RECENT DEVELOPMENTS IN UKRAINIAN INTERGOVERNMENTAL FINANCE

Executive Summary

By changing the way in which taxes are allocated between governments, in 1997 the system of intergovernmental finance in Ukraine was radically altered. These changes raise many questions about the efficiency and performance of the new system of intergovernmental finance that are explored in this article. Major conclusions include:

- ♦ Because of imperfect information flows and the consequent inability to accurately forecast local government revenues, the Ministry of Finance is technically incapable of designing a rational configuration of subventions and contributions for Ukrainian oblasts.
- ♦ If executed, the Ministry of Finance proposal to limit 1998 second quarter expenditures would exacerbate the trend towards increasing regional expenditure disparities.
- ♦ The current method of calculating subventions to oblasts fails to provide proper incentives for expenditure economy and revenue mobilization. A formula based approach to intergovernmental transfers would provide a more appropriate vehicle for designing and implementing transfers to lower level governments and encourage them to adopt budgetary measures that will raise more revenue and achieve greater expenditure efficiency.
- ♦ Observed differences in per capita oblast expenditure are not rationally related to measurable differences in expenditure needs and the cost of service provision across the oblasts, but rather are explained mainly by differences in revenue availability.
- ♦ Although robust collections from the enterprise profits tax helped oblasts to maintain their real expenditure levels in 1997, inter-regional expenditure disparities grew in 1997 and were much larger than those envisioned in the 1997 State budget.
- ♦ Although the current distribution of expenditure and revenue assignments among different levels of government is generally sensible, several important benefits would be realized from reassigning the profits tax to the central government and using the proceeds to finance added social protection responsibilities and an enriched program of transfer payments to local governments.

A BRIEF HISTORY OF INTERGOVERNMENTAL FINANCE IN UKRAINE

Since independence subnational governments in Ukraine have experienced steady fiscal pressure to reduce the size of their budgets. Between 1993 and 1996 per capita real spending by subnational governments fell by 63 per cent mirroring the sharp decline in total subnational revenues. During this period local governments were financed by a mixture of shared taxes, subventions and, less importantly, local fees and taxes. Local governments received a fraction of the main central government taxes collected in their jurisdiction to finance their planned expenditures. By 1996, with the exception of the value-added tax(VAT), the tax sharing rates became uniform for all of the shared taxes between the central government and the oblasts. Tax sharing rates for the VAT were differentiated across oblasts as a means of effectively redistributing revenue from richer to poorer oblasts.

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In 1997 the previous method of funding oblast level governments was fundamentally altered. The new system of financing oblasts was a response to Article 143 of the Constitution enabling different levels of government to have independent sources of revenue. With the exception of excise taxes, which until 1998 continued to be shared on a 50-50 basis, tax sharing has been abandoned in favor of assigning separate sources of revenue to the oblasts and the central government. Under the new intergovernmental fiscal arrangements oblasts are allowed to retain all of the proceeds from the personal income and enterprise profits taxes collected within their territory. Both the base and the rates for these income taxes, however, continued to set at the national level. All of the revenues from the VAT are now assigned to the central government budget. Within each oblast the traditional system of tax sharing was maintained as the method of financing rayon and city level budgets. Given the large disparity in income tax bases among the oblasts, the finances of twenty fiscally poorer oblasts are shored up by deficit-filling subventions from the central government while a smaller number of income-rich oblasts, seven in all, are required to make contributions to the central government budget.

QUESTIONS ARISING FROM THE FISCAL EXPERIENCE OF 1997

Now that executed budgetary data are available to the Fiscal Analysis Office for 1997 it is possible to assess the performance of the new financial arrangements between the oblasts and the central government.Several questions and issues are posed in this article concerning these new arrangements that will be of interest to members of Parliament.

- When the 1997 budget was finally approved by the Verkhovna Rada what outcomes did the Ministry of Finance envision for the new system?
- In what way did the actual results for 1997 differ from those that had been anticipated in the 1997 budget plan?
- What factors explain the discrepancy between the budget plan and the executed budget data?
- Based on preliminary data, does it appear that the patterns observed in 1997 will continue in 1998?
- What are the major problems associated with this new system and can it be modified to successfully deal with those problems?
- Finally, what further policy actions need to be considered in order to put subnational government finance on a sounder financial footing?

