

ICPS newsletter[®]

Government uses public policy approach to develop a vision of Budget reform

The fact that Budget reform remains incomplete has created a situation in Ukraine where not enough money is being transferred into local budgets for local governments to provide quality public services, there is no incentive to increase local revenues, local governments are too dependent on the central government for the use of allocated resources, and they have no money to invest in developing their own territories. Government experts are using the Green Paper format to propose their own vision of ways to improve funding for those responsibilities delegated from the central Government and to change the division of powers among levels of government in order to resolve local budget issues

As part of the "Policy Analysis Group on Fiscal Decentralization" project, experts from the Economy Ministry, ICPS and the National Security Council, under the direction of First Deputy Economy Minister Anatoliy Maksiuta, are developing a Government vision of reforms in budgetary relations. According to the rules generally applied in mature democracies, the first stage of policy-making is to present the relevant issue in the format of a Green Paper. A Green Paper is a Government document that is used for consultations with stakeholders. It describes problems in a given area and proposes possible solutions for discussion. The European Commission uses Green Papers as a working tool to involve the public in formulating and instituting policies.

A Green Paper called "Decentralizing Ukraine's State Budget in the Context of Local Government Reform" will be discussed at roundtables in Kyiv, Lutsk, Mykolayiv, and Zhytomyr on 7–17 March 2006. This article is a brief presentation of key points in the Green Paper. Readers who are interested in an in-depth analysis of this issue can find the full text of this Green Paper online at: www.icps.com.ua/eng/project.html?pid=97.

Incomplete Budget reform

Budget decentralization is the process of transferring functions, powers and responsibilities from higher to lower levels of government. As a rule, when a central Government is interested in improving the public administration system, it will decentralize the Budget. This is partly to "unburden" itself of the business of providing public services that are based on local conditions such as the place residence of the population, its ethnicity, traditions, and so

on. These functions are transferred to regions, municipalities or associations of cities, along with part of the country's financial resources and the necessary powers to institute and collect taxes and to borrow money.

In recent years, reforms were implemented in Ukraine that partly delegated the power to spend Budget funds to the local level. However, this reform is incomplete, as there has been no clear division of powers and responsibilities between Kyiv and local governments. Because Ukraine's administrative and territorial system was inherited from the Soviet Union, while the executive branch and local governments are based on a top-down decision-making system, these incomplete reforms have resulted in a conflict of interest, where local governments actually depend on the central government to make decisions about spending financial resources at the local level.

One of the main causes behind the inefficiency of the current system of budget transfers is that the decentralization of the fiscal system has not been properly defined, that is, what the share of local budgets in the Consolidated Budget should be, the distribution of spending funds among levels of government, and the division of revenues among different budgets.

Budget problems hold up local development

The authors of the Green Paper identified two examples of what's wrong with the state of budget decentralization right now:

- Having gained the right to provide social services to their populations, local

governments have not been given enough money to cover the provision of these same services. Because the formula for calculating budget transfers requires surplus local revenues to be transferred to the State Budget, there is no incentive for local governments to try to raise revenues locally.

- Because of social commitments placed on them by the central Government, local governments are forced to spend 99% of their funds to cover current needs and have nothing left for development.

According to the authors of this study, these problems are caused by:

- **No clear division of functions and responsibilities among governments for providing services.** The Budget Code divides revenues and expenditures among levels of government, but no one is actually responsible for the quality of services provided. Some kinds of spending, such as educational, healthcare and sports facilities, are funded by both local budgets and the State Budget, depending on their subordination.
- **The dependence of local governments on the central Government for decisions on revenues and expenditures.** The decisions of the central Government have a direct impact on revenues and expenditures of local budgets and this does not allow local governments to properly plan and carry out local development.
- **The combining of service provision with quality control.** Oblast and regional administrations function simultaneously as executive and oversight bodies.

To tackle Budget decentralization, the authors of the Green Paper propose changes in the division of powers among governments and ways to improve funding of those responsibilities that have been delegated by the central Government.

How to improve funding for delegated responsibilities

To increase funding for those responsibilities that have been delegated, the state should:

- objectively identify the volumes of local spending that will be used to calculate interbudgetary leveling transfers. For this purpose, a system of standards for the provision of social services to local populations needs to be instituted;
- improve the way that it calculates interbudgetary transfers;
- regulate situations where local governments refuse to carry out responsibilities that have been delegated to them but are not funded properly;
- establish institutions that would handle budget disputes arising among different levels of government.

