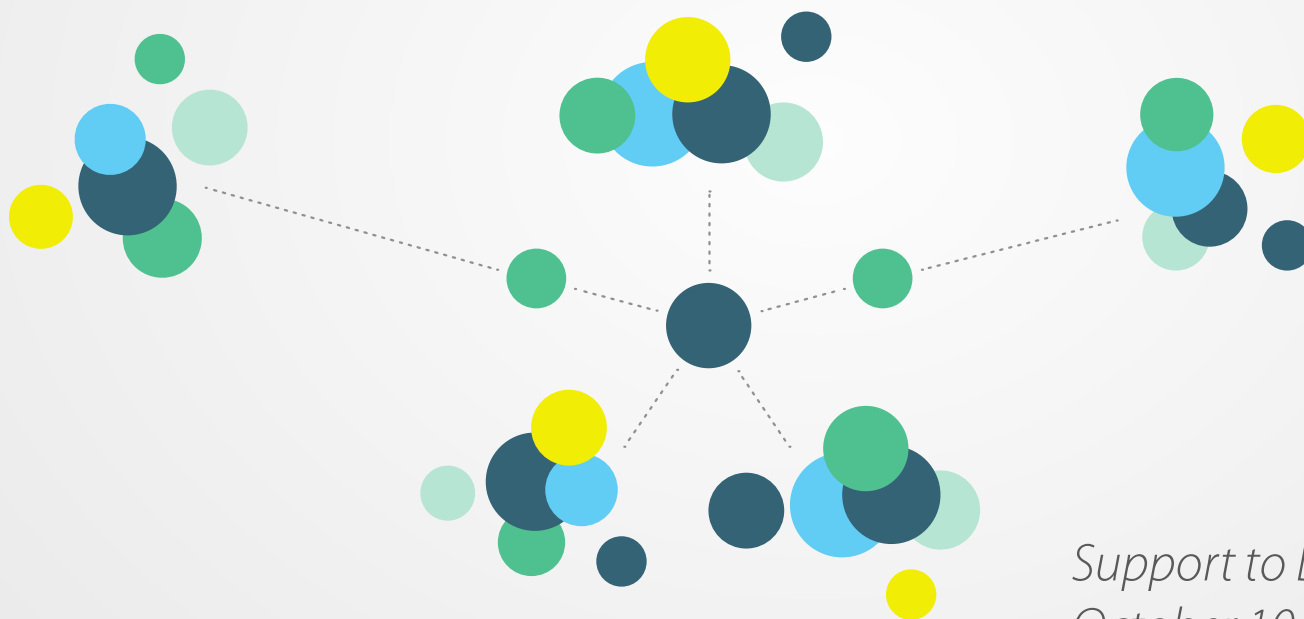


Tony Levitas & Jasmina Djikic

*Kyiv, October 2018*

# Fiscal Decentralization and Local Government Finance Reform: 2014-2017



*Support to Decentralization in Ukraine Project  
October 10, 2018*

# Purpose of the Report

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- April 2014 Council of Ministers approves: **“Concept of Local Self-Governance and Territorial Power Reform in Ukraine”**

“Concept” defines three goals:

- Amalgamation of c. 12,000 hromada in larger OTH
- Clarifying roles and governance structures of oblasts and rayons
- Reform of finance system to align finances with new division of responsibilities.

Report reviews progress towards achieving these goals by analyzing local government revenues and expenditure btwn 2014-2017.

# Amalgamation

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Through a voluntary process, 705 OTH have been formed to date:

- 7.1 million citizens
- 19% of total population
- 39% of rural population

Report analyzes the finances of 366 OTH in operation in FY 2017.

- 159 in 2016
- 207 in 2017

3.1 million people, 8% of total population 17% of rural population

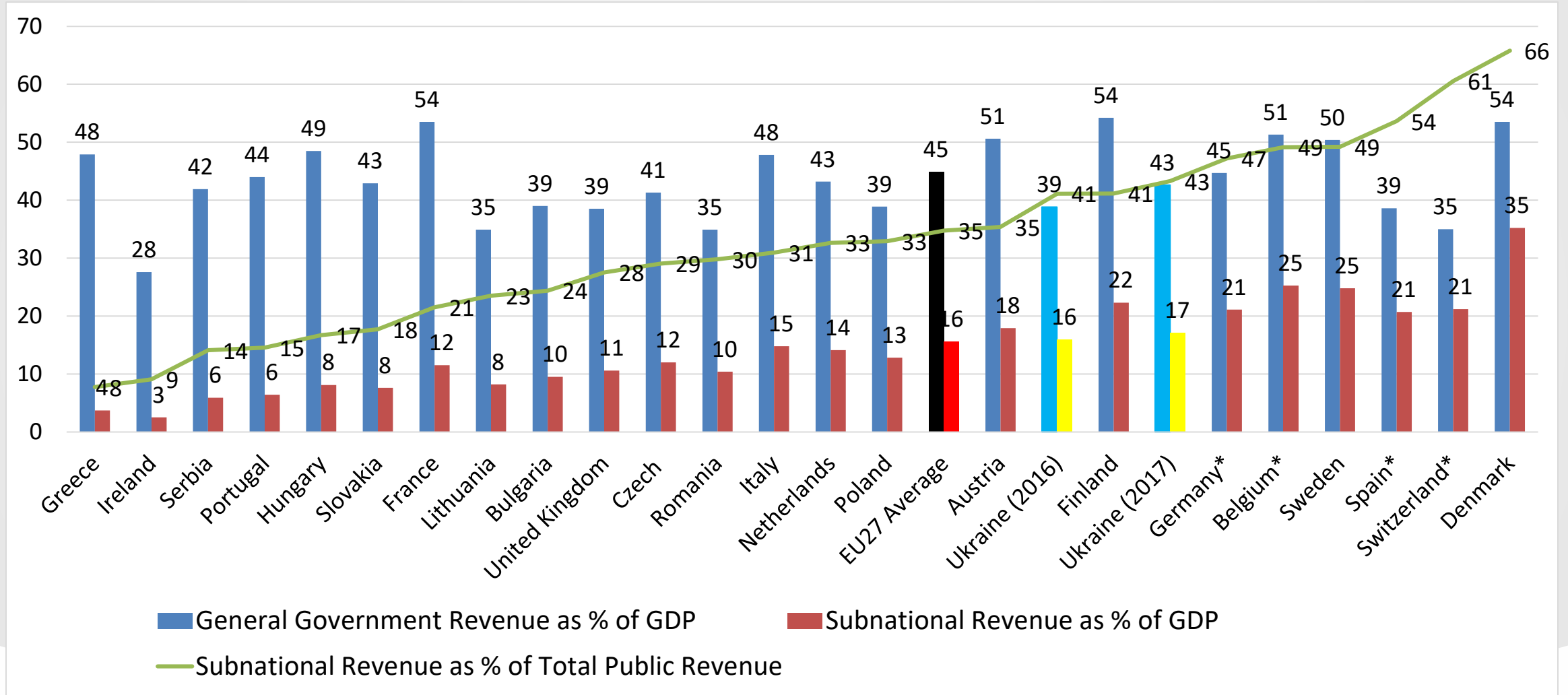
# General Background

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- Ukraine is one of the most fiscally “decentralized” countries in Europe.
- This has been true for a long time.
- Ukraine’s problems with “decentralization” have never been primarily financial.