THE 1997 BUDGET PLAN AND WHAT REALLY HAPPENED

Table I presents the Ministry of Finance(MOF) budget plan for 1997 that was approved relatively late in the year. Collectively, the oblasts were expected to raise 9,831 million UAH from their own revenue sources. After contributions to the central budget were exacted from some oblasts, net subventions from the central budget of 1,058 million UAH would augment own revenues and permit total planned expenditure of l0,889 million UAH for all of the oblasts. Seven oblasts were required to make contributions of l,062 million UAH out of their budgets to the central budget. The combined effect of these subventions and contributions would result in a reasonably equal level of per capital expenditures across the oblasts. Per capita expenditure in the highest spending oblast, Zhytomyr, would be 46 per cent higher than per capita spending in the lowest spending oblast, Odessa. In eight of the poorest oblasts subventions would represent a half of more of their total revenues. The city of Kiev, with the largest tax base per capita of any oblast would contribute over half of its revenue to the central budget.

Table II indicates the amount of revenue forecast by the different oblast financial departments and the amount of revenue that was actually collected by the oblasts. As can be seen from this table, oblast financial officials were much better at forecasting their own revenues than the MOF was. The MOF forecast of oblast own revenues was 24 per cent less than the amount of revenue that the oblasts were actually able to collect. By contrast, the oblast forecast was only 3 per cent less than the amount collected.[1]

What happened in the course of executing the 1997 budget? The central government payed 40 million UAH more in subventions than it had planned in 1997 and received about 250 million UAH less in total contributions than it had anticipated.[2] As a result the central government transfer to oblast budgets was actually 1,348 million UAH , or nearly 27 per cent higher than the planned amount. In addition, mutual settlements in favor of the oblasts from the central budget and a relatively small amount of bank loans enabled oblasts to support a total expenditure package of 13,750 million UAH.

In nominal terms, this total oblast expenditure level was 17 per cent larger than in the previous year. On average, consumer prices were 16.4 per cent higher in 1997 than in 1996. In short, there was no real compression of subnational budgets in the aggregate in 1997. Largely because of their vigorous revenue raising efforts, subnational governments on the whole were able to maintain their real spending levels in 1997 contrary to what had been projected in the 1997 budget.

At a disaggregated level, however, there is a great deal of inter-oblast dispersion around this average revenue and expenditure performance. Some oblasts experienced significant real expenditure growth; others underwent a fairly steep reduction in real spending. Table III displays the difference between executed and planned per capita expenditures. It is apparent from this table that the more heavily industrialized oblasts such as Dnipropetrovsk, Poltav, Kharkiv and the city of Kiev enjoyed real expenditure gains while more rural oblasts such as Ivano-Frankivsk, Zarkarpata, and Lvov suffered real expenditure losses. On an overall per capita basis, the city of Kiev, for example, spent almost twice as much as the oblast of Lvov.

On a sectoral basis, per capita expenditure disparities were equally striking. Per capita health spending was 61 per cent greater in the city of Kiev than in the relatively poor oblast of Zarkapatya. In the case of expenditures on education, the oblast of Dnipropetrovsk spent 65 per cent more than the neighboring oblast of Lugansk. The per capita variation in social protection spending is especially remarkable and deserves additional comment below. In this expenditure category, the oblast of Dnipropetrovsk spent 268 per cent more than the oblast of Volyn did.

[1] The superior accuracy of the oblast revenue forecast is somewhat misleading since it is largely attributable to timing differences between the MOF and the oblasts in their budgetary cycles. MOF makes its forecast early on in the budgeting process and bases its forecast to a large extent on previous revenue performance. Oblasts, on the other hand, estimate their expected revenue much later on in the yearly budget cycle when there is considerably more information about actual revenue collections.

[2] Current budgetary reporting procedures obscure the interpretation of these executed transfers because of the ubiquitous presence of mutual settlements among different levels of government that may be included in the amounts that are reported. Ukraine urgently needs a more transparent system of budgetary reporting.

Statistically, the pattern of total per capital oblast expenditure is well explained in terms of forecast errors on the revenue side. Simply stated, per capita oblast expenditure rises by approximately one Hryvnya for every Hryvnya by which per capita executed revenue exceeds the amount of MOF per capita planned revenue, and for every Hryvnya by which actual per capita subventions(contributions) exceed(are less than) the amount planned by MOF. By far the largest forecast errors occurred in the case of the Kiev City and the Dnipropetrovosk oblast. Both of these oblasts experienced much larger revenue growth, particularly for profits tax revenue, than had been expected and both made smaller contributions to the central budget than had been contemplated in the 1997 budget. These unexpected revenue spurts propelled both oblasts to the top of the per capita expenditure list.

