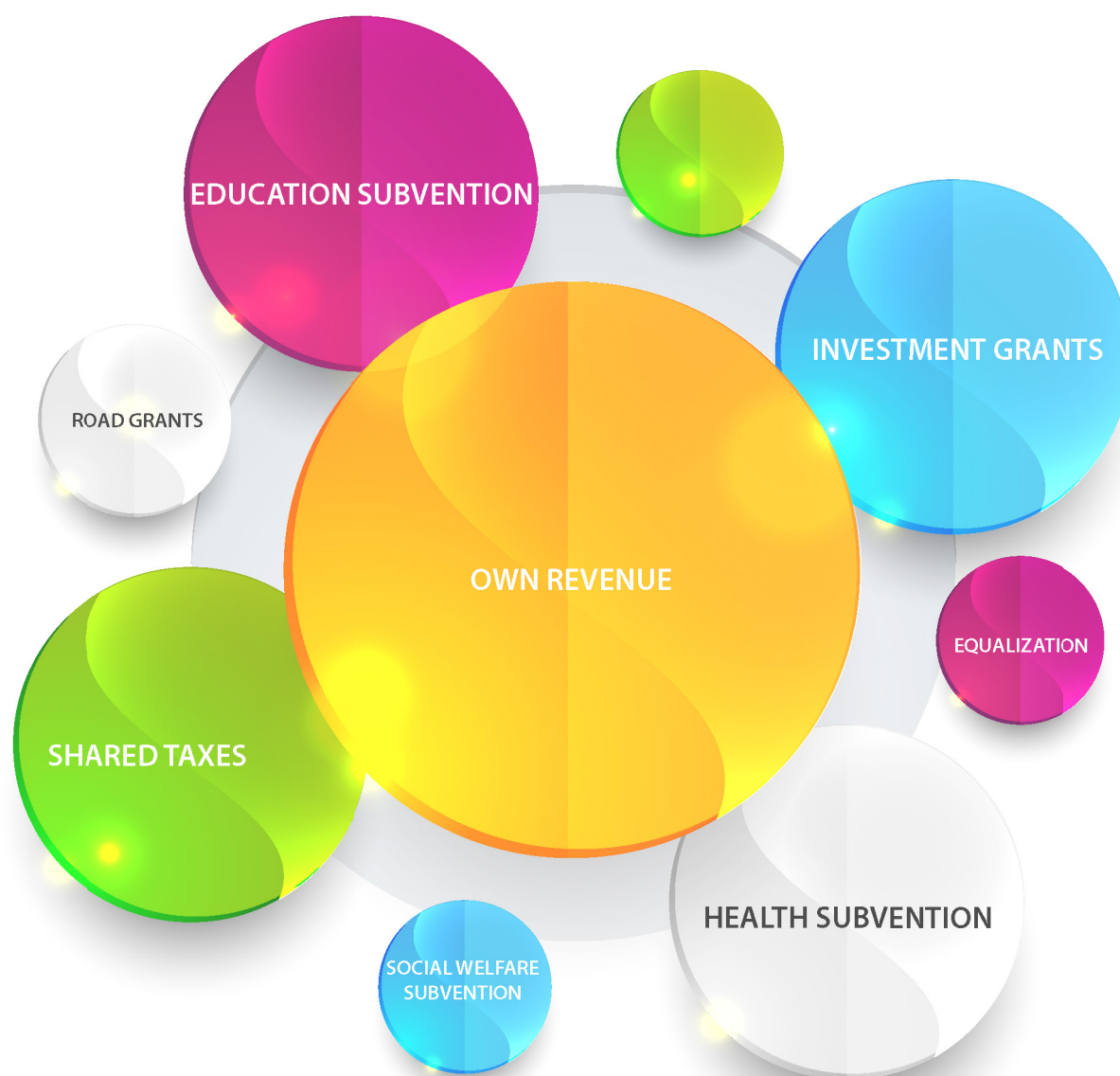


SUBNATIONAL GOVERNANCE REFORM AND LOCAL GOVERNMENT FINANCE IN UKRAINE: 2014-2018



KYIV

2019

Policy Brief

**Subnational Governance Reform
and Local Government Finance in Ukraine: 2014-2018**

Tony Levitas & Jasmina Djikic

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Executive Summary

In April 2014, the Cabinet of Ministers approved the “Concept of Local Self-Governance and Territorial Power Reform in Ukraine”. This document identified three critical weaknesses in Ukraine’s system of local self-governance: (1) the ineffectiveness of its tiny villages, (2) the unclear division of responsibilities between levels of government, and (3) the ambiguous status of its regions and districts (oblasts/rayons) as self-governing bodies. To correct these problems, the resolution called for:

- Amalgamating more than 12,000 hromada into larger townships (Amalgamated Hromada/OTH) and assigning them with new revenues and responsibilities.
- Clarifying the responsibilities and governance structures of oblasts (regions) and rayons (districts) by reducing their provision of day-to-day public services like education and endowing them with democratically elected executives.
- Reforming the intergovernmental finance system to more transparently provide all levels of local government with revenues adequate to meet their new service responsibilities.

This policy brief reviews the operation of key aspects of Ukraine’s intergovernmental finance system and in their light assesses the progress that has been made in meeting the Government of Ukraine’s (GoU) objectives since 2014. We find that Ukraine has taken major but sometimes unclear steps towards the goals outlined in the Concept.

On the positive side of the ledger we find that:

- Through a voluntary process of amalgamation, 936 OTH have been formed. Ten million people (54% of the rural population, 26% of the total population) now live in townships that should be large enough to manage their basic public services --including most importantly their schools¹.
- Local governments’ share of total public revenue rose from 34% to 41% between 2014 and 2018, making Ukraine --at least in strictly fiscal terms— one of the most decentralized countries in Europe. Over the same period, local government revenues rose from 441 to 569 billion hryvna (29%) after adjusting for inflation. The growth of both the share and the real value of local government revenue demonstrates a remarkable commitment by the national government to adequately fund local governments in the face of recession and war.
- The 2014 reforms of the intergovernmental finance system replaced a complicated and non-transparent equalization grant with separate block grants for education and health, and a smaller, but clearly calculated revenue equalization grant. The block grants have helped clarify responsibilities in health and education, while the new more efficient and transparent equalization grant has prevented the emergence of radical fiscal disparities among local governments.

¹ This report examines the finances of the 665 OTH which functioned as independent local governments in 2018. The population shares are calculated without the people living in the occupied territories of Lugansk and Donetsk. For data on the status of the amalgamation process see: https://storage.decentralization.gov.ua/uploads/library/file/465/10.08.2019_ENG.pdf

- The 2014 reforms also significantly expanded the tax powers of COS, hromada, and OTH and their own revenues grew from 42 to 69 billion hryvna (64%) between 2014 & 2018. There is also clear evidence that at least some local governments are increasing their effort to collect own revenue.
- In 2016, the Ministry of Education introduced a new formula to allocate the Education Block Grant. The formula is designed to cover the pedagogical costs of schooling and to clarify local education responsibilities by making facility maintenance and improvement an own function.
- In 2016, the government adopted legislation mandating the creation of a single-payer health care system. This legislation holds the promise of reducing local governments' financial responsibilities in the sector, and of clarifying their relationships with hospitals, clinics and doctors. In 2018 the newly established National Health Service began contracting directly with primary health care providers.
- The revenue structures and service responsibilities of COS and OTH are converging, indicating significant progress towards the Concept's objective of making them the primary level of local governance in Ukraine. This convergence should accelerate with the recentralization of hospital finance, and the direct payment of social welfare subsidies to poorer households.

On the more negative side of the ledger we find the following:

- While the amalgamation process now seems irreversible, the process remains open ended, creating costly uncertainties and delaying important decisions about how the new system should function as a system.²
- Relatively little progress has been made in reforming the governance structures and functions of oblasts and rayons. The idea to make oblasts true local governments by endowing them with democratically elected executives seems to be on hold.
- Current plans to give districts and oblasts new powers to oversee the legality of COS and OTH decisions while preserving their democratically elected councils leave unanswered two questions that have haunted local government reform in Ukraine since independence: Should oblasts be territorial representatives of the national state, or democratically elected regional governments? And what powers should they have over the rayons, COS and OTH 'below' them?
- It is also unclear whether rayons should be local governments or district-level representatives of the national government. It is similarly unclear what functions should be left at the rayon level as OTH take over their responsibilities in education and the reform of the health care system reduces –over time– their responsibility to finance regional hospitals. Here, however, apparent plans to make rayons state administrative units while creating a smaller number of them based on the service areas of regional hospitals, hold the promise of resolving many of these issues.

² The new Government of Oleksiy Honcharuk has recently announced that it expects to finish the amalgamation process by early 2020 and to hold new, nation-wide local government elections <https://en.hromadske.ua/posts/ukraines-pm-honcharuk-presents-his-government-program>

- Much of the recent growth in local government revenue has come from grants that flowed primarily to oblasts and rayons. This marks a change in policy from 2015 and 2016 when most new revenue flowed to COS and OTH. The concentration of new revenue at the oblast and rayon level deprives COS and OTH of new money and increases their financial dependence on oblasts and rayons, both of which are at odds with the Concept's objective of making COS and OTH Ukraine's primary units of local governance.
- In 2017 and 2018 the government funded a large, new Health and Education Facilities Grant (c. 16 bn hr. in both years). The grant was introduced because the national government was concerned that the new formula for allocating the Education Subvention would leave many local governments unable to pay for the maintenance of school facilities. As a temporary measure this is understandable. But the longer the Facilities Grant is in place, the harder it will be to convince local governments that they should consider facilities maintenance as an own function.
- In 2017 the national government substantially increased the minimum wage. Because the base pay of public sector workers is tied to the minimum wage, its increase raised the operating costs of local governments. The increase of the minimum wage also increased the revenues that local governments receive from their share of the Personal Income Tax (PIT). But the increase was not enough to fully compensate for the rise in their labor cost and as a result investment rates have fallen since 2016 particularly among poorer OTH and COS.
- While the new equalization represents a very significant achievement, it now needs to be adjusted and better financed. More money needs to be put into the system because many OTH simply do not have enough taxable employment to generate the PIT revenue which anchors their finances. This is not surprising given that most OTH have been formed by consolidating poor rural areas with the small towns nearest to them.
- The system also needs to be adjusted because: COS pay the most into it but get the least out of it; rayons, whose functions are being reduced, pay almost nothing into the system but get the most out of it; Kyiv does not contribute to system despite being the richest jurisdiction in the country; and the system's current costs to the national government are trivial (c. 2 bn hr.) when compared to the discretionary grants (43 bn hr.) the government has recently provided to oblasts and rayons.
- The current employment-based allocation of local government PIT shares creates perverse incentives for cities and small towns to exclude surrounding areas from joining into common OTH because cities and small towns know they will get these revenues even if the employees who generate them, live elsewhere.

In light of these findings we make the following recommendations:

- The government should set a date for the completion of the voluntary amalgamation process and announce that hromada that have not formed themselves into OTH will be amalgamated by fiat.
- The government should be more concerned with whether amalgamated OTH have the scale to reasonably manage school systems and network infrastructure than with whether they are fiscally

self-sufficient: While all OTH can be made large enough to effectively administer public services, many of them, perhaps even most, cannot be made fiscally self-sufficient because tax and employment base of much of rural Ukraine is simply too weak.