Instead, and as the “Concept Resolution” recognized the problems lie elsewhere

# Subnational Revenues as a % of GDP and Total Public Revenues in Select EU and Non-EU Countries 2015 (Ukraine 2016 & 2017)



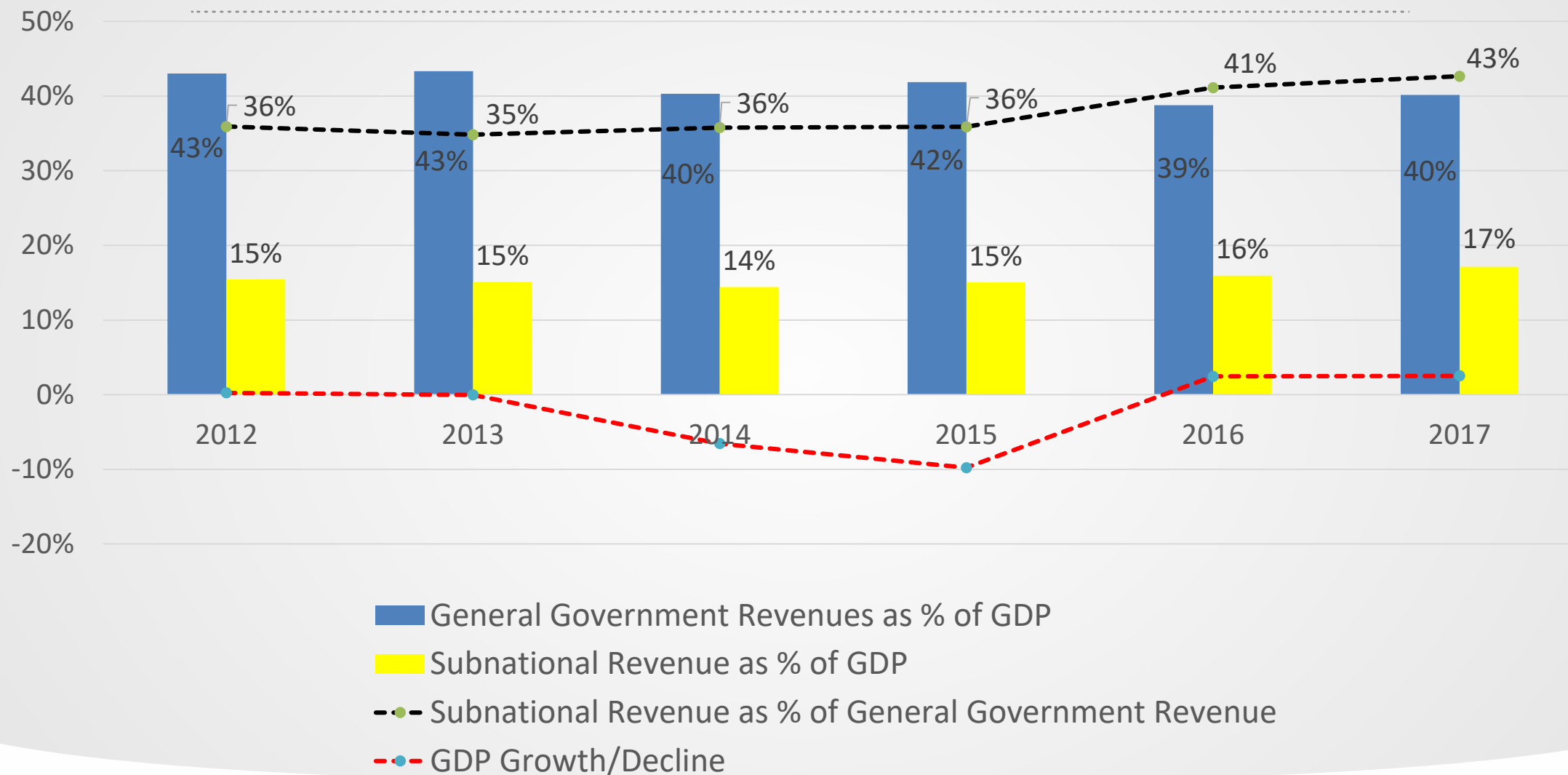
# Total Local Government Revenues

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Despite war and recession, local government revenue has risen from 36% of total public revenue in 2014, to 43% in 2017 (and from 15 to 17% of GDP).

This demonstrates a remarkable commitment by the national government to adequately fund the nation's local governments.

