



UKRAINE

TECHNICAL ASSISTANCE REPORT—FISCAL DECENTRALIZATION AND LEGAL FRAMEWORK FOR FISCAL RISK MANAGEMENT AND MEDIUM-TERM BUDGETING

November 2019

This Technical Assistance Paper on Ukraine was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in October 2017.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: <http://www.imf.org>
Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.

F I S C A L A F F A I R S D E P A R T M E N T
& L E G A L D E P A R T M E N T

Ukraine

Fiscal Decentralization and Legal Framework for Fiscal Risk Management and Medium-term Budgeting

Miguel Alves, Veronique Salins, Alessandro Gullo, Camila Aguilar, Francis Conway,
and Nikita Aggarwal



Technical Report

December 2017

CONTENTS

GLOSSARY	5
PREFACE	6
EXECUTIVE SUMMARY	7
I. IMPROVING THE ORGANIZATION OF SUB-NATIONAL GOVERNMENT	14
II. IMPROVING THE BALANCE BETWEEN REVENUE AND EXPENDITURE ASSIGNMENTS	20
A. Revenue Sharing Arrangement	20
B. Expenditure Assignments	27
C. Key Findings on the Balance of the Arrangement	31
III. IMPROVING THE FORMULATION AND EXECUTION OF SNG BUDGETS	36
A. SNG Deposits with the State Treasury	36
B. SNG Budget Structure and Process	38
C. SNG Capital Expenditure Planning	43
IV. ENHANCING INTERGOVERNMENTAL FISCAL COORDINATION	47
A. Intergovernmental Fiscal Coordination Framework	47
B. Local Government Risk Monitoring	49
C. Cash Management	53
V. STRENGTHENING THE LEGAL FRAMEWORK FOR FISCAL RISK MANAGEMENT AND MEDIUM-TERM BUDGETING	56
A. Fiscal Risks Monitoring	57
B. Medium-term Budgetary Framework	60
BOXES	
2.1. Examples of Uncertainty in Delimitation of Revenue	22
2.2. Revenue Arrangement and Expenditure Mismatch – An Example for Cities and Hromada	35
3.1. Key Features of the SNG Budget Structure and Process	41
FIGURES	
2.1. Subnational Government Revenue, by Tier	21
2.2. Subnational Government Own Revenues	23
2.3. Revenues of SNG Tiers, by Type of Revenue, 2016	24
2.4. Grants and Subventions	26
2.5. Subnational Government Expenditure, by Tier	28
2.6. Distribution of Responsibilities for Implementation	29
2.7. SNG Expenditure by Function, 2014 vs. 2016	30
2.8. SNG Expenditure by Economic Type, 2014 vs. 2016	30
2.9. SNG Capital Expenditure, by Tier	31

2.10. Trends in Balance Between Revenue and Expenditure _____	32
3.1. How the High Balances May Have Originated _____	38
3.2 Performance of PIT: Budget vs Outturn, 2015–17 _____	43
3.3. City of Kyiv Capital Expenditure, 2010–17 _____	44
3.4. Investment by Subnational Governments, Comparison with Peers, 2015 _____	45
3.5. State Investment Grants by Program, 2014–17 _____	46
4.1. Stock of Treasury Bills and Funds at Commercial Bank Accounts _____	55

TABLES

0.1. Recommendations and Action Plan _____	10
1.1. Physical Information on Hromada Amalgamation, as of August 11, 2017 _____	16
2.1. Subvention and Expenditure in Education, Cities of Oblast Significance _____	33
2.2. Subvention and Expenditure in Education, 2016 _____	34
2.3. Impact of Wage Increase in Education Spending of SNGs _____	34
3.1. SNG Treasury Deposits by Tier of SNG, 2014–17 _____	36
3.2. Ratio of Cash Balance to Average Monthly Expenditures by Tier of SNG _____	37
3.3. Average Monthly Revenue, Expenditure, and Balance of SNGs, 2015–17 _____	37
3.4. Main Protected Expenditure Items, 2016 _____	39
3.5. Earmarked Revenues, 2015–17 _____	40
3.6. Capital Expenditures by Tier of SNG, 2014 vs. 2016 _____	44
4.1. Subnational Fiscal Rules in Selected European Countries _____	48
4.2. Selected Financial Stress Indicators of SNGs, 2016 _____	50
4.3. Heat Map of Financial Stress Indicators, Oblasts and City of Kiev _____	51

ANNEXES

I. Distribution of Powers to Local Government _____	65
II. Subnational Fiscal Rules in Selected European Countries _____	69
III. Draft Legislative Suggestions on Amendments to the Budget Code _____	72

GLOSSARY

BCU	Budget Code of Ukraine
COS	City of Oblast Significance
CMU	Cabinet of Ministers of Ukraine
DLB	Department of Local Budgets
DSA	Debt Sustainability Analysis
DPD	Debt Policy Department
FAD	Fiscal Affairs Department
FBE	Forward Baseline Estimates
FRMD	Fiscal Risk Management Division
FRS	Fiscal Risk Statement
GRB	Gender Responsive Budgeting
IMF	International Monetary Fund
KSU	Key Spending Unit
LEG	Legal Department
LM	Line Ministry
MEDT	Ministry of Economic Development and Trade
MoF	Ministry of Finance
MTBF	Medium-term Budget Framework
NBU	National Bank of Ukraine
PPP	Public Private Partnership
PFM	Public Financial Management
PIM	Public Investment Management
QFA	Quasi-Fiscal Activities
SOE	State-Owned Enterprise
TA	Technical Assistance
UAH	Ukrainian Hryvnia
VR	Verkhovna Rada (Parliament of Ukraine)

PREFACE

In response to a request from the Minister of Finance, Mr. Oleksandr Danyliuk, a technical assistance mission from the Fiscal Affairs Department (FAD) and Legal Department (LEG) of the IMF visited Kiev, Ukraine during the period October 3–16, 2017. The mission assisted the authorities in reviewing the results of the 2015 fiscal decentralization reform and the amendments to the Budget Code for implementation of certain PFM reforms. It was led by Miguel Alves, and consisted of Veronique Salins (both FAD), Alessandro Gullo (LEG), Camila Aguilar, Francis Conway (both FAD short-term experts), and Nikita Aggarwal (LEG short-term expert). The technical assistance was provided with financial support from the Government of Canada.

The mission met with Ms. Oksana Markarova, First Deputy Minister of Finance, Mr. Serhiy Marchenko, Deputy Minister of Finance; Mr. Mykhailo Bosak and Ms. Olena Mykhailenko, Deputy State Budget Directors; Ms. Olena Malchuna, Deputy Director of the Department of Local Budgets; Mr. Andrey Savenko, Head of the Fiscal Risk Management Division; Ms. Olena Skrypkinia, Head of Legal Department; Mr. Gladun Yevhen, Head of the Revenue Forecasting Department; and Ms. Polina Yakova, Deputy Director of Debt Policy Department, and Nataliya Nabedyk, Head of Intergovernmental Relations at the State Treasury Service. At the level of local authorities, the mission had discussions with Mr. Volodymir Repik, Director of Finance of the Kyiv City State Administration; Ms. Tetyana Kharenko and Mr. Roman Zhovnir, Deputy Directors of Cherkasy City's Financial Policy Department, Ms. Natalia Kravchenko, Director of the Finance Department of the Cherkasy Oblast; Anatoliy Olexandrovych, Mayor of Amalgamated Territorial Community of Baranivka; and senior staff of these local authorities.

The mission also met with Mr. Gennadiy Zubko, Vice Prime Minister and Minister of Regional Development, Building and Housing and Communal Services of Ukraine and senior representatives from this Ministry; Mr. Pavlo Kovtonyuk, Deputy Ministry of Health; Ms. Olga Shchelgova, Ministry of Education; Mr. Roman Kropivnitsky, Ministry of Economic Development and Trade; Mr. Ihor Voliansky, State Audit Service; and senior staff of these agencies as well as members of the Local Budgets Sub-Committee of the Verkhovna Rada. Finally, the mission met with local civil society groups including the Associations of Ukrainian Cities, Villages, and Amalgamated Territorial Communities, and the Reanimation Package of Reforms, as well as members of the international donor community, including Mr. Erik Faxgård and Ms. Jasmina Dikic of the Support to Decentralization in Ukraine Project; Ms. Alexandra Fehlinger, Team Leader of the U-Lead with Europe Project; and representatives from the World Bank, the European Commission, the Organization for Cooperation and Economic Development, and the Swedish and Canadian Embassies.

The mission would like to thank the authorities and other participants for their collaboration during the mission. The mission is also extremely grateful for the support given to the team by staff at the IMF office, in particular to Mr. Ihor Shpak for his excellent support in coordinating the mission. The mission is also grateful to Ms. Oksana Burakovska and Mr. Victor Verhun for their excellent interpretation and translation efforts over the course of the mission.

EXECUTIVE SUMMARY

In the aftermath of *Euromaidan* revolution early 2014, the public demand for local self-government and devolution of power, brought fiscal decentralization to the top of the reform agenda. As a result, a decentralization reform was introduced in late 2014, which helped to improve subnational government's financial capacity, self-sufficiency, and flexibility.

The reform resulted in an overall improvement of subnational government finances. Compared with 2014, own revenues of subnational governments increased, while current expenditure declined. This created additional space for capital expenditure, which almost doubled as a percent of GDP, from 2014 to 2016. Overall subnational governments recorded a combined surplus of 1.0 and 0.7 percent of GDP in 2015 and 2016, respectively.

Despite these significant reforms and positive fiscal outcomes, Ukraine's subnational finance system is still facing important challenges, which are described below, together with proposed measures to address them.

Organization of Subnational Government

The territorial organization of Ukraine remains highly fragmented (around 9,300 subnational units organized on a four-tier structure) and the distribution of powers and responsibilities between State administration levels (oblasts and rayons) and local self-governments (cities and hromada), and among the latter, is unclear. Furthermore, a number of design issues are slowing the process of voluntary amalgamation of territorial communities and will lead to a proliferation of small units, with low potential for financial self-sufficiency. Addressing these challenges would entail:

- Improving the amalgamation process by (i) basing it on clear criteria that ensure the financial viability of the resulting new units, and (ii) making it mandatory for the smaller units that incur in recurrent deficits; and
- More broadly, clarifying the roles and responsibilities of each level of government, and distinguishing between those powers that are assigned, delegated, and shared with subnational governments, and the rights and responsibilities associated with each.

Balance between Revenue and Expenditure Assignments

The positive financial outcome of subnational governments was primarily based on an overperformance on shared taxes (primarily the Personal Income Tax, distributed on a basis that is disconnected from the structure of service provision by subnational units), bottlenecks in the execution of capital expenditure, and the fact that the devolution of spending responsibilities has happened in successive stages and not always through fully transparent systems. These factors will exert pressures on subnational finances in the near future, so the current trend will likely not continue. Own-revenues grew considerably, but less than anticipated (primarily due to technical difficulties on real estate property tax) and subnational governments still rely, to a great extent, on grants and subventions from the State to cover their rigid structure of expenditure. Furthermore, State Administration levels have observed a reduction in spending responsibilities,

but their revenues have not been reduced proportionally to the tasks that were assigned to local self-government units.

Achieving both an overall balance and a vertical fiscal balance, whereby own revenues cover basic expenditure responsibilities and dependence on State grants and subventions is minimized, would require a combination of changes to the revenue-sharing arrangements and expenditure assignments, such as:

- Sharing PIT revenues based on where employees reside and not where they work, and addressing the technical/design feature of the real estate property tax;
- Facilitating the local authorities' projection of funding for health and education, by clarifying what expenditure items are to be covered by the subventions and transparently sharing information on the parameters used in subvention formulas;
- Reducing revenue assigned to administrative levels (Oblasts and Rayons) according to their roles after decentralization;
- Ensuring greater continuity in the policies impacting subnational finances and regularly reviewing the system for identification of potential mismatches.

Formulation and Execution of Subnational Government Budgets

Local governments have recently accumulated large idle deposits, in response to (i) the uncertainty about the devolution of spending responsibilities, (ii) the rigid structure and short-term focus of the budget formulation and execution processes, and (iii) the difficulties they face in building a pipeline of investment projects. Achieving a more efficient budgetary process that allows subnational authorities to make independent decisions on issues of concern to the local community and provides for lower cash-at-hand needs, would require:

- Replacing the General and Special Funds with separate appropriations for operating and capital expenditure;
- Reducing the number and scope of earmarked revenues and protection of specific expenditure items;
- Improving the forecasting of subnational government revenues;
- Introducing a framework to address fiscal distress of local authorities;
- Implementing multi-year budgeting at the subnational level, starting with their capital budgets, and taking into account not only construction costs but also costs associated with the operation and maintenance of those facilities.

Framework for Intergovernmental Fiscal Coordination

There is no structured arrangement for ensuring a collaborative and coordinated approach in pursuing broad fiscal objectives and ensuring fiscal sustainability at all levels of government. The authorities should take steps to ensure an active and open dialogue between the different levels on the conduct of fiscal policy, notably by:

- Introducing fiscal rules for subnational governments, such as a limit on the deficit or expenditure growth rate;

- Until such rules are introduced, ensuring the pursuance of the general government fiscal target, through a reserve at the State Budget, large enough to accommodate any SNG overspending arising from the use of accumulated idle balances.
- Establishing an Intergovernmental Commission to agree on each level's contribution to the broad fiscal policy objective and analysis;
- Enhancing the monitoring and management of fiscal risks arising from subnational governments; and
- Establishing an efficient and transparent treasury arrangement for local authorities, that allows a more active management of available cash at all levels of general government.

Legal Framework for Fiscal Risk Management and MTBF

In parallel, the authorities are planning to strengthen the legal basis for fiscal risk oversight and medium-term budgeting by updating the Budget Code, through targeted amendments, in two important PFM areas—fiscal risks oversight and medium-term budgetary framework—on which the Fund has recently provided technical assistance. The draft amendments to the Budget Code, prepared by the MoF, could be made more prescriptive and specific, to foster transparency and accountability, the clarity of the legal framework, and to mitigate fiscal risks.

Fiscal Risk Oversight

The draft amendments on fiscal risk oversight should be revised to:

- strengthen the mandate of the MoF and its power to collect information related to fiscal risks;
- prescribe that a CMU resolution will specify roles and responsibilities of the MoF, ministries and government agencies in the preparation, approval and publication of the fiscal risk statement, and can further detail the contents of the fiscal risk statement; and
- broaden the definition of fiscal risks.

Medium-term Budgetary Framework

The draft amendments on the medium-term budgetary framework should be revised to:

- Prescribe that additional contents are included in the Budget Declaration, such as information on the consolidated general government sector and on the criteria for the determination of the expenditure ceilings;
- Modify the budget calendar relating to the approval of the Budget Declaration to provide for a stronger strategic involvement of the CMU at an early stage;
- Strengthen the legal provision on expenditure ceilings by, among other things, removing the distinction between general and special fund and providing for transparency requirements in case of changes made to ceilings after the approval of the Budget Declaration.

Table 0.1 sets out the recommendations of the report and an action plan for their implementation.

Table 0.1. Ukraine: Recommendations and Action Plan

Recommendation		November 2017 – April 2018	May – December 2018	2019/2020	Responsible entity *
FISCAL DECENTRALIZATION					
Improving the Organization of Subnational Government					
1.1	Introduce financial viability considerations in amalgamation process	Amend legal framework for voluntary amalgamation	Adopt financial viability criteria in new amalgamation processes		
1.2	Compel amalgamation of subnational authorities with recurrent fiscal deficits	Amend legal framework for voluntary amalgamation		Apply mandatory amalgamation to units with recurrent distress	MoF, MRD
1.3	Clarify legal framework for organizational structure and fiscal decentralization	Draft legal amendments	Adopt legal amendments		
Improving the Balance Between Revenue and Expenditure Assignments					
2.1	Share PIT revenues based on where employees reside and not where the employer is located		Amend Tax Code and other relevant legislation		MoF
2.2	Adjust the real estate tax so that greater resources can be perceived	Update the cadaster and land registry information	Amend Tax Code and other relevant legislation		MoF
2.3	Facilitate the local authorities' projection of funding for health and education	Clarify what expenditures are subventions supposed to cover in each subnational government level		Undertake a population census	MoF UkrStat
2.4	Clarify the assignment of expenditure responsibilities between levels of government			Amend relevant legislation	MoF
2.5	Reduce revenue assigned to administrative levels according to their roles after decentralization			Amend relevant legislation	MoF

Table 0.1. Ukraine: Recommendations and Action Plan (Continued)

Recommendation	November 2017 – April 2018	May – December 2018	2019/2020	Responsible entity *	Recommendation
2.6	Ensure greater continuity and financial balance in the policies impacting subnational finances	Calculate the full costs associated with the expenditures to be covered by subventions;	Develop rules and procedures to estimate the medium-term impact of new policies on subnational finances	Apply new rules and procedures Launch 3-year review of balance between revenue and expenditure of SNG	MoF, MoH, MoE, MRD
Improving the Formulation and Execution of Subnational Governments' Budgets					
3.1	Develop a standard policy for the cash balance of SNGs	Develop cash balance standard policy and related guidance for SNGs	SNGs evaluate their cash position using standard policy If not in compliance prepare plan to achieve compliance		MoF
3.2	Amend Budget Code to simplify budget structure, reduce earmarking and eliminate protected items	Adopt amended Budget Code	Prepare guidance and conduct training for SNG officials on new budget structure	New SNG budget structure applied starting in FY 2019	MoF
3.3	Amend Budget Code to address fiscal distress of local authorities	Adopt amended Budget Code	Prepare guidance and conduct training for SNG officials on measure to remedy fiscal imbalances	Measures on fiscal distress applied to all SNGs	MoF
3.4	Improve techniques for forecasting SNG revenues, especially PIT	Analyze recent performance, adjust forecasting techniques	Prepare guidance and conduct training for SNG officials on forecasting technique	New forecast applied in FY 2019 budget	MoF
3.5	Accelerate plan to implement multi-year budgeting at the level of SNGs	Implement pilot in each SNG tier, start with multi-year capital investment budget	Evaluate pilot capital investment budget experience Prepare guidance and conduct training for SNG officials	Multi-year capital expenditure budgeting implemented in all SNGs	MoF MRD

Table 0.1. Ukraine: Recommendations and Action Plan (Continued)

Recommendation	November 2017 – April 2018	May – December 2018	2019/2020	Responsible entity *	Recommendation
Enhancing the Framework for Intergovernmental Fiscal Coordination					
4.1	Introduce fiscal rules specific to subnational governments		Design fiscal rules, in consultation with subnational representatives	Apply fiscal rules	MoF, MRD
4.2	Enhance coordination between central and subnational governments in the conduction of fiscal policy	Establish an Intergovernmental Commission for Fiscal Coordination	Decide 2019 fiscal targets for the different levels of government in the Intergovernmental Commission	Expand activities of Intergovernmental Commission	MoF, MRD, Subnational representatives
4.3	Improve monitoring and management of fiscal risks arising from local government finances	Develop monitoring system to track individual unit financial stress indicators Strengthen MoF control over subnational borrowing and PPPs	Compile and publish internal report of local governments' financial stress Expand external audit of local governments, both in frequency and scope of audit	Expand information on local government-related risk in Fiscal Risk Statement	MoF
4.4	Establish an attractive treasury arrangement for local authorities	Decide on the location of the new treasury arrangement. Develop of a concept note explaining the proposed new function, its objectives and the roles of the key stakeholders Design the types of instruments to be offered to local authorities	Analyze systems needs with subsequent implementation of a technical solution Recruit and train the required staff Improve the management of risks arising from these new arrangements	Launch the new treasury services	MoF

Table 0.1. Ukraine: Recommendations and Action Plan (Concluded)

Recommendation	November 2017 – April 2018	May – December 2018	2019/2020	Responsible entity *	Recommendation
PFM LEGAL FRAMEWORK					
Strengthening the Legal Framework for Fiscal Risk Management and Medium-term Budgeting					
5.1	Amend the Budget Code to clarify the MoF's mandate and powers relating to fiscal risks	Adopt amended Budget Code Adopt a CMU resolution detailing further technical aspects relevant for fiscal risk monitoring and management			Rada CMU MoF
5.2	Amend the Budget Code to increase the transparency and clarity of the MTBF rules and processes	Adopt amended Budget Code Adopt a CMU resolution detailing further technical aspects relevant for medium-term budgeting			Rada CMU MoF

* MoF - Ministry of Finance; MRD – Ministry of Regional Development; UkrStat – Ukraine State Statistics Service; MoH – Ministry of Health; MoE – Ministry of Education; CMU – Council of Ministers of Ukraine; Rada – Verkhovna Rada (the Parliament)

I. IMPROVING THE ORGANIZATION OF SUB-NATIONAL GOVERNMENT

1. The current territorial structure of Ukraine was established in the 1996

Constitution. The organization, functions, and resources of Ukraine’s subnational governments are defined in the 1996 Constitution of Ukraine (Articles 132 to 146), 1997 Law on Local Self-Government, and related legislation (as amended). In addition, the Budget Code contains specific provisions relating to fiscal decentralization, notably the distribution of resources and expenditure obligations between State and local budgets. The territorial structure, defined in those original fundamental legal instruments, has four principal levels:

- 24 oblasts (regions) plus two cities of special status (Kyiv and Sevastopol) and the Autonomous Republic of Crimea;
- 474 rayons (districts within regions);
- 166 cities (either cities of oblast or republican significance - major cities or municipalities within oblasts - or cities of rayon significance – cities within districts);
- Over 8,800 hromada (territorial communities, some of which amalgamated), including towns, settlements and villages.¹

2. Ukraine’s shift to a local self-government system is ongoing. The 2014 Government’s Coalition Agreement included strong commitments to improve the autonomy, efficiency, transparency, and accountability of local governments in Ukraine. Under this agreement, detailed in the “Concept of Reform of Local Self-Government and Territorial Organization” (the “Concept Note”), the Government committed to:

- a. make oblast and rayon administrations directly accountable to their respective councils for the resourcing and delivery of local services and refocus State-appointed governors on prefectural duties (representing State government in the region);
- b. cut the number of local governments with the aim of reducing the number of rayons from 474 to around 100 and the number of hromada from over 11,000 to around 1,500.
- c. grant the new amalgamated hromada direct access to shared taxes and transfers from the State budget on the same terms as rayons and major cities.
- d. increase the financial self-sufficiency of local governments through the assignment of additional revenues to local budgets; and
- e. devolve additional expenditure responsibilities and borrowing powers to local governments.

¹ In the interest of brevity, these subdivisions will be referred to as “local governments” or “subnational governments.” However, their status as forms of local self-governments is not fully clear and has important implications, as examined in this chapter and throughout the report.

3. Tangible results have been achieved on many of these commitments, although the process of legal reform was not completed. The decentralization reform enhanced the financial autonomy of local governments, although significant challenges remain, as elaborated throughout this report. Moreover, while the Concept Note launched a process of constitutional reform, the amendments to the Constitution were not enacted, and several bills on decentralization are now pending before the Verkhovna Rada (VR, the Parliament of Ukraine).