- If the government has the parliamentary majority necessary to amend the constitution, it should decide as quickly as possible whether oblasts and rayons should be territorial representatives of the national state or independent local governments. But either way, the ambiguous status of oblasts and rayons that has haunted local government reform in Ukraine since independence should be ended.
- The equalization system should be reviewed and enhanced. Rayons should no longer be equalized to the same per capita PIT thresholds as COS and OTH and the national government should increase its contribution to the system by moving some of the discretionary funding it has been giving to oblasts and rayons into the equalization system. Kyiv, as the richest jurisdiction in the country should also contribute to the system and the idea that the goal of amalgamation should be to create fiscally self-sufficient OTH should be abandoned as impractical.
- The equalization system should also be based on all shared taxes and not just PIT and the national government should consider introducing multiple, progressive thresholds for taxing back revenue from wealthier local governments because too much of these taxes are paid for by COS of moderate means.
- The per capita PIT revenues of a small number of OTH are many times higher than the national average and exceed those of even the wealthiest COS. Another small group of OTH derive rents and land taxes from legal entities that make them among them richest jurisdictions in the country. These OTH have been formed around particularly strong industrial and/or agricultural bases but at the expense of the poorer areas surrounding them. In the completion of the amalgamation process, the national government should compel hromada with exceptionally high per capita revenues from PIT or land assets to join with as many of their poorer neighbors as possible.
- The government should take steps to move the allocation of PIT shares from place of employment to place of residence both to avoid the perverse incentives this creates for amalgamation and to ensure that local governments whose residents commute to work have the revenues necessary to maintain their school systems and their basic public infrastructure.
- Efforts should be made to accelerate the process of paying Social Welfare transfers directly to poorer households instead of having oblasts, COS and rayons reallocate these monies to loss making public heating, water, and electrical companies.
- Going forward, the national government should adjust the value of the Health and Education subventions when it chooses to raise minimum wages.

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I. The Data Used in the Brief

This brief is based on a review of local government finances between 2014 and 2018. It builds on studies of the previous two years and attempts to synthesize the most important findings for the entire period.³ As before, the brief is based on local government line-item revenues and expenditures as reported through the Treasury system.⁴

The data in the report, however, may look unfamiliar to Ukrainian analysts for the following reasons: First, unless otherwise indicated all data has been adjusted for inflation using the National Bank of Ukraine's Consumer Price Index.⁵ This has been done to make the data comparable from year to year, and to identify real trends in local government revenues and expenditures. But it also means that the values for years prior to 2018 will differ from what people remember and that the increase in local government revenue that has occurred since 2014 has been less pronounced than the nominal figures suggested. Indeed, most of the real growth has come in 2017 and 2018.

The second reason the data may look unfamiliar is because the categories we use to aggregate it differ from those commonly employed in Ukraine. Most importantly, we consider taxes and fees whose yield is shared with local governments, but over which they have no rate or collection power to be "shared taxes,"⁶ and not "own revenue." This is in line with standard international practice but results in local governments having significantly less "own revenue" than people may be accustomed to seeing.

Finally, we ignore the distinction in Ukrainian Budget Law that segregates revenues and expenditures into a freely disposable "General Fund" and an earmarked "Special Fund." This is because the legal specification of the revenues and expenditures that flow into these funds changes frequently and accounting for them would be extremely time consuming. Ignoring the Special Fund, however, means that our data suggest that local governments have more expenditure power than they really do. More generally, we do not think this separation is particularly useful for analyzing local government finances, and that while the GoU should specify the legal use of some of grants and transfers, it should not be in the business of requiring local governments to spend specific local revenues on particular functions.⁷

It is also important to note, that two recent changes in the rules governing public sector accounting have complicated the reading of the data. In 2016, the GoU passed legislation creating a new single-payer health care system. Eventually, a new National Health Service will enter into service contracts with all health-care providers, and hospitals, clinics, and doctors will be paid in accordance with the number of citizens they serve (primary health care), or the number of procedures they perform (secondary health care). This will replace the current system in which local governments receive block grants to pay for the

³ See Levitas & Djikic (2017) and Levitas & Djikic (2018)

⁴ To simplify the analysis, data for unamalgamated hromada has been consolidated to the rayon level.

⁵ CPI 2014 1.433; 2015 1.124; 2016 1.137; 2017 1.098; multipliers: 2014 2.011; 2015 1.4032; 2016 1.2484; 2017 1.098

⁶ PIT, CIT, Excise Taxes, Environmental Fees, and State Fees are considered shared taxes.

⁷ See Appendix 2 for a summary of how the Special Fund has changed since 2014 and for why we think its use should be phased out.

operating costs of the hospitals and clinics that they own and manage. As such, the new system will recentralize health care finance while also opening the sector to private providers.

For the moment, however, local governments are still responsible for financing the hospitals and clinics they own and manage. Nonetheless, in 2017 they were required to account for these expenditures as “purchases of goods and services” and not as before, as wages and other types of spending. As a result, spending on wages in health care --a very significant local cost— appears to have plummeted in 2017 and 2018, when this is not the case.

The second accounting change that complicates interpreting the data concerns Social Welfare and Housing expenditures. For many years, the national government has given a large and shifting number of grants to local governments to support these functions. Some of these grants local governments then transfer to low income households. But most of them are passed on to utility companies to make up for revenue (presumably) lost from poorer households.

In 2017, however, local governments were required to report all housing and social welfare grants as “Transfers to Individuals” because there are plans --agreed upon with the IMF-- to replace the subsidization of utilities with more targeted support to poorer households.⁸ As a result, current accounting practices substantially underreport transfers to utilities while overreporting transfers to individuals.

Finally, it is important to note that in 2017 the GoU raised the minimum wage by 13%. This at once increased the value of the PIT share that local governments receive and raised local government costs. Determining the net impact of this wage increase is difficult because the rules governing how the minimum wage affects the salaries (of different types) of public sector worker are extremely complicated, and because the accounting practices discussed above make it impossible to see wage spending in the health care sector.

II. Historical Background

In April 2014, Ukraine’s Cabinet of Ministers approved the “Concept of Local Self-Governance and Territorial Power Reform.”⁹ The Concept identified critical problems with Ukraine’s local government system, and then outlined actions to correct them. Its central proposition was that with an average population of 1,500 people, the country’s 12,000 villages (hromada) were simply too small to provide basic public services. Not surprisingly then, the document called for their consolidation into larger townships (amalgamated hromada or OTH).

The Concept also argued that the division of power between state-appointed executives and democratically elected councils at the regional (oblast) and district (rayon) levels was contradictory and dysfunctional. Indeed, the Concept called for the Constitution to be amended in order to permit the

⁸ IMF Ukraine Letter of Intent <https://www.imf.org/external/np/loi/2016/ukr/090116.pdf>

⁹ Cabinet of Minister (2014)

democratic election of oblast and rayon executives.¹⁰ It also suggested that the roles of these levels of government be reduced by assigning responsibility for all day-to-day public services to Cities of Oblast Significance (COS)¹¹ and the newly created OTH. Finally, the Concept sketches out reforms that would give local governments a more transparent set of grants and shared taxes, greater tax powers, and above all more revenues.

Since April 2014, Ukraine has made major, if in places still fragile progress towards achieving the objectives defined in the Concept. Beginning in 2014, parliament passed a series of laws that allow, encourage, and facilitate the voluntary amalgamation of hromada into OTH. To date, this has made possible the formation of 936 OTH, and 10 million people (26% of the total population, and 54% of the rural population) now live in townships with democratic governance structures, and functions and finances that resemble those of

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COS. It is important to note, that the analysis, which follows, however, is based on the 655 OTH that were functioning as independent local governments in 2018.

At the end of 2014, the government also overhauled the intergovernmental finance system. It replaced a large, complicated, and non-transparent equalization grant with separate block grants for education, health and social welfare and a smaller, but clearly calculated revenue equalization grant. COS, rayons, and OTH were all assigned 60% shares of the Personal Income Taxes (PIT) generated in their jurisdictions, as well as a new 5% share of locally collected excise taxes.¹² For the first time, COS and OTH were granted limited powers to set the rates of the property tax and the so-called Single Tax, a tax which the self-employed pay in lieu of PIT.

¹⁰Most outside observers do not consider oblasts or rayons to be “local self-governments” (*samovryaduvannya*) precisely because their executives are appointed by the state. Instead, they would be called “subnational governments” or even “territorial representatives of the national government”. However, in both Ukrainian law and everyday speech they are referred to as local self-governments. At the expense of much conceptual clarity, we defer to Ukrainian practice and refer to oblasts and rayons as “local governments” when the title should be reserved for COS and OTH.

¹¹ 149 urban settlements that are considered COS. Since the mid-1990s, they have had democratically elected mayors and councils. But only after the Orange Revolution, did they gain control over the hiring and firing of all department heads, including the critically important Finance Department. COS are politically powerful and well organized in the Association of Ukrainian Cities. Half of all COS have less than 50,000 residents and 15 have less than 20,000.

¹² Initially, local governments were given the right to set a surcharge of up to 5% on locally sold excise goods. But this surcharge was turned into a fixed share after all local governments set their surcharges at the maximum rate.

The GoU also significantly increased the share of public revenue going to local governments. This demonstrates the government's commitment to reform and is particularly remarkable because countries at war typically recentralize their finances. The Ministry of Education has made important, if still contested efforts to better align the education block grant with the costs of schooling in rural and urban areas. And the new single-payer health care legislation holds the promise of reducing local government responsibilities in the sector and clarifying their relationships with hospitals, clinics and doctors.

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But a fractious parliament has also made it impossible to move forward on key elements on the Concept's agenda. While over 50% of hromada have amalgamated, there is still no legislative deadline for the

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completion of the process despite the expectation spelled out in the Concept that OTH would be universal by 2017. Similarly, the GoU has not put forward the constitutional amendments that would clarify the governance structures of oblasts and rayons.

Equally important, the Concept's call for the clear specification of how major responsibilities in health, education and social welfare should be divided between levels of government is still very much a work in progress. And nobody seems to be sure what rayons should do once all the hromada within them have amalgamated and their basic functions have been transferred to OTH.

There are also important debates over how the new single-payer health care system should be implemented, as well as uncertainty about which level of government should be responsible for vocational education. Finally, it remains unclear exactly which institutions will oversee the legal and fiscal probity of local governments as well as who these institutions should report to --parliament or the president. It is against this background that we now turn to our most important findings.