# Subnational Revenue as a % of Total Public Revenue and GDP 2012-17



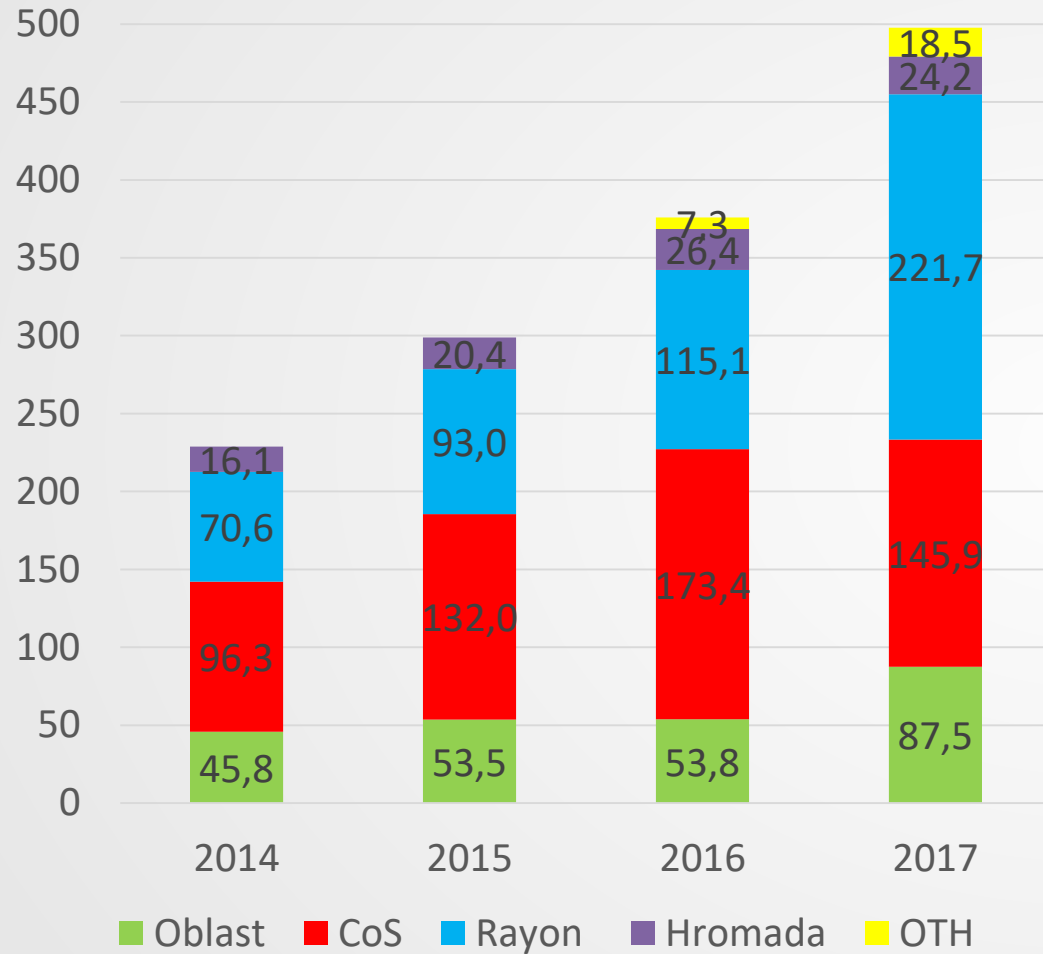
# Total Local Government Revenue

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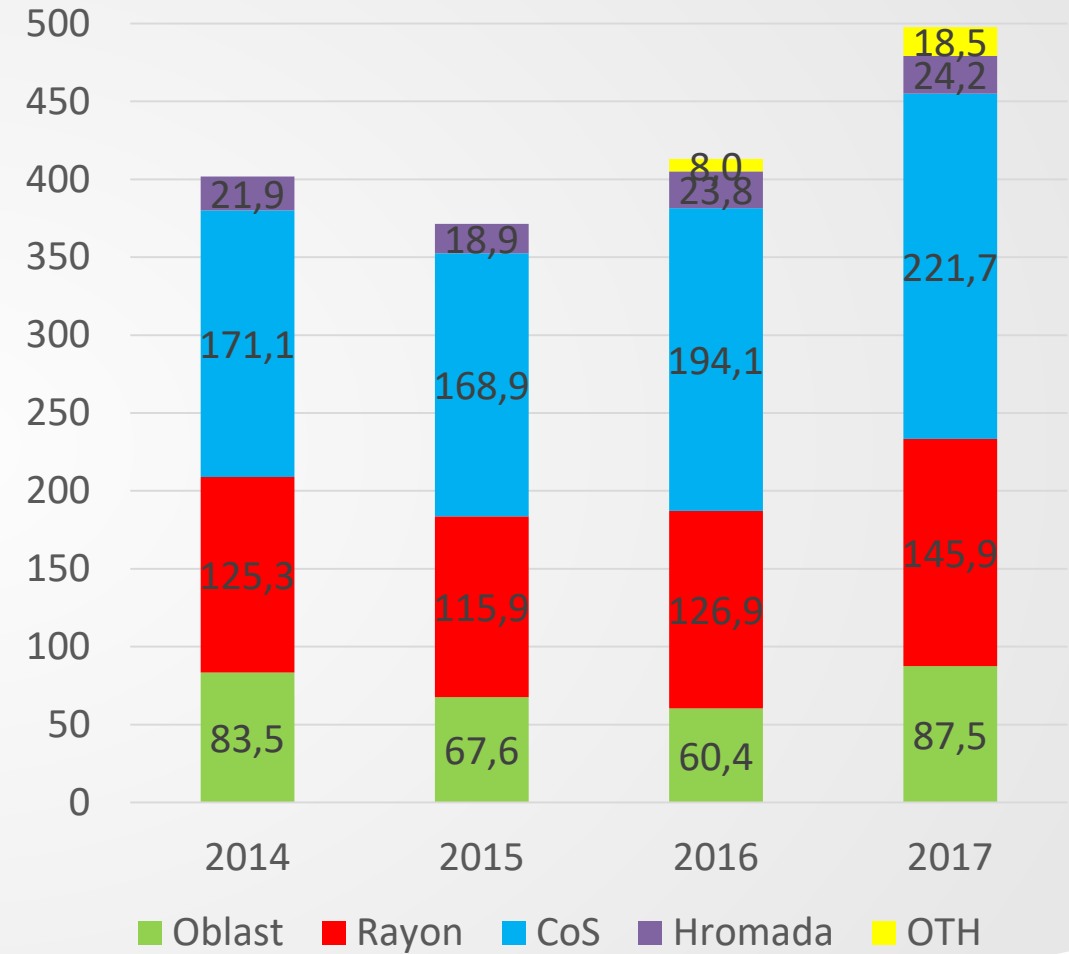
- But a rising share of total public revenue does not *necessarily* mean that local governments get more money.
- After adjusting for inflation, total local government revenue:
  - fell slightly in 2015,
  - recovered to 2014 levels in 2016,
  - increased by 20% in 2017 to 500 billion hryvna.
- (Report is in inflation adjusted terms, so some of the numbers may look different than what people are used to seeing).