It is clear that, despite the elaborate use of norms to formulate subnational budgets, the observed differences in oblast per capita spending are not rationally related to measurable differences in expenditure needs and cost of service provision across the oblasts. Differences in per capita expenditure across oblasts are driven for the most part by differences in revenue availability.

EARLY TRENDS IN 1998: SUBVENTION SLASHING AND REVENUE DROUGHT

The revenue trends detected for 1997 promise to continue in 1998. For the first two months of 1998 subnational governments have been able to realize 19 per cent of their planned revenues for the year. By contrast, the central government has managed to collect only about 6 per cent of its planned annual revenue in the same period, in large part because of an unforseen and surprising shortfall in VAT collections. One hypothesis put forward to explain this disparity in revenue performance is that tax inspectors working at the local level have responded to local pressures to concentrate on income tax collections to the detriment of VAT collections that now all go to the central government. Another explanation for the VAT decline is the increasing barterization of business transactions combined with defects in the implementation of the VAT principle.[3]

Because of its dismal revenue performance, the central government has been compelled to impose severe expenditure cuts for the second quarter of 1998. For this period MOF has proposed that subventions payable in this period be scaled back by 85 per cent and the Cabinet of Ministers has issued a decree confirming this proposal. This intended contraction in transfers to the oblasts is of questionable merit and has several unpleasant implications. Because the intended reduction in transfers will affect only those poorer oblasts receiving subventions, it threatens to reinforce the tendency towards increasing regional expenditure disparities that was observed in 1997. Moreover, such an abrupt drop in subnational funding may trigger a rash of new expenditure arrears at the local level where budget commitments have, in some cases, already been made for 1998.

A simple numerical example can serve to illustrate how the proposed reduction in subventions works to the relative disadvantage of the poorer oblasts in Ukraine. As shown in Table IV below, suppose, hypothetically, that there are three oblasts each with the same

[3] For example, according to an article in the business weekly *Delovaya Nedelya* (Number 17, 1998, p.6) Ukrainian firms engaging in barter with foreign firms pay no VAT on this intermediate transaction. However, Ukrainian firms that subsequently re-export the bartered product have, until recently, been entitled to claim a refund for the VAT that was not paid on their intermediate purchases. This violation of proper VAT procedures has severely eroded the base of the VAT in 1997 and early 1998.

population. Every oblast is assumed to have the same total expenditure of 100 UAH. Oblast A , the relatively poor oblast, receives a subvention of 60UAH. Oblast B is relatively well off and receives no subvention. Oblast C enjoys a modest subvention of 20UAH. Given this initial situation, if subventions are pruned proportionately by 85 per cent, oblast A will see its subvention shrink to 9UAH and its total expenditure fall to 49UAH, or by more than a half. Oblast B, because it is not affected by the reduction in transfers, will be able to maintain its original expenditure of 100UAH. The impact of the transfer reduction will be less severe in oblast C where the lower subvention level of 3UAH will require it to reduce its expenditure from 100UAH to 83UAH. Clearly, proportional subvention reductions severely adversly affect the poorest oblasts and the pain of lower central government spending is shared in an extremely unequal fashion.

Table 4
The Impact Of Reduced Regional Subventions

Oblast	Own Revenues	Initial Subvention	Initial Spending	New Subvention	New Spending
A	40	60	100	9	49
B	100	0	100	0	100
C	80	20	100	3	83

Imperfections in MOF revenue forecasting reinforce this tendency towards growing regional inequality and expose a serious flaw in the current budgeting process. If MOF had been aware of, , for example, the extent to which the city of Kiev had substantially overexecuted its revenues in 1997, it arguably would have tried to impose a larger exaction from this oblast in the 1998 budget. However, MOF was unable to learn what had happened to the city of Kiev’s revenues until after the 1998 budget was passed and by then it was too late to make any sensible adjustments to the amount of contributions the city would be required to make to the central budget. Given its unanticipated revenue surplus, the city should have been asked by MOF to make a larger contribution in 1998 to the central budget than it made in 1997. In fact, in the 1998 budget that has been passed, the city of Kiev is required to make a smaller, rather than a larger, contribution to the central budget.