4. The progress on the organizational aspects of the decentralization reform sets the context for the analysis of its fiscal and financial management results. This mission focused primarily on the fiscal and financial management aspects of the decentralization reform. To frame our analysis, this chapter provides a general overview of the current challenges in the amalgamation process, organizational structure and legal framework of Ukraine's decentralization reform, based on a preliminary review of the legal instruments which were available to the mission.

Amalgamation Process

5. The process of hromada amalgamation has yielded positive results. According to the Ministry of Regional Development, Building and Housing and Communal Services (MRD, the ministry in charge of implementing Local Self-Government Reform),² as of August 2017, 648 amalgamated hromada were formed, resulting from the amalgamation of 3,040 hromada, with a total population of around 6 million (14.1 percent of the total population of Ukraine) and covering 151 thousand square kilometers (26 percent of the area of Ukraine) (Table 1.1 shows the status of hromada amalgamation in each oblast, presenting some physical parameters to more objectively assess the process).

6. There are still 8,823 hromada in Ukraine, which is high by international standards and substantially short of the target of 1,500 units set in the Concept Note. While the average population of amalgamated hromada is relatively high at around 8,900 persons per unit, around 35 percent of the new units have less than 5,000 inhabitants. Finally, the coverage of the new units varies greatly across oblasts, ranging from 54 percent of the total Oblast in Zhytomir to around 3 percent in Kyiv.

² The MRD has constituted a monitoring team for the Decentralization reform that discloses regular updates on the status of the reform on its website (<http://www.minregion.gov.ua/decentralization/>). The status of the reform is assessed through a set of 18 indicators, covering physical, financial, and sectoral aspects of the Reform.

Table 1.1. Ukraine: Physical Information on Hromada Amalgamation, as of August 11, 2017

Oblast	NUMBER OF AMALGAMATED HROMADA (AH)				Area of the oblast, sq.km	AREA OF AH, sq.km			No. of hromada in the oblast	NUMBER OF HROMADA THAT AMALGAMATED		NUMBER OF AHs WITH POPULATION LESS THAN 5 THOUS. PERSONS	
	2015	2016	2017	Total		Total in 2015-2017				Total in 2015-2017		Total in 2015-2017	
	Number of AHs	Number of AHs	Number of AHs			AH area	%	No. of hromada		%	No. of AHs	%	
VINNYTSIA	2	19	12	33	26,513	3,726	14,1	707	99	14,0	16	48,5	
VOLYN	5	10	24	39	20,144	8,931	44,3	412	164	39,8	13	33,3	
DNIPROPETROVSK	15	19	19	54	31,914	14,567	45,6	348	160	46,0	23	42,6	
DONETSK	3	3	3	12	26,517	3,459	13,0	386	69	17,9	3	25,0	
ZHYTOMYR	9	23	13	45	29,832	16,133	54,1	631	328	52,0	16	35,6	
ZAKARPATTIA	2	1	3	6	12,777	616	4,8	337	19	5,6	0	0,0	
ZAPORIZHZHIA	6	10	18	34	27,180	12,983	47,8	299	129	43,1	14	41,2	
IVANO-FRANKIVSK	3	8	9	21	13,900	1,986	14,3	516	102	19,8	1	4,8	
KYIV	1	1	4	9	28,131	926	3,3	659	38	5,8	1	11,1	
KIROVOHRAD	2	3	8	15	24,588	2,149	8,7	415	47	11,3	6	40,0	
LUHANSK	2	1	5	11	26,684	4,415	16,5	332	61	18,4	2	18,2	
LVIV	15	7	11	34	21,833	3,164	14,5	711	134	18,8	11	32,4	
MYKOLAIV	1	19	2	26	24,598	6,568	26,7	313	91	29,1	10	38,5	
ODESSA	8	3	12	24	33,310	6,958	20,9	490	105	21,4	5	20,8	
POLTAVA	12	6	14	39	28,748	5,606	19,5	503	135	26,8	16	41,0	
RIVNE	5	13	6	25	20,047	4,282	21,4	365	93	25,5	9	36,0	
SUMY	1	13	13	28	23,834	7,630	32,0	419	131	31,3	9	32,1	
TERNOPII	26	10	4	40	13,823	5,394	39,0	615	240	39,0	18	45,0	
KHARKIV	0	4	8	12	31,415	3,676	11,7	458	57	12,4	0	0,0	
KHERSON	1	11	12	25	28,461	6,763	23,8	298	90	30,2	9	36,0	
KHMELNYTSKYI	22	4	7	34	20,645	10,229	49,5	605	302	49,9	6	17,6	
CHEKASY	3	3	18	24	20,900	3,517	16,8	556	90	16,2	11	45,8	
CHERNIVTSI	10	6	6	24	8,097	2,257	27,9	271	84	31,0	4	16,7	
CHERNIHIV	5	11	17	34	31,865	15,135	47,5	569	272	47,8	12	35,3	
TOTAL	159	207	248	648	575,756	151,082	26,2	11215	3040	27,1	215	35,3	

Source: Ministry of Regional Development, Monitoring Report on Fiscal Decentralization, September 2017.

Note: Number of amalgamated hromada include those new units waiting for first elections or for the Central Election Committee authorization to set the first elections.

7. Voluntary amalgamation will be increasingly difficult. Hromada amalgamation is essentially a voluntary process, regulated by the Law on Voluntary Amalgamation of Territorial Communities 2015.³ This voluntary nature was deliberately adopted to ensure buy-in of territorial communities. Discussions during the mission have, however, pointed to a lack of incentives on

³ Under Article 140 of the Constitution, only “voluntary associations” are mentioned as territorial communities with rights of local self-government.

the part of smaller hromada to amalgamate, inter alia due to concerns of loss of autonomy and revenue. The amalgamation process, currently envisaged to take place on a voluntary basis, faces three main challenges:

- shared taxes are distributed to amalgamated hromada, according to the location of the employer, which often is different from the location of education and health facilities used by the commuting population; the amalgamation of a suburban community, will likely therefore yield little additional revenue but substantial expenditure;
- the ownership of land and the rents that can be obtained from leasing the land weigh significantly in the decision to amalgamate, because smaller communities fear that their available land will be taken over by the more powerful neighboring communities or that they will lose control over the use of rent revenue;
- political economy considerations, whereby leaders of unamalgamated communities fear losing access to power positions within the structure of the new amalgamated units.

8. Under the current framework, further amalgamation will likely lead to a proliferation of smaller units, with low potential for financial self-sufficiency. The above-mentioned Law on Voluntary Amalgamation of Territorial Communities includes no criteria on the financial condition of the amalgamating community.⁴ Nevertheless, it still grants to the amalgamated community direct access to State support, including the additional funding made available to support the amalgamation. The combination of these design features with the practical challenges described in the previous paragraph, poses a risk that future amalgamations will result in units of insufficient size to ensure their financial viability and development, and therefore still dependent of State funding.

9. Recommendation 1.1: Future amalgamation should be guided by clear criteria that ensure the financial viability of the newly amalgamated hromada. As indicated in the 2015 FAD TA Report,⁵ these criteria could include:

- a. Minimum population: The new authority must have a minimum population of 3,000–5,000 inhabitants;
- b. Self-sufficiency: The authority's own and shared resources must cover at least 50 percent of their total expenditures;
- c. Provision of basic services: The authority must be able to provide access to the full range of basic local services to their population including primary education and healthcare and municipal services (but not necessarily of the same quality and level of access);

⁴ The Law provides only qualitative criteria for the amalgamation of communities, including the requirement that the resulting community offers the same "quality and accessibility of public service", and that the merger "not result in changes in the status of settlements as rural or urban".

⁵ Hughes et al (January 2015), "Ukraine: Fiscal Decentralization" Fiscal Affairs Department, IMF.

- d. Efficiency of service delivery: Services must be organized so as to be able to realize economies of scale in each sector. There could also be specific criteria regarding the minimum number of pupils per school (e.g., at least 100 pupils) or doctors and nurses per clinic (e.g. at least two of each to cover absences and vacancies);
- e. Fiscal space for development: The new authorities must be able to spend at least 10 percent of their total budget on investment to ensure the area has the potential for growth; and
- f. Financial integrity: The new authority must have had a clean external financial audit within the past year which validates its compliance with all of the above criteria.

10. Recommendation 1.2: Amalgamation should be made mandatory for those smaller unamalgamated hromada that incur in recurrent financial deficits for more than five years.

This policy change would include the following main features:

- The MRD, while coordinator of the decentralization reform, would be the unit in charge of enforcing this compelled amalgamation, following the criteria described in the previous recommendation;
- The responsibility for servicing the debt accumulated prior to amalgamation should remain with the resulting amalgamated hromada, but the authorities may consider supporting a rescheduling process to attenuate the initial financial impact; and
- Further legal amendments will be required to reflect a mandatory process of hromada amalgamation, including a possible amendment to the Constitution to recognize “mandatorily” amalgamated hromada, and as a result of which, their right to local self-government.

Organizational Structure and Legal Framework for Decentralization

11. The basic territorial division identifies territorial subdivisions, rather than forms of “local self-governments” per se.⁶ In particular, Article 133 of the Constitution states that the administrative and territorial structure of Ukraine *shall include* the Autonomous Republic of Crimea, oblasts, rayons, cities, city districts, settlements and villages, and that the cities of Kyiv and Sevastopol *shall have* special status determined by the law of Ukraine. It also specifically names all of the oblasts that shall make up this territorial structure. The Constitution also permits the creation of a fourth level of “self-organizing” bodies (e.g., of residents, houses, streets, blocks) with their own competencies, property and budget. It should be noted that neither hromada nor amalgamated hromada are identified under the Constitution as territorial subdivisions, although there are references to them in relation to the assignment of rights and obligations of local self-government (see below).

⁶ The key laws are: Law on Self Government of 1997 (LSG), as amended; Law on Cooperation of Territorial Communities of 2015; and Law on Voluntary Amalgamation of Territorial Communities of 2015.

12. The relative power and autonomy of the different territorial units of subnational government, and the nature of their relationship with the central government, is often unclear based on the laws reviewed. While the legal framework sets out various *competences, obligations, rights, and powers* that are granted to subnational governments, there appears to be frequent mismatches between them. For example, there is a mismatch between the *right* to local self-government (given to hromada and amalgamated hromada), and the *competences and powers* of local self-government, which are specifically granted to village, settlement and city councils, under the Law on Local Self Government. Similarly, while the Constitution (Articles 142 and 143) defines certain “*obligations*” of State and subnational governments (including in relation to budget execution), they do not accurately reflect the distribution of competences and powers under the Law on Local Self-Government.

13. Several apparent overlaps between the obligations and powers of different levels of government seem to result from that lack of clarity. For example, it is unclear whether approval of the oblast or rayon council is also required for development programs approved by hromada local governments, or whether the oblast council also needs to approve programs approved by the rayon council. Similarly, the scope of the State government’s “participation” in local budget revenue collection, as stated under those two articles of the Constitution, and how this interacts with the powers of the oblast and rayon councils to approve budgetary programs, is not clear from the legal instruments reviewed by the mission.

14. There is also a lack of clarity as to how functions are granted (i.e., delegated, assigned or shared) from the State to/with subnational governments. For instance, whilst the Law on Local Self-Government distinguishes between those powers that are assigned and those that are delegated to local governments, the concept of “shared” powers (if any) does not appear to be addressed in the legal framework.⁷ The distribution of powers to local governments is described in detail in Annex I.

15. This arrangement is ostensibly complex, with significant duplication and asymmetries in the distribution of obligations and powers. The coexistence of parallel governance structures clouds financial responsibility and accountability at the subnational level and could potentially frustrate their effective governance, including on budgetary matters. The recommendations below are made on the basis of the existing Constitution and do not seek to imply constitutional amendments. In any event, they remain subject to a careful review by the authorities under Ukraine’s public and constitutional law.

⁷ This is a significant issue from a fiscal and financial perspective. Indeed, the State is required to finance, from the State budget, the exercise of any powers that are assigned to local self-government bodies—either in full, or through the allocation of certain national taxes to the local budgets (Article 143 of the Constitution). Additionally, expenditures of local self-government bodies arising from the decisions of state power bodies must be reimbursed by the State (Article 142 of the Constitution).

16. Recommendation 1.3: Clarify the legal framework for territorial organization and fiscal decentralization. In particular:

- **The distinction between the different territorial subdivisions, and their relationship *inter se* as well as with the State government should be made clear in the legal framework.** A clear two-tier distinction is needed between (1) state and (2) local government, with the law clarifying which of the territorial subdivisions fall under which category. For example, cities, villages, settlements, either separately or as (amalgamated) hromada all appear to comprise “local government.” However, as the definitions are inconsistent between the laws (Budget Code, Constitution, and Law on Local Self-Government), the division between national and subnational government remains unclear.
- **The legal framework should more clearly distinguish between those powers that are assigned, delegated, and shared with subnational government, and the rights and responsibilities associated with each.** This could be done by amending Law on Local Self-Government.
- **The administrative status of hromada should be clarified.** Although hromada are not a legal territorial subdivision of Ukraine recognized as such under the Constitution (see above paragraph), the right to self-government is assigned to them under the Law on Local Self-Government.⁸
- **There should be a streamlining of the administrative structures at each subnational level.** For example, unamalgamated hromada do not have a separate administrative structure (e.g., a council and executive body) to exercise the rights, competencies, and powers of self-government. Rather, this must be exercised through the legislative and executive bodies of the villages, settlements and towns that comprise the hromada.
- **Overlaps in the powers and obligations of each level of government should be removed.**

II. IMPROVING THE BALANCE BETWEEN REVENUE AND EXPENDITURE ASSIGNMENTS

A. Revenue Sharing Arrangement

Overview of the Revenue Sharing Arrangement

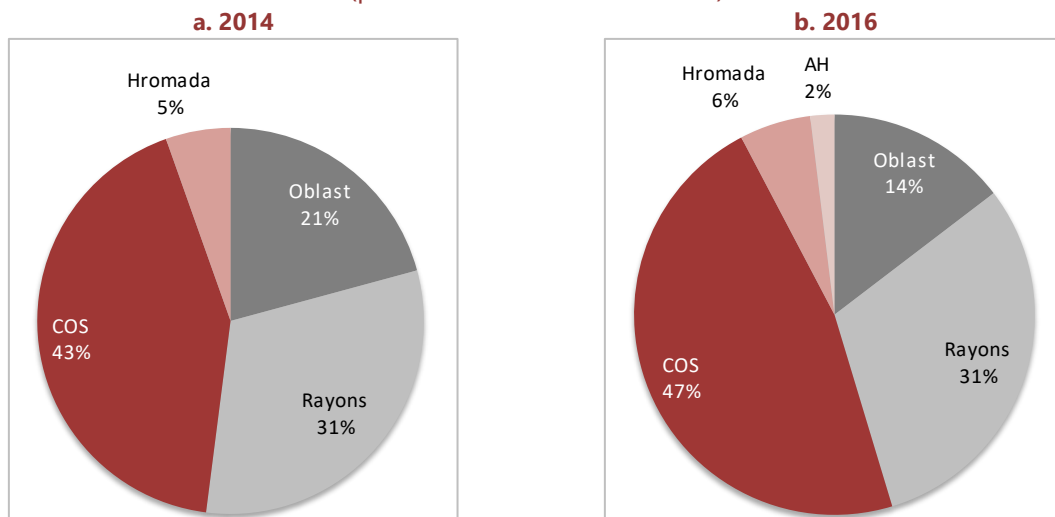
17. Subnational Government (SNG) revenue has been growing since the decentralization reform was adopted. In 2014, total subnational government revenues as a percentage of GDP were 14.6 percent and increased by 0.2 percent in 2015. In 2016, SNG

⁸ The mission understands that Constitutional amendments proposed in 2014 would have created a new territorial division of hromada. It is also unclear whether hromada are distinct from villages, given that under Article 140 a hromada could be comprised of the residents of one village only (and not necessarily a voluntary association of multiple villages and settlements).

revenues were 15.2 percent of GDP, which implied an increase of 0.6 percent compared to the observed SNG revenues before the reform was implemented. This increase, driven by both shared taxes and own revenues, although important, is lower than what had been anticipated as a result of the reforms.

18. Since the decentralization reform was introduced, the share of revenue received by local self-government levels has consistently been increasing. In parallel with the increase in total SNG revenues, there was an adjustment in the distribution of revenues across tiers of government. As expected, there was a shift from levels corresponding to State administration—oblasts and rayons—to levels of local self-government (cities of oblast significance (COS) and hromada). Oblasts were the main “losers,” with revenue share falling from 21 to 14 percent, primarily due to the decrease in shares of taxes attributed to them and the transfer of the basic grant directly to local self-government levels. These changes favored cities and hromada which saw their share of SNG revenue increase from 48 to 55 percent (Figure 2.1). This shift reflects the pursuance of the decentralization reform objective of attributing more resources to levels of government that are closer to citizens.

Figure 2.1. Subnational Government Revenue, by Tier
(percent of total SNG revenue)



Source: State Treasury and IMF staff estimates.

19. The distribution of revenues between the different levels of subnational government, set out under the Budget Code of Ukraine (Budget Code, or BCU), is unclear.⁹ The main components of subnational revenue in Ukraine are shared taxes, own revenue, and

⁹ Article 29 (with respect to the State budget) and Articles 64 to 69-1 (with respect to local budgets). Article 64 lists the revenues of the general fund of the budgets of the cities of Kiev and Sebastopol, the rayon and local self-governments (which includes the amalgamated hromada). Article 65 lists the revenues of the general fund of the oblast budgets. *Article 68* provides that the structure of revenue and expenditure of budgets of rayons, and distribution of budget transfers between the city and rayon budgets, shall be determined by the relevant city council in accordance with their delegated. Article 69 sets out the revenues of the general fund of the budgets of the city rayons, towns and villages. Article 69-1 sets out the revenues of the special fund of local budgets.

grants and subventions. The general approach is to assign all budgetary revenue to the State budget, except where receipts are specifically assigned to local budgets under the Code. However, the delimitation of revenue between the different budgetary levels is often unclear and creates room for misinterpretation. Box 2.1 examines a few examples in this respect.

Box 2.1. Examples of Uncertainty in Delimitation of Revenue

The Budget Code contains each of the following three provisions relating to revenue to local budgets from licenses and certificates:

- Revenue from payments for licenses and certificates go to the budgets of the *cities of Kyiv and Sevastopol* based on the *location of their operations* (Article 64(22) BCU);
- Revenue from payments for licenses and certificates go to *oblast budgets* based on the *location of their operations* (Article 66(19) BCU); and
- Revenue from payment for licenses for certain types of economic activity and certificates which are *issued by executive bodies* of the relevant *local councils* are credited to the corresponding budget (Article 69(10-1) BCU).

These provisions overlap considerably, making it unclear how revenues from license payments should be distributed between cities of special status, oblasts and local governments. Furthermore, the basis of revenue collection is not uniform: in the case of oblasts and the cities of Kiev and Sevastopol, it appears that revenue is collected on the basis of the location of a licensee's operations while in the case of local councils, the basis of revenue collection appears to be the place of issuance of the license.

Shared Taxes

20. Shared taxes are distributed across subnational governments according to where they were generated, as an incentive to increase its collection. This is resulting in larger resources flowing into big cities and less income to suburbs where employees demand the majority of services. Shared taxes include income taxes (personal income tax –PIT and corporate income tax –CIT), the recently introduced excise tax, and the environmental fees and concessions. As of 2015, the state government retains 25 percent of the yield of the tax; oblasts receive 15 percent, and COS and rayons receive 60 percent. Unconsolidated hromada lost the 25 percent of the PIT share as an incentive to amalgamation. For total SNGs, shared taxes as a percentage of total revenue decreased between 2014 and 2015 from 29.4 to 23.6 percent, but in 2016 this share registered an increase to 27.4 percent. This increase is driven by an over performance of PIT due to an upturn in the economy. These results should not be confused with an improvement of overall revenues, and actions should be taken considering that PIT is very likely to decrease again.

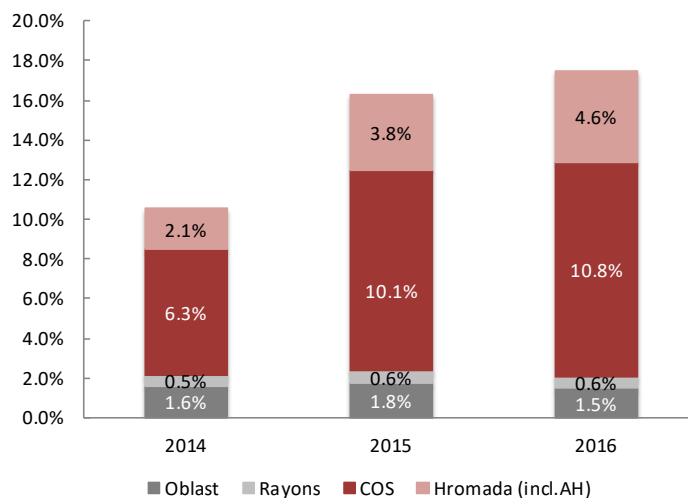
21. Recommendation 2.1. Share PIT revenues based on where employees reside and not where the employer is located. This adjustment would attribute revenue on a basis that is closer to the demand for services provided by subnational units. It would also provide subnational governments with resources for improving the transport infrastructure which is used daily to commute from residential suburbs to metropolitan places of work. Together with the

recommendation for introducing financial viability criteria in future amalgamation, it should also create the right incentives for the ongoing rationalization of service provision networks.

Own Revenue (Vertical Fiscal Balance Analysis)

22. Own revenues are a primary component of subnational revenues and are expected to grow as the decentralization process expands. Vertical fiscal balance entails that SNGs own revenues should cover their basic expenditure responsibilities and dependence on State grants should be minimized. Own revenues include land and property taxes, rents, proceeds from the sale of assets and other fees and charges, own revenue of budget users,¹⁰ and the single tax (a flat rate tax imposed on individual entrepreneurs and legal entities with income or land assets that are below an established threshold, to simplify income taxation). Although the state government sets both the rate and the threshold for different type of business activities or entrepreneurs to which the tax applies, 100 percent of the collected tax goes to subnational governments. Figure 2.2 shows that own revenues have been on a growing trend in all levels of subnational government, except for the oblast level. However, the percentage of own revenues is still very low compared to other countries of the region.