## Local Revenue in Nominal Hryvna: 2014-17 (bln)



## Local Revenue in Real Hryvna: 2014-17 (bln)

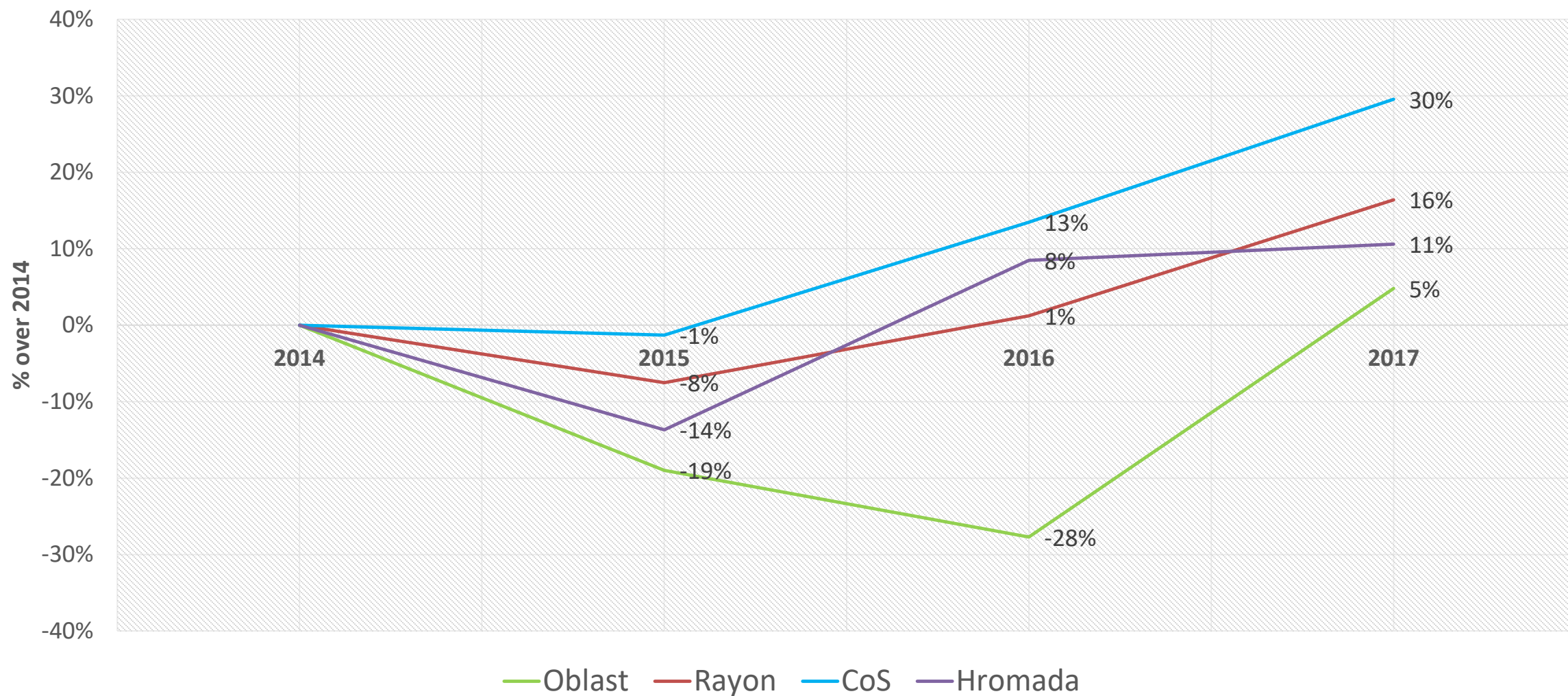


# Total Local Government Revenue

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- In 2015 and 2016, oblast revenue declined sharply, while rayon and hromada revenue fell in 2015 and then recovered or increased in 2016.
- At the same time, COS revenue fell the least in 2015, and rose sharply in 2016, while significant revenue went to new OTH.
- Suggests a clear movement towards the “municipalization” of the system at the expense of rayons and oblasts.
- But in 2017, this movement seems to loose momentum.

# Real Revenue Growth/Decline by Level of Government 2014-17

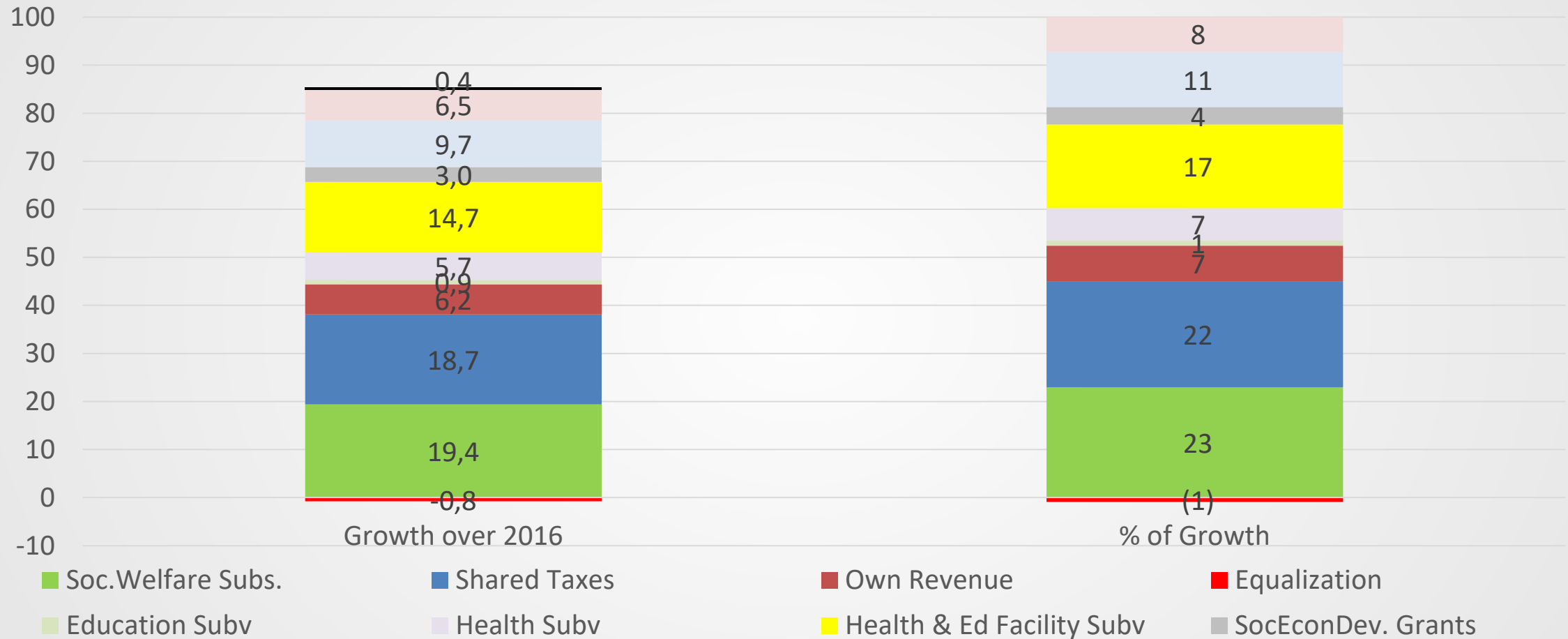


# Total Local Government Revenue

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- In 2017, oblast revenue increases 44%, rayon 15%, and unconsolidated hromada 13%
- COS revenue rises a healthy 14%.
- But OTH revenue stagnates in per capita terms, rising from 5,780 hr to 5,920 hr p/c or only 2.3%.
- Equally importantly, the investment incentives for amalgamation fall from 785 to 465 hryvna per capita.