The problem illustrated by the experience of Kiev is that the MOF does not possess sufficiently timely information to implement a rational system of subventions and contributions. However, even in the absence of this information problem, the current method of determining subventions and transfers is subject to a number of important shortcomings. This issue, and others of an intergovernmental nature, are explored next.

CRITICAL POLICY ISSUES IN UKRAINIAN INTERGOVERNMENTAL FINANCE

Looking back at the performance of intergovernmental finance in 1997 suggests that reform towards achieving a more satisfactory set of intergovernmental outcomes needs to concentrate on four crucial policy issues relating to fiscal decentralization, expenditure assignment, revenue assignment and the elaboration of a formula-based grant system. Each of these matters is discussed in detail below.

Fiscal Decentralization

Article 143 of the Constitution which champions the concept of budgetary independence for different levels of government should be read as a statement of intent rather than an explicit legislative guideline outlining how budgetary independence will be achieved. Transitional provisions of the Law on Local Self-government state that until the laws establishing the procedure for drafting local budgets in accordance with the Constitution have been approved, local budgets will be based on the existing 1991 Law on the Budget System for Ukraine. As a result, all of the attempts of local radas to draft their budgets independently of the actions of higher level governments have failed miserably. The traditional budget "matroshka" will continue in Ukraine until new budgetary laws and processes are adopted to support the goal of fiscal decentralization.

Expenditure Assignment.

With one exception, the pattern of expenditure assignments among different levels of government in Ukraine is a sensible one. The national government supplies and supervises the provision of public services that are of nation-wide significance, such as national defense and the judicial system. Oblast governments provides public services of regional significance such as specialized health care facilities and educational institutions. Rayons, cities and smaller communities offer their local residents a package of basic social services such as primary health care and education and a wide variety of social protection measure in addition to a number of communal services in the form of water, energy, local roads and garbage collection.

The single exception to the generally acceptable assignment of expenditure responsibilities is social protection. Since independence the responsibility for financing social protection programs has been increasingly shifted downward to local governments, in particular to rayon and city level budgets. In most other countries expenditures of a redistributive nature are designed and funded by higher levels of government, although lower levels of governments may be delegated to administer these programs and to exercise some discretion in determining who among the local population is eligible to receive some kinds of social support.

In Ukraine the central government mandates eligibility for social protection payments and the minimum amounts that must be paid out of local budgets to recipients under different kinds of programs. Local governments, if they have the means, may top up these minimum amounts. Some of the richer oblasts, such as the city of Kiev and Dnipropetrovsk, have used their superior revenue capacity to do just that. Other oblasts with more straightened revenue potential have struggled to pay even the minimums and have run up substantial expenditure arrears for social protection payments. As a result, the extent to which a Ukrainian citizen is protected by the existing social safety net has increasingly come to depend on where that citizen lives. If socially vulnerable groups are deserving of state support, no convincing argument can be made that their level of support should be a function of the place in which they reside. As mentioned above, in 1997 the inter-oblast dispersion in per capita spending on social protection is alarmingly large. The most equitable way to correct this situation and achieve uniform levels of social support is to recentralize social protection and make the central government responsible for financing its provision.

Revenue Assignments

In general, the distribution of revenue-raising powers in Ukraine among different levels of government is consistent with practices in the rest of the world. A good local tax is one whose burdens rest on local residents. The personal income tax meets this criterion. However, the enterprise profits tax fails to pass this test.The robust behavior of the enterprise profits tax in 1997 and so far in 1998 is a deceptive indicator of its suitability as a local government revenue instrument. Assignment of all of the revenues from the profits tax to subnational budgets in 1997 was a matter of political expediency since a major revenue source was needed to plug the revenue gap in local budgets caused by the central government's appropriation of all VAT revenues. However, the profits tax is generally not available to local governments at the city or rayon levels of government in other countries and, in Ukraine, on serves to provide revenue which rescues local budgets from insolvency.

There are a number of serious problems associated with the assignment of the enterprise profits tax to local governments. First, the profits tax base is distributed in a highly uneven fashion among the various oblasts and, consequently, as the discussion in the previous section indicates, some oblasts will have a greater capacity to finance their expenditure responsibilities than others. In principle, a well designed system of subventions and contributions could offset these horizontal fiscal imbalances. In light of the information lags and gaps facing the Ministry of Finance, however, it is not technically feasible to develop and implement such a system at this time.