Figure 2.2. Subnational Government Own Revenues
(percent of total revenue)



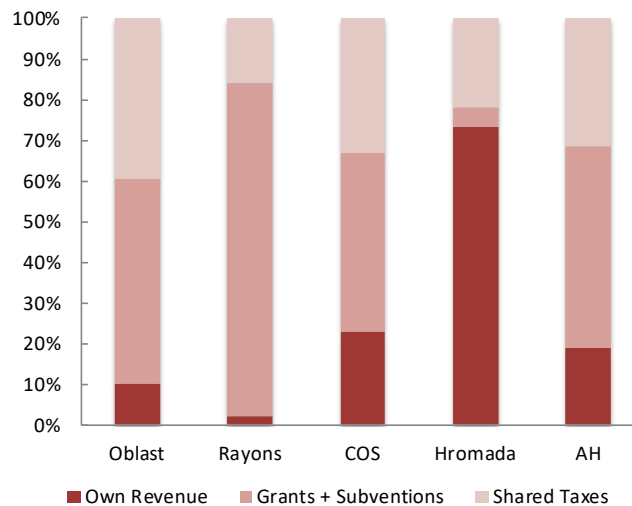
Source: State Treasury and IMF staff estimates.

23. Hromada collect a higher share of own revenues than the rest of subnational governments. Reflecting the revenue sharing arrangement, there is also a marked distinction between state administration and local self-government levels regarding the composition of type of revenue they receive (Figure 2.3). The share of single tax increased significantly due to the decision of the state government to increase the rate, in addition to an improved collection of

¹⁰ Revenues from fees for services provided by budgetary institutions under the law.

Land and Property taxes, which almost doubled between 2014 and 2015. Although the mobilization of local taxes is a good result, it is unclear if the trend will continue.

Figure 2.3. Revenues of SNG Tiers, by Type of Revenue, 2016
(percent of total revenue)



24. However, the growth of own revenues was lower than anticipated. At the time of the introduction of the decentralization reform, the authorities expected the share of SNGs' own revenues to reach around 28 percent, as a result of the maximum allowable tax rates and assignments (an 11.5 percentage points increase relative to the pre-reform share). The share observed in 2016 was 17.1 percent, 6.6 percentage points increase from 2014 (Figure 2.2 above). Some of the proposed adjustments, such as greater flexibility to vary tax bases and rates for own taxes and design features in real estate tax, were not fully implemented, reducing the expected impact of the decentralization reform.

25. That lower growth is associated primarily with the collection of real estate tax, where implementation of previous FAD recommendations was notably weak. Technical problems related to the cadaster and registry of property and improved building spaces are one of the main obstacles to an adequate collection of the real estate tax and thus are impeding its growth. Also, contributing to that, are certain design features, such as: (i) assessment of the tax based on the size of the property, rather than its market value; (ii) unnecessary exemptions for properties of a certain size; and (iii) the setting of tax rates well below the ceiling rate. These issues were identified by the November 2014 mission, but little action was taken regarding the related recommendations, which remain valid and are therefore reiterated below.

26. Recommendation 2.2. Adjust the real estate tax so that greater own revenue can be collected and vertical fiscal balance can be achieved. This may be possible by following these actions:

- Put in place a transparent market for properties, particularly agricultural land, and take into account the market value of properties in the calculation of the tax;
- Broaden the base by eliminating current tax-free thresholds and exemptions to non-living spaces and commercial properties;
- Adopt the maximum allowable tax rates;
- Improve the quality of information on the surface area of real estate stock or value of capital improvements within their jurisdictional boundaries;
- Systematically record new or improved building spaces;
- Fix a centrally determined rate range for real estate tax with a positive starting rate of 1 percent to a maximum rate of 2 percent. This would help protect the tax base against a race to the bottom by subnational governments seeking to attract new business and residents and relieve pressure on shared revenues and transfers; and
- Design an incentive scheme to update the cadaster and land registry information to improve the performance of the tax.

Grants and Subventions

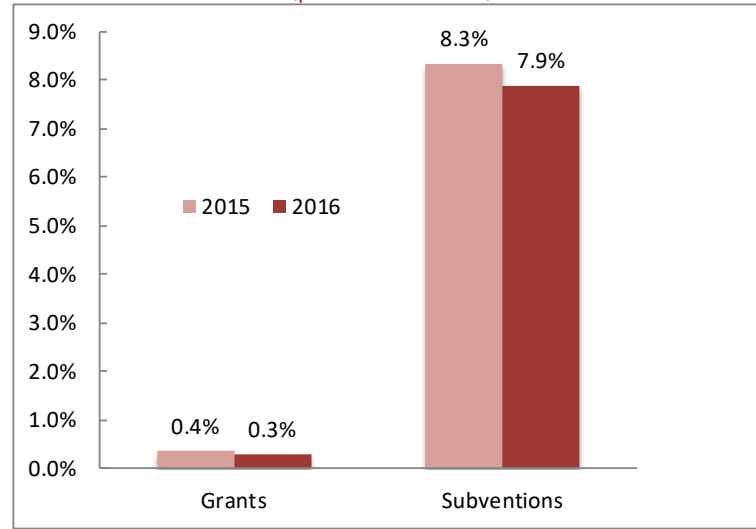
27. Grants and subventions are still large in both size and number of specific schemes.

Contrary to the original intention of the decentralization reform, this category of revenue still comprises a large number of items (11 grants and 56 subventions in 2016), each with different rules and formulas to calculate the amount of the transfer. While decreasing in size recently, subventions and grants still account for a substantial part of SNG revenue (see Figure 2.4).¹¹ There are many types of subventions and the most significant ones are related to assistance and privileges. Within grants, the basic grant accounts for almost 80 percent of the total value. And subventions account for about half of the total revenues of subnational governments.

28. The equalization grant existing before the reform was adjusted and complemented with a basic grant, therefore not effectively achieving the intended simplification of the system. This equalizing grant levels the tax-paying capacity of local budgets instead of balancing the whole system. It is done separately under each type of tax using a tax paying capacity index and including a reverse grant for those SNGs with more tax income. Although this change significantly improved and simplified the way equalization was done previously, the results of the system might be reflecting the existing problems in the design of taxes. Since Kiev has a different revenue-sharing arrangement, it is excluded from the formula. The total amount for this grant was 6.7 UAH billion, two percent of the total subnational revenues.

¹¹ Simplification of state transfers, replacing the 24 separate subventions from the state budget with three formula-based subventions for schools, vocational education, and health administered by the Ministries of Education and Health. Social protection subventions to subnational government budgets would be abolished and paid directly by the Ministry of Social Policy.

Figure 2.4. Grants and Subventions
(percent of GDP)



Source: State Treasury and IMF staff estimates.

29. Information used in subvention formulas is still not transparently available to local self-government units, which prevents a better planning of their sectoral policies. Although formula-based subventions are now in place (the health-related ones still under discussion—see below), there is still space to enhance the transparency, predictability, and efficiency of the SNG finance system. Discussions with local officials revealed that they do not recognize the parameters data used in subvention calculation, which is consistently lower than the data held locally that is used for planning purposes. This disconnect prevents a better alignment of incentives, leading to inefficient resource allocation and financial imbalances, as discussed below.

30. Although recently updated, the education subvention still has a number of weaknesses. The decentralization reform introduced an independent mechanism for determining the Education subvention. However, the formula currently used is the same formula that has been used during the last 15 years: the total pool of funds allocated to education is divided by the weighted number of students in the country (where weight reflects different relative costs of providing education to a particular group of students), According to Herczynski (2017),¹² this formula has a number of weaknesses:

- a. It does not put pressure on optimization of schools, but instead results in increasing average class size.
- b. Some schools are overfunded while others are underfunded.
- c. It cannot be determined if the level of allocated funding is enough.
- d. There are important inherent difficulties to review or change the allocation formula.

¹² "Education Finance in Ukraine, Selected Strategic Issues", Herczynski, J, 2017

- e. Due to lack of clarity in the legislation, subnational governments expect the subvention to cover all educational expenditure, but the Budget Code specifies that it is supposed to finance only wages of teachers (those of non-pedagogic staff and other expenses have to be funded through own resources).

31. Health subvention is calculated according to principles similar to those used for the education subvention and are therefore prone to the same weaknesses. Current medical subventions cover prevention, primary care, and outpatient/inpatient services. The total amount of medical subvention is calculated for each level of government according to a capitation formula that accounts for population size and differences in service provision, with an additional coefficient for providing services in geographically disperse areas. Again, the parameter data used in the formula is not directly observable by local governments.

32. The funding for local authorities' health care services may be substantially changed by the Health Care Reform bill, currently being discussed in the Rada. The underlying principle of the reform is to create a new health institution that plays the role of purchaser and pays according to number of services provided (similar to the mechanism in place in the UK National Health Service). It is intended that the State government will have direct contracts with medical institutions which will be paid according to the number of services provided and defined costs.

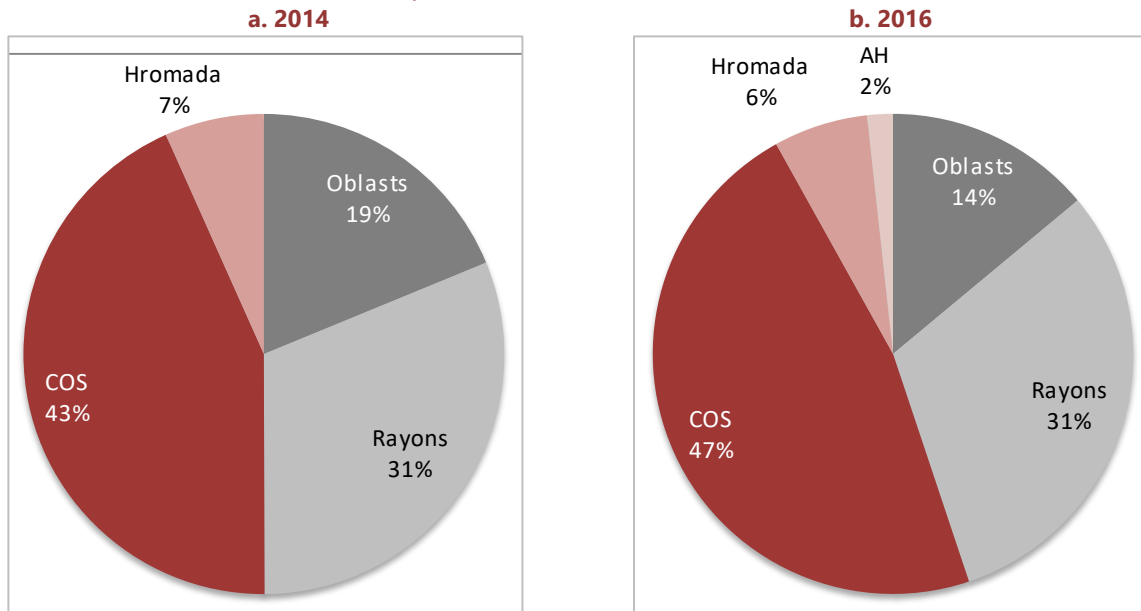
33. Recommendation 2.3. Facilitate the projection of funding for health and education by local authorities, by:

- Clarifying the coverage of expenditure subventions for each SNG level;
- Publishing the source of parameter data used in subvention formula calculations and transparently disclosing those data to SNG units.
- Undertaking a population census. The last one was made in 2001.
- Discussing in advance the responsibilities that are going to be transferred in order to permit internal arrangements and planning.

B. Expenditure Assignments

34. The share of expenditures by local self-governments has increased from the pre-reform levels. The composition of expenditures across the different SNG levels has followed a pattern similar to that of revenues. Figure 2.5 shows that oblast expenditure fell from 19 to 14 percent of total expenditures between 2014 and 2016, in favor of local self-government units (COS and hromada). The share of the State administration levels was 45 percent of total SNG revenue in 2016—a relatively high share taking into account the intention of devolving more expenditure assignments to local self-government, as sought in the recent decentralization reform.

Figure 2.5. Subnational Government Expenditure, by Tier
(percent of total SNG revenue)



Source: State Treasury and IMF staff estimates.

35. A primary, broad distinction is made between expenditures that are carried out by the State budget and those carried out by local budgets. The former category includes expenses relating to state integrity, sovereignty, judiciary etc., while the latter includes expenses for the exercise of rights of local self-government as well as expenses for functions that have been delegated to subnational governments on the principle of subsidiarity.¹³ The legal framework also carves out certain categories of protected expenditure—for both State and local budgets—for which in-year adjustment is prohibited.

36. However, the decentralization reform didn't fully clarify the assignment of expenditure responsibilities between levels of government, as originally intended. The Budget Code assigns both broad categories as well as specific items of expenditure to the different levels of government. However, there are many overlaps and the demarcation of expenditure responsibilities, particularly with respect to the different levels of subnational government, is not clear. Figure 2.6 illustrates the significant overlapping of responsibilities, with only three functions clearly assigned to a single level of government (colored in green).

37. The distribution of expenditure and revenue under the Budget Code could also be better aligned with the distribution of powers to local self-governments under the Law on Local Self-Government (LSG). At present, it appears that local governments are given extensive

¹³ Article 82(2) of the Budget Code refers to "functions" generally and does not specify them (it merely identifies a general category of budgetary expenditure relating to the execution of State government functions that have been delegated to subnational governments). The specific types of expenditure that subnational governments carry out are listed in Articles 87 to 91 of the Budget code.

powers under the LSG (for example, in the area of education), however the expenditure responsibilities delegated to exercise these powers under the Budget Code are somewhat more limited.

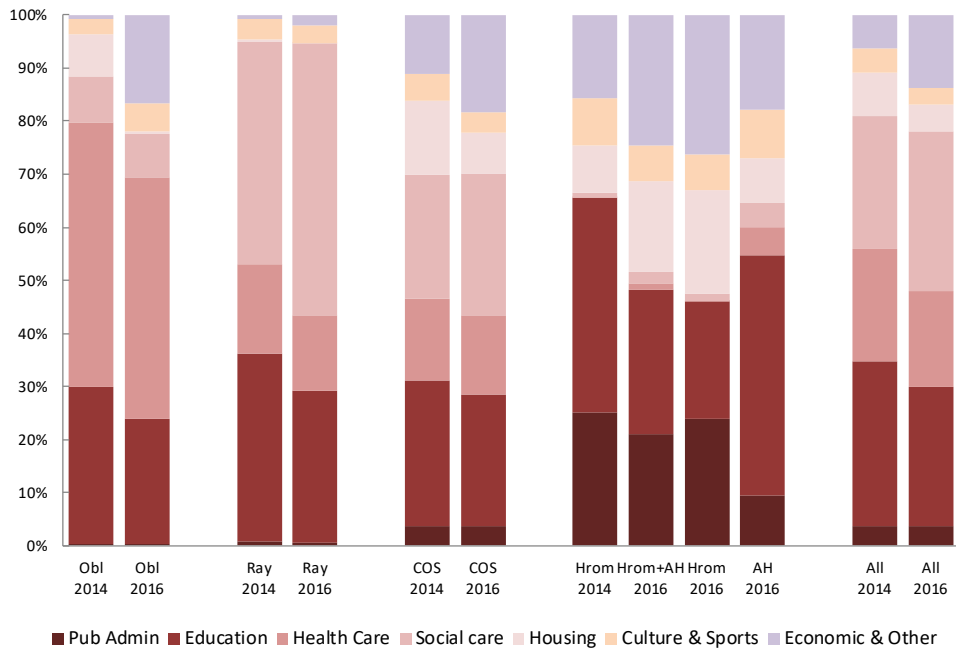
Figure 2.6. Distribution of Responsibilities for Implementation

Functions	Sub-Function	State	Oblast	Rayon & City	Hromada
Housing and Community	Housing				
	Utilities				
Environmental Protection					
Social Protection	Benefits				
	Services				
Education	Nursery				
	Primary				
	Secondary				
	Vocational				
	Higher				
Recreation and Culture					
Health	Primary				
	Secondary				
	Tertiary				
Public Order & Safety					
Defense					
Economic Affairs	Transport				
	Other				
General Administration					



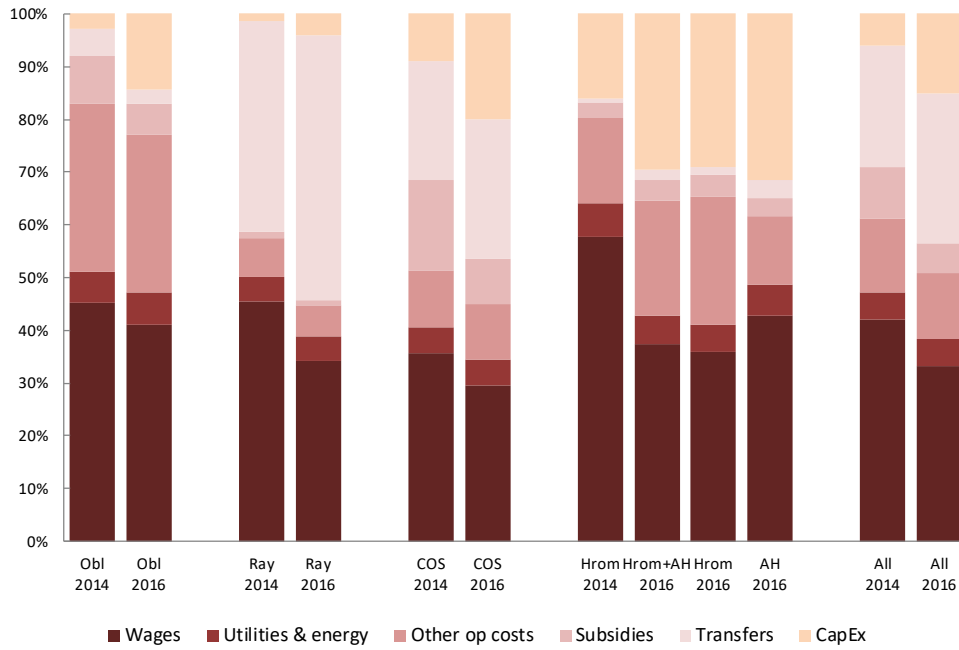
38. So far, the decentralization reform fell short of inducing changes in the structure of expenditure of the different SNG tiers. Figures 2.7 and 2.8 show that the expenditure structure (by function and economic category) changed very little between 2014 and 2016. This was to be expected in relation to the education and health functions (and the associated wage expenditure), which the reform was not aiming to change considerably, except for funding arrangements. In the social care function, the observed minimal change in spending share reveals that the envisaged centralization did not take place, and there remains scope for improvement. The fact that social care spending is predominant in the oblast and rayon levels, reflects the fundamental difference between the State administration and the local self-government tiers of SNGs.

Figure 2.7. SNG Expenditure by Function, 2014 vs. 2016
(percent of total expenditure)



Source: State Treasury and IMF staff estimates.

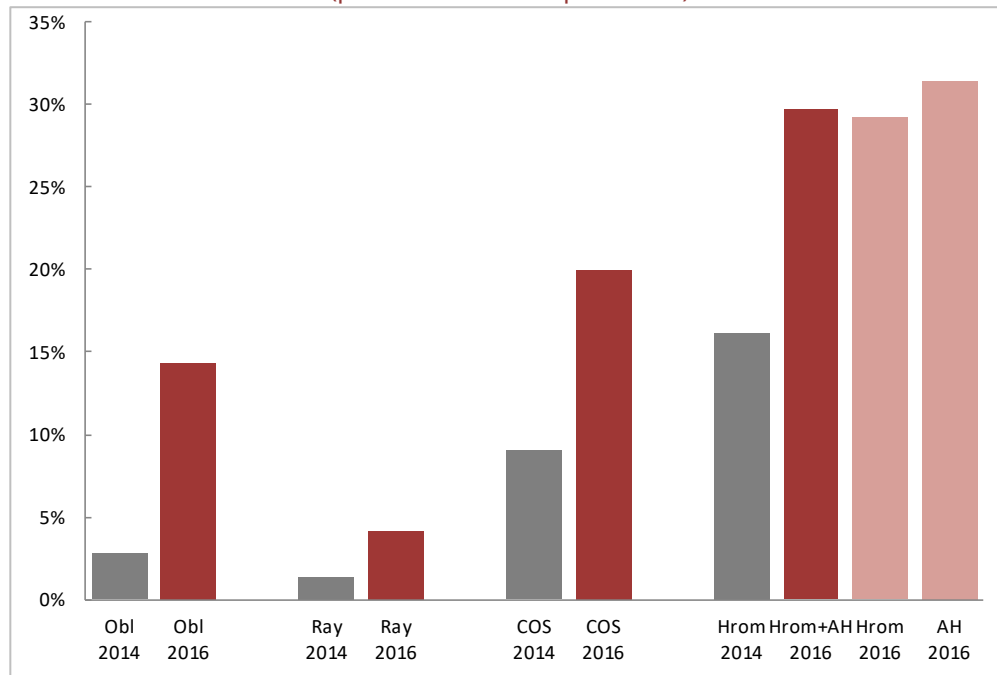
Figure 2.8. SNG Expenditure by Economic Type, 2014 vs. 2016
(percent of total expenditure)



Source: State Treasury and IMF staff estimates.

39. Availability of funding for infrastructure development resulted in a generalized increase in the share of capital expenditure between 2014 and 2016. Although the share of capital expenditure for all subnational governments as a share of total expenditure is relatively low compared to other countries, all subnational levels observed an increase in the share of capital expenditure, which can be largely explained by the access to specific funds created to support investment projects of subnational governments (see Section 3.C). The size of the increase varies across tiers of government: for oblasts this share increased 5 times, from 4 to 15 percent. Rayons capital expenditure tripled and COS and hromada doubled (Figure 2.9).

Figure 2.9. SNG Capital Expenditure, by Tier
(percent of total expenditure)



Source: State Treasury and IMF staff estimates.

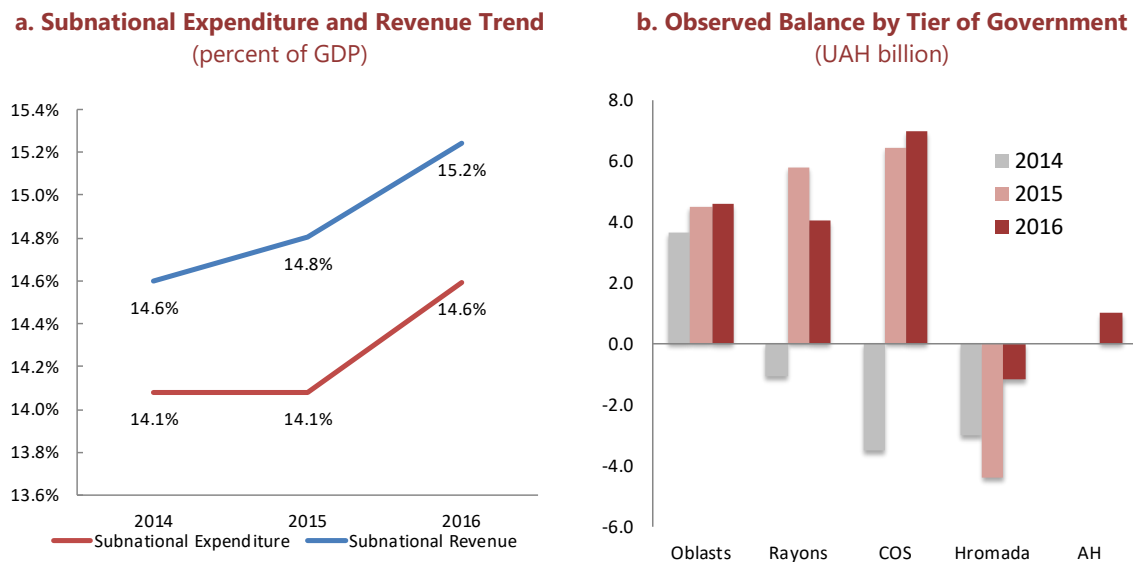
40. Recommendation 2.4. Align the distribution of expenditure and revenue assignments in the Budget Code with the distribution of powers to local self-government units under the LSG. This would ensure that the legal framework for fiscal decentralization is harmonized, clear, and stable, contributing to better resource allocation and planning of service delivery.