## Drivers of Revenue Growth between 2014 and 2016 (bln hrn & % of total)



# Total Local Government Revenue

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- 22% of 2017 increase in local government revenue comes from shared taxes (19 bln hr), driven by the 2017 increase in the minimum wage.
- But almost all of the rest comes from an increase in grants and transfers, particularly:
  - Social Welfare Transfers (19.4 bln hr, or 23% of growth)
  - New Health and Facilities grant (14.7 bln hr, or 17% of growth)
  - New Road Grant (from Customs duties, 9.7 bln hr, or 11% of growth)
  - Health grants (6.5 bln hr or 8% of Growth)
- Most of these new grants flowed to oblasts and rayons.

# Select Grants by Level of Government in 2017

	Road Grant	% of Total	Health & Ed Fac. Subv	% of Total	Other Health Grants	% of total	Socio Econ Dev Subs	% of Total	Invest. Grants	% of total	All	% of All
<b>Oblast</b>	<b>11.3</b>	<b>92%</b>	<b>5.9</b>	<b>40%</b>	<b>6.0</b>	<b>85%</b>	1.2	20%	0.0	0%	<b>23.4</b>	<b>63%</b>
<b>COS</b>	1.0	8%	0.0	0%	0.6	9%	2.0	31%	0.5	23%	2.5	7%
<b>Rayons</b>	0.0	0%	<b>7.7</b>	<b>52%</b>	0.3	4%	1.5	24%	0.0	0%	8.3	<b>22%</b>
<b>Gromada</b>	0.0	0%	0.0	0%	0.1	1%	1.1	18%	0.1	6%	0.4	1%
<b>AG</b>	0.0	0%	1.1	8%	0.0	0%	<b>0.4</b>	<b>7%</b>	<b>1.5</b>	<b>70%</b>	2.6	7%
<b>Total</b>	12	100%	14.7	100%	7.1	100%	6.2	100%	2.1	100%	37.2	100%

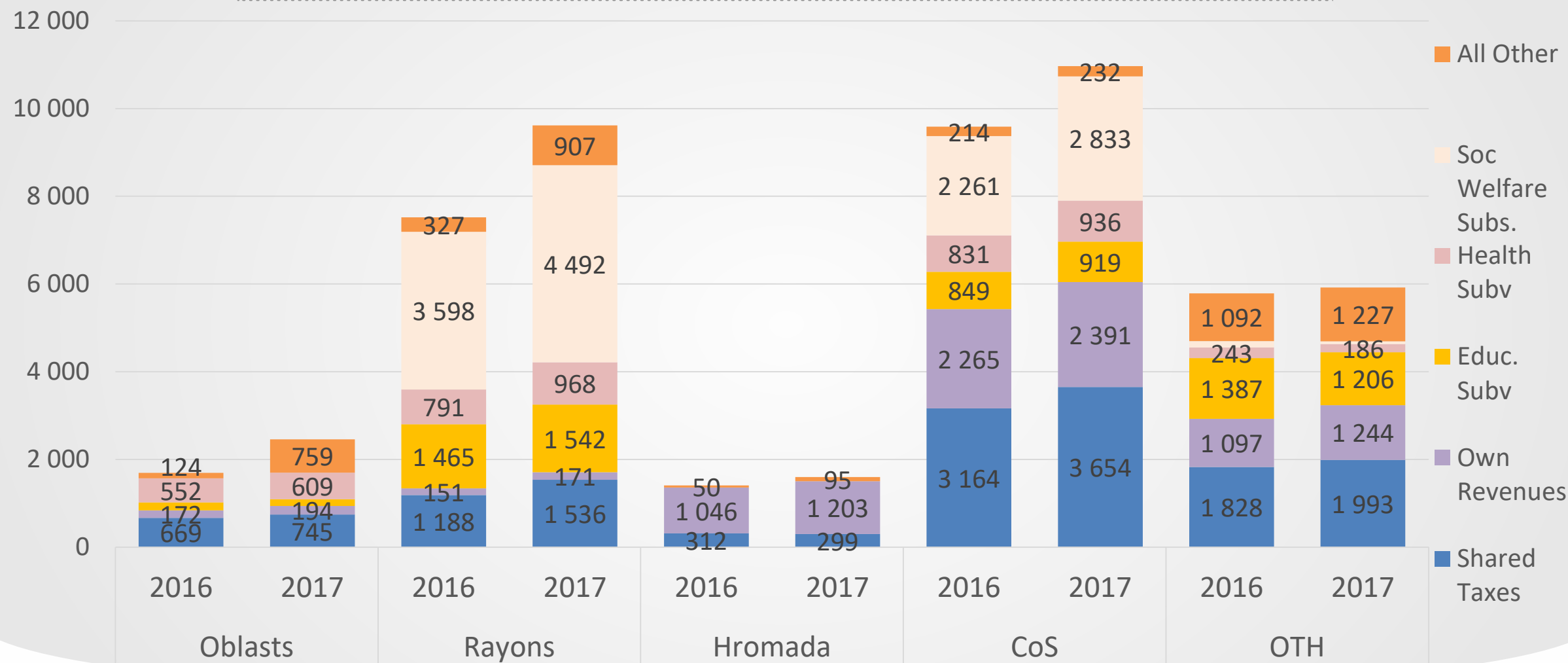
# Health and Education Facilities Grant

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- Unclear how much is spent on health and how much on education.
- Introduced at the same time that the:
  - Ministry of Education changes formula for allocating the Education grant.
  - Ministry of Health prepares for new system of financing health care.
- New Education formula is designed to cover only the pedagogical costs of schooling and to make facility maintenance a local government “own function” (encourage network consolidation).
- In theory, there should be no need for the facilities grant.
- Understandable as a temporary measure.
- But if made permanent, the new grant will undermine efforts to clarify responsibilities in the education sector.