A second problem with a local profits tax concerns its volatility. Profits are the cyclically most volatile component of GNP and therefore do no provide a stable source of funding for subnational governments. The problem is compounded at the rayon or city level of local government where the availability of a significant portion of revenue is tied to the profitability of local enterprises. If local enterprises fare badly, so will local budgets. In the event of an unexpected decline in the profitabilty of local enterprises local governments, with either no or very limited capacity to borrow, will be forced to make unplanned expenditure cuts or go begging to higher levels of government for financial assistance.

A further problem with a profits tax imposed at the local level is that it invites beggar-thy-neighbor tax competition among local governments seeking to entice more enterprise activity to their area by offering various forms of profits tax relief. Competition of this sort leads to the erosion of the profits tax base and geographic inefficiencies in the location of enterprise activity. In addition, the profits tax is also difficult to administer effectively at a local level. This is especially true in the case of multi-regional companies where arbitrary rules must be constructed to apportion a company's global profits among the different localities in which it operates.

Taken together, these concerns about the stability, equity and administrability of a local profits tax suggest that there would be several important benefits from reassigning the profits tax to the central government and using the proceeds to finance reallocated social protection responsibilities and an enriched program of transfer payments to local governments.

Formula Driven Grant Systems

Ukraine's present system of subventions and contributions does reasonably well in achieving one important fiscal objective-it significantly equalizes the fiscal capacity of different regions,or the ability of different regions to provide reasonably comparable levels of public services at reasonably comparable tax rates Table V demonstrates how much equalization is achieved. Prior to withdrawing contributions and granting subventions, the differences in fiscal capacity across regions are enormous. The most well-off region, the City of Kiev, enjoys a fiscal capacity, measured in terms of per capita own-source revenues, that is seven times greater than that of the poorest oblast, Zakarpattya. However, after contributions are exacted from the regions with the greatest fiscal capacity and subventions are made to regions with the lowest fiscal capacity, the highest per capita expenditure oblast spends only about twice as much as the lowest per capita expenditure oblast. The coefficient of variation in per capita oblast expenditures declines from 48.5 per cent to 17.7 per cent in the presence of both subventions and contributions. That is, nearly two-thirds of the dispersion in oblast per capita spending is removed as a result of the levelling influence of subventions and contributions.

Despite its redistributive virtues, the current system of determining oblast subventions and contributions needs to be replaced by a formula based approach to intergovernmental grants. The current system has several egregious defects. It is highly non-transparent because it relies so heavily on closed-door negotiations among all levels of government. It also creates adverse fiscal incentives for transfer recipients and contributors alike to overstate their true expenditure needs and understate their real revenue raising capacity. Moreover, because of the information lags and gaps that hamper the budget preparation process, it is beyond the technical expertise of the Ministry of Finance to determine a rational pattern of subventions and contributions.

A formula driven system of intergovernmental grants would be an improvement in almost every respect. If the formula were based on simple, objective criteria that measured expenditure needs and revenue potential with reasonable accuracy, the twin problems of unequal regional tax bases(horizontal fiscal imbalance) and overall revenue adequacy(vertical fiscal imbalance) could be dealt with in a transparent fashion that would not discourage local governments from increasing their revenue raising efforts. The exact form that such a formula might take is beyond the scope of this article because the particular design features of any sensible formula are sensitive to the choice of both expenditure and revenue assignments. That is, an appropriate formula for the situation in which both social protection and the profits tax are reclaimed by the central government would have different features than one which would be workable in the absence of these measures. The point remains, however, that a suitable formula can be made to work in Ukraine regardless of which expenditure and revenue assignments are made. Research is currently underway to develop such a formula for policy discussion and implementation.

URGENT NEEDS FOR LEGISLATIVE ACTION

Consideration of draft laws developing the decentalization concepts of the Constitution and the Law on Local Self-government is one of the highest priorities for the 14th convocation of the Verkhovna Rada.The desirable package of draft laws would include legislation on the national budget system, local budget systems, communal ownership of property, local taxes and fees and on the introduction of a new property tax. Reform of budgetary reporting is also urgently needed because the current system of budgetary reporting is contaminated by mutual settlements that make it impossible to accurately assess budget execution. Consideration of a formula-based approach to determining subventions and contributions should also be placed near the top of the future political agenda. Given the required legislative attention to these matters, Ukraine has an opportunity to enter the new millennium with an efficient and equitable system of intergovernmental finance that would be consistent with European practices and, at the same time, would also reflect Ukraine's historical and national uniqueness.