C. Key Findings on the Balance of the Arrangement

41. Subnational governments have achieved a surplus in all years after the reform, a trend observed in all levels, except unamalgamated hromada. The introduction of education and health subventions as of 2015 implied a consistent increase in surpluses at the Oblast and Rayon levels, allowing a major improvement in the financial situation of SNGs, reverting most of the deficits observed in 2014 (Figure 2.10). Cities and Hromada observed even better results due to the increased collection of own revenues, which added up the subventions received.

42. However, there appears to be a mismatch between the assigned revenues spending responsibilities. State administration levels appear to have had a smooth adjustment to a more decentralized scheme, with regard to their revenues. Rayons have observed a reduction in responsibilities under the decentralization reform but their revenues have not been reduced proportionally to the tasks that were assigned to local self-government units. In particular, shared taxes increased 1.2 percent between 2014 and 2016. The observed surpluses at the oblast and rayon level may imply that there has been no proper analysis of costs of the tasks assigned, and that probably these tiers will have to adjust to reduced resources. In the case of cities, resources were transferred and some responsibilities assigned. However, as discussed previously this devolution has been made in successive stages, through annual ad hoc changes to the budget code, which prevented a more effective financial planning by those units.

Figure 2.10. Trends in Balance Between Revenue and Expenditure



Source: State Treasury and IMF staff estimates.

43. Recommendation 2.5. Reduce revenue assigned to administrative levels according to their roles after decentralization. This can be achieved through a more precise arrangement of responsibilities, coordination, and accountability mechanisms between State administration and local self-government tiers.

44. There are reasons to expect this trend of consecutive surpluses to deteriorate in the near future:

- a. **The PIT overperformance will likely not materialize in the coming years.** One of the main drivers of the surpluses has been the increase in shared taxes, in particular the PIT. The latest IMF Staff Estimates point to a substantial decrease in the growth rate of PIT, from 2018 onward, due to a declining average wage growth, which is partly related to the recent hikes in the minimum wage;

- b. **Capital expenditure will likely increase.** As discussed in more detail in Section III.C, most local authorities had no investment project pipeline at the launch of the reform. Since then, given the availability of specific funding for investment projects, it is likely that they have been preparing new projects, which will have a significant impact on subnational government finances once they start being implemented; and
- c. **New expenditure responsibilities have recently been devolved to SNGs.** The education and health reforms assign additional expenditure to subnational governments, without the attribution of additional funding.

45. The surplus of amalgamated hromada should be interpreted carefully. The surplus observed might not be showing a good economic performance, but rather reflecting operational difficulties that prevent hromada from undertaking normal spending during the initial stages of its amalgamation process. Furthermore, one needs to bring into the analysis the fact that the remaining hromada may not have the resources to either attract others to join them or to be attracted by similar hromada, and therefore will likely continue to have a negative impact on the aggregate balance.

46. SNG’s own revenues are still not sufficient to cover their basic expenditure responsibilities. As discussed earlier, the dependence of SNGs on subventions is still high and basic expenditure responsibilities are not clearly defined. Table 2.1 illustrates the case of education in COS: the subvention covered 47 percent of the total expenditure in the sector in 2015. For 2016 the subvention covers only 37 percent of total education expenses. Although it is clear that the subvention is not meant to cover the total expenditure of the sector, this year-on-year variation shows that there is almost no variation in the grant, despite the substantial increase in expenditure.

Table 2.1. Ukraine: Subvention and Expenditure in Education, Cities of Oblast Significance
(UAH billion, unless otherwise specified)

Expenditure & Revenue	2015	2016
Education Expenditure	35.8	40.4
Education Grant	16.7	15.1
Grant (in percent of Expenditure)	47.6	37.3

Source: State Treasury and IMF staff estimates.

47. Subnational governments spend on average 59 percent of their total education expenditure on wages. In 2016 subnational governments received 44 billion UAH for the education subvention and spent 56 billion UAH on wages in the education sector. Hence, in the aggregate, the expenses in wages are 12 billion UAH higher than the education subvention given to the SNGs to pay what they are entitled to. By looking at each level of subnational government, cities and hromada are the most affected. Cities had to cover 10 billion UAH of wages with their resources and hromada 2 billion UAH (Table 2.2). The situation was similar during 2015, when they had to cover wages expenses in 6 billion UAH and 3 billion UAH respectively.

Table 2.2. Ukraine: Subvention and Expenditure in Education, 2016
(UAH million, unless otherwise specified)

	Share of wages on total expenditure	Education Wages Expenditure	Total Education Expenditure	Total Education Grant	Revenue - Wages
Oblasts	42%	4,818	11,388	5,559	741
Cities	63%	25,294	40,391	15,090	-10,203
Rayons	70%	21,554	30,636	21,743	189
Hromada	58%	2,827	4,844	16	-2,811
AH	61%	1,723	2,815	1,691	-32
All (Avg/Total)	59%	56,215	90,075	44,099	-12,116

Source: State Treasury and IMF staff estimates.

48. Furthermore, policy decisions by the State, such as increases in wage and subsistence rates, will put additional pressure on SNG finances. For example, the statutory pay rates for 2017 increased substantially and it is not clear if the expansion of the Health and Education subventions will be sufficient to cover the rise in wage bill. If they're not, the funds will have to be diverted from other unprotected expenditure items, such as capital expenditure (the rigidities of Ukraine's budget processes are explained in more detail in the following chapter). Table 2.3 illustrates this challenge by comparing the 2016 situation with a projection for 2018, assuming a wage increase of 20 percent for 2018 and a 5 percent decrease in the subvention (an assumption on the decrease deriving from the subvention no longer covering the wages of non-pedagogical staff). In aggregate, the projected deficit would be 38 UAH billion, three times larger than the 2016 deficit. Again, the bigger losers would be cities and hromada, but rayons would also observe an important impact in their balance.

Table 2.3. Ukraine: Impact of Wage Increase in Education Spending of SNGs
(UAH million)

Subnational Government	Education wages 2016	Education Subvention 2016	Balance 2016	Education wages 2018 P*	Education Subvention 2018 P*	Balance 2018 P*
Oblast	4,818,331	5,559,322	740,991	5,781,997	3,706,215	-2,075,783
Cities	25,293,595	15,090,460	-10,203,135	30,352,314	10,060,307	-20,292,007
Rayon	21,553,542	21,742,579	189,037	25,864,250	14,495,053	-11,369,198
Hromada	2,826,553	15,509	-2,811,044	3,391,864	10,339	-3,381,524
AH	1,722,960	1,691,361	-31,599	2,067,552	1,127,574	-939,978
ALL	56,214,981	44,099,231	-12,115,750	67,457,977	29,399,487	-38,058,489

Source: State Treasury and IMF staff estimates.

49. In recent years, there have been too many ad hoc legal changes affecting the revenue-sharing arrangement and the expenditure assignments. Similarly, adjustments to the calculation of subventions or to which expenditure items they are supposed to cover, are

often treated separately, and therefore with disregard to the impact of those changes on the balance between revenue and expenditure of SNGs. According to the Association of Ukrainian Cities, between 2010 and 2016 the Ukrainian budget code was amended multiple times, with most of these changes ending up impacting the finances of SNGs. This shows that there is not a clear and stable way to define responsibilities between levels of government, and that the revenue-sharing arrangement ends up being an adjustment variable in the aggregate finances. Box 2.2 shows which expenditure responsibilities were transferred to cities and hromada during 2015-2017, and an estimate of its cost, as well as the resources those local authorities had to cover those expenses, and which of those resources have been eliminated.

**Box 2.2. Revenue Arrangement and Expenditure Mismatch
An Example for Cities and Hromada**

After the decentralization reform, some additional adjustments to the revenue-sharing arrangement of cities and hromada have been made through the Budget Code, annually. According to the Association of Ukrainian Cities, the continuous transfers of expenditures since 2015 and the removal of assigned resources (grants or subventions), implies an increase of 66 billion UAH in local self-governments' expenditures.

2015 → 34 UAH billion		2016 → 52.7 UAH billion		2017 → 66 UAH billion	
Transferred expenditures		Transferred expenditures	7.8	Transferred expenditures	29.6
Kindergartens	14.9	Vocational Education	5.8	Communal services and energy (Health)	6
Roads of communal property	2.5	Privileged travel	2	Communal services and energy (Education)	9.3
Public administration	8.7	Increased costs	10.9	Salary for non-teaching staff	9.2
Cultural institutions	2.3	Kindergartens	1.5	Other expenditure (Education)	5
Sports schools	0.1	Public administration	2.2	3 State institutions - Ministry of Health Care	0.1
Education	2.7	Cultural institutions	0.2	Not Regulated	5.8
Health Care	2.8	Education	2.6	Privileged travel	2.2
		Health Care	4.3	Professional Education	3.6
		Sports schools	0.1		
Resources		Removed additional sources of coverage:		Additional Compensators	
Excise Tax	PIT	Privileged Travel Subventions		Additional dotation for institutions of education and health care (Oblast and Rayon budgets)	14.9
Basic Grant	10% CIT	Subvention for the difference of Tariffs		Financing vocational education as the expense of educational subvention	2.2
Privileged Travel Subventions	Education al	Subvention for vocational education		Subvention for the difference in tariffs	5
Subvention for the difference of Tariffs	Medical				
Subvention for vocational education					

Source: Association of Ukrainian cities.

50. Recommendation 2.6: Ensure greater continuity in the policies impacting the revenue sharing-arrangement and expenditure assignments. This will require:

- Calculating the real costs associated with the expenditures intended to be covered by subventions;
- Reviewing, every three years, whether the subvention formulas still allow the full coverage of assigned expenditure and adjust the formula accordingly;
- Minimize ad hoc legal changes that may impact SNGs finances during that three-year period; when those changes are inevitable, develop rules and procedures to estimate the medium-term impact on revenue and expenditure of subnational governments of all levels, which have a direct financial relationship with the State.

III. IMPROVING THE FORMULATION AND EXECUTION OF SNG BUDGETS

A. SNG Deposits with the State Treasury

51. Subnational governments have accumulated significant idle deposits with the State Treasury.¹⁴ Such deposits existed prior to the beginning of the fiscal decentralization reform. They have increased in volume and as a share of GDP post reform. As of January 1, 2017, total deposits were UAH 36.1 billion, equivalent to 1.5 percent of GDP. Rayons currently have the highest volume of deposits followed by the cities of oblast significance and oblasts (Table 3.1).

Table 3.1. Ukraine: SNG Treasury Deposits by Tier of SNG, 2014–17
(UAH million, unless otherwise specified)

Tiers of SNG	Jan 2014	Jan 2015	Jan 2016	Jan 2017	Sept 2017
Oblasts	3,294	3,286	5,830	7,212	11,710
Kyiv city	401	420	1,775	4,023	11,302
Cities of Oblast Significance	5,980	6,086	8,294	10,207	8,891
Rayons	7,343	8,305	9,803	12,750	16,495
Amalgamated hromada	-	-	-	1,959	3,382
Total	17,018	18,097	25,702	36,152	51,780
Total (percent of GDP)	1.2	1.1	1.3	1.5	1.9
<i>GDP (UAH billion)</i>	<i>1,465</i>	<i>1,587</i>	<i>1,989</i>	<i>2,383</i>	<i>2,734</i>

Source: State Treasury and IMF staff estimates.

Note: Figures for the SNG deposits with the State Treasury as of the month and year indicated in the column header. GDP figures are for the year immediately prior. GDP figures for 2014-16 are actual. GDP for 2017 is estimated.

¹⁴ This section analyses the funds on deposit with the State Treasury as of January 1 of any given year. This provides a more accurate and complete picture of the cash position of individual subnational governments than what is obtained by looking only at SNG deposits in state-owned banks. The latter must be closed no later than 10 days before the end of the fiscal year and the balance in those accounts returned to the State Treasury. The correct, complete measure of the cash position of SNGs other than on January 1 is the sum of the balance in the TSA account in the State Treasury and total deposits with state-owned banks at the time of measurement.

52. As of January 2017, all but the COS in aggregate had cash on hand at the State Treasury in excess of one average month of expenditures (Table 3.2). COSs have the longest history as independent units of local government, so it is not surprising that their revenues and expenditures are more closely balanced, resulting in lower accumulated deposits in the State Treasury relative to average monthly expenditures. The reverse is true for amalgamated hromada, which had the highest deposits relative to average expenditures. These are all newly constituted units of local government that are still developing services and planning investments in response to the needs of their community. So, it is not surprising that they had the highest ratio.

Table 3.2. Ukraine: Ratio of Cash Balance to Average Monthly Expenditures by Tier of SNG

	Treasury Deposits as of January 2017	Expenditure Turnover 2016	Deposits as months of expenditure
	(UAH million)		(Months)
Oblasts	7,212	48,525	1.8
Rayons	12,750	107,545	1.4
Kyiv	4,023	33,482	1.4
Cities (OS)	10,207	130,125	0.9
Amalgamated hromada	1,959	6,026	3.9
Total	36,152	325,703	1.3

Source: State Treasury and IMF staff estimates.

53. An evaluation of whether the accumulated deposits in the State Treasury are appropriate or not should be done on a case by case basis. Table 3.3 shows that in aggregate, SNGs appear to be able to maintain a positive monthly balance of revenues over expenditures. This is certain to vary by individual units of SNG. Some SNGs probably do not need to rely on the funds deposited in the State Treasury to manage their cash flow. For others, these deposits may be critically important. This might be the case, for example, for those SNGs that have a large pipeline of capital projects under construction. Currently there is no standard policy that could be used to determine the appropriate cash balance for an individual SNG.

Table 3.3. Ukraine: Average Monthly Revenue, Expenditure, and Balance of SNGs, 2015–17
(UAH million)

As of	2015					2016					2017		
	Jan	May	Aug	Oct	Year end	Jan	May	Aug	Oct	Year end	Jan	May	Aug
Total Revenues, of which	18,146	21,521	22,162	22,816	24,538	20,765	27,918	28,433	28,540	30,503	37,733	39,847	39,928
- Transfers	11,527	12,301	12,647	13,168	14,498	12,019	15,423	15,088	15,062	16,283	24,346	22,690	21,966
- PIT	4,259	4,365	4,584	4,693	4,933	4,440	6,217	6,646	6,646	7,071	6,565	8,619	9,181
- Local	739	2,019	2,169	2,217	2,253	2,441	3,240	3,443	3,502	3,522	4,171	4,157	4,312
Total Expenditures	11,518	18,760	19,578	20,406	23,339	14,197	23,378	24,469	25,186	29,201	28,475	35,026	36,133
Current Expenditures	11,467	17,135	17,746	18,282	20,658	14,145	22,007	22,233	22,391	24,821	28,153	32,749	32,627
- Payroll	5,402	7,571	8,022	8,249	8,809	6,615	8,502	9,134	9,183	9,693	8,413	10,092	10,217
Capital Expenditures	51	1,625	1,833	2,124	2,681	52	1,372	2,236	2,795	4,380	323	2,277	3,506
Balance	6,627	2,761	2,584	2,410	1,199	6,568	4,540	3,964	3,354	1,302	9,257	4,822	3,795

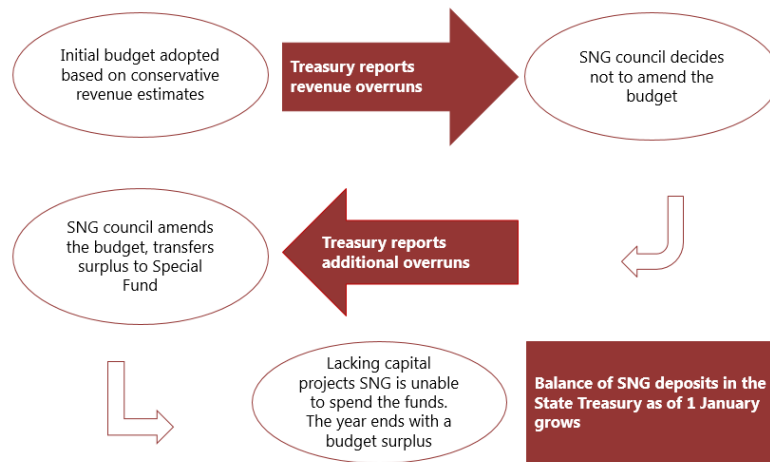
Source: State Treasury and IMF staff estimates.

54. Recommendation 3.1: The MoF, in consultation with SNG representatives, should develop a standard policy for an appropriate cash balance for SNGs. This should be accompanied by guidance that requires that SNGs:

- Apply these policies to evaluate the adequacy of their cash balance, and
- If required, prepare a practical plan to bring the balance into conformity with the policy.

55. The accumulation of deposits by SNGs seems to derive from shortcomings in budget formulation and execution. The rigid structure and short-term focus of the local budgets and the difficulties SNGs appear to face building a pipeline of investment projects may explain why SNGs have accumulated these somewhat high cash balances (Figure 3.1). From the perspective of fiscal decentralization these are the issues that need to be analyzed more in depth and addressed. The next two sections of this chapter discuss in more detail the issues that may have contributed the most to this accumulation of deposits.

Figure 3.1. How the High Balances May Have Originated



B. SNG Budget Structure and Process

56. Protected line items in the SNG budget limit the range of options available to SNGs to deploy funds consistent with local priorities and prudent financial management. The concept of P “protected expenditure items” (the main categories of which are shown in Table 3.4)¹⁵ applies to expenditures in both the General and Special Funds.¹⁶ In 2016, together,

¹⁵ In addition to the expenditure categories listed in the table, protected items include also confidential (intelligence) expenditure and other special expenditure programs, added to Article 55 of the Budget Code, on an ad-hoc basis, during the budget negotiations.

¹⁶ According to the Budget Code, the budget consists of two independent sections—a General and a Special Fund—that must be adopted, balanced and managed separately. The General Fund consists of all revenues used to fund expenditures of general government agencies. The Special Fund consists entirely of revenues that are earmarked for a specific purpose, including some own-source revenues, donor funded activities, and certain borrowings.

they accounted for around three-fourths of total SNG expenditures. The requirement to pay protected expenditures squeezes out any non-priority expenditures including those financed by own source revenues.

Table 3.4. Ukraine: Main Protected Expenditure Items, 2016

Budget Code	Budget Category	General Fund	Special Fund	Total	Total
		UAH million			Percent of Total Exp.
2100	Wages and social contributions	114,736	1,576	116,313	33.2
2220	Medical supplies	6,149	2,467	8,616	2.5
2230	Meals and food	5,976	2,515	8,490	2.4
2270	Utilities	17,474	320	17,794	5.1
2280	Research and development	3,853	1,413	5,267	1.5
2400	Debt service	313	0	313	0.1
2620	Transfer to other government units	3,732	6	3,739	1.1
2700	Transfers to households	99,767	35	99,802	28.5
	Total Protected Items	252,001	8,332	260,333	74.3
	Total Expenditure Outturn	285,729	64,684	350,413	100.0

Source: State Treasury and IMF staff estimates.

57. Earmarking of revenues limit the ability of SNGs to deploy funds consistent with local priorities. The Budget Code allows for earmarking of revenues to specific expenditures, subject to Parliamentary authorization, to the Special Fund of both the State and local levels. Earmarks accounted for more than half of total SNG revenues each year from 2015 to 2017 (as of August), although the share of earmarks in total SNG revenues has declined slightly from 58 percent in 2015 to 56 percent as of August 2017 (Table 3.5). By far, the predominant earmark are the subventions for health, education, and social assistance. They represent 97 percent of all earmarked revenues of SNGs. There also are numerous small earmarks. Finding eligible uses for such small earmarks must take up an inordinate amount of the attention and effort of SNG staff on items that represent a tiny percent of the budget. The problem with earmarks is that they reflect State policies and priorities and may or may not be aligned with local needs and priorities.

Table 3.5. Ukraine: Earmarked Revenues, 2015–17

Budget Category Descriptor	Outturn			Earmarks		
	2015	2016	2017 (8)	2015	2016	2017 (8)
	UAH million			percent of total revenue		
Ecological tax	1,586			0.5		
Part of the net profit (income) of communal enterprises	149	125	81	0.1	0.0	0.0
Proceeds from the sale of assets whose owners are unknown	13			0.0	0.0	0.0
Subventions	165,920	187,870	159,790	56.3	51.3	54.2
Subtotal General Fund	167,667	187,995	159,871	56.9	51.4	54.2
Ecological tax		3,368	2,248	0.0	1.0	0.8
Tax on owners of vehicles and other self-propelled machinery	2	1	1	0.0	0.0	0.0
Compensation for losses of agricultural and forestry production	116	96	110	0.0	0.0	0.0
Environmental fines	40	108		0.0	0.0	0.0
Income from lending operations and provision of guarantees	1	1	1	0.0	0.0	0.0
Receipts of equity participation in development of communal infrastructure	793		948	0.3	0.0	0.3
Proceeds from the sale of communal property	725	468	418	0.2	0.1	0.1
Proceeds from the sale of land	888	921	736	0.3	0.3	0.2
Grants (gifts) received in budgets of all levels	12	35	10	0.0	0.0	0.0
Subventions	783	689	2,032	0.3	0.2	0.7
Subtotal Special Fund	3,361	5,687	6,503	1.1	1.6	2.2
Total Earmarked Revenues	171,028	193,682	166,375	58.1	52.9	56.4
Total Revenue Outturn	294,460	366,041	294,972	100.0	100.0	100.0

Source: State Treasury and IMF Staff Estimates

58. Recommendation 3.2: The Budget Code should be amended to simplify the SNG budget structure and provide more room to reflect local needs and priorities in the SNG budgets, by:

- Replacing the distinction between General and Special Fund with separate appropriations for operating and capital expenditure based on international standards;¹⁷
- Reducing the number and scope of earmarked revenues; and
- Reducing or eliminating entirely the concept of protected expenditure items, other than those arising from contractual obligations, notably payment of interest on outstanding debt obligations.

¹⁷ This has been a recurrent recommendation of previous FAD TA missions. The ongoing revision of the Budget Code provides the opportunity for its implementation.