# Local Government Revenue Per Capita

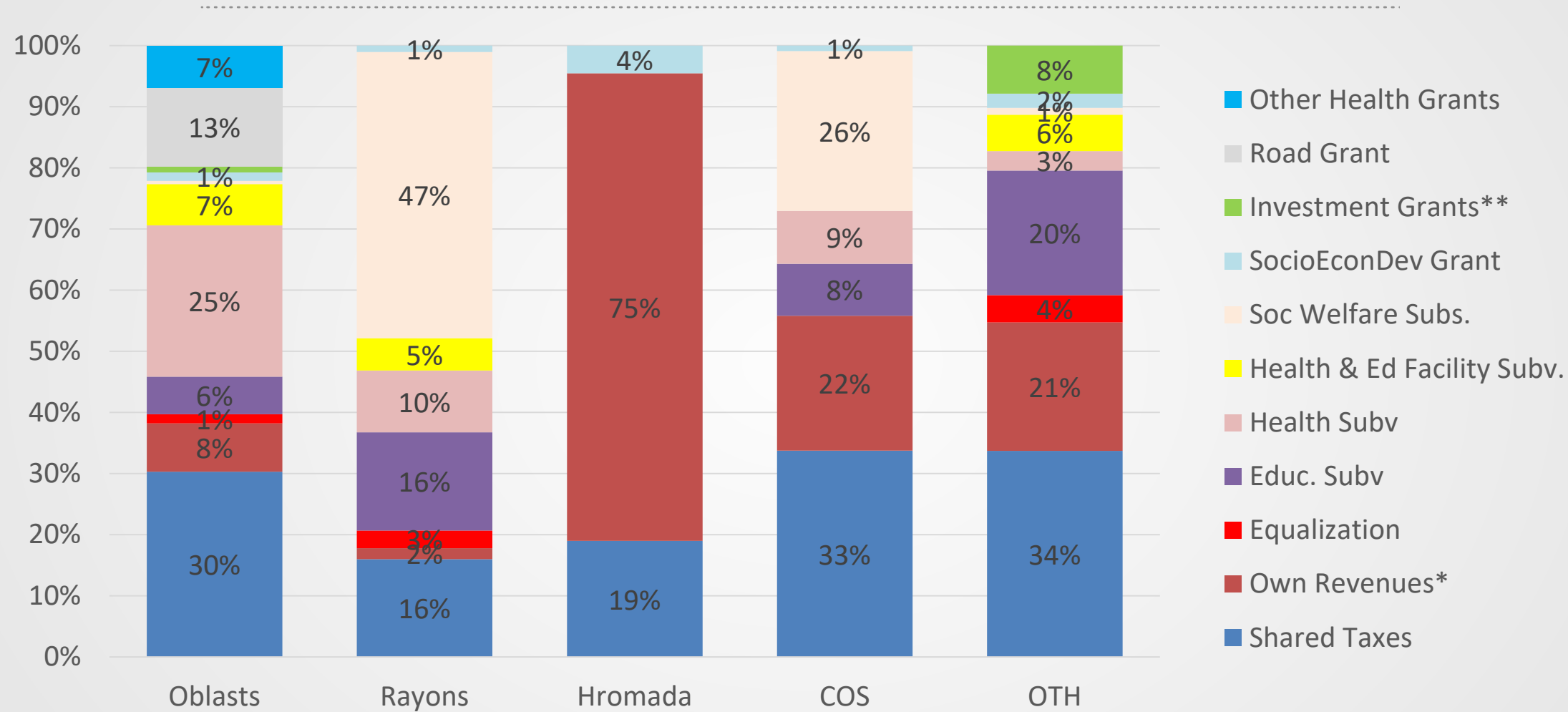


# Total Local Government Revenue

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- COS and rayons receive (and spend) more money per capita than all other levels of government.
- But 47% of rayon revenues are social welfare transfers over which they have little or no discretion.
- The revenue structures of COS and OTH are becoming more and more similar.
- This similarity will accelerate as reforms in health care recentralize the financing of hospitals and clinics.

# The Composition of Local Revenue by Level of Government in 2017



# The Implication of Health Care Reform

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- After amalgamation, the single most important reform for local governments is the implementation of the new single-payer health care system.
- Local governments will remain the owners (and creditors of last resort) for many health care facilities.
- But they will no longer pay for the operating costs of hospitals and clinics.
- Instead, these costs will be covered by contracts that these entities will enter into with the national government.
- At present expenditures on health care represent:
  - 38% of oblast expenditures (single most important function)
  - 14% of rayon expenditures (47% Social Welfare, 32% education)
  - 18% of COS expenditure

# Local Government Expenditure by Function in 2017 (bln hryvna)

	Public Admin	Educ.	Health	Soc. Welf.	Hsing & Muni Econ	Culture, Art, Sport	Const	Trans & Comm	Agric. Funds, Debt, Emerg. Prev	Other	Surplus	Total
<b>Oblast</b>	0.4	17.3	<b>29.7</b>	5.2	3.0	3.6	3.5	9.9	3.0	2.8	9.0	78.5
<b>COS</b>	9.2	55.4	<b>32.6</b>	62.5	17.6	8.5	10.0	15.0	1.4	13.3	-3.9	225.5
<b>Rayons</b>	1.1	42.1	<b>21.5</b>	70.9	0.1	4.8	0.8	0.2	0.2	1.2	3.0	142.9
<b>Gromada</b>	7.2	6.1	<b>0.0</b>	0.5	4.8	1.9	2.7	3.4	0.7	1.1	-4.1	28.4
<b>AG</b>	2.1	8.8	<b>0.9</b>	0.5	1.4	1.1	1.0	0.8	0.2	0.5	1.2	17.3
<b>Total</b>	<b>20.0</b>	<b>129.7</b>	<b>84.7</b>	<b>139.6</b>	<b>26.9</b>	<b>19.9</b>	<b>18.0</b>	<b>29.3</b>	<b>5.5</b>	<b>18.9</b>	<b>5.2</b>	<b>492.6</b>

# Need to Rethink the Functions of Rayons and Oblasts

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- After amalgamation, the most costly function left at the rayon level will be the payment of social welfare transfers.
- Responsibility for this could easily be moved to OTH.
- 17 rayons have already been fully transformed into OTH.

So the question is what should rayons do and how many of them are really needed?

- Should they retain ownership of hospital and clinics?
- Should they be responsible for coordinating the execution of state inspection services at the local level?

# Need to Rethink the Functions of Rayons and Oblasts

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Similar questions can be posed for oblasts because their most important day-to-day function –health care– will shrink radically with the implementation of the single-payer system.

- Should they assume responsibility for monitoring the fiscal and legal probity of COS and OTH?
- What role should they have in vocational education?
- Do they really need democratically elected executive authorities?
- Might they be better conceived of as territorial representatives of the national government?

# Important Effects of New Finance System- Own Revenue

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2014 Reforms gave local government new tax powers:

- COS, Hromada and OTH were all given limited rate control over land and property taxes, as well as over the Single Tax.

Since 2014, total local government revenues have increased from 41 to 63 billion hryvna (52%).

- Own revenues have risen most dramatically in hromada (55%), suggesting that they are responding to fiscal pressure by mobilizing their own revenues.



