2007, most of these subsidies were received by the population in the middle income deciles (Chart 11).

Chart 11. World Bank: the share of the programme budget on Housing and Utilities Subsidies received by income deciles[97]



[94] http://ling.infostream.ua/view.php?l=rus&docn=439130&q=%CF%D4%CD%C5%DE%C1%C5%CD
[95] http://www.fisco-inform.com.ua/?module=news&action=view&id=2724
[96] *"New approaches to social assistance: an academic whim or an urgent necessity?"*, presentation by K.Petrina, Senior Social Policy Specialist, Kyiv, 26/03/2009.
[97] Ibid

3.4. Are there legal and procedural obstacles to low income households gaining access to social assistance?

- Poor targeting is, primarily, a result of systemic failures in social protection system – and not so much of specific legal obstacles to access for the poor. The key factors behind poor targeting of the current social assistance system are a large number of categorical programmes (not related to family income), lack of agreed concept and criteria for social protection (resulting in almost equal role of social transfers with wages in household incomes), and poor allocation methodologies.

3.5. Is any encouragement being given to increasing the role of voluntary and community care to lessen costs of local government provision for social services?

- Ukraine's government continued to develop reforms in social service provision (to strengthen the role of community services) at the routine speed, without specific response to crisis-related pressures.
    - Ukraine's system of social services suffers from a number of weaknesses, which make it extremely cost-inefficient. One of such inefficient aspects is domination of residential services by large, state providers. Ukrainian government and non-state actors have jointly recognised this problem in 2003, with the approval of a framework law "On Social Services", which sets strategic benchmarks for reform. Actual implementation of these strategic reforms since 2003 has been problematic because of the scale of policy coordination which is needed to achieve tangible change (including alignment of administrative and financial responsibilities between levels of government, alignment of policy responsibilities fragmented between line ministries, performance-based and long-term budgeting, competitive commissioning of services implying risks to current monopolistic providers, etc.).
    - Despite the expectation of significant efficiency gains after the reform, its implementation requires additional fiscal space – especially in terms of potential recovery of the hidden demand for social services with expansion of their menu through voluntary and community care. Therefore, no immediate saving is expected for local governments from introduction of such alternative services.
    - Throughout the crisis, the Government continued its routine process for gradual development of these reforms. In particular, the following planned measures have taken place:
        - Continued work on developing and introducing licensing for social service providers[98];
        - Continued work on introducing integrated services for education of disabled[99];
        - Introduction of a new social benefit for adopted children and increase in social benefit for children taken under guardianship.[100]

[98] http://www.fisco-inform.com.ua/?module=news&action=view&id=2040
[99] http://www.fisco-inform.com.ua/?module=news&action=view&id=2091
[100] http://www.fisco-inform.com.ua/?module=news&action=view&id=2218, http://www.fisco-inform.com.ua/?module=news&action=view&id=2626