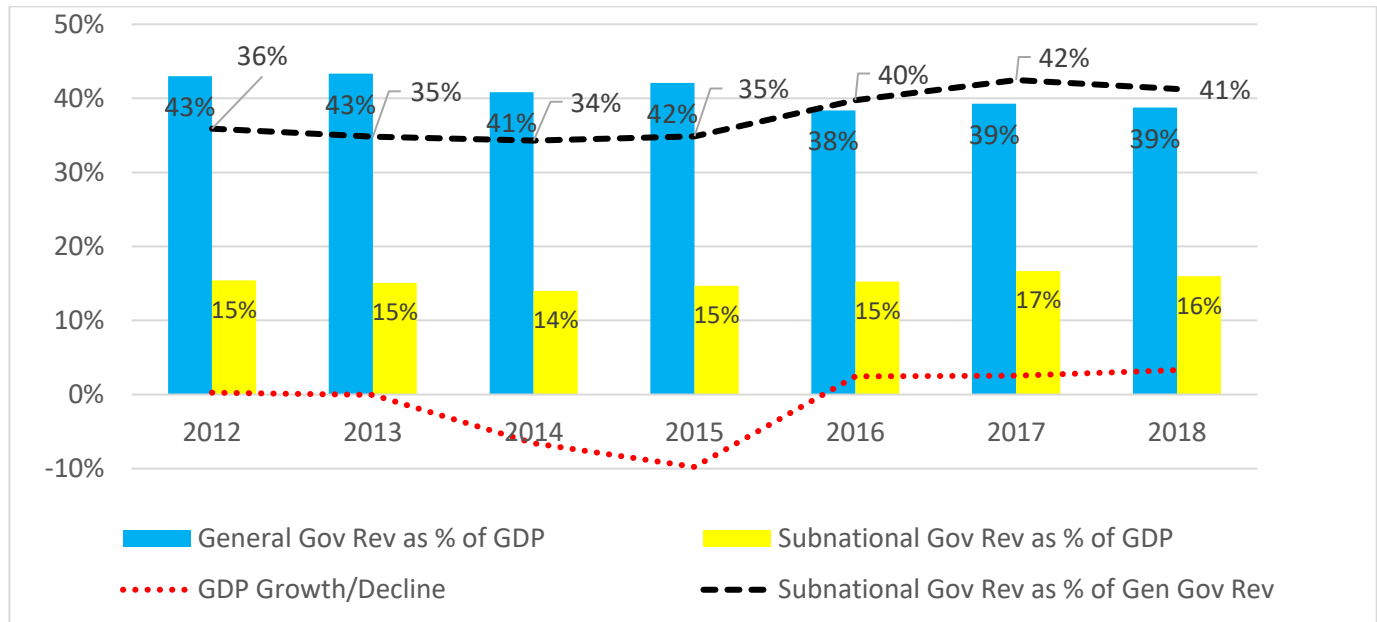
III. Overview of Local Government Revenue Trends

One of the most common indicators used to assess decentralization is the share of total public revenue that a country's local governments receive and spend: if local governments have little revenue, their governance role is clearly limited, and the extent of decentralization can be said to be minimal.

Chart 1 (below), shows local government revenue in Ukraine as a percentage of total public revenue and GDP since 2012. As can be seen from the chart, even in 2012 local governments received about 35% of

total public revenue. Indeed, the figure would be much the same if the left hand of the Chart was extended backward in time to 1991 and Ukraine's independence. In short, if only local government revenue is considered, Ukraine has been one of Europe's more decentralized countries for quite some time¹³.

Chart 1: Subnational Revenue as a % of Total Public Revenue and GDP 2012-2018



This, however, is not the case and while giving local governments a significant share of public revenue may be a necessary condition for decentralized governance, it is not a sufficient one. Or, putting the matter differently, Ukraine's problems with local governance have never been strictly or even primarily financial. Instead, and as the Concept document of 2014 outlined, these problems have congealed around the unclear governance structure of oblasts and rayons, the ineffectiveness of its tiny villages, and the unclear division of responsibilities between all levels of government.

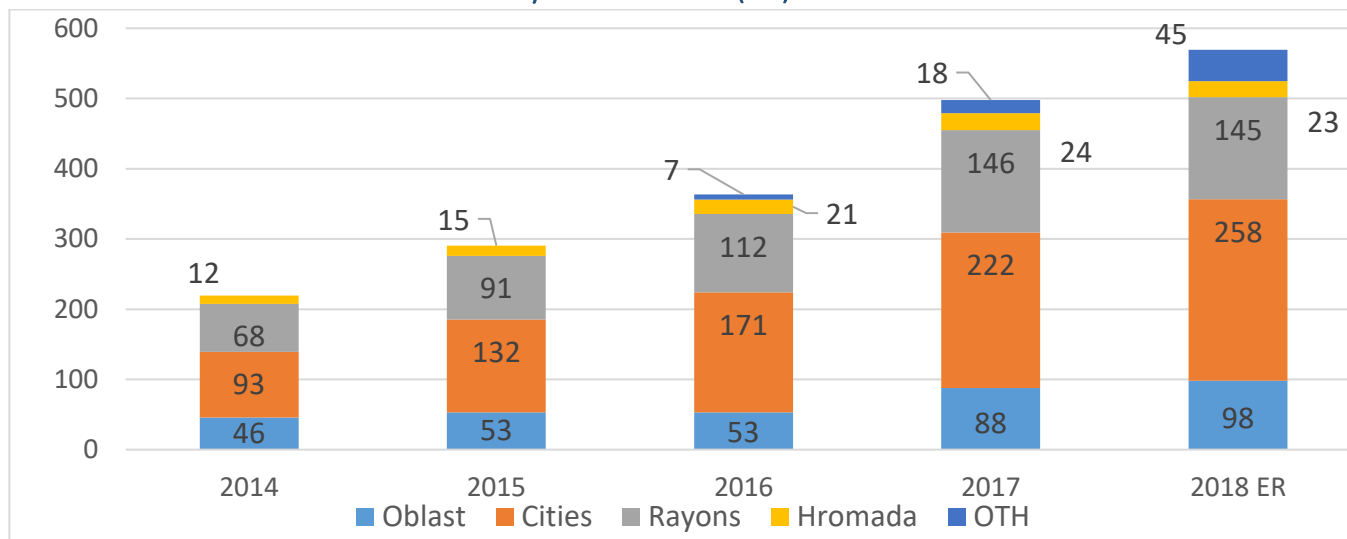
That said, Chart 1 is still striking because it shows that local government revenue has increased both as a share of GDP (14 to 16%) and of public revenue (34 to 41%) since 2014. This is remarkable given the recession of 2013-2015, the overall reduction of the size of the public sector, and most importantly war with Russia. In short, the national government has remained remarkably committed to providing local governments with adequate funding despite forces that typically encourage the centralization of public revenues.

Local government revenue has increased significantly both as a share of GDP (14 to 16%) and of total public revenue (34 to 44%) since 2014. In short, the national government has remained remarkably committed to providing local governments with adequate funding despite forces that typically encourage the centralization of public revenues.

¹³ See Chart I in Appendix 1

Chart 2 (below) shows total local revenue by level of government between 2014 and 2018 in nominal hryvna. As can be seen from the chart, local revenue rose substantially in nominal terms in all three years following the 2014 reforms. Indeed, the government has presented this nominal growth as evidence of its financial commitment to local government –a commitment that in fact has been extraordinary.

Chart 2: Local Revenue in Nominal Hryvna: 2014-18 (bn)



But as extraordinary as that commitment has been, it is important to recognize that once inflation is accounted for, local revenue growth has been more modest than the nominal figures suggest. This can be seen from Chart 3 below which presents local government revenue by level of government in inflation adjusted terms. As can be seen from the chart, real revenue declined slightly in 2015, recovered to 2014 levels in 2016, and then grew by 20% in 2017 and another 5% in 2018.

Chart 3: Local Revenue in Inflation Adjusted Hryvna: 2014-2018 (in 2018 hr. bn.)

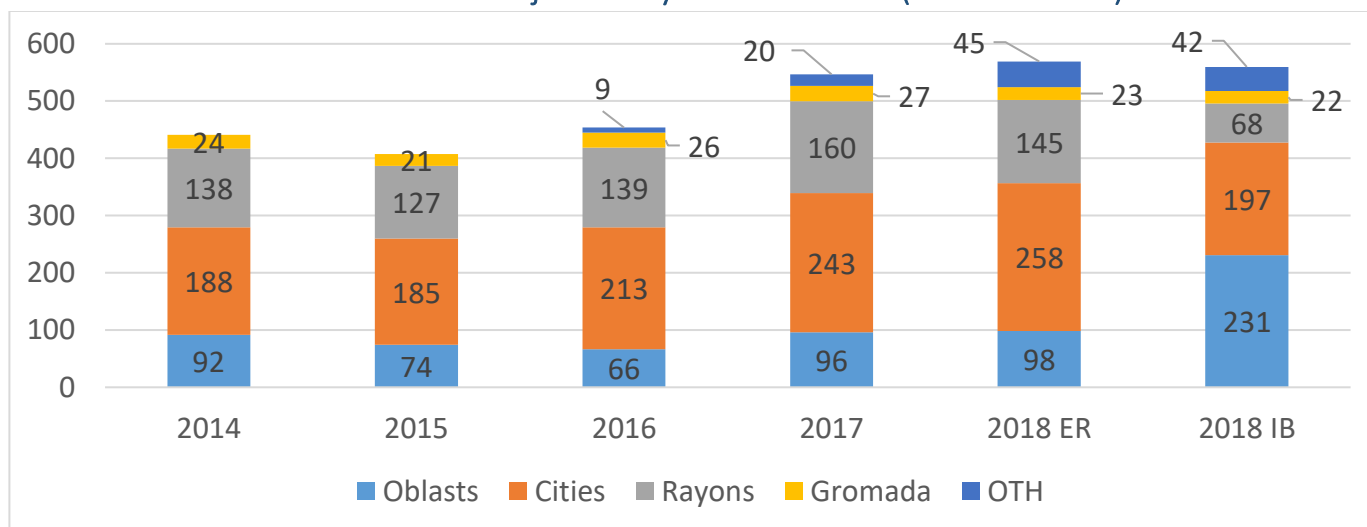


Chart 3 also presents two columns for revenues in 2018. The first column indicates the “End Recipients” of public revenues while the second column indicates the “Initial Beneficiaries” of these revenues, before some were passed on to other levels of government. As can be seen from the chart, oblasts received 132

billion hryvna more in revenue as “Initial Beneficiaries” than they did as “End Recipients.” What this means is that oblasts ultimately transferred these monies to other levels of local government.¹⁴

Of these monies, 120 billion hryvna were for Social Welfare and Housing Subsidies which, as we have already mentioned, should be formula-based transfers allocated directly to poorer households. But this is not yet the case, and instead most of these funds are ultimately distributed to utility companies that are running deficits. How oblasts allocate these monies to other levels of government is unclear. Indeed, it is unclear whether oblasts or the end recipients of these funds decide which utilities should receive what subsidies. As such, what Chart 3 highlights is that oblasts control the allocation of well over 20% of all local government revenue, giving them substantial --and problematic-- powers over the budgets of COS, rayons, hromada, and OTH.

Table 1 (below) presents the evolution of the per capita revenues of all levels of local governments since the 2014 reforms. The Table is important because it suggests that the national governments effort to make Cities and OTH the most important levels of local government in Ukraine have not been consistently realized from year to year. For example, in 2015 and 2016 the per capita revenues of oblasts fell significantly, a trend which we initially identified as being in line with the government’s objective to shift power and money to COS and OTH as Ukraine’s “base self-governing communities.”¹⁵

Table 1: Local Government Per Capita Revenue and their Growth Rates 2014-2014 (in 2018 hr.)

	2014	2015	2016	2017	2018	% 2015 / 2014	% 2016 / 2015	% 2017 / 2016	% 2018 / 2017	% 2018 / 2014
Oblasts	2,555	2,070	1,862	2,699	2,769	-19%	-10%	45%	3%	8%
Rayons	7,444	6,896	8,256	10,559	11,529	-7%	20%	28%	9%	55%
COS	9,272	9,139	10,524	12,040	12,832	-1%	15%	14%	7%	38%
OTH			6,355	6,501	7,950			2%	22%	25%
Hromada	1,301	1,125	1,547	1,754	1,803	-14%	37%	13%	3%	39%

In 2017 however, the per capita revenues of oblasts and rayons increased much more dramatically than those of COS, while the per capita revenue of OTH stagnated. This strongly suggests that the initial effort to strengthen the relative power of COS and OTH had lost some of its initial momentum. In 2018, however, OTH gained the most in per capita revenue, indicating at least a partial correction of the earlier drift off course.