Changing the balance of spending powers

For the division of powers between regional and local levels of government to be clear and appropriate, three principles need to be followed:

- allowing local governments to influence the size of tax and non-tax revenues formed on their territories and paid by residents and businesses. This will provide residents with incentives to pay higher taxes in return for better quality public services;
- applying economies of scale in order to reduce the cost of providing certain state-funded benefits by can be considered. For example, spending is optimized when secondary schools are used by 20,000 residents, fire-fighting services by 40,000 residents, sports facilities by 500,000 residents, and post-secondary institutions by 2mn residents;
- making the provision of state-funded services the responsibility of that level of government that is closest to the users of those services and can fund them the most efficient manner.

With each type of state-funded service provided at the regional and local levels, legislation needs to clearly identify which level of government is responsible for:

- setting standards and regulating various state-funded services;
- funding different state-funded services;
- providing different state-funded services to the local population.

Changing the distribution of tax revenues among budgets

The authors of this Green Paper propose four general criteria for choosing which

local taxes will be the source of local revenues:

- they are paid by those individuals and companies who use that government's services;
- they do not entail high administration costs;
- their revenues are as equal as possible across local budgets;
- they should not be too dependent on business cycles.

Taxes that meet these criteria most closely are personal income taxes, real estate taxes and fees for local services. However, none of these is ideal as a source of local budget revenues.

Budget reform must follow a number of other reforms

Budget decentralization depends on other reforms, especially territorial administrative reforms and political reforms, which involve changing the system of government in oblasts and regions and the re-distribution of powers among them. Further budget decentralization must take place after changes in the territorial administration of the country, the public administration system, the social security system, and the tax system. Because the parameters of related reforms remain unclear, it is impossible to find an optimal Budget system, as it is not known in advance what the volumes of local spending will be and which revenues—taxes, fees, transfers—will be used to cover them.

Moreover, the Budget reform of 2001 made it clear that, without changes in these areas, any achievements of reform become unsustainable. In recent years, there was an increasing tendency towards centralization and towards confusion in relations among different levels of government. The dependence of Budget reform on other reforms is the Achilles' heel of this process, as the chances that any of these other reforms will be carried out any time soon are low. ■

The "Policy Analysis Group on Fiscal Decentralization" project is being implemented by ICPS jointly with experts of the National Security Council and the Ministry of Economy with the support of the Canadian International Development Agency (CIDA), the Canadian Bureau for International Education (CBIE), and the Policy Advice for Reform in Ukraine (PAR) program. For additional information, contact Project Manager Andriy Bega by telephone at (380-44) 484-4400 or via e-mail at abega@icps.kiev.ua.

By the way...

- A constituent council to launch the "Setting up 10 Policy Analysis Groups in Central Executive Bodies" project was held on 9 March 2006. Project participants will be groups of experts from the Presidential Secretariat, the Secretariat of the Cabinet, the Ministries of Economy and Transport and Communication, the Anti-Monopoly Committee, and other government committees and agencies. Each of these groups will use public policy formats and procedures to develop relevant reforms and to establish the conditions necessary to introduce programs to transfer the standards of the EU government institutions known as Twinning programs to the Ukrainian Government.
- As part of a project to improve Ukraine's migration policy, a group of ICPS experts went to Zakarpattia oblast 2–3 March 2006. They visited a center for detaining illegal migrants in the village of Pavshyne. Afterwards, they held a seminar on readmission and Ukraine–EU relations in Uzhhorod.
- The candidate for mayor of Kyiv from the Pora–PRP bloc, Vitaliy Klitschko, presented his strategy for municipal development 28 February 2006. The Ukrainian Fund for Supporting Reforms, KPMG, a top auditing consultancy, the International Centre for Policy Studies, the Urban Institute, and other specialized institutions participated in developing this strategy. ICPS was represented by Deputy Director for Development Volodymyr Nikitin at this presentation.
- A conference on developing a quality management system in Ukrainian cities based on ISO 9001:2000 requirements took place in Chuhuyiv, Kharkiv oblast, on 28 February 2006. Using methods developed by the "People's Voice" project, a poll was carried out in Chuhuyiv to measure the level of public satisfaction with services provided by local government offices. The results were used as a basis for developing a management system and helped identify areas for reforming the local government.

By the way... is a new column that will briefly inform readers about current ICPS activities and update you on various research projects undertaken by ICPS and other events that are not always covered.

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To be included in the distribution list, mail your request to: marketing@icps.kiev.ua.

icps newsletter editor: Yevhen Shulha (shulha@icps.kiev.ua)

Phone: (380-44) 484-4400. Fax: (380-44) 484-4402.

English text editor: L.A. Wolanskyj

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Address: vul. Pymonenka 13A, Kyiv, Ukraine 04050

Web-site: <http://www.icps.com.ua/eng/>