LARGIS

CAPITAL INVESTMENT GRANTS

Part I: General Principles

1.Introduction

1.1. These proposals arise from discussion in the Working Group on 19 and 22 March 2002. Part I deals with general policy choices and Part II with detailed procedures.

1.2 The Working Group is charged with preparing proposals for the award of investment grants under the provisions of the Budget Code These proposals are therefore designed to relate the allocation of investment grants as closely as possible to the principles of the Budget Code as applied to the funding of operating expenditure.

1.3 However State investment policies cannot ignore the implications of the Concept of Regional Policy which, like the Budget Code, was adopted in 2001. The representation of the Ministry of Economy on the Working Group suggests that its recommendations should reflect the principles of the Concept as well as the Budget Code.

1.4 The proposals also reflect the preference of the Working Group for a "mixed approach" which combines the framework of a nation-wide, multipurpose investment system with elements of regional policy.

2.Purposes

2.1 The grants should cover all State Budget investment in all competences which are assigned to local budgets under the Budget Code.

2.2. Should the grants be all-purpose or targeted on specific sectors of local government responsibility, and, if so, which sectors?

2.3 Practice varies internationally, but grants for investment are usually more targeted to national priorities than those for equalisation of current budgets, i.e. they contain more conditions about end use. These grants are likely to be given greater support in the formulation of the State Budget if their allocation and conditions of use reflect sectoral policies and priorities. This means

(1.) The grants should be restricted to a specified group of sectors, defined in this paper as "eligible" sectors

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(2.) Within each “eligible” sector, the Cabinet of Ministers may define types of investment project which are eligible for funding, defined here as “eligible projects

(3) Certain standards may be specified for the eligible projects within each eligible sector

(4) Sectoral expenditure needs indicators will be used in allocating grants.

2.4 However, local governments may vary the allocation between eligible sectors and may choose between the range of eligible projects.. (This is similar to the equalisation formula in the Budget Code; sectoral expenditure totals are used to calculate the total expenditures of each local government, but local budgets are not compelled to follow this expenditure pattern).

2.5 Which sectors should be eligible? The Budget Code distinguished between the autonomous and delegated competences of local government. The Code’s equalisation system applies only to the delegated competences implying that these are the fields of expenditure for which the State Budget should guarantee a minimum level of support. The same logic suggests that the priority for the investment grants should be *social infrastructure* in the fields of education, health, social welfare, culture and sport. This would be consistent also with the Cabinet of Ministers’ Decree 107R conferring priority on investment in social infrastructure in rural areas.

2.6 However implementation of the Concept of Regional Policy suggests that investment grants should also address the needs of regions with above average levels of unemployment and below average household incomes. This suggests that *economic infrastructure* affecting employment and incomes should also be eligible for the grants. I am not sure what types of investment would be appropriate to this sector in Ukraine but imagine that it would include transportation improvements (roads etc), agricultural processing and marketing facilities and industrial estates.

2.7 There is also a question whether *environmental infrastructure* (water, waste disposal, heating etc) should be eligible. There are two arguments for excluding this sector. Firstly these are autonomous rather than delegated competences under the Budget Code. Secondly, these are private goods services, primarily funded by consumer charges rather than taxes (although taxes are used to subsidise poorer consumers).

2.8 On the other hand environmental degradation is a major aspect of regional deprivation in Ukraine and, also, a major obstacle to economic investment. It is therefore suggested that environmental infrastructure should be eligible but only as an aspect of regional policy. It is worth consideration whether grants for this type of infrastructure should take the form of subsidies to the interest on loans.

3. Co-financing

3.1 Investment grants usually require some matching contribution from the recipient local government. This is an incentive to efficient choice, design and execution and also increases the utility of the State Budget allocation.

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3.2 It is suggested that the co-financing ratios between State and local budget contributions should vary according to

(1) differences in the per capita revenues of the recipient local governments, and

(2) the type of investment: grants for revenue earning investments would either require a higher matching contribution or take the form of interest rate subsidies (see 2.7)

Part II: Specific Criteria and Procedures

4. Total Volume

4.1 What should be the total volume of investment grants to be included in the annual State Budget? There are, in theory two approaches.

4.2 Under the first approach investment targets would be set for each sector for a fixed period, e.g. the next three or five years e.g. all schools to have one computer per *x* pupils, all settlements over 2000 population to be connected to a sewage treatment plant. The total cost of meeting these targets would then be calculated and divided by the number of years. The matching contributions would then be deducted to yield a net annual spending target. The aggregate of these sectoral targets would become the annual State Budget allocation. This is a relatively objective method, but the likelihood is that the resulting expenditure would have no relationship to the revenues available.

4.3 The alternative is to take the previous year's State Budget allocation for investment grants and increase it by the forecast rate of growth in State Budget revenues. This is close to the way most budget choices are actually made, but it does not encourage the Government or Parliament to give special priority to these investments.

4.4 The middle way would be to make calculations of aggregate investment needs on the lines of 4.2, but only to demonstrate the degree of priority which regional investments deserve. A decision might then be made to increase the total volume of grants each year by the rate of growth of the State Budget plus an additional fixed percentage. In this way the investments will be guaranteed an increasing share of State Budget resources over a number of years..

4.5 Because investment projects take a number of years to complete, grant allocations should be made on a three-year rolling programme. The 2003 Budget would make a fixed allocation for 2003, and forecast allocations for 2004 and 2005. The 2004

Budget would revise and confirm the 2004 allocation, update the 2005 forecast, and add a forecast for 2005. Forecasts for future years would not be legal commitments.

5. Distribution

5.1 The distribution system would work on the same principles as the calculation of the expenditure part of the equalisation formula under the Budget Code.