59. The provisions of the Budget Code regarding the SNG budget balance do not preclude a budget deficit at the end of the fiscal year. An SNG could follow faithfully current budget balance rules when adopting and amending its budget and still conclude the fiscal year with a deficit.¹⁸ The Budget Code establishes a limit on the “working balance” of budgetary funds (defined as the part of the balance of funds of the general funds formed to cover temporary cash gaps) of 2 percent of the planned expenditures of the general fund of the budget. This provision is unclear and does not seem to require a budget balance at the end of the fiscal year. Therefore, the SNGs could carry the resulting accounts payable into the budget of the next year and pay them with revenues from that budget (Box 3.1). In the absence of clear fiscal rules requiring a return to balanced or positive outturns, this practice is not consistent with sound financial management of the budget. It allows SNGs to ignore an insufficiency of revenues to expenditures that might evolve into more serious problems if not addressed.

Box 3.1. Key Features of the SNG Budget Structure and Process

General Fund

Revenues (93 percent)

- Own taxes and fees
- Shared tax revenues
Education, health and social assistance State budget subsidies (Earmarked - 55 percent)

Expenditure (all current)

- Expenditures for health, education, other local services, within which
Protected items, among others:
 - Compensation of public employees
 - Debt service
 - Certain utility costs
 - Certain medical and social assistance costs
 - Certain training and research related costs
- Transfer of surplus to the Development Budget for capital expenditures (cannot be reversed)

Special Fund

Revenues (7 percent) (Earmarked – 100 percent)

- Proceeds of various land and urban development programs
- Proceeds of repayment of loans made by local government
- Transfers from other Special Funds (including State Budget)
- Revenues of the Development Budget

Expenditure (current & capital)

- As mandated by earmarked funding
- Transfers to other Special Funds
- Development Budget expenditures, among others:
 - Debt service
 - Capital expenditures
 - Appraisal of land subject to sale
 - Town planning expenditures

Rules and procedures for adopting and amending the budget

Initial General and Special Fund budgets must be adopted by December 25 of the preceding fiscal year

Amendments of the budgets

- At any time to move items between line items without changing the total, subject to respecting earmarking and protected items
- At the beginning of the fiscal year to incorporate funds balances in the State Treasury (see below)
- Quarterly based on revenue overruns (shortfalls) as reported by the State Treasury
- Upon amendment of the State Budget

Rules regarding the budget balance

The initial General and Special Fund budgets must be balanced

Subsequent amendments

¹⁸ One scenario involves an amendment of the General Fund budget, which appears to be in surplus, to transfer that surplus the Special Fund for investments. A change in national policy regarding the minimum wage or the price of energy that increases current expenditures might move the General Fund into a deficit. By law, there are no transfers from the Special to the General Fund thus leaving the Special Fund in surplus and the General Fund in deficit at year end.

- The General Fund may be in deficit subject to incorporating surplus funds in the State Treasury account (as financing below the line)

Box 3.1. Key Features of the SNG Budget Structure and Process (concluded)

- The General Fund may be in surplus to
 - Provide for the transfer of funds to the Special Fund for investments
 - Pay accounts payable inherited from the prior fiscal year
- The Special Fund may be in deficit subject to incorporating as financing below the line
 - The transfer of funds from the General Fund for investments
 - Proceeds of loans
- The Special Fund may be in surplus to provide for
 - Debt service on outstanding loans (does not specify if just amortization of principle)

Source: Budget Code of Ukraine.

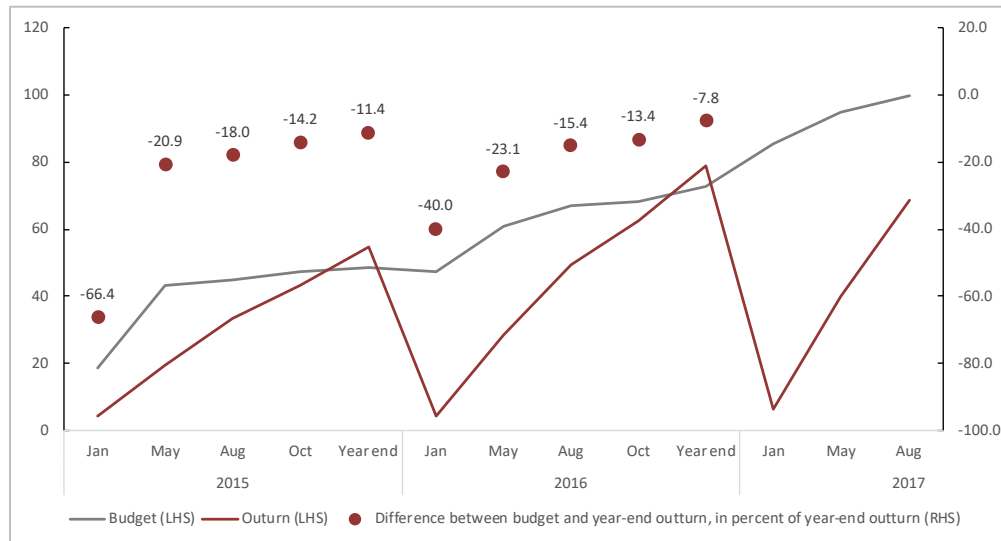
60. Recommendation 3.3: The Budget Code must be amended to preclude recurring negative outturns that could undermine the sustainability of SNG finances. This could entail:

- A requirement for SNGs to take steps to return to a balanced or positive outturn within two or three years at most.
- Sanctions in case of recurrent deficits above a certain magnitude or for longer periods, ranging from the withholding of transfers, to the compelled merger with a neighboring authority or to be taken under direct State administration.

61. The recurring annual change in the assignment of SNG expenditure responsibilities implemented primarily through the annual budget law hinders effective forward planning of the SNG budgets. In 2016, 2017, and in the proposed budget for 2018, the MoF has assigned additional expenditure categories to SNGs, largely in health, education and social assistance—payment of the operating expenses of hospitals and medical facilities; payment of the wages of the non-pedagogical staff in local schools; social benefits provided to households and special categories of citizens. This MoF practice undermines budget formulation, by providing a disincentive to any attempt by SNGs to prepare forward looking budget plans. The implications for fiscal decentralization are discussed in Chapter II, while Chapter IV addresses this trend from the perspective of intergovernmental coordination.

62. SNGs appear to be having a difficult time developing an accurate forecast of revenues from the PIT. Currently the Ministry of Economic Development and Trade (MEDT) prepares the annual forecast of the revenues from the PIT, which is transmitted by the MoF to each SNG beneficiary of PIT shares. SNGs subsequently modify the forecast based on their knowledge of local circumstances—registration of new firms, shadow workers added to the formal payroll—that impact PIT revenues specifically within their area of jurisdiction. In 2015 and again in 2016, SNGs adjusted the revenue forecast upward throughout the year but still underestimated the final outturn by 11 and 8 percent, respectively (Figure 3.2). SNGs have insufficient time to execute expenditures to absorb this overrun in the final months of the year. The result is an end of year surplus, which contributes to the growth of idle deposits in the State Treasury.

Figure 3.2. Performance of PIT: Budget vs Outturn, 2015–17
(UAH billion, unless otherwise specified)



Source: State Treasury and IMF staff estimates.

63. Under these circumstances, the accumulation of balances in the State Treasury may have been the preferable outcome. Most governments would not be able to absorb last quarter revenue overruns. While the optimal solution for this problem is to improve forecasting capacity, a second best is what SNGs have been doing—accumulate deposits in the State Treasury that can be allocated more effectively in future years. This is preferable to poorly planned and inefficient “last-minute” spending. The conservative revenue assumptions and resulting accumulation of deposits have also lowered overall general government spending pressures and contributed to meeting fiscal targets.

64. Recommendation 3.4: The MoF coordinate an effort with the MEDT to improve forecasting of SNG revenues, by:

- Analyzing recent over performance primarily of the PIT and refining forecasting techniques; and
- Disclosing and explaining the new forecasting techniques to SNG officials.

C. SNG Capital Expenditure Planning

65. Prior to the local self-government reform, SNGs had no incentive or need to adopt an investment plan based on local priorities or to prepare a pipeline of investment projects for financing. SNGs were heavily dependent on State investment grants to fund capital projects. Since the volume of such grants in 2014 was barely UAH 500 million (0.03 percent of GDP),

investment rates by SNGs pre-reform were well below levels seen elsewhere in the region.¹⁹ Levels in oblasts and cities were below 10 percent of total expenditure (Table 3.6). Only Kyiv among cities managed to allocate more than 10 percent of expenditures to investment. The higher levels of investment activity were taking place in the hromada, where much of the State subsidies were concentrated.

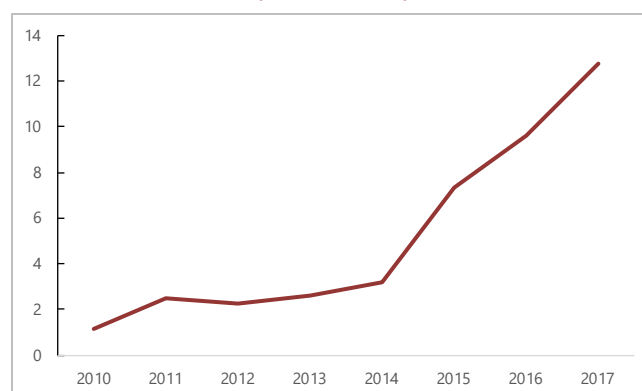
Table 3.6. Ukraine: Capital Expenditures by Tier of SNG, 2014 vs. 2016
(percent of total expenditure)

Tiers of SNG	Oblasts	Cities	Rayons	Hromada	Amalgamated Hromada
2014	2.8	9.1	1.3	16.1	
2016	14.3	20.0	4.2	29.2	31.4

Source: State Treasury and IMF staff estimates.

66. As a result, after the reform was launched, most SNGs started with no pipeline of investment ready projects and limited initial capacity to design and obtain required permits for such projects. Interviews with donor representatives, state officials and senior SNG staff point to various obstacles related to the public investment processes. The technical specification and design of the few projects that might have been available had to be revised and updated. Some of the current needs, such as capital repairs to bridges, involve challenging technical design issues that require specialized professionals and take time to complete. SNGs had limited or no specialized staff with experience in these areas. A telling example is the case of Kyiv city, which only now, late in fiscal year 2017 has begun to put in place a pipeline of major investment projects consistent with their own needs and priorities (Figure 3.3). Although by 2016 SNGs had succeeded in surpassing the low levels of investment in 2014, the levels are still low when compared with other European countries (Figure 3.4). Hromada and amalgamated hromada that are a priority target of State investment subsidies are the exception.

Figure 3.3. City of Kyiv Capital Expenditure, 2010–17
(UAH billion)

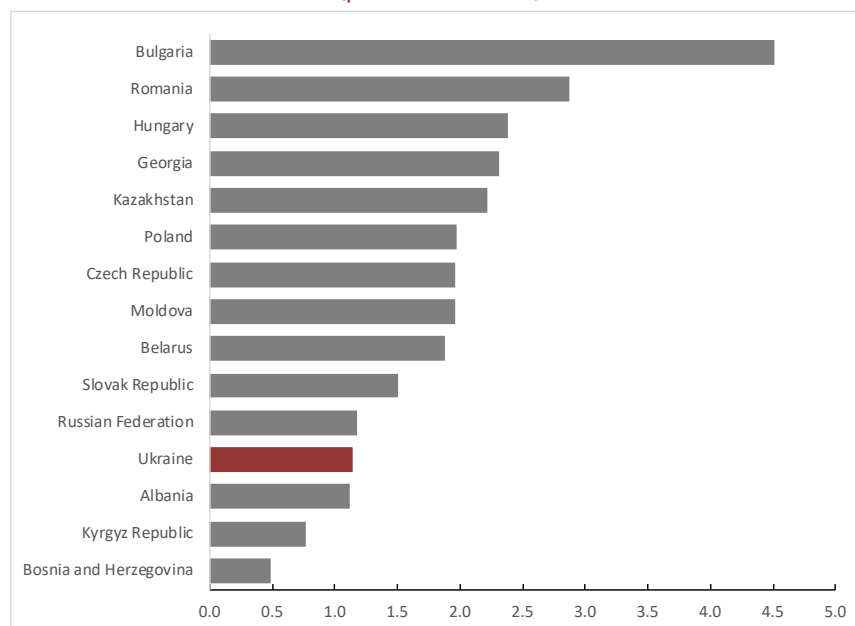


Source: City of Kyiv

Note: Figures for 2010–16 are actual, 2017 budget

¹⁹ Hughes et al (January 2015), "Ukraine: Fiscal Decentralization" Fiscal Affairs Department, IMF.

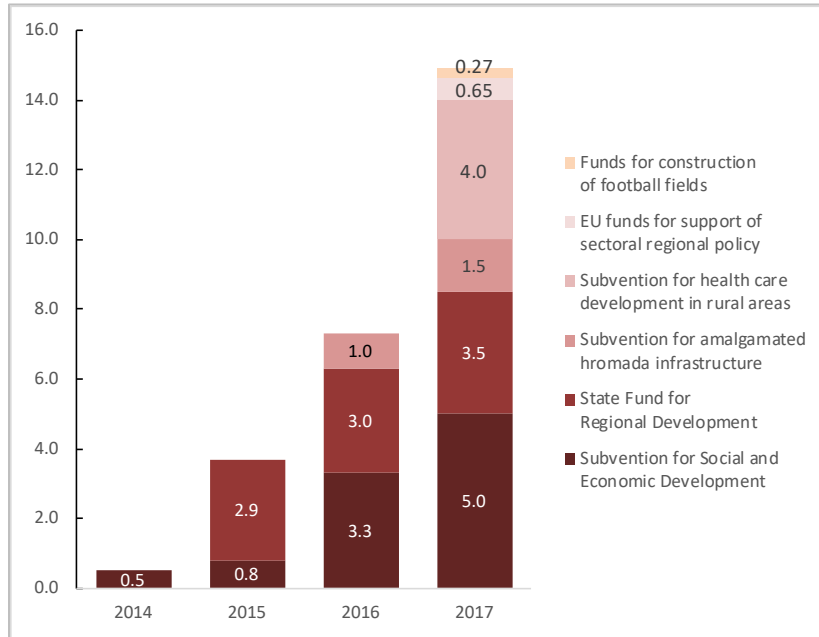
Figure 3.4. Investment by Subnational Governments, Comparison with Peers, 2015
(percent of GDP)



Source: IMF Government Finance Statistics Yearbook database.

67. State investment grants provided to SNGs grew rapidly post reform. Total funding doubled from 2015 to 2016 and doubled again in 2017 (Figure 3.5). Currently, the grants are managed through four distinct programs. The largest at UAH 5 billion is the subvention for Social and Economic Development (SSED) that is new in 2017. SNGs apply through their respective oblast, which forwards the projects they select to a commission that sits in the MoF. There is concern that the selection process will be politicized, since at least half the members of the commission must be MPs from the Parliamentary Budget Committee. The State Fund for Regional Development (SFRD) is next at UAH 3.5 billion. The focus is on regional development, as the name suggests. The SFRD, which started off well in 2015 and has EU support, as of 2017 has earmarked 30 percent of the funding for specific types of projects, such as sports facilities. The concern is that this may detract from a focus on regional development and from a bottom up setting of investment priorities. The MRD has a UAH 1.5 billion fund to support infrastructure development in the amalgamated hromada. Finally, there is a new large allocation of UAH 4 billion in 2017 to develop the health system in rural areas.

Figure 3.5. State Investment Grants by Program, 2014–17
(UAH billion)



Source: Ministry of Regional Development, Monitoring Report on Fiscal Decentralization, September 2017.

68. The availability of State investment grants may be encouraging continued emphasis by SNGs on preparing projects eligible for such financing at the expense of building a pipeline of projects consistent with own priorities. Over 7,600 investment projects have been approved for the SSED and subvention for amalgamated hromada infrastructure. Donor representatives commented that competition for grants such as these is detracting local administrations from focusing on local needs and priorities. There is concern as well about the quality of some of the projects that are being approved.

69. Recommendation 3.5: The MoF should consider implementing multi-year capital budgeting by SNGs in advance of the planned introduction of an MTBF at that level. This might be achieved by starting pilot programs as early as 2018 in selected SNGs in all tiers to develop and adopt local multi-year capital expenditure budgets that:

- Reflect local community and regional development priority needs;
- Include investment ready capital projects consistent with these priorities;
- Include projections of the impact on the local budget of operating and maintaining, and staffing as appropriate, the new networks and facilities once construction has been completed; and
- Are taken into account when setting the criteria and approving financing for State investment subsidy funds and donor financing of SNG investment projects.

IV. ENHANCING INTERGOVERNMENTAL FISCAL COORDINATION

70. The implementation of previous FAD recommendations in the areas of fiscal coordination and management of fiscal risks arising from SNGs has been weak.²⁰ Previous assessments highlighted weaknesses in (i) the oversight of subnational borrowing and PPPs; (ii) the in-year monitoring of local governments budgets; (iii) the internal and external audit of SNGs financial performance; and (iv) the State Treasury management of SNG cash and liquidity. These issues have not been solved and most of the recommendations made at that time remain valid. They are reiterated here along with additional steps to improve fiscal coordination.

A. Intergovernmental Fiscal Coordination Framework

71. Ukraine needs sound coordination among different levels of governments to ensure the consistent conduct of fiscal policy. Local governments need a clear understanding of their likely transfers from the State budget for the budget year and the medium term and an opportunity to comment on the formulation of any national policies with implications for their expenditures, revenues, or financial management. For the State government, and especially in the context of a fiscal policy objective covering the general government, it is essential to monitor the health of subnational government finances and ensure that they do not threaten the fiscal targets.

72. Local authorities find it difficult to get a timely notice of State government policies that affect their responsibilities or revenues. While the framework for intergovernmental fiscal coordination allows for early central-local consultation during budget formulation and coordinated approval of national and local budgets, local governments have, in practice, few insights regarding measures that affect their budgets. Moreover, there are no formal opportunities for local governments to voice their concerns about such measures.

73. The institutional and legal framework is not conducive to a well-coordinated use of the local government deposits, which could significantly widen the general government deficit. Legislation requires subnational governments to balance annual operating revenues and expenditures but allow for a general fund deficit in the event of the use of an idle balance of budget funds. Since local governments, per the Budget Code, can carry over their leftover special fund balance from one year to another, their accumulated financial surplus, estimated at 1.9 percent of GDP by end-September 2017, could translate into sizable SNG deficits in the coming years. Moreover, there is no fiscal rule in place to limit expenditure growth, ex post

²⁰ Most of these recommendations have been formulated in the above cited FAD “fiscal decentralization” mission report, by Hughes et al (January 2015) and in a more recent FAD “Strengthening PFM” mission report, by Alves et al (May 2017).

deficits, or the scope of the carry-overs, as implemented in some European countries (see Table 4.1; an expanded set of this information can be found in Annex II).²¹

Table 4.1. Subnational Fiscal Rules in Selected European Countries

Country	Target/Constraint	Description
Italy	Budget balance (LG); Nominal Expenditure growth rate (RG) Budget balance in nominal terms	Internal stability Pact provides RG with measures to limit expenditures and LG with measures to limit financial balances. Public finance targets of RG (expenditures ceiling and financial balance) are updated by the Public Finance Decision. Golden Rule: local and regional bodies are allowed to carry on deficits only to finance investments
France	Budget Balance	Golden Rule: voted budget must be in balance; ex post deficits cannot exceed 5 percent of current revenues (10 percent for small municipalities)
Slovenia	Debt Ceiling: limit on repayment as percent of revenue in previous budget year	The total payment of principal and interest in each year must not exceed 8 percent of revenues of the previous year. LG cannot borrow abroad. LG approval needs the approval of the MoF
Ireland	Budget balance in nominal terms	For any given year, LG must have a net total deficit of no more than a fixed nominal amount.

Source: State Treasury and IMF staff estimates.

74. Recommendation 4.1: Strengthen the intergovernmental fiscal coordination framework with subnational specific fiscal rules to ensure that the general government meets its fiscal objectives. The implementation of such rules would require a strengthened monitoring of local governments finances (see below) and the setting up of a clear mechanism to map deviations from the numerical targets into incentives to take corrective actions. Those fiscal rules could take the form of:

- A limit on expenditure growth rate. An example of such a rule would be to impose annual growth rate of total expenditures not to exceed the average annual growth rate of revenue excluding central government transfers over the previous three years; and
- A limit on the overall deficit of subnational governments.

Until fiscal rules for SNGs are established, to ensure the pursuance of the general government fiscal target, the MoF should establish a reserve at the State Budget, large enough to accommodate any SNG overspending arising from the use of accumulated idle balances.

²¹ There are a number of fiscal rules currently applied to subnational governments by different European countries, each presenting advantages and disadvantages. Some countries enforce strict non-deficit rules on the overall (i.e., current and capital) balance for regional and/or municipal governments (Belgium, Ireland, Sweden, Spain, and Germany for local governments). Balancing the fiscal current balance (“golden rule”) grants a larger degree of flexibility to accommodate investment, but at the expense of a less direct link to the overall balance and hence, to debt accumulation (France, Italy, Germany for regional governments, Lithuania, Romania).

75. There is currently no common formal platform for intergovernmental coordination in Ukraine. The country is missing an intergovernmental structure that would include representatives of all levels of government mandated to ensure a collaborative and coordinated approach to achieve common fiscal objectives and ensure fiscal sustainability at all levels of government. In putting in place such a structure, consideration should be given to how it would fit in the legislative powers of the Verkhovna Rada (VR) and in the functions of the relevant parliamentary committees (e.g., the budget committee and the sub-committee on local budgets).

76. Recommendation 4.2: Establish an Intergovernmental Commission to ensure collaborative approach on common fiscal objectives. The Commission would:

- Be chaired by the Minister of Finance or its Deputy
- Include representatives of all levels of government, local elected officials as well as representatives of the State (including Oblast and Rayon representatives). It would be important for the Ministry of Regional Development, the Ministry of Education, the Ministry of Health and the Ministry of Social Policy to be represented;
- Meet at least twice a year;
- Be mandated to provide strategic guidance for fiscal policy formulation and coordination among the different spheres of governments with a view to meet fiscal policy targets, set at the government general level, and ensure long-term macro-fiscal stability. In particular, it would be mandated (based on MoF inputs) to monitor SNG finances and to suggest fiscal targets for the various levels of government and for the largest subnational units;
- Be consulted on all draft laws, amendments, or regulations which have an impact on local finances (including any reforms recommended in the remainder of this report that are launched after the establishment of the Commission). The MoF would be in charge of providing the necessary analysis for those elements of the state budget which affect local governments;
- Be consulted on matters relating to borrowing and the framework for State loans and guarantees provided to subnational units; and
- Participate in all major discussions about on-going fiscal decentralization reform.

B. Local Government Risk Monitoring

77. The consolidated SNG financial position masks significant disparities across jurisdictions. By end-2016, more than half of the villages recorded a deficit, as about a fourth of the cities and rayons, and a fifth of the oblasts (see Table 4.2). Up to 2016, only 11 out of 160 of the amalgamated community displayed a deficit but this situation is likely to change with the tendency of rural and poor villages to amalgamate among themselves to avoid losing their voices. This raises the question of the financial viability of some of the newly formed or future amalgamated hromada: among the 453 villages that remained to be amalgamated by end-2016,

251 recorded a deficit and 286 spent more than 50 percent of their operational revenue on remuneration.