Nonetheless, and perhaps most strikingly, the level of government that should shrink the most with the formation of OTH —rayons-- remains the level of government which has seen the greatest increase in per capita revenue since the beginning of the reforms (55%). As such, it seems fair to say that the financial

¹⁴ This was the first year that the Treasury data we received was organized in this way, so comparison with previous years is not possible.

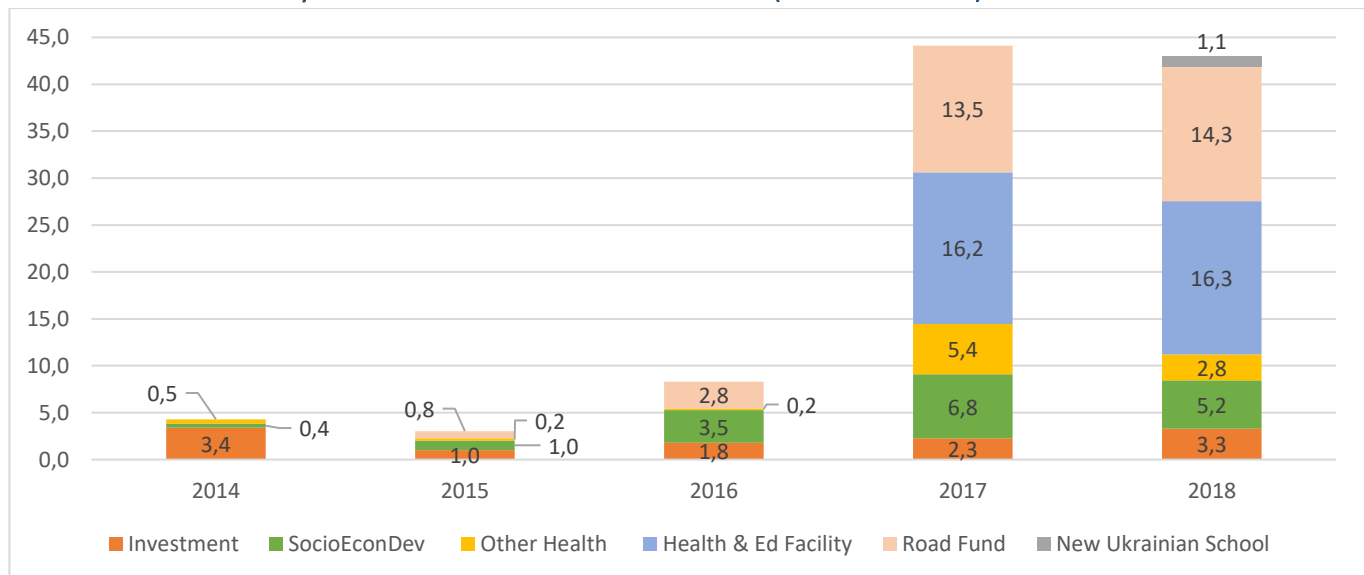
¹⁵ We identified this shift as evidence of the government’s commitment to the “municipalization and hromadization of public power” See Levitas & Djikic (2016)

policies of the national government are still not fully aligned with its stated structural objectives. Here, two areas of financial policy are worth singling out, the allocation of investment grants, and the functioning of the equalization system. We deal with each in turn.

Per capita revenues of oblasts and rayons increased much more dramatically than those of COS, while the per capita revenue of OTH stagnated. This strongly suggests that the initial effort to strengthen the relative power of COS and OTH had lost some of its initial momentum. In 2018, however, OTH gained the most in per capita revenue, indicating at least a partial correction of the earlier drift off course.

As can be seen from Chart 4 (below), the national government radically increased the volume of grants to going to local governments in 2017. A new grant worth 16.2 billion hryvna (in 2018 hr.) as introduced to help local governments maintain the physical infrastructure of schools and hospitals.¹⁶ At the same time, oblasts and Kyiv were permitted to retain 50% of the customs duties collected on their territories above a planned level, and to use these monies for road investments. This introduced another 13.5 billion hryvna (in 2018 hr.) into the intergovernmental finance system. Finally, grants for health-related purposes were expanded with the addition of new grant for the purchase of ambulances in rural areas. Taken together, these grants amounted to 35 billion hryvna and accounted for about 37% of the total increase in local government revenue (93 bn hr.) between 2016 and 2017.¹⁷

Chart 4: Discretionary Grants between 2014 and 2018 (in 2018 hr. bn)



¹⁶ The Ministry of Education introduced the facilities grant at the same time as it overhauled the formula for allocating the Education Bock grant. The new formula is designed to cover only the pedagogical costs of schooling, while making the financing of school maintenance a local government “own function”. As such, there should be no need for the facilities grant. But the government was clearly concerned that many local governments would not be able to finance the maintenance of their schools (and medical facilities) and introduced the Facility Grant to provide additional monies to those in need.

¹⁷ Another 22% came from a substantial increase in Social Welfare and Housing Subsidies. Most of the rest came from an increase in the yield of the local government PIT share, driven in part by economic growth and in part by the 2017 increase in the minimum wage. See Levitas & Djikic (2018).

This very substantial injection of new grant monies, however, flowed disproportionately to oblasts and rayons. This can be seen from Table 2 below which shows the allocation of these grants between levels of local government in 2017 and 2018. In 2017, 80% of all discretionary grants flowed to oblasts and rayons (56% & 24%) while only 17% flowed to Cities and OTH (10% & 7%). In 2018, the situation improved somewhat as the total amount of grants going to oblasts and rayons fell to 74% while the share going to Cities and OTH rose to 25%.

Nonetheless, the high share of these grants that were directed to oblasts and rayons is out of alignment with the national government's stated purpose of making Cities and OTH the fundamental units of local self-government in Ukraine: By giving oblasts the power to allocate large amounts of new money, the grants increased their financial influence over other levels of government. The grants also significantly bolstered the finances of rayons, a policy that seems strange given that the number and service populations of rayons is shrinking as OTH are formed, and that the new monies almost certainly helped some rayons to resist the amalgamation process.

Table 2: Allocation of Discretionary Grants in 2017 & 2018 (2018 hr. bn)¹⁸

	Hromada		OTH		Cities		Rayons		Oblast		All	
Type of Grant	2017	2018	2017	2018	2017	2018	2017	2018	2017	2018	2017	2018
Health & Ed Fac.			1.2	2.1		0.6	8.5	6.5	6.5	7.1	16.2	16.3
Investment	0.1	0.2	1.6	1.9	0.5	1.9		0.3		9.9	2.3	14.3
New School				0.2		0.4		0.4		0.1	0.0	1.1
Health Related		0.1		0.1	0.4	0.6	0.3	0.7	4.7	1.2	5.4	2.8
Road Fund					1.1	0.2			12.4	3.0	13.5	3.3
SocioEconDev	1.2	0.1	0.5	0.7	2.1	1.8	1.7	1.7	1.3	0.9	6.8	5.2
Total	1.3	0.4	3.3	5.1	4.2	5.5	10.4	9.6	24.9	22.4	44.1	43.0
% of Total	3%	1%	7%	12%	10%	13%	24%	22%	56%	52%	100%	100%

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¹⁸ In 2018, it seems that the national government allowed oblasts to spend monies from customs duties on investments other than roads.

IV. Equalization

For different reasons, the 2014 equalization system is also overfunding rayons, at the cost of COS and OTH, while allowing the richest jurisdiction in the country –Kyiv– not to contribute to the system at all. This system resembles those of other European countries in which significant percentages of national taxes –most often personal and corporate income taxes-- are shared with local governments on an origin basis¹⁹. In Ukraine, this system is referred to as the Base/Reverse Grant system and is governed by two basic rules.

The 2014 equalization system is also overfunding rayons, at the cost of COS and OTH, while allowing the richest jurisdiction in the country –Kyiv– not to contribute to the system at all. This system resembles those of other European countries in which significant percentages of national taxes –most often personal and corporate income taxes-- are shared with local governments on an origin basis.

The first rule is that local governments whose share of Personal Income Tax (PIT) produces less than 90% of the national per capita average are entitled to a Base Grant equal to 80% of the difference between their per capita average and the 90% threshold. Thus, if the national per capita average of PIT is 100 hryvna, a local government whose per capita revenues from these taxes was 70 hryvna would receive an grant equal to 80% of the difference between its per capita level and the 90% threshold (16 hryvna) multiplied by its population ($90 - 70 = 20$, $20 \cdot .8 = 16$).

The second rule “taxes back” money from local governments whose per capita revenue from PIT is higher than the national average –hence, the name “Reverse Grant”. The rule states that local governments whose per capita revenue from shared taxes are greater than 110% of the national average must pay into the system 50% of all revenue above the 110% threshold. Thus, if a local government received 130 hryvna per capita in PIT, it would have to pay a Reverse Grant equal to 10 hryvna multiplied by its population ($130 - 110 = 20$, $20 \cdot .5 = 10$).

In countries with multiple levels of local government, these sorts of rules are typically applied to each level of government independently, particularly when different levels have been assigned different types of shared taxes. In countries that share corporate income tax (CIT) with local governments, it is only shared with regional governments –as is the case in Ukraine. More importantly for our purposes here, the average per capita baselines off which equalization and “claw back” thresholds are set, are typically calculated separately for each level of government because each has different functions, different revenue streams, and therefore different equalization needs.

¹⁹ In most countries, PIT revenues are shared with local governments in accordance with where taxpayers live. In Ukraine, however, they are shared with local governments in accordance with where taxpayers are employed. As a result, jurisdictions that have many residents who commute to work lose significant amounts of PIT revenue but still have to provide public services for these residents and their families. We return to these issues below.

In Ukraine, however only oblasts are treated separately, while Kyiv is treated exceptionally.²⁰ Oblasts are entitled to 10% of the PIT and 15% of the CIT generated on their territories, and the per capita revenue from both is used to determine the oblast baseline for equalization.²¹ Kyiv however is treated exceptionally as the capital of the country and because it performs some oblast functions. It receives a 40% share of PIT and a 10% share of CIT. It also does not contribute to the equalization system.

These rules make Kyiv by far the richest jurisdiction in the country. They also mean that money Kyiv would otherwise contribute to the system has to come from somewhere else, and that its revenues are not used to calculate in the equalization base line for COS, OTH and rayons. As a result, the equalization baseline for COS, OTH and rayons is lower than it would otherwise be, making fewer of them eligible for Base Grants, and more of them obligated to pay Reverse Grants. We return to the exceptional treatment of Kyiv shortly.

Meanwhile, COS, rayons and OTH all receive a 60% share of PIT. Equally importantly, their equalization baseline is calculated together. This lowers the equalization baseline for COS but raises it for rayons and OTH. Chart 5 below, shows the impact of calculating the baseline for the group as a whole

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Chart 5: PIT Per Capita in COS, Rayons and OTH: 2016-2018 (in 2018 hr.)

