

ICPS newsletter[®]

Reforming local government audit and control systems as part of fiscal decentralization

In September 2007, the "Auditing Functions Survey" project came to an end. The result was a detailed analytical report that covered various issues of legal and institutional support for auditing budgets, how to verify the qualifications of internal and external auditors, and compliance with international standards for control and audit. The main conclusion of this study was that establishing a system for local internal financial control must be an integral part of the reform of interdepartmental relations that must, in turn, accompany fiscal decentralization

Needed: Financial management systems for local governments

Reform aimed at fiscal decentralization, which was launched after Ukraine adopted its Budget Code, requires that the financial management systems of local governments be further developed. And part of any financial management system is the control and audit system.

Control and audit functions carried out by local governments belong to internal financial oversight. According to Art. 26 of the Budget Code, internal financial control must, at all stages of the Budget process, provide:

- ongoing evaluations of the judiciousness and appropriateness of the work of budget-funded entities as regards internal financial control;
- an evaluation of activities and results according to established objectives and plans;
- information about the results of any checks (evaluations, investigations, studies or reviews) conducted by its office of internal financial control, directly to the head of the budget-funded entity.

The head of each publicly-funded entity is expected to establish an effective internal system for overseeing economic activity. These managers are also responsible for the organization and state of internal financial control and audit systems both in

these institutions and in any budget-funded entities directly subordinate to them.

Evaluating Budget fulfillment at the interagency level

Notably, as an element of financial management, Ukraine's reform of financial control is seriously lagging behind its reform of interagency relations. The current system of interagency relations requires that clear performance measures be developed for the assigned control functions over targeted and actual use of Budget funds. By assessing Budget performance at all levels of government, it will be possible to determine typical distortions caused by:

- lack of legal standards for local government and executive authorities during Budget formation and execution alike;
- lack of ongoing oversight of subordinate institutions and organizations and no effective preventive measures for the purpose of such ongoing oversight;
- many problems involving non-cash settlements.

Local financial control needs institutions to develop

Among other urgent problems, there is the issue of initiating and expanding effective local internal financial control in Ukraine, that is, there are no institutions

that might guarantee effective and rational control in each individual region. For instance, the Cabinet Resolution subordinating local state administrations does not provide for separate departments in the structure of these administrations.

In practice, the situation with organizing internal control differs from region to region. Most oblast state administrations include audit and control offices in their structures. In some administrations, these functions are performed by subdivisions that are the part of the related ministries; in others, there are no such subdivisions.

Missing: An integrated concept of local financial control

In Ukraine, the basis for local internal financial control is laid down in Art. 26 of the Budget Code. This defines the administrative responsibility for establishing and implementing local internal financial control systems. However, it is poorly formulated and secondary legislation does not elaborate on it. In fact, the concept of decentralized liability for local financial control has still not been instituted in Ukraine.

Nor is the system of internal local financial control regulated by a specific piece of legislation. There is, instead, a series of legislation that regulates separate instances, but no unified concept for what the local internal control system should look like. Moreover, even though some local governments have control divisions and sections within their executives, the effectiveness of these departments is quite low.

The capacity of internal auditors is quite low as well, due to:

- lack of interest among local administrators in overseeing the bigger portion of local revenues, which is

actually controlled by the state. This is the result of the fiscal dependence of local governments on the State Budget;

- lack of strategic vision and poor financial management skills among specialists in local executive bodies;
- lack of financial incentives among staff of local administrations. Uncompetitive salaries make it hard to hire well-qualified professionals.

Incentivizing local governments

Internal financial audit and control can be instituted as an integral part of the local financial management system at the initiative of local governments. In practice, the main motivation to carry out internal audits and hire independent auditors is the desire to develop their region and to make capital investments.

For example, this can mean working with borrowed money at the local budget level. Under Ukrainian law, the Ministry of Finance requires a number of conditions for local governments that want to borrow from banks or enter capital markets.

One such requirement is to get credit ratings from nationally or internationally recognized agencies. In order to receive such a rating, a local government must hire a local independent auditor to collect all information necessary to be given a credit rating. As a rule, such services are affordable only for local governments with a budget of at least UAH 200mn. Local governments with smaller budgets cannot afford to pay for the cost of credit ratings or for the services of major consultancies.

Another incentive for local governments to institute financial control systems and audit their budgets can be the desire to attract foreign investors who want access

to budget information and to be able to read financial reports in an internationally accepted format.

Thus, establishing an internal local financial control system should be an integral part of market reforms and be aimed at adopting modern methods of local government and continuing fiscal decentralization. ■

This project was implemented by ICPS senior economist Olha Romanyuk. It was commissioned by the Open Society Institute as part of the "Local Government and Public Service Reform Initiative" program. The results of this study will be used by the Open Society Institute to formulate future technical assistance projects in Ukraine.

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Consumer pessimism starting to fade?

In August 2007, the Consumer Confidence Index (CCI) in Ukraine was 102.7. A value above the 100-mark shows that positive consumer confidence prevails in Ukraine. Prior to that, pessimistic expectations prevailed in Ukraine for 18 months: the last time the CCI went above the 100-mark was in February 2006.

Compared with June 2007, the CCI has grown 5.8 points. Consumer confidence improved mainly thanks to more positive economic expectations among Ukrainians. The Index of Economic Expectations (IEE) grew 7.7 points, to 100.7. In particular, short-term economic expectations improved significantly: the index x3 grew 15.8 points to reach equilibrium, 99.9. This points to the fact that Ukrainian consumers have finally accustomed themselves to political instability. As a result, the political factor has become less important in determining consumer confidence. In addition, the election campaign was calm and did not increase the level of uncertainty in Ukrainian society.

The Index of the Current Situation (ICS) was 105.8 in August 2007, 3.0 points above the value registered in June. The Index of Current Personal Financial Standing (x1) grew 4.4 points over this period, to 97.6, which is a record-high value since the beginning of 2006. The Index of Propensity to Consume (x5) reached a new record-high value in August 2007—113.9.

In August 2007, the Index of Inflationary Expectations (IIE) was 185.3, 3.6 points below the value registered in June. This decline matches the dynamic of the Consumer Price Index (CPI) in Summer 2007: consumer prices grew at a rapid pace in June and July, 1.4% and 2.2%, but the Index grew

a mere 0.6% in August. However, inflationary expectations continue to be high. In August, the IIE was higher than at the beginning of the year.

Optimistic consumer confidence prevails in all regions, except Eastern and Northern Ukraine. The highest CCI value, 113.4, was registered in southern oblasts. Over June–August 2007, consumer confidence in Western Ukraine improved the most. The CCI for this region rose 17.7 points, to 112.9. In Eastern Ukraine, the CCI was 92.1 in August 2007, 2.2 points above the value registered in June.

In August, optimistic consumer confidence also prevailed in small towns and mid-sized cities. But the CCI for rural areas fell 5.8 points from June to August 2007, to 94.7. Evidently, the poor crop had a negative impact on the confidence of rural residents. Rural consumers also have the highest inflationary expectations: their IIE was 189.0 in August.

The CCI survey registered an improvement in consumer confidence among representative of all income groups. The Index for Ukrainians with average incomes climbed 5 points from June to August, to 101.6. The CCI for this income group had not gone above the 100-mark since June 2005.

Consumer confidence improved mainly among middle-aged and older Ukrainians. From June to August, the CCI for middle-aged consumers, those aged 31–45, grew 9.1 points, to 104.3. The last time the CCI value went above the 100-mark for this age group was in February 2006.

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