Table 4.2. Ukraine: Selected Financial Stress Indicators of SNGs, 2016

	#	Rev.	Exp.	Balance		Financial stress indicators (examples)			
		UAH million	UAH million	UAH million	# in deficit	# with basic and stab. subs./ Current rev.>10	# with Personnel exp. / op. exp.>50 percent	# with Dev. Exp./ Rev.< 10 percent	# with Dev. Exp./Rev.< 20 percent
Oblasts	24	53.1	48.5	4.6	4	1	13	13	20
Rayons	457	111.6	107.5	4.0	110	3	2	446	457
COS	148	170.5	163.6	7.0	40	4	3	74	126
Villages	453	20.9	22.1	-1.2	251	1	286	49	186
AH	160	7.1	6	1	11	39	135	8	57

Source: State Treasury and IMF staff estimates.

78. Overall, the Ukrainian legal framework incorporates procedures for reporting on execution of State and Local budgets, as well as publication of such reports.

- Pursuant to the Budget Code, performance reports on the execution of the local budget must be presented to the relevant local council on a quarterly and annual basis, within two months of the end of the corresponding budget period and must be approved by the relevant local council (Art 80).
- Reporting on local budget execution is also part of the procedure of reporting on the State budget. Pursuant to Articles 58–61 and 80 of the Budget Code, the local agencies of the State Treasury are required to submit specific information on local budget execution on a monthly, quarterly and annual basis to the VR, as well as the MoF, CMU, and the Accounting Chamber of Ukraine (ACU).²² In turn, monthly, quarterly, and annual reports on execution of the State budget are prepared and submitted by the State Treasury to the VR, CMU, President, MoF, and ACU.

79. In spite of the availability of execution reports, there is no regular analysis of the financial situation of local government. As pointed in the 2015 FAD TA report,²³ the MoF exercises no tracking of key financial stress indicators for individual local government budgets such as overall and operating balance, accounts payable, debt and debt service. Similarly, a

²² Respectively, within 15 days of completion of the reporting month, within 35 days of completion of the reporting quarter, and within 3 months of the end of the fiscal year.

²³ Hughes et al (January 2015), "Ukraine: Fiscal Decentralization" Fiscal Affairs Department, IMF.

monitoring of revenue shortfalls or expenditure overruns to identify local government that chronically face financial difficulties and may require State intervention, is also missing.

80. An analysis of financial indicators, for the oblasts and cities displays mixed results (Table 4.3) in terms of local financial health. On the one hand, the exposure to borrowing risk seem extremely limited in all regions. Indeed, few entities outside of the city of Kiev borrow for investment purposes, other than on-lending arrangements related to loans provided by international financial institutions to the State. On the other hand, expenditures seem biased toward current expenditures and development expenditures represent less than 10 percent of revenues in most oblasts.

Table 4.3. Ukraine: Heat Map of Financial Stress Indicators, Oblasts and City of Kiev
(number of oblasts in each situation)

Financial Ratio	Level of Risk		
	Low	Medium	High
Debt service coverage ratio (available revenue/annual debt service)	25 [More than 2.5 times]	0 [1.5-2.5 times]	0 [Less than 1.5 times]
Debt service/Current revenue	25 [Below 10 percent]	0 [10-15 percent]	0 [Greater than 15 percent]
Total debt/ Current revenue	25 [Less than 100 percent]	0 [100-150 percent]	0 [Greater than 15 percent]
Personnel expenditure/operating expenditures	1 [Less than 35 percent]	2 [35-50 percent]	13 [Greater than 50 percent]
Development expenditures	4 [Greater than 20 of revenue]	7 [10-20 percent]	13 [less than 10 percent of revenue]

Source: State Treasury and IMF staff estimates.

81. While borrowing risks seem currently limited in most sub-national governments, the monitoring framework could be strengthened to avoid the emergence of such risks. The legal framework sets clear limits to local government borrowing, although their scope and purpose is not always clear:

- Local debt service is limited to 10 percent of the expenses of the general fund of the local budget during any budget period when servicing is planned;
- There is a limit on the total amount of local debt (including guaranteed debt) of 200 percent of forecast revenues of the development budget (400 percent for the City of Kiev). The annual local budget sets a limit on total local debt and local guarantees on a yearly basis;
- Lending between local budgets is expressly prohibited (Art 73 of the BC);

- Local governments are required to seek approval from the MoF to issue guarantees but not to contract PPPs;
- While Article 73 of the BC provides for loans to cover temporary cash gaps on the general fund and development fund, Article 74 stipulates that local borrowing should be limited to the purpose of financing development budgets, financed by the special fund; and
- Similarly, while Article 73 extends the borrowing powers to all local budgets, Article 74 only refers to city budgets.

82. The legal mandate of the MoF to oversee local borrowing could be further specified. The Budget Code includes a general requirement for the “scope and conditions of local borrowing and the provision of local guarantees” to be agreed with the MoF without providing more specifications. Moreover, the automatic granting of MoF approval of subnational borrowings request on a one-month lapse-of-time basis—introduced with the aim of enhancing local financial flexibility—raises questions on the nature of controls exercised by the MoF.

83. PPPs and concessions at the local level are not a large source of fiscal risk but they benefit from a very limited follow-up. Local authorities appear not to be widely engaged in PPPs and most projects that include the participation of the private sector require no explicit funding from the government as they take the form of concession contracts. However, there is no central database that records total fiscal commitments under PPPs to control the emergence of such risks. Further, the MoF plays a very limited role in the PPP/Concession approval procedures. MoF approval is only required for explicit government funding, through direct payments or loan guarantees.

84. Strengthening in-year monitoring will also require strengthening internal and external audit requirements for local authorities. Currently, internal audit and control is conducted under the purview of the State Audit Service (SAS) of Ukraine as well as the internal audit units (IAU) of each budgetary spending unit. The mandate of the SAS extends to compliance audits of local budgets.²⁴ The procedure for SAS audit of local budgets is set out in a CMU Resolution—it includes the requirement to send an audit report to the local government, and authorizes the local branches of the SAS to take measures for implementation of any requirements under the audit report that have not been implemented by the relevant local government. With respect to external audit, the Accounting Chamber of Ukraine (ACU), is only empowered to carry out audit of local budgets “at their request.” However, this does not include the audit of own revenues of local budgets and their frequency is not defined.

85. Recommendation 4.3: Improve monitoring and management of fiscal risks arising from local government finances. Specifically:

²⁴ CMU Resolution no.43 On the Charter of the State Audit Service, Article 4(4).

- The department of Local Budgets in the MoF should set up a monitoring system to track local government finances, including:
 - Tracking indicators of fiscal stress including overall balance, operating, accounts payable, debt and debt service to revenue ratios.
 - Monitoring revenue shortfalls and expenditure overruns.
 - Identifying hromada with persistent deficits.
 - Compelling those local authorities to raise taxes, reduce spending or merge with more financially viable authorities.
- Reconfigure subnational borrowing rules to require explicit MoF approval for domestic borrowing above a threshold value or any borrowing in foreign currency in lieu of having them approved automatically on a lapse-of-time basis.
- Require all PPP contracts to be reported to the MoF and require MoF approval for all PPP contracts worth more 10 percent of local operating revenue.
- Strengthen the requirements for external audit and increase their frequency to ensure that each major local government unit undergoes such an audit at least every two years. The law should provide for external audit as a requirement rather than as a permission to audit. These audits could be conducted by an approved list of private audit firms to complement the ACU controls.

C. Cash Management

86. Modern government cash management is founded on three primary pillars. To be effective, cash management requires (i) a consolidated and comprehensive treasury single account (TSA) system of banking arrangements; (ii) reasonably accurate, updated cash flow forecasts and projections; and (iii) active financial cash management transactions based on a dynamic cash buffer level. Such a system can ensure that cash resources available to the whole of government are known and understood; are utilized as and where required; surplus cash is invested for appropriate periods; and that borrowing is maintained at the lowest possible level.

87. The government's banking arrangements for local authorities in Ukraine provide for the establishment of a TSA. Article 43 BCU establishes a Treasury Single Account (TSA) structure held with the National Bank of Ukraine, into which all revenues must be paid. The coverage of the TSA is comprehensive, incorporating all general government revenue (State and Local) and the social funds. The responsibility for managing the TSA is assigned to the State Treasury Service, in accordance with the provisions of the Budget Code and procedures approved by the CMU.²⁵ The State Treasury Service is granted extensive powers to open, close and manage government bank accounts, and generally control public revenues that are consolidated into the TSA (see Art 43(1) and (6) BCU, and Art 4 STS Decree).

²⁵ See Article 2 CMU Decree of 15 April 2015 On Approval of the STS ("STS Decree").

88. The accumulation of local authorities' idle balances at State-owned commercial banks prevents a more active cash management across the general government. As discussed in Section 3.A, the local authorities, as a whole, have been accumulating funds, particularly over the last couple of years. The State Treasury Service does not remunerate these funds, when deposited in the TSA. Local authorities are currently allowed to deposit idle balances, exclusively with state-owned commercial banks, during the course of the year. These funds must be returned to the budget accounts from which they were transferred no later than 10 days before the end of the fiscal year. The transfer is carried out by the State Treasury Service.

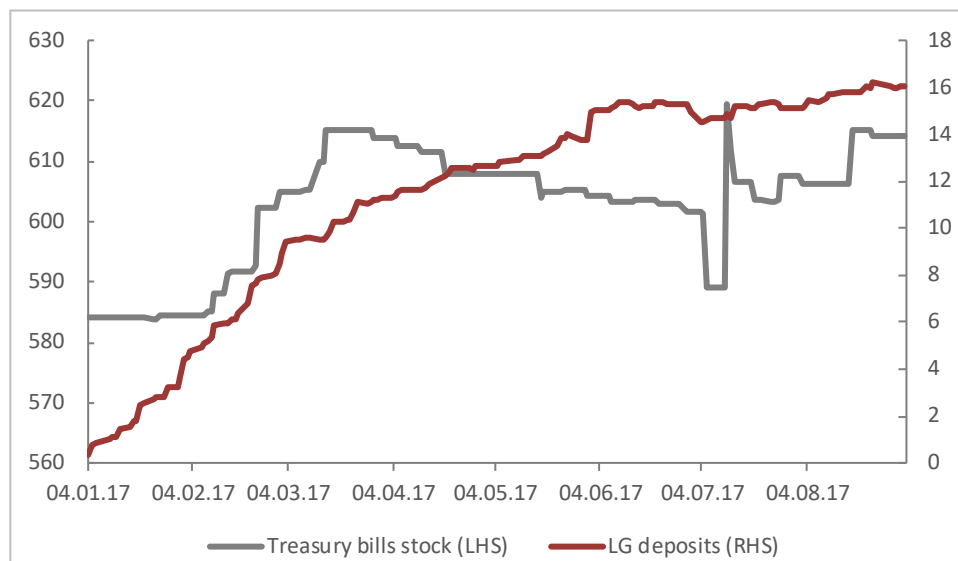
89. Efficiency gains and economies of scale can be major benefits from the provision of centralized government treasury services. Taken as a whole, the public sector, or its subset the general government, should operate homogeneously. It is highly inefficient for one part to be borrowing short-term funds at the same time that another part is maintaining temporary cash surpluses. Economies of scale can also be important in increasing financial efficiency of the government. Negotiating large scale deposit rates with the commercial banking sector or utilizing large repo markets often leads to higher returns on these investments and will also reduce transaction fees substantially.

90. The State Treasury Service continues to provide short-term unremunerated loans to cover local authorities' in-year financing shortfalls. The accumulation of surplus at the local government level is not widespread, with a significant number of units incurring in deficits or making limited surpluses, with cash-flow shortages during the year. As discussed in this report and those of previous technical assistance missions,²⁶ these shortfalls derive primarily from lack of realism in budgets and the problem of underfunded spending responsibilities devolved to some tiers of local authorities and financed by central government transfers. To overcome these financing shortfalls, the State Treasury Service has traditionally offered local authorities two types of loans: short-term loans that must be repaid within the fiscal year; and medium-term loans that may be outstanding past the end of the year.

91. Moreover, liquidity needs of other levels of government continue to be managed through issuance of additional short-term debt instruments. As an illustration, the stock of Treasury Bills issued by the State has increased by UAH 30 billion since the beginning of the year; during the same period, the accumulated idle local government funds deposited at commercial banks reached around UAH 16 billion (Figure 4.1).

²⁶ See for example, Olden et al (2014) "Public Financial Management Overview" Fiscal Affairs Department, IMF.

Figure 4.1. Stock of Treasury Bills and Funds at Commercial Bank Accounts
(UAH billion)



Source: National Bank of Ukraine.

92. Recommendation 4.7: Establish an attractive treasury arrangement for local authorities, with deposit-taking and lending facilities offering market rates. Efficiency and transparency considerations in this arrangement would require the MoF to:

- *Decide on the location of the new treasury arrangement.* Within the current framework, the Debt Policy Department would be well equipped to perform this function given their existing financial market capacity and the linkages of debt management to broader cash management objectives;
- *Develop of a concept note explaining the proposed new function, its objectives and the roles of the key stakeholders.* This will include, identification of the universe of local authorities to be targeted; selection of the authorities most likely to be of interest (i.e., those with the most surplus cash); preparation of a series of road shows with these authorities to discuss their needs and to explain the benefits to them of investing in instruments developed for general government treasury services;
- *Design the types of instruments to be offered to local authorities for lending and borrowing purposes.* It will be important to build trust with local authorities if they are to cooperate and be willing to lend surplus funds to the central government. Entities must believe that they are entering into contractual arrangement, whereby they will be entitled to repayment on the maturity date. This will require that they are comfortable with the terms and conditions of any lending/borrowing arrangement. Analysis of possible legislative changes in this respect will also be needed;
- *Analyze systems needs with subsequent implementation of a technical solution.* Given the number of local authorities with direct financial relationship with the State, the volume of these operations could eventually be quite high, back office and processing requirements will

have to be addressed. A system will be needed as is the case for government debt management operations for front office requirements;

- *Recruit and train the required staff.* There may be limited need for new recruitment if skilled staff in issuance of market based short-term paper/repos and investment of cash are already in place for government paper (however, the new treasury arrangement may need some staff to be seconded from the financial sector, at least initially);
- *Improve the management of risks arising from these new arrangements.* An analysis of operational and market risks associated with launch of treasury services and risk management strategy will need to be developed and implemented. As with any Treasury operation, there will be significant operational risks if the appropriate oversight/governance/systems and internal controls are not in place prior to launch;
- *Launch the treasury services.* This may require a marketing campaign aimed at local authorities to make them aware of the new products available to them to manage their liquidity.

V. STRENGTHENING THE LEGAL FRAMEWORK FOR FISCAL RISK MANAGEMENT AND MEDIUM-TERM BUDGETING

93. The Ukrainian authorities are planning to update the Budget Code in two important PFM areas—fiscal risks oversight and MTBF—addressed in previous Fund TA.²⁷ The objective of the planned reforms is to provide a legal foundation for the MoF to be responsible for a fiscal risk oversight function and for the introduction of a fully-fledged MTBF in Ukraine. The intent of the authorities is in line with the advice previously given by Fund staff, particularly in a March/April 2017 FAD/LEG mission and a follow-up June 2017 FAD mission. These reforms will be incorporated in Ukraine’s legal framework by amending specific provisions of the Budget Code. The MoF has shared with the mission, during its visit, a preliminary version of the draft amendments. The findings and recommendations made with respect to the draft amendments in this Section are further illustrated by draft legislative suggestions included in Annex III, and build upon the advice given in previous missions.

94. The draft amendments to the Budget Code could be made more prescriptive and specific, to foster transparency and accountability. The MoF’s efforts to amend the legislation must be commended, as an adequate legal basis in the primary law is necessary to ensure the effectiveness of the fiscal risks oversight function and of the MTBF. However, the language of the draft amendments is often generic and lacks detail. While details can be left to implementing

²⁷ Alves et al (May 2017) “Strengthening Public Financial Management,” Fiscal Affairs Department and Legal Department, IMF; Sayegh et al (July 2017) “Medium-Term Budget Framework and Fiscal Risk Statement,” Fiscal Affairs Department, IMF.

regulations, more prescriptive provisions, clearly setting the rules guiding the authorities' action, would strengthen the MoF's mandate for fiscal risk oversight and enhance the legitimacy and credibility of the MTBF.

95. The introduction of surgical amendments to the Budget Code is a sub-optimal solution. The mission has reviewed the draft amendments shared by the authorities and sought to contribute to the authorities' efforts taking into account that these amendments are expected to be tabled with the VR in few weeks. Therefore, the mission has focused on certain key aspects included in the authorities' proposal by providing alternative drafting suggestions to such proposal. It should be noted, however, that the MTBF impacts a much broader array of aspects than those covered by the draft amendments, such as those examined in this report (e.g. removal of the distinction between general and special fund). The strengthening of the PFM framework in Ukraine requires a more comprehensive revision of the Budget Code, as recommended by Fund staff in past TA missions, and a strategy for such revision should be operationalized.

96. More in general, it is crucial to enhance the clarity of the legal framework for PFM in Ukraine. Discussions on the Budget Code highlighted complexities, inconsistencies, and ambiguities which may lead to lack of implementation or blurred accountability. Loose or unclear provisions are sometimes accompanied by a plethora of implementing regulations, decrees, resolutions, which may often appear overlapping or duplicative. It is also for this reason that the framework for fiscal risk and MTBF needs a clear and enforceable legal foundation in the Budget Code. More broadly, high-quality legislative drafting is important to uphold the rule of law in Ukraine, and efforts towards this direction in the PFM area must be supported by a close dialogue between the legal function of the MoF and the various policy departments of the MoF and a careful consideration of the legal complexities entailed by law reform.

A. Fiscal Risks Monitoring

Mandate

97. The draft amendments should clarify the legal nature of the MoF mandate in relation to fiscal risk oversight. The current language of the amendment seems to describe the specific activities, or some of the activities, of the MoF that are included in fiscal risk oversight, rather than to vest upon the MoF a general mandate. The mandate of a public authority is generally understood to comprise: (i) its objectives (i.e., the purpose of the authority, such as, in this case, the mitigation of fiscal risks); its functions (i.e., the scope of the authority, such as, in this case, the collection of information, analysis, monitoring and disclosure of information on the various sources of fiscal risks) and powers (i.e., the legal capacity to perform the functions consistent with the objectives, such as in this case, the preparation and submission of a fiscal risk statement). Clarifying the MoF mandate on fiscal risk oversight along these lines in the Budget Code would strengthen its position—particularly when it requests other government agencies or

SOEs to provide information relevant for the analysis of fiscal risks—and ensure a clear line of accountability.²⁸

98. The timeframe for the implementation by the MoF of its mandate over the various sources of fiscal risks should be clarified by the legislation. It is understood that, in line with previous Fund TA, the MoF will initially focus on risks related to SOEs and will then broaden its analysis to other sources of fiscal risks.²⁹ This phased implementation may be addressed in the legislation through different legal mechanisms. A first approach may be to include a specific list of fiscal risks and include a transitional clause, providing for the immediate entry into force of the amendments with the exception of those relating to certain sources of fiscal risks (e.g., risks from sub-lending or pensions), as enumerated in the law. A second approach would be to include in the Budget Code an authorization to the CMU to determine such timeframe. The latter solution would give more flexibility, while the former would provide more certainty by setting a clear timeframe for the exercise by the MoF of its fiscal risks function.

Broadening the Definition of Fiscal Risks

99. The definition of “fiscal risks” should be broadened. In line with previous Fund TA, the definition included in the draft amendments should include all factors that may lead to the deviation of fiscal outcomes (i.e. revenues, expenditures, deficit and public debt) from expectations or budget forecasts.³⁰ It may also be useful to revise the definition of “contingent liability” so that it includes, rather than only contractual commitments, also liabilities that may arise from non-contractual obligations. An enabling provision may also authorize the CMU to further detail the contents of the fiscal risk statement.

Fiscal Risk Statement and Methodology

100. Institutional cooperation and transparency in the process of preparing, submitting and publishing the fiscal risk statement can be enhanced by adding an enabling provision in the Budget Code. The draft amendments provide that the fiscal risk statement will include “the assessment of the conditional commitments, quasi-fiscal transactions and other fiscal risks.” However, they contain no reference to any form of cooperation that should take place between the MoF, other ministries, and government agencies when the MoF prepares, submits and publishes the fiscal risk statement. The amendments could thus be revised to provide that the CMU shall adopt a resolution specifying roles and responsibilities of the MoF, ministries and

²⁸ In parallel, the MoF public debt department is working on certain amendments to the Budget Code that aim to develop the regime for state guarantees and public debt, only some of which are included in the preliminary draft shared by the MoF during the mission. These were not analyzed in this mission. Given that they address important areas of public financial management and public debt in Ukraine, they should be reviewed separately.

²⁹ See Annex 5 (“Phased Approach to Development of the Fiscal Risk Statement”) of the May 2017 TA report.

³⁰ See FAD TA report “Fiscal Risk Disclosure,” draft dated October 2017.

government agencies in such process. In addition, a requirement to publish the fiscal risk statement could be explicitly provided.

101. The provisions on the timeframe for the preparation and submission of the fiscal risk statement should be aligned with possible changes to the calendar of the MTBF. As the fiscal risk statement is included in the budget declaration (the key instrument of the MTBF in Ukraine), the preparation and submission of the former document should be consistent with the parallel process relating to the latter. Any change to the calendar of the MTBF—as recommended by the mission in the paragraphs below—should be reflected in the relevant provisions for the fiscal risk statement.

Information Gathering Powers

102. The draft amendments contain useful provisions on the information exchange necessary for the assessment of fiscal risks, but can be finetuned and tightened. In order to exercise its functions, the MoF needs to gather information from a number of agencies and entities. The suggested provisions in the annex provide for an explicit power of the MoF to collect information and for a general duty of cooperation of the addressee of the request, subject to limitations as specified. In line with recommended best practices for the oversight of SOEs, the MoF should be authorized to request information directly from SOEs as well as line ministries, although the information requested directly from SOEs should be limited to financial performance data required for the monitoring of fiscal risks. Furthermore, to safeguard the functional independence of SOEs, this request should be addressed to the supervisory boards of the SOEs with copies to the shareholding line ministries and executive agencies that exercise ownership rights over SOEs. The return of the data should likewise be sent to the shareholding ministry at the same time it is sent to the MoF.

103. The failure by other ministries to comply with MoF information requests can be handled mainly through transparency mechanisms and references to applicable provisions of budgetary and administrative law. When the addressees of information requests are mainly line ministries and executive agencies, in the authorities' view it is legally difficult to design adequate sanctions if the information requested by the MoF is not provided. Any failure to cooperate would indeed be resolved by means of a discussion in the CMU rather than through legal mechanisms. A similar conclusion applies, in the authorities' view, when the information request is made to SOEs, which, as business entities, may not be subject to the sanctions available under administrative law. Even if this interpretation were to be correct, it would still be useful to refer, in the amendments to the Budget Code, to the relevant sanctions that might be applicable under administrative law, such as for instance, those enforceable against SOEs that receive budgetary funds. In the interest of transparency, the law could also specify that the MoF shall report (e.g., to the CMU) on cases where its information requests have not been complied.