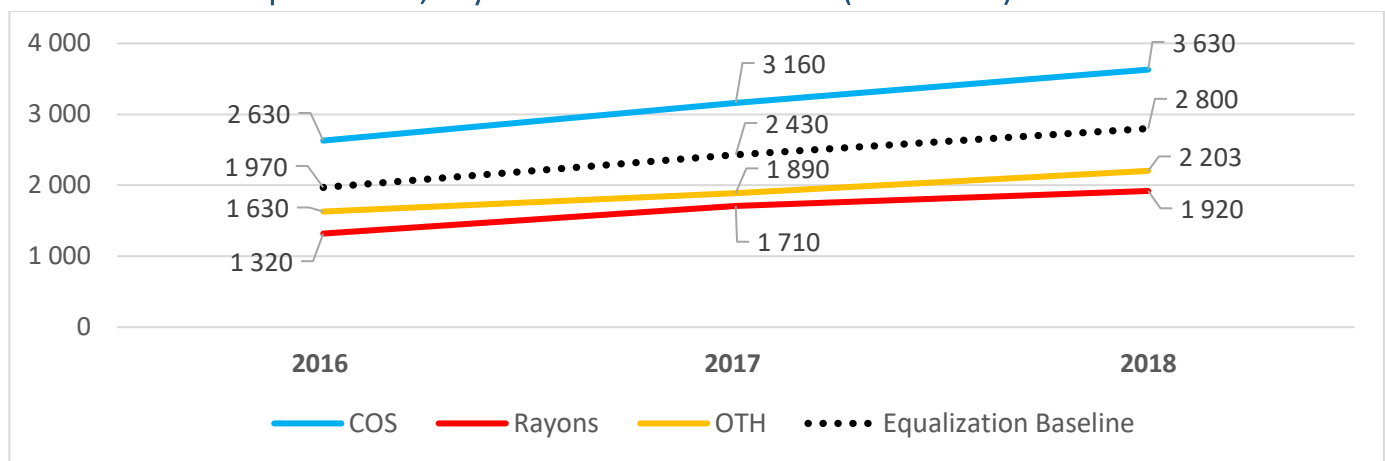


Table 3 below shows the systemic impact of these rules for the entire equalization system between 2016 and 2018. As can be seen from the Table, COS pay the most into the system, while getting almost nothing

²⁰Unamalgamated hromada are also treated differently, but in a specific way: In 2014, they lost their PIT share in 2014 were excluded from the equalization system in order to encourage amalgamation.

²¹ In 2016, 2017, and 2018, these baselines were respectively 600, 710, and 850 hryvna per capita.

out of it: In 2018, 65 COS paid 3.33 billion hryvna in reverse grants, while 52 COS received Base Grants of only 0.65 billion. Meanwhile, rayons paid the least into the system, but got the most out of it: In 2018, 45 rayons paid Reverse Grants worth 0.5 billion hryvna while 356 rayons received Base Grants of 4.35 billion hryvna, well over double what OTH received. Finally, in 2018, 497 OTH, received 1.9 billion in Base Grants while 106 of them paid 0.5 billion in reverse grants.

Table 3: The Equalization System 2016 – 2018 (2018 hr. bn)

	2016					2017					2018				
	Recipients		Payees			Recipients		Payees			Recipients		Payees		
	#	Bln HR	#	Bln HR	Diff	#	Bln HR	#	Bln HR	Diff.	#	Bln HR	#	Bln HR	Diff.
Oblasts	18	1.03	6	0.66	-0.37	17	1.00	5	0.69	-0.31	17	1.04	5	0.73	-0.31
CoS	52	0.41	61	2.77	2.36	53	0.43	63	3.01	2.58	52	0.65	65	3.33	2.68
Rayons	380	4.09	34	0.29	-3.79	368	4.00	38	0.41	-3.60	356	4.35	45	0.50	-3.84
OTH	125	0.36	22	0.08	-0.27	298	0.84	48	0.17	-0.67	497	1.90	106	0.50	-1.40
Total	575	5.88	123	3.81	-2.08	731	6.27	154	4.28	-2.00	922	7.93	221	5.07	-2.86
Cost of Equalization to the National Government					-2.08					-2.00					-2.86
Additional Stabilization Grant					2.49					1.24					0.21

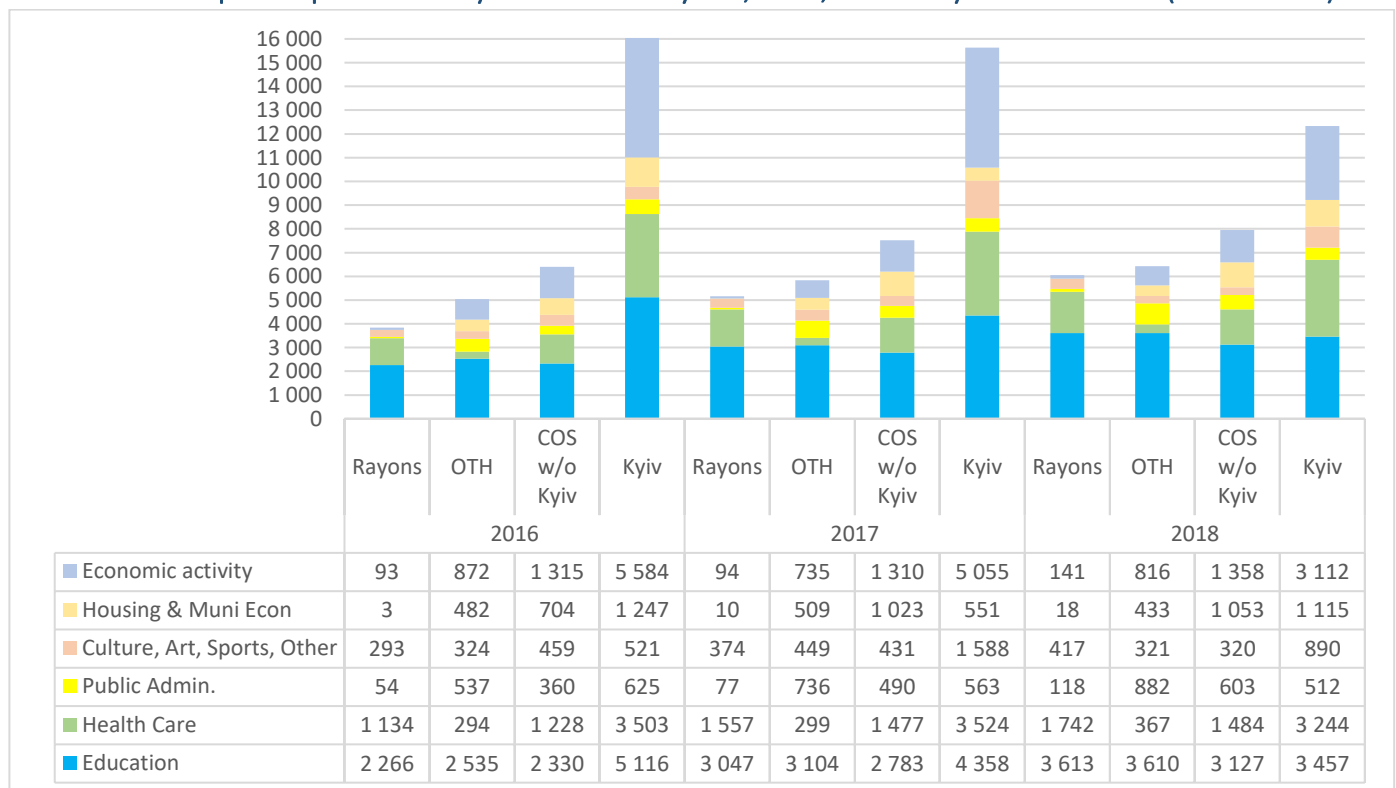
the richest quartile. Moreover, for both OTH and COS, there are far more significant differences between the total revenues of the 2nd and 3rd quartiles to those of the 5th than there are for rayons.

As such, it is fair to say that not only does most of the money in the current equalization system go to rayons (Table 4) but that this money has a much stronger equalization effect on their total revenues than those of either OTH or COS. These results, in turn, are being driven by the fact that a single equalization baseline is being calculated for all three groups, a calculation which assumes that rayons, OTH, and COS all have the same basic responsibilities and thus should be equalized to the same level.

This assumption, while understandable given the progressive nature of the amalgamation process was never true and will be obviously false when all hromada have been transformed into OTH. For starters, rayons -unlike both OTH and COS-- were never responsible for providing basic municipal functions like water supply and sewage treatment, or solid waste collection and disposal. Nor have they ever been responsible for maintaining or improving local public infrastructure like roads and parks. Instead, the unamalgamated hromada under them are responsible for these functions.

This can be seen from Chart 6 below, which shows the per capita expenditure of rayons, OTH, COS, and Kyiv by function between 2016 and 2018 (without social welfare transfers). As can be seen from the chart, rayons spend almost no money in 'Housing and Municipal Economy' or 'Economic Activity', the categories in which expenditures on the responsibilities we have just discussed would be shown. But for both COS and OTH these are significant expenditure categories.

Chart 6: Per Capita Expenditure by Function: Rayons, OTH, COS & Kyiv: 2016-2018 (in 2018 hr.)



Moreover, when the amalgamation process is complete, virtually all rayon education responsibilities will be transferred to OTH. Indeed, the responsibility for contracting primary health care providers passes from rayons to OTH with amalgamation, a process that is already underway and which can be seen by in the growth of per capita health spending by OTH between 2016 and 2018.

Funds devoted to equalization at the rayon level are both excessive and out of sync with the national government's intention to make COS and OTH Ukraine's primary levels of local government. Indeed, the relatively high equalization payments that rayons receive is almost certainly helping some of them resist the amalgamation process.

Indeed, once the amalgamation process is complete and the reform of the health care sector advances, rayons will have only two major public service responsibilities.²³ They will remain the owners of hospitals and responsible for maintaining and improving their equipment and facilities, as well as –importantly— any debts they may incur. But hospitals will finance their operational costs through contracts with the National Health Service and not from transfers from rayon budgets and may eventually be privatized.²⁴ And rayons will be responsible for transferring social welfare payments to the poor, a function which could be transferred to OTH, or as now seems to be the plan, centralized.

What all this suggests is that the funds devoted to equalization at the rayon level are both excessive and out of sync with the national government's intention to make COS and OTH Ukraine's primary levels of local government. Indeed, the relatively high equalization payments that rayons receive is almost certainly helping some of them resist the amalgamation process. Most importantly, as amalgamation moves towards completion, it makes little sense to treat rayons as if they had the same equalization needs as COS and OTH, and to essentially tax wealthier COS to maintain them.

Indeed, on this front, two policy changes suggest themselves: The first is simply that a separate equalization threshold should be set for rayons. And the second is that the national government should commit to fully covering the costs of equalization at the rayon level.

But there are more profound reasons for the national government to critically review the current equalization system and to consider deeper reforms. This point needs to be stressed because over the last few years there has been much talk about eliminating the national government's contribution to the equalization the system by making it “self-balancing,” as well as more recent handwringing about the creation of “deficit OTH.” In other words, there seems to be a feeling in the air that the current equalization system costs too much and should be rolled back.

²³ Important regulatory functions like veterinary and sanitary inspection will likely remain in their hands.

²⁴ Local governments will remain “creditors of last resort” for the hospitals they own. This means that if the National Health Agency underfunds hospital contracts, local governments will be on the hook for their deficits and debts (something that happened repeatedly in Poland during the 2000s). As the new health care system comes online, the funds local governments currently receive through the Health Subvention will be shifted to the NHA to pay for health service contracts.