5.2 The first step would be to divide the total volume between the eligible sectors i.e. education, health, social welfare, economic infrastructure, culture, environmental infrastructure. If long term investment targets have been calculated per para 4.3, these would be the basis for the percentage division between sectors. If not, the division would have to be based on a subjective judgment of priorities, probably reflected in negotiation when the allocation rules are approved by the Cabinet of Ministers. Allowance might also have to be made for the scale of investment funding in each sector from other sources (e.g. European Union, World Bank).

5.3 This would yield a total allocation to each sector. This would then be divided between oblasts according to an appropriate index of inter-regional needs. Examples might be:

Education: school age population

Health: population weighted by age related mortality

Social welfare: age weighted population (possibly with a coefficient adjusting for per capita incomes)

Economic infrastructure: inverse to levels of income and employment

Environmental infrastructure: environmental degradation (air and water pollution etc)

5.4 The individual sectoral allocations to each oblast would then be aggregated to yield an investment total for the oblast. The appropriate matching contribution under para3.2 would then be deducted to yield the preliminary total grant to each oblast.

5.5 The total of preliminary grants will be less than the total allocation in the State Budget, the difference being the sum of the matching contributions. This saving can then be split between oblasts pro rata to their preliminary grant total and then added to form their final grant total.

5.6 An alternative to the procedure just described would be to divide the total volume of grant between oblasts according to an integrated index. However, it would be necessary to go through the same process as in paras 5.2 to 5.4 to calculate an appropriate index. The financial results should be the same but would be less comprehensible by the recipients.

5.7.As described in para 2.3 the Cabinet of Ministers may specify which types of investment project may be eligible for funding within each sector or possibly exclude certain uses. They might specify minimum standards. They should lay down maximum unit costs.

6.Distribution by Oblasts

6.1 Under para 5.4 each oblast's share of the total volume is the sum of its share of each sectoral total. It is a matter for decision whether the oblast should be able to vary this sectoral composition. In the case of the equalisation subsidies the sectoral breakdown of the expenditure total is not binding on local governments; it is only used for calculating spending needs relative to other local governments. Moreover the fact that the Budget Code routes investment grants through oblasts suggests an intention to give them some discretion. This would justify giving oblasts freedom to reallocate their total grant between the eligible sectors (but not to other purposes). They would automatically have such freedom if an integrated index is used (Para 5.6)

6.2 On the other hand sectoral ministries may argue that the sectoral breakdown agreed by the Cabinet of Ministers reflects national priorities and should be observed by oblasts. The Ministry of the Economy might argue that the very specific regional policy objectives of the economic and environmental infrastructure sectors should be protected by ring-fencing the allocations to them.

6.3 There are several options for defining oblast discretion:

(1) Oblasts must follow the sectoral breakdown of their grant calculation

(2) Oblasts may vary the sectoral breakdown within a certain percentage range (e.g.20%)

(3) Oblasts may vary the sectoral breakdown, but a minimum level of allocation is prescribed for certain sectors

(4) Oblasts have complete discretion to allocate their total grants between eligible sectors.

6.4 Ideally, once the total allocation to each sector has been determined at oblast level, it should be divided between cities and rayons by the same criteria as used for the division between oblasts (para 5.3). e.g. the education total should be divided between cities and rayons pro rata to school age population.

6.5 As a result of this process each city or rayon should receive an allocation for each sector, firm for the current budget year and provisional for the following two years. It should then submit proposals to the oblast for the use of these funds within the conditions prescribed under para 5.3, and subject to the co-financing level determined under para 3.2. Oblasts should accept these proposals providing

(1) the projects are eligible for grant financing,

(2) the designs comply with the prescribed minimum standards and

(3) the costs are within the maximum unit costs (unless the city or rayon contributes more than its co-financing obligation).

6.6 This process may be impossible to adopt, however, if the oblast total is too small to divide into a significant allocation to each city and rayon. In such case bids should be invited from cities and rayons according to priorities announced by the oblast, the final allocation being approved by the oblast rada.

7.Control

7.1 Grants which are unspent or spent on ineligible purposes should be returnable after a period reasonable for project execution.

7.2 The Government should monitor the allocation to projects to ensure that it complies with the allocation and eligibility rules. Any Government priorities should be reflected in the rules made by the Cabinet of Ministers. Government should not substitute its choice of projects for that of the oblast providing it complies with these rules. Oblast should be responsible for monitoring the design specifications and costs of individual projects to ensure compliance with grant conditions.

7.3 Project execution should comply with national legislation over public tendering.

8. Next Steps

8.1 These proposals are only a framework for discussion. Once they have been agreed or modified by the Working Group it would be necessary to formulate detailed proposals concerning

(1) the calculation of the total volume of grants and its future rates of growth

(2) the choice of eligible sectors and types of eligible projects within each sector

(3) the division of the total volume between sectors

(4) criteria for dividing sectoral totals between oblasts

(5) minimum standards

(6) maximum unit costs

(7) co-financing ratios.

9. Conclusion

9.1 These proposals attempt to strike a balance between sectoral and regional priorities. State sectoral priorities will be reflected in

(1) the choice of sectors eligible for funding and of eligible types of project within each sector

(2) the definition of standards for eligible projects

(3) the balance of funding between eligible sectors in the allocation formula.

9.2 Regional priorities will be reflected in the choices between eligible sectors and projects made at oblast, city and rayon level within the overall allocations to oblasts.

9.3 Regional policy is promoted by

(1) the inclusion of economic and environmental infrastructure in the list of eligible sectors and projects and the indices used for their allocation

(2) the variation of co-financing contributions according to per capita revenues.

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