104. Given the challenges encountered by the MoF in gathering information, further consideration should be given to whether it is legally feasible to provide for any specific

sanctioning mechanism in the law. Specifically, the MoF should be allowed to set a reasonable deadline for the provision of the requested information, after which sanctions can be imposed.³¹ Possible sanction mechanisms could include: additional reporting requirements, imposition of additional controls (for example, over staff recruitment, pay, or major investment decisions); administrative measures (for example, steps to dismiss or suspend members of the management board); or, ultimately, imposition by the government of direct control over a public corporation's day-to-day operations. When possible sanctions affect corporate governance arrangements and the role of the shareholding ministries, they should be coordinated with them. In some countries, sanctions may also be applied to members of the public corporation's management board or individuals in government who have been charged with the oversight of public corporations.

105. Recommendations 5.1: Amend the Budget Code, by revising the draft amendments prepared by the MoF, to:

- strengthen the mandate of the MoF and its power to collect information related to fiscal risks;
- broaden the definition of fiscal risks; and
- prescribe that a CMU resolution will specify roles and responsibilities of the MoF, ministries and government agencies in the preparation, approval and publication of the fiscal risk statement, and can further detail the contents of the fiscal risk statement.

B. Medium-term Budgetary Framework

106. The draft amendments to the Budget Code on the MTBF should be fleshed out in more detail, to ensure transparency and to build the credibility of this important PFM reform. While the authorities are understandably phasing the introduction of the MTBF over time, gradualism and flexibility should not lead to a soft implementation. On the contrary, the credibility of the MTBF should be supported by an adequate framework in the Budget Code that clearly spells out rules and processes applicable to key stakeholders, including the CMU, the MoF, the line ministries and the other key spending units (KSUs).

107. The need for more prescriptive provisions in the Budget Code is heightened by the specific features of Ukraine's legal system. There is no concept of an "organic" Budget Code, ranking higher than other laws, in Ukraine's legal framework—as a consequence, the provisions on the MTBF can be superseded at any time by any other laws, including the annual budget law.³² These features provide a compelling case for spelling out, in the amendments to the

³¹ See further details in Allen R., and Alves, M. (November 2016), "How to Improve the Financial Oversight of Public Corporations," IMF How-to-Note, Fiscal Affairs Department, IMF, available at <http://www.imf.org/external/pubs/ft/howtonotes/2016/howtonote1605.pdf>. The specific procedures and mechanisms for the information exchange could be set out in a CMU resolution, also with a view at avoiding duplication.

³² For an analysis of the legal architecture for PFM in Ukraine, see IMF LEG report "Legal Framework for Public Financial Management and Fiscal Oversight of State-owned Enterprises."

Budget Code introducing the MTBF, a clear process, setting the right incentives and rules of the game and requiring adequate transparency if the medium-term fiscal objectives and targets agreed in the Budget Declaration are subsequently changed during the budgetary year.

Budget Declaration

108. The draft Article 33 of the Budget Code prepared by the MoF prescribes the inclusion in the Budget Declaration of several useful elements. The “Budget Declaration” is defined in the draft amendments as the “state strategic document that defines the basic principles of budget and tax policy in the medium term,” while “medium-term period” is in turn defined to encompass “the planning period and the next two budget periods following the planning period.” Therefore, the Budget Declaration represents, in the authorities’ envisaged MTBF, the key document anchoring macro-fiscal projections, budgetary objectives, expenditure ceilings (in aggregate and for KSUs), strategic goals and performance indicators for KSUs over a three-year horizon. These elements are included in the suggested Article 33 of the Budget Code and draw also from the pilot MTBF exercise conducted earlier in the year.³³

109. However, the proposed provision on the Budget Declaration needs to be fleshed out to cater for a number of important aspects that should be part of the forthcoming MTBF. These include, among others:

- *Consolidated general government sector perspective.* According to the draft amendments, the Budget Declaration would include the “interaction of government budget with local budgets.” While the MTBF would only cover the central government budget, it is important that the Budget Declaration offers a comprehensive perspective on the consolidated general government sector. This would also foster coordination between the central and sub-national governments regarding the achievement of broader fiscal targets and objectives.
- *Ceilings.* Under the proposed revisions to Article 33 of the Budget Code, the Budget Declaration would include aggregate and KSUs-specific expenditure ceilings, as well as strategic goals and performance indicators of KSUs over the medium-term.³⁴ In the interest of transparency, Article 33 should prescribe to include in the Budget Declaration not only the ceilings per se, but also the specific criteria used for their determination (both with respect to the aggregate and KSU-specific ceilings), as well as the rules governing any possible deviation from the ceilings that may be determined (e.g., in the annual budget law) subsequently to the approval of the Budget Declaration.

³³ The IMF FAD report “Medium-term Budget Framework and Fiscal Risk Statement” (July 2017) takes stock of the lessons learnt from the pilot MTBF exercise and provides an assessment of the key elements to be included in the Budget Declaration.

³⁴ The translation of the draft amendments refers to “thresholds” rather than to “ceilings.” Our understanding is that the wording of the provision of Article 33 would be interpreted to refer to the latter concept.

- *Implementing regulations.* An enabling provision could be added to the draft amendments to the Budget Code, authorizing the CMU resolution to further specify the contents of the Budget Declaration.

110. The form and timing of the approval of the Budget Declaration should be specified in amendments to the Procedural Rules of the Verkhovna Rada. The authorities pointed out that the approval of the Budget Declaration by law would require significant procedural hurdles that may not fit easily into the calendar of the budgetary process. It is therefore envisaged that, in light of the gradual implementation of the MTBF, the Budget Declaration would be initially approved through a resolution of the Verkhovna Rada. Only after a number of years, once the MTBF is firmly established, the approval of the Budget Declaration would take place by law. In any event, the draft amendments should specify the legal form of approval of the Budget Declaration (i.e., a resolution of the Verkhovna Rada), and the date when it is expected that such resolution is adopted (e.g., June 30). This would contribute to the credibility of the MTBF process, considering that in the context of the pilot exercise in 2017 the Verkhovna Rada has decided not to vote on the Budget Declaration submitted to it. The amendments to the procedural rules should be submitted for legislative approval together, or at least coordinated, with the draft amendments to the Budget Code.

Budget Calendar and Interaction with the Annual Budget Process

111. The draft provisions on the MTBF calendar could be revised, bearing in mind the need for adequate rules on the discussions over the expenditure ceilings. The credibility of the MTBF relies on its sequencing, logic, and on the strategic involvement of key stakeholders (such as the CMU) at an early stage. The calendar of the MTBF envisaged by the authorities in the draft amendments differs in certain respects from the recommendations made in previous Fund TA, particularly with respect to the approval process of the Budget Declaration. For instance, it does not provide for a staged approach through a CMU first approval (e.g., at the end of the first quarter of the year) of the expenditure envelope and KSU ceilings based on the macro-fiscal framework and consolidation requirements or use of fiscal space. Instead, the CMU steps in only after the MoF and KSUs start negotiating the expenditure ceilings, to reconcile differences before the Budget Declaration is approved on June 1 of each year. This timeframe may not provide the appropriate top-down approach and incentives in this process and will weaken the MoF's stance in discussions with the KSUs. While the budget calendar has to take into account what is feasible in Ukraine's budgetary process, consideration should be given to reviewing the relevant provisions of the draft amendments, to take into account the strategic role of the CMU, the MoF, and the line ministries in the discussions over ceilings.

Expenditure Ceilings

112. The draft amendments to the Budget Code provide for a quite fluid and flexible framework on expenditure ceilings. No distinction is made between fixed and indicative ceilings, as in the authorities' view any mention in the Budget Code to "indicative ceilings" would not contribute to the credibility of the MTBF process, particularly in the first phase of its gradual

introduction.³⁵ In addition, under the proposed amendments to Article 33–1 of the Budget Code, aggregate ceilings may be revised in the draft annual budget law upon two circumstances: (i) “in case of deviation from key macro indicators for economic and social development of Ukraine from the forecast which was considered when compiling the Budget declaration; (ii) in case of “approval of legislation... which impact the indicators of the government budget during the mid-term period.”

113. The framework for the definition, negotiation of, and possible changes to expenditure ceilings can be significantly improved. While the need for flexibility is understood, it is recommended to tighten the proposed draft amendments to Article 33–1 of the Budget Code in a number of respects.

- *Definitions and Approval.* The draft amendments could explicitly provide that the ceilings will be approved by the CMU. The definition of expenditure ceilings could also be bolstered by clarifying that ceilings represent an explicit commitment of the government or the KSU over a maximum level of expenditures.
- *General and special fund.* The draft amendments have a different regime for KSU expenditure ceilings for the general and special fund, including with respect to the possible deviations from the ceilings. For the general fund, ceilings may be changed, in addition to the general circumstances mentioned in the above paragraph, in case of transfer of responsibilities from one KSU to another and in case of “allocation of expenditures which were not allocated between the [KSUs] during approval of the budget declaration.” For the special fund, deviations can occur at any time given the balance rule between revenues and expenditures provided for them.
- *Interaction between KSUs, MoF, and the Verkhovna Rada.* After the Budget Declaration is submitted to the Verkhovna Rada, the KSUs report to the Verkhovna Rada on the strategic goals and performance indicators over the medium-term period. It is unclear how this proposed provision would interact with the discussion at the Verkhovna Rada of the expenditure ceilings, including in the context of the annual budget law. The draft legislative suggestions in the annex delete this provision, as the strategic goals and performance indicators are in any case included in the Budget Declaration.
- *Criteria for deviation.* The criteria for any deviation from the ceilings appear to be very broad as they include the approval of legislation that would expand programs or introduce new

³⁵ Aggregate and KSU ceilings are respectively defined in the draft amendments as follows: “aggregate expenditure ceiling and lending—total expenditures and loans from the state budget, which corresponds to the financial resources of the state budget in the corresponding year of the medium-term period”; “ceiling of expenditures and lending to key spending unit of the state budget funds means the amount of expenditures and provision of loans from the state budget for the corresponding year of the medium-term period, within which the key spending unit plans and carries out its activities, in order to achieve strategic goals in the corresponding sphere of activity (sector).” Moreover, under the proposed draft amendments, “amounts of government capital investments to develop and implement government investment projects for mid-term period are stipulated by the Budget declaration within the range of aggregated expenditure ceilings and loan facilities.” These amounts do not seem therefore to be included within KSU ceilings.

policies. While it is granted that newly enacted legislation can alter fiscal policies and outcomes, it does not seem appropriate to include such criterion as a ground for deviation from expenditure ceilings, whose key purpose is to instill fiscal discipline.

- *Transparency in case of deviation from ceilings.* The draft amendments do not provide any rule prescribing to explain changes to the expenditure ceilings, as approved in the Budget Declaration, that may be made in the annual budget process. It will be possible to infer that any such change has occurred based on the draft annual budget documentation. However, it would be important to provide for an explicit requirement that any change to the expenditure ceilings be adequately explained in the annual budget documentation and any other relevant laws.

114. Recommendation 5.2: Amend the Budget Code and Procedural Rules of the Verkhovna Rada, by revising the draft amendments prepared by the MoF, to:

- Prescribe that additional contents are included in the Budget Declaration, such as information on the consolidated general government sector and on the criteria for the determination of the expenditure ceilings;
- Modify the budget calendar relating to the approval of the Budget Declaration to provide for a stronger strategic involvement of the CMU; and
- Strengthen the legal provision on expenditure ceilings by, among other things, removing the distinction between general and special fund with respect to the legal regime for expenditure ceilings and providing for transparency requirements in case of deviation from ceilings.

Annex I. Distribution of Powers to Local Government

Introduction

1. The following analysis of distributions of powers to Local Government is based on the analysis of the main decentralization-related legal instruments in Ukraine. The organization, functions, and resources of Ukraine's subnational governments are established primarily in the 1996 Constitution, 1997 Law on Local Self-Government, and related legislation (as amended). In addition, the Budget Code contains specific provisions relating to fiscal decentralization, notably the distribution of resources and expenditure obligations between State and local budgets. Reforms to the administrative and fiscal subnational structure were introduced in 2015 (inter alia, under the Law on Voluntary Amalgamation of Territorial Communities and the Law on Cooperation of Local Communities).

2. As other legal instruments may have an impact on fiscal decentralization, this should be considered a preliminary analysis. A detailed review of the Tax Code was outside the scope of the current TA, however it will be important to conduct this analysis in follow-up work. The mission understands that additional legislative amendments have been tabled and are awaiting approval in parliament, which could address some of the observations in this report. The mission stands ready to update our analysis, as needed, upon receipt and review of the draft amendments. Specifically, the mission is aware of the following proposed amendments (although there may be others): the Draft Law "On prefects"; amendments to the Law "On Local Self-Government in Ukraine"; the Draft Law "On Amendments to the Constitution of Ukraine concerning the Decentralization of Power"; the Draft Law "On Amendments to Some Legislative Acts of Ukraine concerning the Conditions changing district boundaries under the process of voluntary amalgamation of communities"; and the Draft Law "On Amendments to Some Legislative Acts of Ukraine concerning the Status of a Village and Town Headman."

Distribution of Powers to Local Government

3. “Rights” of local government:

- i. **The right of local self-government is specifically granted to “hromada” (communities),¹ or amalgamated hromada where amalgamation has taken place.²** Hromada are defined as either: (1) residents of a village; or (2) a voluntary association of residents of several villages, settlements or cities into one community.³ As noted above, hromada of the second type (i.e. associations of villages and settlements) are not separately recognized under the Constitution as an administrative-territorial subdivision of Ukraine.⁴
- ii. **Hromada can exercise their powers of self-government either directly, or through “local self-government bodies”:** namely, the councils and executive bodies of the hromada’s constituent villages, settlements and cities.⁵ However, if hromada have amalgamated, they can elect a separate local council and executive body that exercises rights and obligations for the newly amalgamated community (NAC).⁶ Oblast and rayon councils and their executive bodies are given the competence to manage matters of common interest to multiple hromada. City councils are given the competence to manage matters relating to the organization and administration of city rayons.⁷

¹ The right of local self-government includes inter alia the right to own, use and manage property, land, revenues of local budgets, other funds, and natural resources. This is defined as a “right to communal property” (Articles 1, 16(3) and 60 LSG). Furthermore, hromada can agree to combine communal property and budget funds for joint projects or to co-finance communal enterprises, organizations and institutions, as well as create necessary bodies and services for this purpose (see Article 142 Constitution).

² The voluntary amalgamation of hromada is governed by the Law on the Voluntary Amalgamation of Territorial Communities 2015, which amended the LSG. Inter alia, this restricts amalgamation to neighboring and contiguous territorial communities, such that the boundaries of the newly amalgamated hromada must correspond to their existing external boundaries (Art 3(1) and 4(2)). Amalgamation also cannot cross oblast borders (Article 4(3)). The law prevents hromada with their own self-government bodies from amalgamating (Art 4(1)), however the precise meaning of this restriction is unclear. Amalgamation can be approved by the Oblast council alone, unless it involves communities in different rayon in which case the Verkhovna Rada needs to approve a boundary change.

³ See Article 140 of the Constitution, Article 6 LSG, and the Law on Voluntary Amalgamation of Territorial Communities 2015 (pursuant to Article 3(2), hromada are subdivided into “city hromada”, “settlement hromada” and “village hromada”, according to the type of territorial subdivision—city, settlement or village—that forms their administrative center). The LSG also sets out criteria for amalgamation.

⁴ This appears to be confirmed under LSG Article 1, which defines an “administrative territorial unit” as oblast, rayon, city, sub-municipality, settlement, and village [Article 1 - check translation].

⁵ Pursuant to Article 16(1) LSG, local self-government bodies are legal entities that can be ascribed powers of executive bodies. They can also unite into associations or voluntary unions of local self-government bodies to help them exercise their powers more effectively (Article 15(1) LSG).

⁶ Article 6(2) LSG and Article 8(1) of the Law on Voluntary Amalgamation of Territorial Communities.

⁷ See Article 140 of the Constitution and Articles 2(2) and 5 of the Law on Local Self Government 1997, as amended (LSG).

4. “Obligations” of Local Government

i. **The Constitution (Articles 142 and 143) defines certain obligations of State and subnational governments.** In relation to public financial management, these include:

- a. For hromada, obligations to: approve budgets of respective administrative and territorial units and control the execution of such budgets; establish local taxes and levies in accordance with law; approve programs of socio-economic and cultural development and control the implementation of such programs; and settle other issues delegated to them by law;
- b. For oblast and rayon councils, obligations inter alia to: approve rayon and oblast budgets formed from the funds of the State budget for their appropriate distribution among territorial communities or for the implementation of joint projects and from the funds drawn on the basis of agreement from local budgets for the realization of joint socio-economic and cultural programs, and control the execution of such budgets; approve programs of socio-economic and cultural development and control the implementation of such programs; and settle other issues delegated to them by law;
- c. For the State government, an obligation to “participate in the collection of revenues for budgets of local self-governments.”

5. “Competences” of Local Government

In turn, *specific competences for local self-government are granted to village, settlement and city councils.* As such, they are given the exclusive competence to:⁸

- i. approve programs of socio-economic and cultural development of the corresponding administrative-territorial units, and target programs on other local self-government issues;
- ii. approve and amend the local budget; to approve the report on the implementation of the corresponding budget;
- iii. establish local taxes and fees, and their amounts, within the limits determined by law;
- iv. adopt decisions on receiving loans from other local budgets and sources, and also on the transfer of funds from the corresponding local budget; and
- v. adopt decisions on providing local tax and fee privileges, in accordance with the effective legislation.

⁸ Articles 25 and 26 LSG.

6. “Powers” of Local Government

Within these areas of competence, the village, settlement and city councils are given specific powers—either exclusive or delegated (where the latter are powers that can be revoked by the central government). The key powers relating to fiscal decentralization are:⁹

- i. Exclusive powers to:
 - a. ensure the balance of financial and labor resources, monetary revenues and expenditures necessary for managing the socio-economic and cultural development of the corresponding territory;
 - b. to submit to rayon and oblast councils the necessary indicators and proposals on programs of socio-economic and cultural development of the corresponding rayons and oblasts;
 - c. to draft the local budget, submit the draft to the corresponding council for approval, and ensure the implementation of the budget; to submit to the council, on a quarterly basis and in written form, reports on the course and results of the budget's implementation; to prepare and submit to rayon and oblast councils, respectively, the necessary financial indicators and proposals on drafting rayon and oblast budgets; and
 - d. to execute, in the established procedure, the financing of local budget expenditures.
- ii. Delegated powers to:
 - a. exercise control over payment by enterprises and organizations to the local budget in accordance with their obligations;
 - b. exercise control over compliance with prices and rates.

⁹ Articles 27 and 28 LSG.

Annex II. Subnational Fiscal Rules in Selected European Countries

Country	Type 1/	Sector 2/	Target/constraint	Description	Accounting system 3/	Time frame (years) 4/	Statutory base 5/	Monitoring body 6/	Enforcement body 6/
Belgium	BBR	LG	Budget balance in nominal terms	Balanced budget rule for LG: mandatory balance of budgetary accounts.	BA	M	L	GS (RG)	GS (RG)
Bulgaria	DR	LG	Ceiling in nominal terms	The annual amount of municipal debt payments for each municipality may not exceed 15 per cent of the annual average amount of own revenue and the total balancing subsidy for the past three years calculated on the basis of information from the annual reports on the municipal budget implementation.	BA	M	L	IND	No body
	DR	LG	Ceiling in nominal terms	The nominal value of the municipal guarantees issued during the current budget year may not exceed 5 per cent of the total revenue amount and the total balancing subsidy specified in the latest annual report on the municipal budget implementation.	BA	M	L	IND	No body
	BBR	LG	Nominal balance, in absolute terms	The medium-term balance objective concerning municipal budgets calculated on a cash basis shall be to maintain a balanced budgetary balance.	BA	M	L	IND	No body
	ER	LG	Nominal expenditure, in %	The average growth rate of expenditure for local activities under municipal budgets for the forecasted medium-term period shall not exceed the average growth rate of the reported expenditure for local activities for the past four years.	BA	A	L	IND	No body
Cyprus	BBR	LG	Nominal balance, in absolute terms	Local authorities should only prepare balanced annual budgets	.	M	L	MF, IND	MF, GS
Czech Republic	DR	LG	Indicator of total liquidity (current ratio)	MoF calculates set of following indicators for all municipalities and units partly funded from their budgets every year: short term assets/short term liabilities; liabilities (debts) / total assets ratio.	National accounting standards	A	L	MF	MF
Germany	BBR	CG, RG	Budget balance in % of GDP	Revenues and expenditures of CG and RG must - as a matter of principle - be balanced without taking account of revenue from loans raised. This principle is fulfilled for CG (RG) where structural net borrowing does not exceed 0.35 % (0.0 %) of GDP.	BA	A	C	CoA	NP, CoA
	BBR	LG	Budget balance in nominal terms	Balanced budget rule for LG ('administrative' and capital accounts).	BA	A	L	GS	GS
	BBR	RG	Budget balance in nominal terms	Golden rule: the credit volume must not exceed the investment volume, except for dealing with adverse macroeconomic developments.	BA	A	C	Lander MF and Lander Parliaments	Lander Parliaments
Estonia	DR	LG	Debt ceiling as percent of budgeted revenues	Local governments are not allowed to increase their debt over the 60 per cent of their budget revenue of which the allocations from the state budget for a specific purpose have been deducted.	BA	A	L	MF	MF
Spain	DR	LG	Debt ceiling as % of current revenue	LG must register a balanced budget or a surplus. When a Local Authority has negative net saving or its indebtedness exceeds 75% of its current revenues all long-term credit operations must be authorized by the Central Government, or the Autonomous Community if the Autonomous Community has the competence on financial supervision on Local Authorities.	BA	A	L	MF, RG	MF
	DR	RG	Debt ceiling	RG need the authorization of the central Government to take loans.	ESA	A	L	MF	MF
Finland	BBR	LG	Budget balance in nominal terms	Local Government Act. Regulates municipalities in bringing their budgets in balance. Contains provisions on budget and financial plans, financial statements, reporting on operations, and financial supervision.	BA	4	L	MF, GS	MF
France	BBR	LG	Budget balance (règle d'or)	Golden rule: voted budgets must be in balance; ex post deficits cannot exceed 5% of current revenues (10% for small municipalities).	BA	A	L	GS: préfet	regional level: GS (préfet) and IND (Chambre régionale des comptes).