There is little reason to believe that the current system is overfunded. At the same time, there are good reasons to think that some of the money currently being allocated to local governments through discretionary grants would be better spent by making the equalization system more robust. At a minimum, this would increase the share of revenues that poorer local governments could count on every year, a predictability that would among other things improve their capacity to plan and absorb whatever investment grants they may eventually receive.

For many reasons, we believe this is precisely the wrong way to think about how the equalization system should be reformed. For starters, the current system is actually very small: In 2018, 922 local governments received equalization payments of 7.9 billion hryvna (see Table 3), less than 1.5% of the total revenue in the intergovernmental finance system. Moreover, of the 8 billion hryvna in Base Grants made in 2018, 5 billion (63%) were paid for by wealthier local governments, meaning overwhelmingly COS whose PIT revenues were over 110% of the national average. Indeed, the national government contributed only 2.9 billion to the system (including ad hoc stabilization grants), a sum equal to about 7% of the 43 billion hryvna it paid out in discretionary grants in 2018.

Thus, there is little reason to believe that the current system is overfunded. At the same time, there are good reasons to think that some of the money currently being allocated to local governments through discretionary grants would be better spent by making the equalization system more robust. At a minimum, this would increase the share of revenues that poorer local governments could count on every year, a predictability that would among other things improve their capacity to plan and absorb whatever investment grants they may eventually receive.

Most importantly, the need for equalization funds will increase as the amalgamation process comes to an end. As can be seen from Table 3, the sum of Base Grants going to OTH has risen every year and it would be foolish to think that this will change as the process near completion. In short, it is critically important to recognize that most OTH will need equalization payments simply because most small-town and rural Ukraine is extremely poor. Or put another way, no amount of creative boundary drawing will make “self-sufficient OTH” out of dirt-poor rural areas.

This is not to say there aren’t better and worse ways to determine the boundaries of OTH. But it is to say that it is unreasonable to expect that better boundaries alone will radically increase the number of OTH that will be able to survive without Base Grants. Indeed, if the primary objective of the reforms is to create a viable first level of public administration in Ukraine’s rural areas, it is more desirable to create fiscally weak OTH, than it is to create OTH that do not have enough children to run at least a couple reasonably sized schools. In short, we think the government would do well to count on the need to put more money into the system as amalgamation processes continues.

Last, but not least we think that the national government should not only contribute more to the system, but to consider forcing Kyiv to also pay into it. From a strictly technical point of view, there is no good reason to exempt the city from making contributions: Yes, Kyiv is both an oblast and a capital city whose services are important to the whole country. And yes, there may well be reasons to treat Kyiv exceptionally.

But under the current rules, Kyiv is still by far the richest jurisdiction in the country: In 2018, its 40% PIT share yielded almost double the per capita revenue (c. 5,000 hr. per capita) of what the 60% PIT share yielded for all other COS (c. 2,700 hr. per capita)²⁵ while its 10% CIT share gave it another 1000 hryvna per capita that other COS don't receive. Indeed, Kyiv's CIT share alone yielded about 40% more in per capita revenue than the average that all other oblasts earned from their combined PIT and CIT.

And while Kyiv should contribute to the system, we also think that the current rule that taxes back 50% of all PIT revenue above the 110% threshold is both too sharp for local governments of moderate wealth, and too flat for the exceptionally well endowed. Ukraine needs its moderately wealthy cities and towns to function as growth centers, and taxing back 50% of their PIT revenues over a rather low threshold works against this purpose. At the same time, Ukraine has a small number of local governments with exceptionally strong tax bases who might well be asked to contribute a higher share of the PIT revenues they earn above some higher threshold value.

Kyiv is still by far the richest jurisdiction in the country and should contribute to the equalization system.

We are suggesting introducing a progressive system of equalization taxation in which local governments of moderate wealth would pay less into the system than they currently do, while local governments of extraordinary wealth might pay somewhat more.

Here, in other words we are suggesting introducing a progressive system of equalization taxation in which local governments of moderate wealth would pay less into the system than they currently do, while local governments of extraordinary wealth might pay somewhat more. But again, the object of the exercise should not be to make the system self-balancing. Instead, the purpose should be to find a more dynamic balance between providing reasonable equalization payments to poorer local governments, taxing richer ones, and having the national government fill the gap between the two, something it can easily afford to do by moving some discretionary funding into the equalization system.

V. Own Revenue Trends

Chart 7 and Chart 8 (below) show the composition of local revenue by level of government as a share of total revenue and in per capita terms. Taken together, the charts show that the revenue structures of COS and OTH are converging. Because a number of recently formed OTH took over primary care hospitals, they –like COS-- began to receive the subvention for health care, something that was not the case in previous years.²⁶ But looking ahead, these revenues will shrink across all local budgets in 2020 as the National Health Service enters into direct service contracts with hospitals.

²⁵ This is possible not just because employment rates and average wages are much higher in Kyiv than elsewhere, but because PIT is allocated back to local governments based on employees' place of work, not their place of residence. Thus, urban centers get the PIT shares of workers who commute to work, while the surrounding areas must pay for public services for people who live there, but whose PIT share they don't receive.

²⁶ OTH expenditures on health in 2017 were 272 hr. pc in 2018 hr. See Levitas & Djikic (2018) Chart 9. p. 31.

Chart 7: Composition of Local Government Revenue in 2018

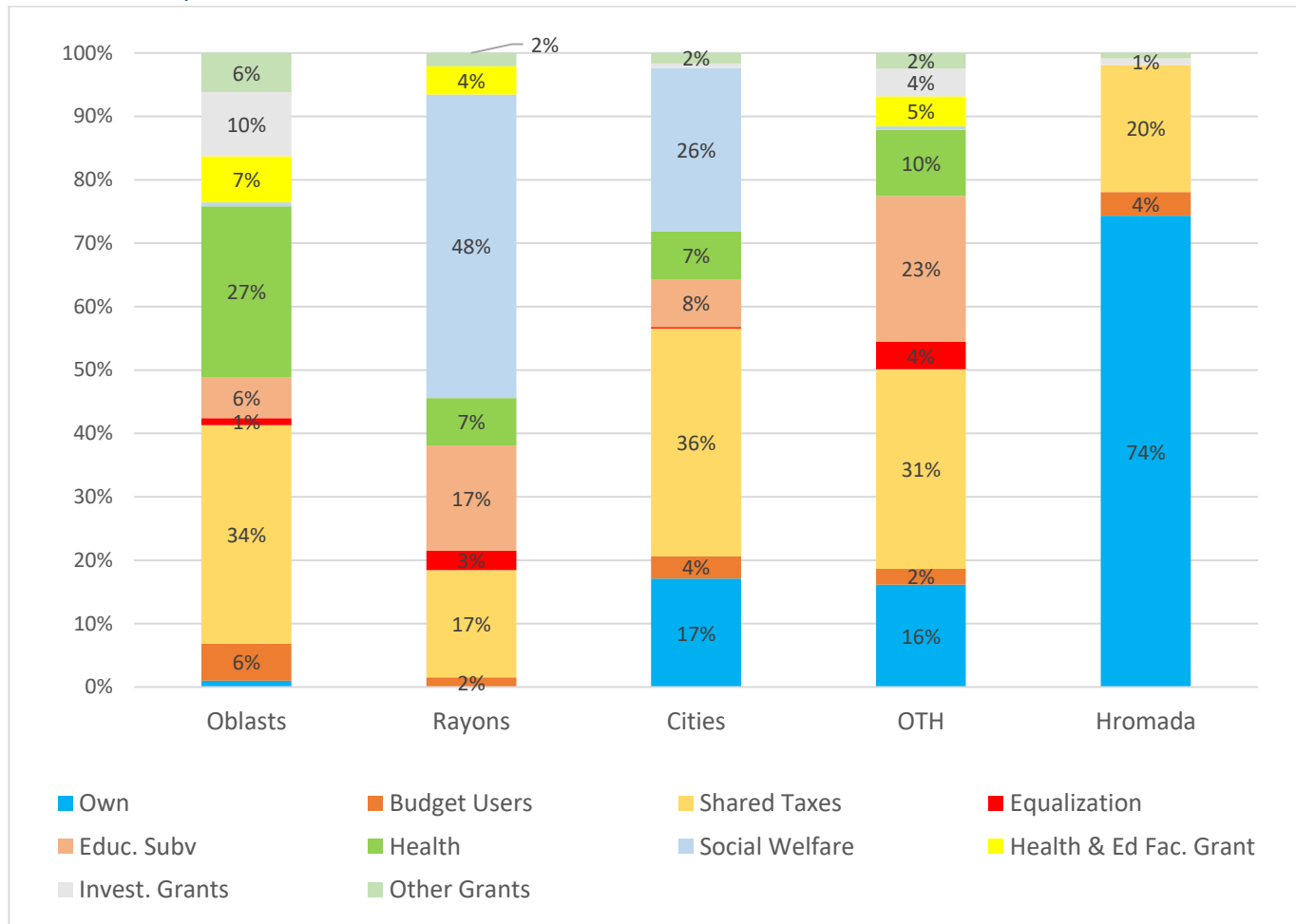
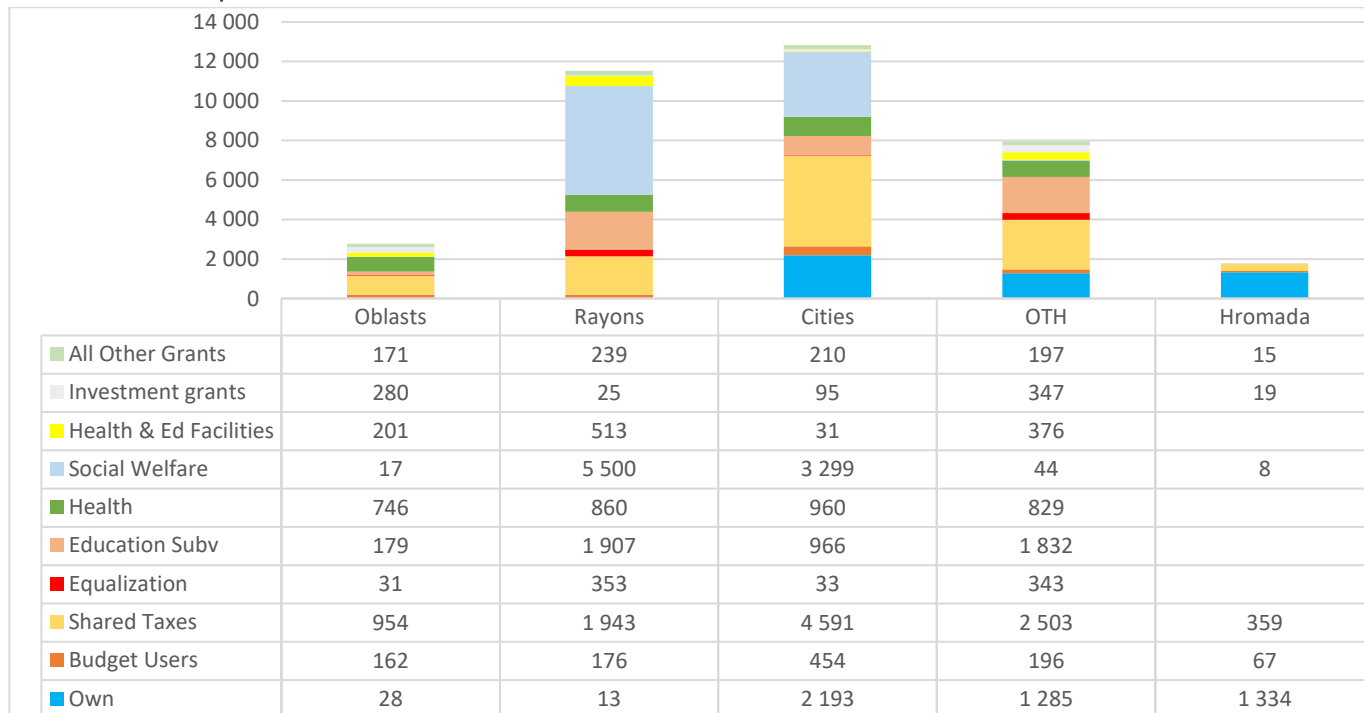


Chart 8: Per Capita Local Government Revenue in 2018



Similarly, if the payment of the social welfare transfers that currently constitute 26% of COS and 48% of rayon budgets were centralized, the revenue structures of COS and OTH would converge further, while rayons would lose their single largest function. It is also worth noting that equalization payments are only significant for rayons and OTH, and the rayons and oblast derive almost no revenue from own sources.