# Local Government Own-Revenue in 2014 & 2017 (bln hryvna)

- without revenues from Budget Users

	2014	2017	% Growth
<b>Oblast</b>	1.7	1.7	0%
<b>Rayon</b>	0.2	0.3	35%
<b>COS</b>	28.5	40.4	42%
<b>hromada</b>	11.2	17.4	55%
<b>OTH</b>		3.3	
<b>All</b>	41.7	63.2	52%

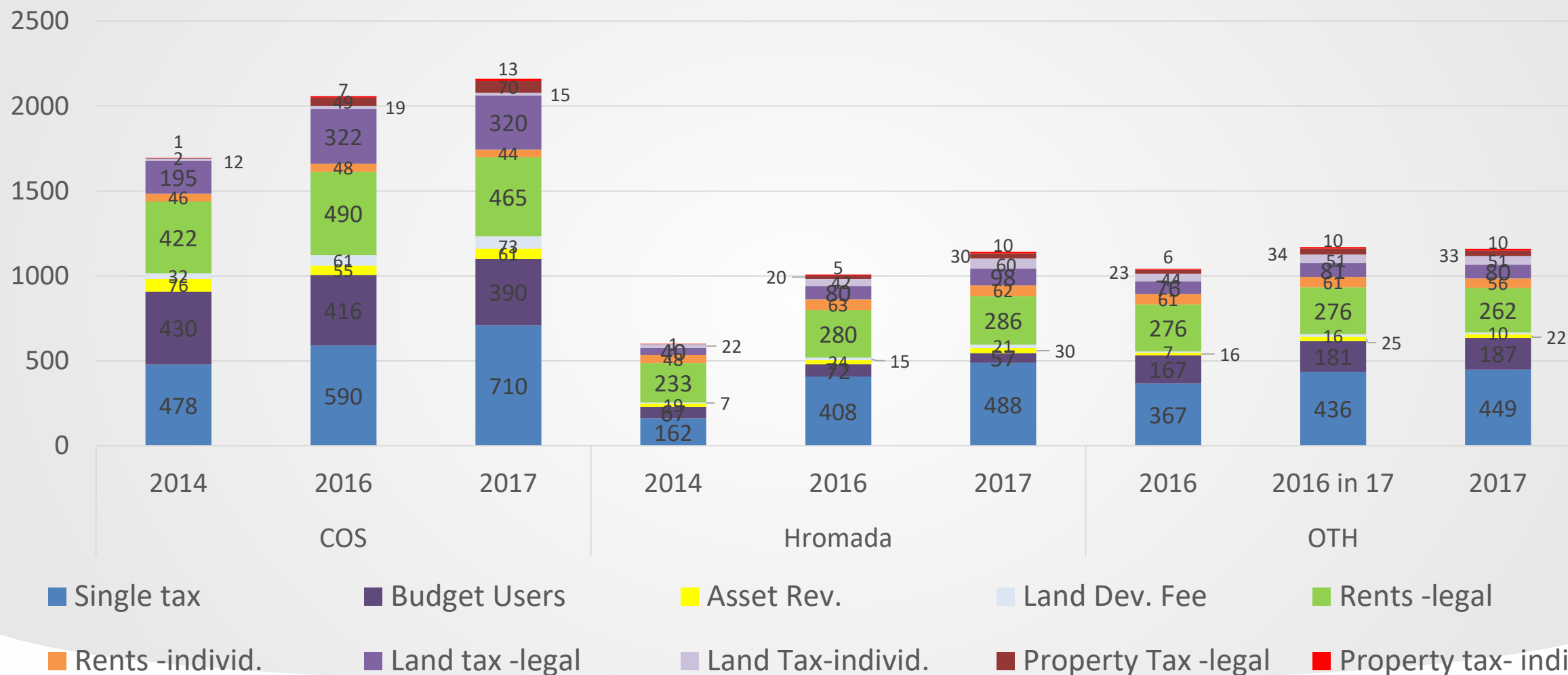
\*without revenues from Budget Users

# Important Effects of New Finance System- Own Revenue

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- The most important own-revenues are the Single Tax and revenue from land rent.
- The growth of these revenues has accounted from most of the growth of own-revenues for all types of local government
- COS, Hromada and OTH have also begun to more aggressively pursue the land tax from legal entities.
- The imposition of the land and property taxes on individuals remains in its infancy, but is stronger in rural areas.

# Own Revenues per capita in COS, Hromada and OTH 2014, 2015 and 2017



# Important Effects of New Finance System-Equalization

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2014 reforms radically simplified the old equalization system by:

- Creating separate block grants for Health and Education
- Equalizing only for revenues (shared PIT and CIT per capita) not differences in expenditure.

New System:

- Has helped clarify the responsibilities of local governments .
- Is much more transparent and efficient.
- Has not led to a serious deterioration of horizontal equity at any level of government.

# The Effects of Equalization on the per capita revenues of Oblasts, Rayons and COS (w/o Kiev)\* in the period 2014 - 2017

	Oblasts						Rayons						COS					
	2014			2017			2014			2017			2014			2017		
	Equal	Total	% of 4 <sup>th</sup>	Equal	Total	% of 4 <sup>th</sup>	Equal	Total	% of 4 <sup>th</sup>	Equal	Total	% of 4 <sup>th</sup>	Equal	Total	% of 4 <sup>th</sup>	Equal	Total	% of 4 <sup>th</sup>
1 <sup>st</sup> Q	1,128	1,775	0.58	93	2,012	0.66	3,931	4,473	1.10	513	4,837	0.82	2,008	3,826	0.74	187	4,962	0.61
2 <sup>nd</sup> Q	1,033	1,854	0.61	50	2,252	0.74	3,348	4,136	1.02	318	4,877	0.82	1,705	4,543	0.88	39	5,902	0.73
3 <sup>rd</sup> Q	852	1,806	0.59	20	2,294	0.76	2,977	3,999	0.98	173	4,933	0.83	1,178	4,943	0.95	6	6,887	0.85
4 <sup>th</sup> Q	914	3,050	1.00	7	3,028	1.00	2,457	4,060	1.00	38	5,931	1.00	318	5,189	1.00	1	8,113	1.00

# Important Effects of New Finance System-Equalization

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But the new system has a number of peculiar features that should be reconsidered.

- The richest local government –Kyiv- is not included in the system.
- The average per capita PIT/CIT thresholds are calculated together for COS, OTH, and rayons.
- This lowers the equalization thresholds for OTH and COS, while raising it for rayons.
- As a result, COS pay the most into the system and get almost nothing out of it.
- While rayons pay almost nothing into the system, and get the most out of it.