Country	Type 1/	Sector 2/	Target/constraint	Description	Accounting system 3/	Time frame (years) 4/	Statutory base 5/	Monitoring body 6/	Enforcement body 6/
	ER	LG	Nominal growth of local expenditure (Odedel)	This is a target on the growth of nominal spending at the local government level, expressed as an annual percentage change defined on the same scope. In the Programming Law of Public Finances (PLPF) for 2014-2019, two levels were distinguished: the evolution of total expenditure and the evolution of the only operating expenditure.	BA	M	L	MF, CoA, NP, IND	No body
Ireland	BBR	LG	Budget balance in nominal terms	For any given year, LG must have a net total deficit (in EDP terms) of no more than a fixed nominal amount.	ESA	A	PC	MF, GS	MF, GS
Italy	ER	RG	Nominal expenditure ceiling	Expenditure ceilings for pharmaceutical products (including patient co-payments, so-called "tickets") expressed as a percentage of the financing level for the national health service contributed by the State. Ceilings: 16,4% (2008); 16% (2009).	ESA	Other (permanent rule, extending the time horizon beyond the yearly budgetary cycle)	L	MF, GS	GS
	ER/BBR	RG, LG	Budget balance (LG); Nominal expenditure growth rate (RG)	The regional spending ceiling is computed both on an accrual basis and on the euro-compatible accrual one. Golden rule: local and regional bodies are allowed to carry on deficit only to finance investments (article no. 119 of the Italian constitution).	BA, ESA	M	L	MF, CoA	GS, CoA
	BBR	RG, LG	Budget balance in nominal terms		BA, ESA	M	C	Board of Performance Assessors (with CG and RG members)	CoA
	BBR	RG	Budget balance in nominal terms	Healthcare pact: agreement to regulate transfers from GOV to regions (regional health bodies) to finance the national healthcare system (Servizio Sanitario Nazionale). The level of the transfers is subject to the fulfilment of certain conditions.	ESA	M	L	GS	GS
Lithuania	BBR	LG	Budget balance in nominal terms	The rule allows deficit of local government budgets that cannot exceed expenditure from borrowed funds for capital expenditure within borrowing limits approved by Parliament.	BA	A	L	GS	GS, NP
Luxembourg	BBR	LG	Budget balance in nominal terms	Local governments current budget must be balanced. Extraordinary expenditure (public investment) can be financed by debt, but repayment costs must be financed by the current budget.	BA	A	L	GS	GS
Latvia	DR	LG	Debt ceiling in nominal terms	LG can only increase borrowing and loan guaranties up to certain limits set by CG.	BA	A	PC	GS	MF
Netherlands	BBR	LG	Structural Budget Balance, in % of GDP	This budget rule is called the multiannual macro norm and applies to the all local governments (municipalities, provinces and regional water authorities) and amounts to a jointly accepted budget balance norm in percentages of GDP per year for all local governments combined. When the sum of all deficits of all local governments exceeds the allowed joint deficit, a correction mechanism will be triggered.	ESA	M	L	MF, other GOV body, IND	MF, IND
Poland	BBR	LG	Budget balance in nominal terms	Planned current expenditures of local government cannot exceed planned current revenues augmented by the budget surplus from previous years and the surplus of funds in the current account resulting from settlements of the securities issued, bank and non-bank loans from previous years. Executed current expenditures of local government cannot exceed executed current revenues. Current deficit is allowed only in budget execution in the amount of expenditure connected with the execution of current tasks financed by the EU funds and non-refundable financial means from EFTA member countries, if not receive in a given year.	BA	M	L	CoA	CoA

Country	Type 1/	Sector 2/	Target/constraint	Description	Accounting system 3/	Time frame (years) 4/	Statutory base 5/	Monitoring body 6/	Enforcement body 6/
	DR	LG	Debt service ratio	The ratio of installments of loans and interest payable in this fiscal year, redemption of securities and interest payable on them, potential payments resulting from sureties and guarantees granted to the planned revenues cannot exceed in given fiscal year the arithmetic mean from the ratio of its current revenues augmented by revenues from the sales of assets and reduced by current expenditures computed for the previous three years to budget revenues in total.	NA	M	L	Regional Chamber of Audit, self-gov. legislative body and management board of LG unit	Regional Chamber of Audit, self-gov. legislative body
Portugal	DR	LG	Nominal debt	The debt at the end of the year cannot exceed 1.5 times on average the current net revenue collected in the previous 3 years. Additionally, the total debt can only increase in each year by 20% of the margin available at the beginning of each financial year.	BA	A	L	Court of Auditors, Directorate General of LG, IND	Court of Auditors
	DR	RG	Nominal debt	Total liabilities should not be higher than 1.5 times the average of the current net revenue collected in the last 3 years. Liabilities include loans, leasing contracts and other kinds of debt to financial institutions and other accounts payable. The law also states that the floating debt cannot exceed 0.35 times the average net current revenue collected over the past 3 years.	BA	A	L	Court of Auditors, IND	Court of Auditors, IND
	BBR	RG	Nominal balance in absolute terms	The current balance minus the average amortization of loans must not be in any year a negative value higher than 5% of the current net revenue collected. The current net revenue collected should be at least in average equal to the current expenditure plus the average amortization of loans. The average amortization of loans is the given by the principal of the loan divided by the initial maturity.	BA	A	L	Court of Audit, IND	Court of Audit, Financial Policies Monitoring Council CoA, GS
	BBR	LG	Budget balance in absolute terms	The collected current revenue should at least be equal (or higher) to the current expenditure plus average medium and long-term loans amortization.	mix between ESA and CA	A	L	GOV	
Romania	BBR	LG	Budget balance in nominal terms	LG budgets, excluding loans to finance investment and debt refinancing, have to be balanced.	BA	A	L	MF	MF
	DR	LG	Debt ceiling as % of current revenue	LG cannot contract or guarantee loans if their annual public debt service (principal payment, interest, commissions) including the loan they want to contract, is higher than 30% of their own revenue.	BA	A	L	GS	GS
Sweden	BBR	LG	Budget balance in nominal terms	Local Government Act: LG are obliged to balance their budgets.	BA	A	L	GS	No body
Slovakia	DR	LG	Debt ceiling and limit on repayment as % current of revenue in previous budget year in nominal terms	Borrowing limits for RG and LG: 1) total debt cannot exceed 60% of current revenue in the previous budget year in nominal terms (i.e. capital revenues and revenues from financial transactions are excluded); 2) annual instalments to reimburse debt cannot exceed 25 % of revenue in the previous budget year in nominal terms.	BA	A	L	IND, MF	MF, IND
	BBR	LG	Budget balance in nominal terms	LG's current budget has to be adopted either as balanced or in surplus. Capital budget can be in deficit, provided that this deficit is financed by unspent funds of local governments transferred from previous years, loans or by surplus of the current budget in the respective fiscal year.	BA	A	L	MF	No body

Source: European Commission, Fiscal Rules database (available at https://ec.europa.eu/info/publications/fiscal-rules-database_en)

1/ BBR: budget balance rule; DR: debt rule; ER: expenditure rule; RR: revenue rule

2/ CG: central government; RG: regional government; LG: local government

3/ ESA: ESA95/2010 accounting system; BA: budgetary accounting system

4/ A: annual; M: multiannual

5/ C: constitution; L: legal act; PC: political commitment

6/ CoA: court of auditors; GS: government structure; IND: independent; MF: ministry of finance; NP: national parliament

Annex III. Draft Legislative Suggestions on Amendments to the Budget Code

The draft legislative suggestions provided below focus on specific provisions of the Budget Code that are relevant for fiscal risks and MTBF, and build upon the preliminary draft shared by the MoF. While these suggestions draw from the language used by the authorities in their proposal, in the interest of clarity they are not marked-up against such proposal. The comments in italics at the end of each draft provision further elaborate on the suggested provision and explain their rationale.

As these suggestions focus on specific articles of the Budget Code, they do not intervene on other draft provisions that the authorities are planning to introduce in different areas regulated by the Budget Code (e.g., on program-based budgeting, on the preparation and publication of local budgets and on capital investments). Moreover, given the targeted nature of the proposed amendments, these suggestions should be reviewed to ensure the overall consistency of the planned amendments—including those which would abrogate certain articles of the Budget Code—with the structure, terminology and cross-references used in the Budget Code.¹

Article 2 (Definitions of the Key Terms)

“Aggregate expenditure ceiling and lending” – the maximum level of expenditures and loans from the state budget, which represents an explicit commitment of the Government corresponding to the financial resources of the state budget in the relevant year of the medium-term period”;

“Budget Declaration” – Statement that sets out the broad strategic priorities and policy goals that will guide the preparation of the budget both for the following year and over the medium term;

“Ceiling of expenditures and lending of key spending units” – the maximum level of expenditures and provision of loans from the state budget for the relevant year of the medium-term period, within which the key spending unit of state budget funds commit to carry out their activities, in order to achieve strategic goals in the corresponding sphere of activity (sector)”.

“Contingent liabilities” – potential fiscal obligations that are contingent on, or determined by, an uncertain future event, depending on the circumstances of each case;

¹ The mission worked on the basis of an English translation of the Budget Code which is of very poor quality. For good practices on legislative drafting (applicable also beyond the area of tax law), see also V. Thuronyi, “Drafting Tax Legislation”, 2012, <https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch3.pdf>.

"Fiscal risks" – factors, such as general macroeconomic risks and contingent liabilities, quasi-fiscal activities and other specific risks, that may lead fiscal outcomes (revenues, expenditures, deficit and public debt) to deviate from expectations or budget forecasts.

"Fiscal risk statement" – a statement that the Government issues periodically on the nature of fiscal risks over the medium term or any other specific period;

Drafting comment: The suggested amendments to Article 2 seek, among other things, to:
(i) strengthen the concept of expenditure ceilings, so that it refers to an upper limit of expenditures, representing an explicit commitment of the government and the key spending unit; (ii) clarify the purpose of the Budget Declaration; (iii) align the concept of "fiscal risks" with a definition suggested in a previous TA report; (iv) broaden the definition of "contingent liability" (which seems to be used in the article prescribing the contents of the fiscal risk statement) to include liabilities that may arise from contractual or non-contractual obligations; introduce a definition of fiscal risk statement. We would also suggest to include a definition of "state budget" (which under the existing provisions of the Budget Code includes both the general and the special fund), as the term is relevant to define the scope of several provisions, including with respect to the expenditure ceilings.

Article 4 (Structure of the Budget Legislation)

Drafting comment: we would suggest the reference to the Budget Declaration further below in the list (e.g. after n. 4, and before the reference to the regulatory legal acts of the CMU), as it is currently envisaged that the Budget Declaration will be approved by a resolution of the Verkhovna Rada.

Article 7 (Principles of Budget System of Ukraine)

The budget system of Ukraine is based on the following principles:

....

11) The principle of stability, consistency and sustainability – formulating and implementing fiscal policy in a manner that does not cause abrupt changes in the macroeconomic and fiscal outlook; avoiding unexpected and undesirable changes and deviations from the revenue and expenditure projections set out in the Budget Declaration and annual budget; ensuring that the spending, borrowing, and debt of the general government is manageable in the short and long term and does not impose an inequitable burden on future generations;

12) The principle of prudent management of fiscal risks.

Drafting comment: The draft amendments suggest to add principles of the budgetary system which may be relevant for the MTBF and the monitoring of fiscal risks. Moreover, it should be clarified why the reference to "high" quality of public services has been deleted in n. 6) and 9) of Article 7. If the reason is that, under the wording of Article 7, the public services are "guaranteed" by the state,

the Autonomous Republic of Crimea, and local self-governments, then the word "guaranteed" could be replaced by "provided."

Article 32 (Organizational Principles of Creation of the Draft of the Government Budget of Ukraine)

1. The Cabinet of Ministers of Ukraine approves the Budget Declaration and the Draft Law on the Government budget of Ukraine.
2. The Ministry of finance of Ukraine is responsible for preparing and submitting to the Cabinet Minister of Ukraine the Budget Declaration and the draft law of the government budget of Ukraine, and for determining the key organizational and methodological principles of budget planning which are used for the preparation of the Budget Declaration and the drafting of law of the government budget of Ukraine.
3. The Budget Declaration is based on the Budget Declaration approved in the previous year. The draft law government budget of Ukraine for a planned budgetary year period is based on the indicators stipulated by the Budget declaration approved in the year preceding the planned budgetary year.

Drafting comment: These draft amendments use the same language of the authorities' proposal. This proposal also states that many provisions currently included in Article 32 are "moved" to Article 33-1, but these could not be found in Article 33-1.

Article 33 (Budget Declaration)

1. The Ministry of Finance, in cooperation with other central bodies of the executive power, prepares the Budget Declaration based on the goals and priorities stipulated in the strategic government document. The Budget Declaration is prepared, submitted and approved, for each year preceding a medium-term period, under the timeframe and with the contents set out in this Article.
2. The National Bank of Ukraine, prior to or on March 1, submits to the President of Ukraine, the Verkhovna Rada of Ukraine and the Cabinet of Ministers of Ukraine:
 - (a) projected monetary indicators and indicators of FX rate policy for each year of the mid-term period including the UAH FX rate average for the year and for the year-end;
 - (b) information on estimated part of income for distribution which shall be forwarded to the government budget, for each year of the mid-term period.
3. The central body of the executive power which develops the government policy in the area of economic and social development, submits to the Ministry of Finance, to key spending

units and to the Cabinet of Ministers of Ukraine, prior to or on March 1, estimated projected key macro indicators for economic and social development of Ukraine for the mid-term period.

4. The Ministry of Finance of Ukraine, on the basis of the key projected macro indicators for economic and social development of Ukraine for the mid-term period and the analysis of the execution of the budget during previous budget periods, projects the amount of revenues, defines the amount of funding for the budget and repayment of loans, and: (i) prior to or on March 15, determines the draft aggregate expenditure ceilings and lending, including the technical amendments to the aggregate expenditure ceilings and lending approved in the Budget Declaration of the previous year; (ii) prior to or on March 31, determines and submits for approval of the Cabinet Ministers the ceilings of expenditures and lending of key spending units.

5. The Cabinet of Ministers of Ukraine, prior to or on April 15 and based on strategic priorities and size of any fiscal adjustment that may be required based on the information submitted to it under paragraphs (2) to (4) above, examines and approves the aggregate expenditure ceilings and lending and the ceilings of expenditures and lending of key spending units.

6. Further to the approval under paragraph (5) above, the Ministry of Finance of Ukraine submits the ceilings of expenditures and lending of key spending units, as approved by the Cabinet of Ministers of Ukraine [and together with an updated macro-economic forecast], to the key spending units. The Minister of Finance submits to the key spending units also the guidelines for the provision of information regarding new policies that may be relevant for the ceilings of expenditures and lending of key spending units. Such guidelines will require the submission of information on savings regarding existing policies, reallocation between existing policies and the costing of brand new policies.

7. The Ministry of Finance, prior to or on May 31, submits the draft Budget Declaration to the Cabinet of Ministers, with an explanatory note on any pending disagreements with key spending units regarding the ceiling of expenditures and lending of key spending units. The Cabinet of Ministers of Ukraine, not later than June 15, reviews and approves the Budget Declaration and submits it to the Verkhovna Rada of Ukraine.

8. The Verkhovna Rada of Ukraine reviews the Budget Declaration and adopts a resolution by June 30, according to the [Procedure of the Verkhovna Rada of Ukraine].

9. The Budget Declaration includes provisions on:

- (a) [key projected macro indicators for economic and social development of Ukraine (including the indicators of nominal and real gross domestic product, consumer price index and prices of manufactures, unemployment level, assumptions on UAH/US\$ rate

average for the year and by the end of the period, as well as other indicators considered during the development of the Budget Declaration);

- (b) main tasks of the budget policy, in particular:
 - a. deficit (surplus) of the government budget;
 - b. share of the projected annual amount of the gross domestic product which is [appropriated] through the aggregated budget of Ukraine,
 - c. marginal amount of state debt and marginal amount of state guarantees,
 - d. amount of minimum salary,
 - e. subsistence minimum and level of its coverage,
 - f. marginal amount of state debt and marginal amount of general amount state capital investments to develop and implement government investment projects indicating the priority areas for such capital investments;
- (c) priority task for the tax policy;
- (d) Information on consolidated general government sector perspective and on the interaction of government budget with local budgets;
- (e) a summary assessment of fiscal risks and their impact on the government budget;
- (f) general indicators of revenues, finance, expenditures and loans of the government budget for each year of the mid-term period;
- (g) indicators per key types revenues to the government budget for each year of the mid-term period;
- (h) indicators per key types of finding of the government budget for each year of the mid-term period;
- (i) the aggregate expenditure ceilings and lending, the ceilings of expenditures and lending of key spending units, the detailed criteria used for their determination and for any possible change of such ceilings;
- (j) strategic goals and performance indicators of the key spending units achieved during the previous year, expected during the year previous to the planned one, and planned during the mid-term period;
- (k) other issues as may be determined by a resolution of the Cabinet of Minister of Ukraine, including those necessary to develop the draft law on the Government budget of Ukraine.

10. The Explanatory note is submitted together with the Budget declaration approved by the Cabinet of ministers of Ukraine, and it includes the following:

- (a) information on considerations over the Budget Declaration approved during the previous year;
- (b) projected indicators of the aggregated budget of Ukraine for the mid-term period (including the government budget and local budgets);

- (c) information on other issues necessary to develop the draft law on the Government budget of Ukraine.]

Drafting comment: The proposed amendment revise the authorities' proposal by aligning the timeframe and contents of the Budget Declaration to previous TA advice (see in particular TA Report "Medium-term Budget Framework and Fiscal Risk Statement," June 2017). They do not focus on the interaction between the approval process of the Budget Declaration and the annual budget law, which is regulated in different provisions of the Budget Code. With respect to the prescribed contents of the Budget Declaration, while they generally draw from the text of the authorities' proposal the proposed amendments focus on certain key provisions, such as those regarding the criteria for the determination of the ceilings. In reviewing the authorities' proposal, a number of further aspects would warrant clarification, such as the deletion of a provision on the judiciary and the reference to the concept of "strategic government document" mentioned under Section (1) of this article. Lastly, it is important to have a clear and consistent definition, throughout the Budget Code, of "key spending unit" (sometimes referred in the translation also as "key government budget owners").

Article 33–1 (Expenditure Ceilings)

1. The aggregate expenditure ceilings and lending and the ceilings of expenditures and lending of key spending units approved in the Budget Declaration may be revised only in case of deviation from key macro indicators for economic and social development of Ukraine from the forecast which was considered at the time the Budget Declaration has been approved.
2. In addition to the circumstances set out under paragraph (1) above, the ceilings of expenditures and lending of key spending units approved in the Budget Declaration may be revised in case of (i) transfer of responsibilities to execute tasks and functions from one key spending unit to another; (ii) allocation of expenditures which were not allocated between the key spending units at the time the Budget Declaration was approved.

Drafting comment: the proposed amendments simplify the provisions on expenditure ceilings, in line with the recommendations made in the report.

Article 33–2 (Mandate of the Minister of Finance over the Monitoring of Fiscal Risks)

1. In order to mitigate their impact on fiscal outcomes, the Minister of Finance shall be responsible for monitoring fiscal risks, by identifying and analyzing such risks, as well as by preparing, submitting and publishing a fiscal risk statement together with the Budget Declaration and the annual budget law, in accordance with this law.
2. The Minister of Finance may require any financial statements, data, and other information that the Minister of Finance reasonably deems it is necessary for the fulfilment of its

responsibility under paragraph (1) above, from any state government bodies, bodies of local self-governance, bodies of social insurance established by the Law, the National Bank of Ukraine, enterprises, institutions and organizations, provided that information requested from state-owned enterprises shall be limited to financial performance data required for the monitoring of fiscal risks. Such request must be in writing and state the date by which, and the manner in which, the information requested must be provided, and in the case of state-owned enterprises, should be addressed to the relevant supervisory boards with copies to the government body(ies) that that exercise ownership rights over the enterprise.

3. State government bodies, bodies of local self-governance, bodies of social insurance established by the Law, the National Bank of Ukraine, enterprises, institutions and organizations must cooperate with the Minister of Finance on matters concerning the fulfilment by the Minister of Finance of its responsibilities under paragraph (1) above, including by:

- a) Submitting to the Minister of Finance the information requested by the Minister of Finance under the terms of paragraph (2) above;
- b) In the case of state-owned enterprises, sending the requested data to the shareholding government body at the same time it is sent to the Minister of Finance;
- c) Providing to the Minister of Finance, on their own initiative or at the request of the Minister of Finance, explanations, comments, recommendations on any actions that could mitigate the impact of fiscal risks, and on the implementation of any such actions;
- d) Holding regular meetings with the Minister of Finance, participate in working groups, commissions and other joint forums on issues related to the monitoring of fiscal risks.

4. In case of failure to provide information or to cooperate with the Minister of Finance in accordance with paragraphs (2) and (3) above, and without prejudice to the applicability of Articles [..... of the Budget Code / the Administrative Code], the Minister of Finance informs the Cabinet of Minister for appropriate follow-up action.

5. State government bodies, bodies of local self-governance, bodies of social insurance established by the Law, the National Bank of Ukraine, enterprises, institutions and organizations shall remain responsible, in accordance with their respective powers and scope of activity, for taking any action that may mitigate fiscal risks.

6. The fiscal risk statement is published on the website of the Minister of Finance, upon its submission with the Budget Declaration and with the draft annual budget law.

7. The Cabinet of Ministers shall set out, by one or more resolutions:

- (a) the methodology for the identification and assessment of fiscal risks, and the timeframe for the exercise by the MoF of its responsibility to monitor different sources of fiscal risks;

- (b) the detailed roles and responsibilities of state government bodies, bodies of local self- governance, bodies of social insurance established by the Law, the National Bank of Ukraine, enterprises, institutions and organizations state government bodies, relevant for the information exchange and cooperation with the Minister of Finance under Sections (2) and (3) above.
- (c) the detailed contents of the fiscal risk statement.

Drafting comment: The provision on the MoF mandate, which in the authorities' proposal is added to the text of Article 32, would fit better elsewhere, as Article 32 sets out the framework for the "Organizational principles of creation of the draft of the Government budget of Ukraine". Moreover, the heading of the draft article should not refer to the "Fiscal risk department," which is an internal division of the MoF, but to the MoF. The fiscal risk mandate lies with the MoF and how the MoF would carry out the fulfilment of its mandate is not a matter to be provided under the law. Lastly, having the MoF fiscal risk function in a specific, stand-alone article in the Budget Code (rather than mixed with other provisions) would enhance clarity.

Article 38 (Material Enclosed to the Bill on the Annual State Budget of Ukraine)

In addition to the bill on the annual state budget of Ukraine, the Cabinet of Minister submits:

.....

(xxx) A detailed statement on fiscal risks and their impact on the state budget in the planned budgetary period, as well as on measures that may minimize such risks.

Drafting comment: This provision has been finetuned to distinguish the summary fiscal risk statement prepared for the Budget Declaration from the more detailed statement prepared for the draft annual budget law. A CMU resolution would further detail the contents of both types of fiscal risk statement.

Article XX – Transitional Provision

[A transitional provision may be added here providing for a date after which the Budget Declaration will no longer be approved as a resolution but through a different procedure (e.g. law).]