Chart 9 (below) shows the per capita own revenues of Kyiv, all other COS, OTH and unamalgamated hromada. The big jump in own revenues between 2015 and 2016 was driven by the increased rate authority that the GoU gave local governments over the so-called Single Tax, a tax which is imposed on the self-employed, collected by the national government and paid in lieu of PIT²⁷. As we shall see in a moment, the Single Tax is the most important own revenue for all levels of local government and generates about 50% of the own revenues of Kyiv, COS, OTH and unamalgamated hromada.

Chart 9: Own Revenue Per Capita by Level of Government 2015-2018 (2018 hr.)

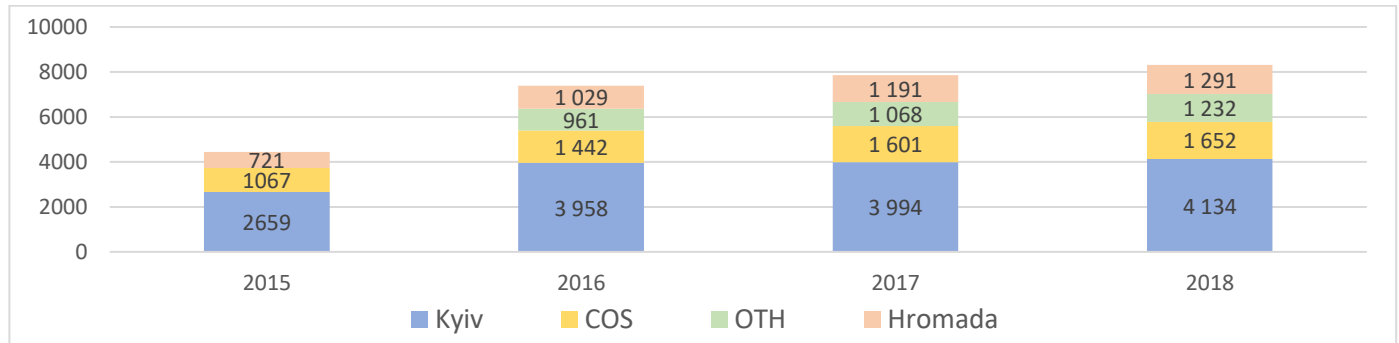


Table 5 (below) shows the percentage growth of own revenues by level of government since 2016. As can be seen from the Table, own revenues have increased least over the entire period in Kyiv, and most in OTH and unamalgamated hromada. Kyiv, it seems, is making relatively little effort to increase its collection of own revenue, while the improved collection is most pronounced among OTH and unamalgamated hromada.

Own revenues have increased least over the entire period in Kyiv, and most in OTH and unamalgamated hromadas.

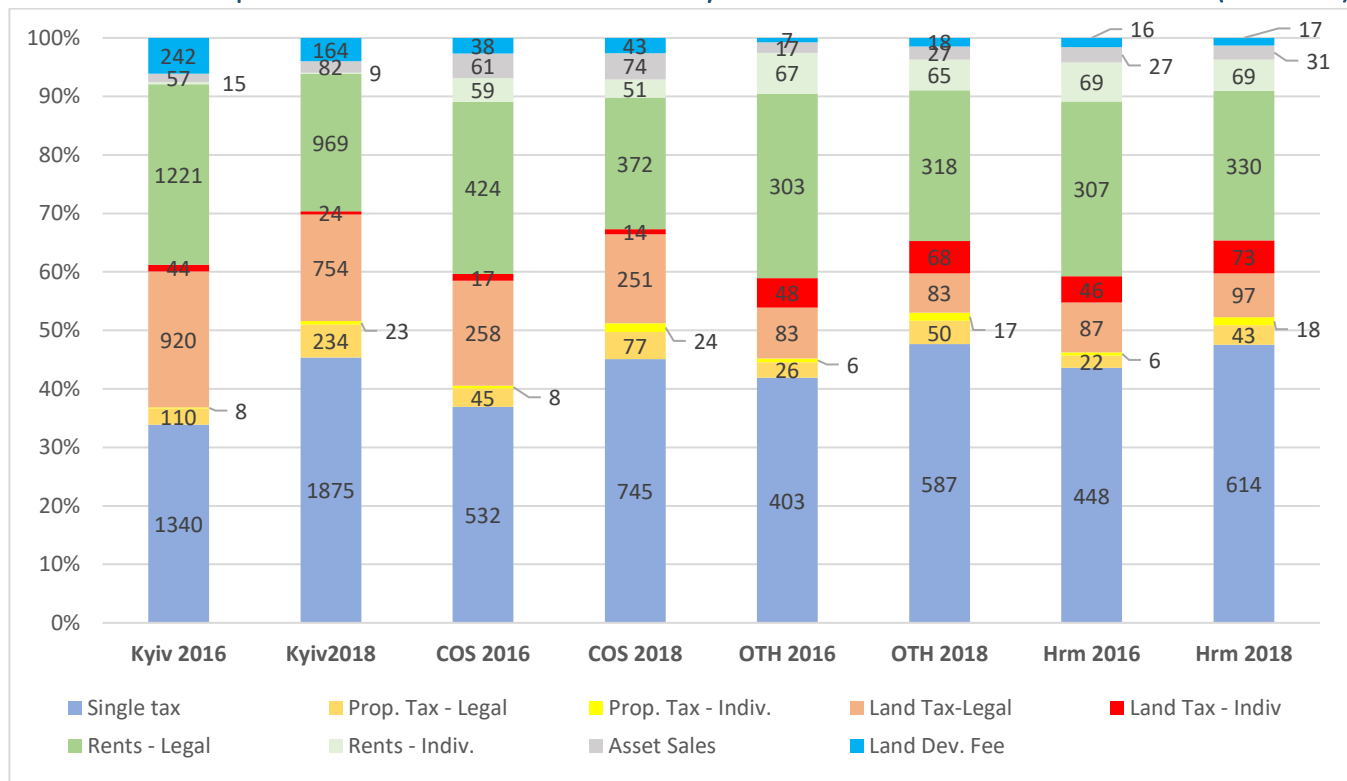
Table 5: Per Capita Growth of Own Revenues by Level of Government: 2016-2018 (in 2018 hr.)

	2017/ 2016	2018/ 2017	2018/ 2016
Kyiv	1%	4%	4%
COS	11%	3%	15%
OTH	11%	15%	28%
Hromada	16%	8%	26%
All	6%	6%	12%

²⁷Three groups of the self-employed pay the Single Tax. Professional consultants –group 3- pay at a rate defined by the national government. But for groups 1 & 2, local governments have the right to set the rate within limits. For group 1 the rate can be up to 10% of the minimum wage. For group the rate can be up to 20% of the minimum wage.

Chart 10 (below) presents the per capita structure of own revenues for Kyiv, COS, OTH and hromada in 2016 and 2018. It helps clarify what is and isn't driving the overall growth of own revenues at different levels of government. As can be seen from the table, in Kyiv revenues from the Single Tax increased from 1,350 to 1,875 hr. pc (40%) while revenues from the Property Tax on Legal entities more the doubled, rising from 110 hr. per capita to 234 hr. per capita.

Chart 10: Per Capita Structure of Own Revenues by Level of Government 2016 & 2018 (2018 hr.)



At the same time however, the yield of both the Land Tax and Rents from Legal Entities fell respectively, from 920 to 724 hr. pc (-18%) and from 1220 to 970 hr. pc (-21%). Land Tax and Rents from legal entities also fell in COS, but only by -3% and -12%. At the same time, however Land Tax revenue from legal entities in OTH increased, albeit marginally, while rental revenue from grew 5%, while both categories of revenue rose more significantly in hromada (11% & 7% respectively).

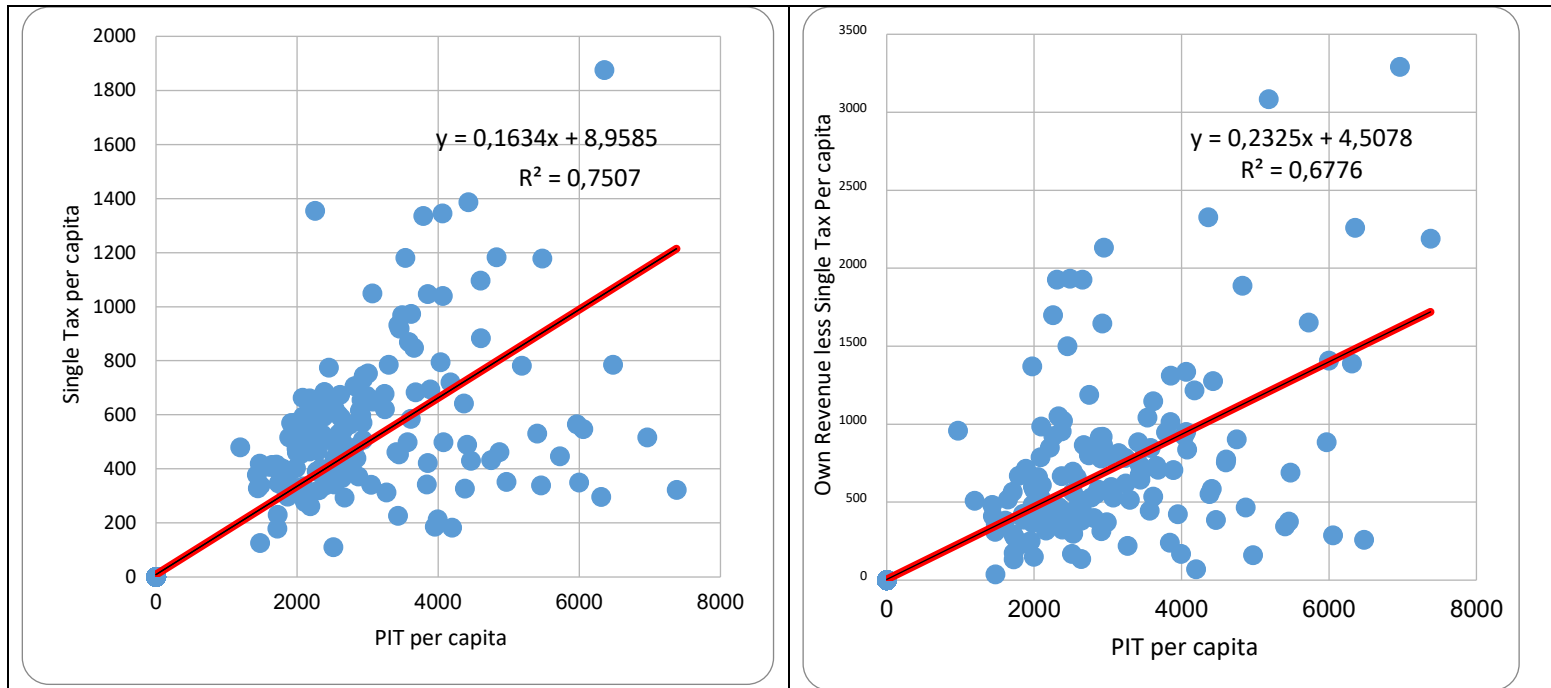
In short, it seems fair to say that Kyiv has made relatively little effort to improve the collection of its own revenues beyond the Single Tax and the Property Tax on Legal entities, and that OTH, hromada and even COS have done a better job ensuring that the value of their Land Tax and rental revenue from legal entities has kept up with, or exceeded inflation. OTH and hromada are also clearly doing a better job of increasing the collection the Land Tax on Individuals, and of collecting rents from Individuals, revenue categories that fell in both Kyiv and COS between 2016 and 2018. Finally, collection of the Property Tax on Individuals continued to grow for all levels of government, but everywhere remains in its infancy.