# The Base/Reverse Grant (Equalization) in 2016 & 2017

	2016					2017				
	Recipients		Payees			Recipients		Payees		
	#	Bln HR	#	Bln HR	Diff	#	Bln HR	#	Bln HR	Diff.
<b>Oblasts</b>	18	0.83	6	0.53	-0.30	17	0.91	5	0.62	-0.28
<b>CoS</b>	52	0.33	61	2.22	1.89	53	0.39	63	2.74	2.35
<b>Rayons</b>	380	3.27	34	0.24	-3.04	368	3.64	38	0.37	-3.27
<b>OTH</b>	125	0.28	22	0.06	-0.22	293	0.77	48	0.16	-0.61
<b>Total</b>	575	4.71	123	3.05	-1.66	731	5.71	154	3.90	-1.82
<b>Equalization's Cost to the National Government*</b>					<b>1.66</b>					<b>1.82</b>

# Important Effects of New Finance System-Equalization

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- This seems at odds with the objective of making COS & OTH the most important levels of local government.
- System is also very small, providing only 1.1% of total local government revenues (5.7 bln hr in 2017)
- Costs the government almost nothing --1.6 bln hr in 2017.
- Despite this, there seems to be an objective to make the system self-balancing (eliminate government contribution entirely).
- This is unnecessary, and in its present structure further penalize COS and OTH.
- More importantly, severely underestimates the need for equalization as more and more (poor) gromada amalgamate.



## The Effects of Equalization on the per capita revenues of Rayons, OTH and COS (w/o Kiev)\* in 2017

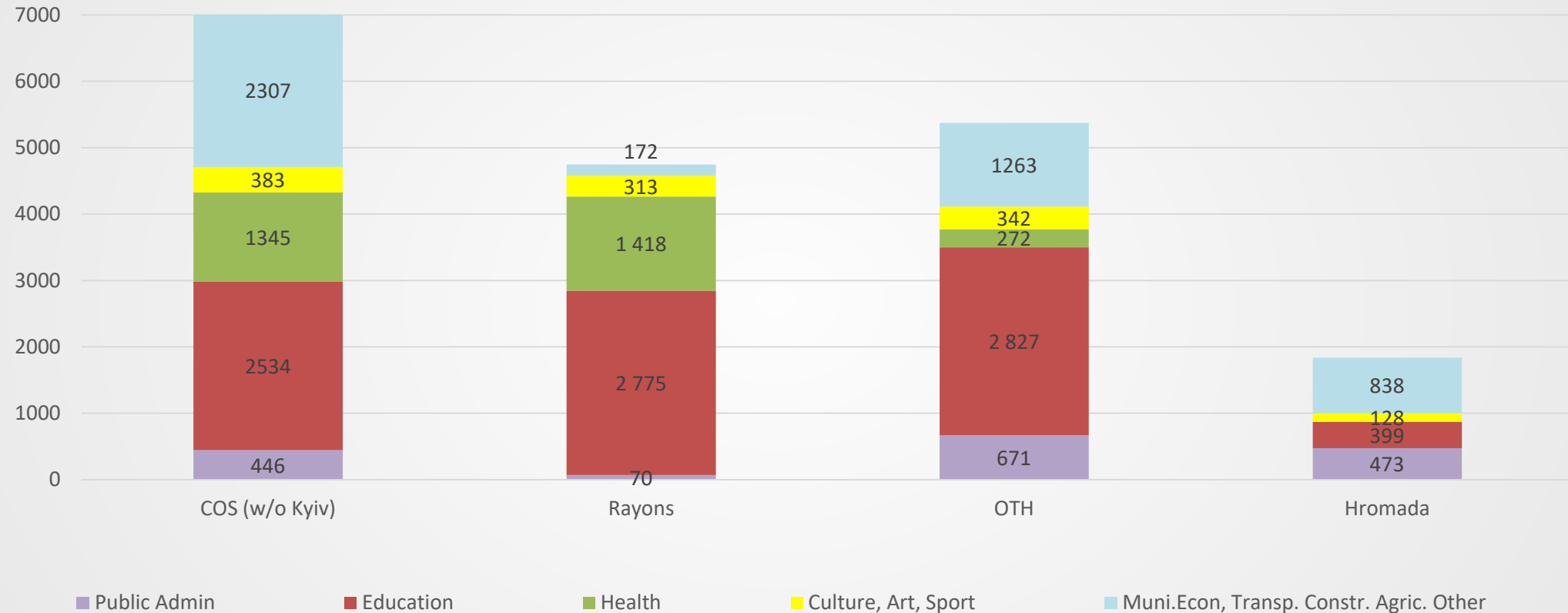
	Rayons				OTH				COS			
	PIT	Equal.	Total	% of 4 <sup>th</sup>	PIT	Equal.	Total	% of 4 <sup>th</sup>	PIT	Equal.	Total	% of 4 <sup>th</sup>
1 <sup>st</sup> Q	838	513	4,837	0.82	629	548	4,623	0.61	1,467	187	4,962	0.61
2 <sup>nd</sup> Q	1,260	318	4,877	0.82	1,113	369	5,296	0.70	1,947	39	5,902	0.73
3 <sup>rd</sup> Q	1,641	173	4,933	0.83	1,567	192	5,644	0.75	2,673	6	6,887	0.85
4 <sup>th</sup> Q	2,602	38	5,931	1.00	3,091	31	7,546	1.00	3,389	1	8,113	1.00

# Important Effects of New Finance System-Equalization

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- Rayons should be equalized to their own average PIT revenues (w/o COS & OTH, c 1500 hr per capita).
- This would reflect the fact that they perform few of the basic municipal infrastructure functions of COS and OTH.
- The national government should cover these (lower) equalization costs directly.
- It would also raise the average per capita revenues of COS and OTH (from 2,100 hr per capita with rayons to 2,600 without)
- As a result, less COS would pay Reverse Grants into the system and more OTH and COS would receive Base Grants, raising the costs of the system for the national government, but facilitating amalgamation.

# Per Capita Expenditures of COS (w/o Kyiv), Rayons, Hromada and OTH by Function in 2017



# Recommendations

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- Set a date by which amalgamation must be completed.
- Increase financial incentives and support to newly formed OTH.
- Give COS and OTH greater powers to register and collect fees and taxes, particularly land and property taxes.
- Reconceive oblasts and rayons as territorial representatives of the national government.
  - Centralize planning and control functions at the oblast level, including responsibility for overseeing the legal and fiscal probity of COS & OTH decisions and (perhaps) financing and managing vocational health
  - Let oblasts and rayons make the hard decisions about rationalizing health care networks as agents of the national government.
  - Consolidate rayons and restrict their functions to the ownership of secondary health care facilities and the coordination of state inspectorates.

# Recommendations

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- Calculate equalization thresholds for OTH and COS together but without rayons.
- Let the national government cover the costs of equalization at the rayon level on its own.
- Increase the level of funding in the equalization system by either including Kyiv in the system and/or increasing the contribution of the national government.