Chart 11 (below) plots per capita PIT revenue against per capita revenue from the Single Tax while Chart 12 plots per capita PIT against per capita revenue from all other own revenues (Property Taxes, Land

Taxes, Rents, Asset Sales and the land development fee²⁸) in 148 COS (without Kyiv). The trend lines in the charts shows the expected value of the Single Tax and Other Own Revenues of COS given the relative strength of their tax bases as measured by PIT per capita.

As can be seen from the Charts, both Single Tax and Other Own Revenues per capita increase as PIT per capita increases. This is what one would expect, since local governments that have wealthier tax bases as measured by PIT should find it easier to impose and collect more significant revenues from the Single Tax and Other Own Revenues. Chart 11 suggests that for every 2000 hryvna in PIT per capita that COS receive they should collect about 400 hryvna per capita in the Single Tax, while Chart 12 suggests that for every 2000 hryvna in PIT they receive they should collect about 500 hryvna per capita in revenue from other Own Revenue.

Charts 11 & 12: Single Tax and Other Own Revenue per capita vs PIT per capita in COS (2018)



But what is interesting, is the number of COS that fall significantly above and below the trend lines in both Charts. Those that fall below the trend lines are collecting less Single Tax and Other Own Revenues than might be expected, given their relative wealth –as measured by PIT per capita, the best single measure we have-- while those that fall above the trend lines are collecting more Single Tax and Other Own Revenue than might be expected, again given their relative wealth.

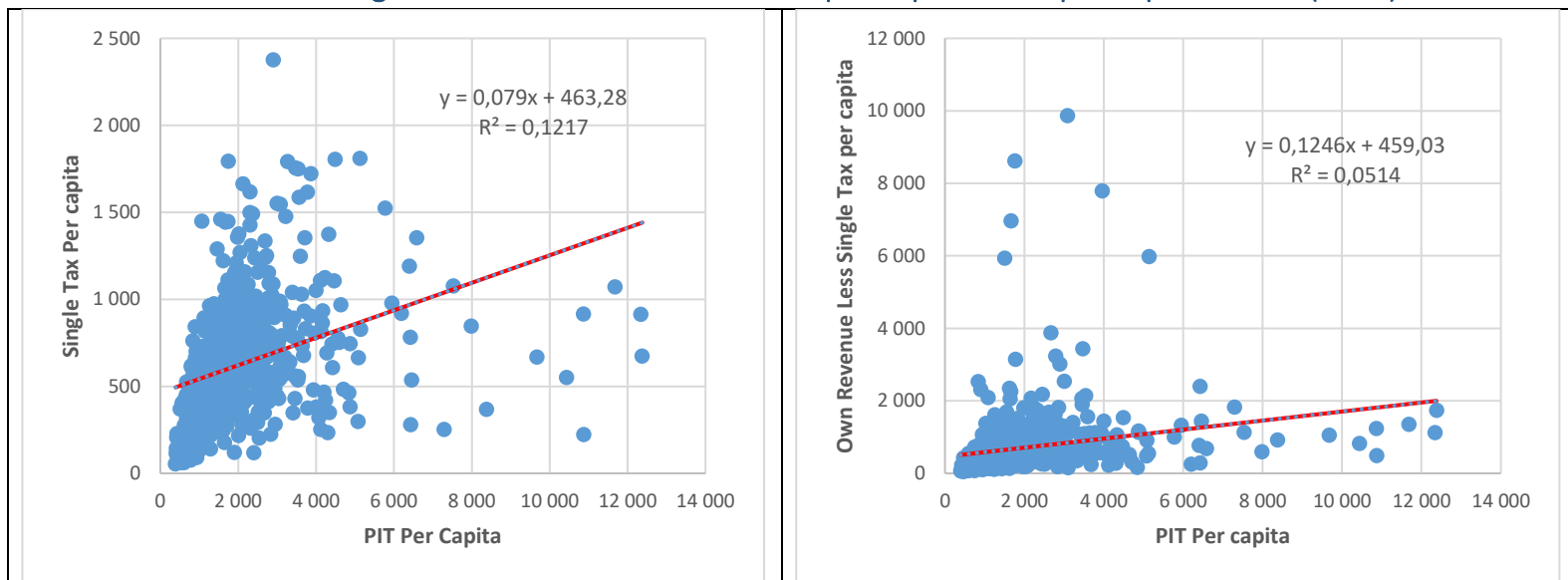
Some of the variation above and below the trend lines is undoubtedly being driven by objective differences in the tax bases of COS. For example, some COS may have unusually high or low numbers of self-employed professionals, generating higher or lower Single Tax revenues than might otherwise be expected. Similarly, some COS may have land that generates high rental income while others may own few assets capable of producing rents.

²⁸ We have excluded the (often substantial) own-revenues of COS budget users because while local governments have control over the level of these fees and charges, they do not flow into their general budgets but are instead retained by the unit of local government empowered to levy and collect them.

Nonetheless the variation above and below the trend lines in these graphs strongly suggests that there are significant differences in the own revenue policies of COS and that some are expending considerable effort to collect their own revenues, while others are less willing to exercise their tax powers. In short, there are many COS that could improve their financial positions by using their tax powers more.

Charts 12 and 13 (below) present the same data for 661 out of the 666 OTH that operated as independent local government in 2018. Four outlying OTH that have PIT revenues above 12,500 hryvna have been eliminated from both charts because including them would radically extend the charts' horizontal axes, distorting their scales. One outlying OTH has been eliminated from the Chart 14 because it has Other Own Revenues greater than 12,000 hryvna per capita and would similarly distort the scale of the chart by radically extending its vertical axis. In both cases however, the data from these excluded OTH have been used in the calculation of trend lines.

Charts 13 & 14: Single Tax and Other Own Revenue per capita vs PIT per capita in OTH (2018)



As can be seen from Chart 13, even after removing the four OTH with PIT revenue above 12,500 hryvna per capita, there are still 11 others whose PIT revenue exceeds 7,000 hryvna per capita, a level obtained by only one COS (Chart 10). Indeed, all 15 of these OTH have per capita PIT levels that range between 2.5 and 7 times the equalization baseline in 2018 (2,800 hr. per capita., Chart 5).

Moreover, 14 of the 15 OTH with exceptionally high levels of PIT per capita, collect much less in both the Single Tax and Other Own Revenue than their relative wealth suggests they should. This is unlike other COS and OTH who have higher than average PIT --say between 4000 and 6000 hryvna per capita—but who are not 'norm busters:' Among these jurisdictions, about half overperform and half underperform relative to expectations with respect to the collection of the Single Tax and Other Own Revenue. In short, this small number of exceptionally well off OTH are also exceptionally uninterested in collecting own revenue.²⁹

²⁹ The low per capita revenue from the Single Tax of these high flying OTH is also responsible for pulling the starting point of the trend line away from zero: Thus, despite the fact that it is clear from the density of scatter points in the left hand side of Chart 13, that like COS, OTH with very low PIT revenues can expect very low revenues from the Single Tax, the trend line suggests otherwise.

While understandable, this behavior is perverse from a systemic point of view. But the more interesting question is how this small group of extremely rich OTH –OTH whose PIT per capita exceeds those of the richest COS-- came to be. And the answer is simply that they made themselves that way: These are OTH that were intentionally formed around a strong employment base, and whose architects did not allow (or made no effort) to include the rural areas around them³⁰.

Indeed, Chart 14 raises similar issues in a more curious way. Here, we see six OTH with Other Own Revenue above 6000 hryvna per capita. A seventh, whose Other Own Revenue is above 12,500 hryvna per capita has already been excluded from this chart as noted above. These levels of Other Own Revenue are well over 2000 hryvna per capita higher than the maximum value achieved by any COS and are truly exceptional. Moreover, four of the OTH with norm busting levels of Other Own Revenue per capita (including the one not represented on the Chart) have low or very low levels of per capita PIT, meaning they violate the expected relationship between higher levels of PIT and –all things being equal–higher levels of own revenue.

In most of these OTH, their high levels of Other Own Revenue are being driven by exceptionally high income from the Land tax on Legal Entities and/or from Rental Income from Legal entities. What this suggests is that these OTH –like the ones with exceptionally high PIT revenues–have been very consciously created around a specific set of assets. In this case, however, the assets are almost certainly large agriculture firms instead of industrial ones.

But the key point, is that there are at least 20 OTH (3.3% of the 666 operating in 2018) that seem to have been very intentionally constructed around assets that were known to yield very high public revenues, and whose construction excluded poorer areas that –at least from a systemic point of view–should have been amalgamated with them. What this suggests is that in the effort to complete the amalgamation process the national government should not allow the formation of OTH that will immediately have exceptionally high per capita revenues from either PIT or from land related own revenues.

This policy position is somewhat counterintuitive if one is convinced that the main objective of amalgamation is to create fiscally self-sufficient OTH. Instead, the policy objective should be to create as *only as many fiscally self-sufficient OTH as is possible*. Such a policy would require exceptionally well endowed hromada to amalgamate with enough of the poorer areas around them so that the resulting OTH was of average or slightly above average wealth.

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But with that said, it is again worth looking at the charts above: While there are only a handful of COS that have PIT revenues less than 2000 hryvna per capita, the vast majority of OTH are clustered around or

³⁰ It is also possible that surrounding rural areas may choose not to join with more urbanized hromada for fear of losing political influence within the new jurisdiction. See Levitas and Djikic “Caught Mid-Stream: “Decentralization,” Local Government Finance Reform, and the Restructuring of Ukraine’s Public Sector 2014 to 2016” (SKL/SIDA 2017) pp.3-4

below this threshold. Indeed, more than 260 of them (40%) have PIT revenues of 1500 hryvna per capita or below.

Moreover, the number of these poorer OTH (though not necessarily their share) can be expected to grow as the amalgamation process is completed. So, while efforts should be made to prevent the formation of super rich OTH whose very construction will increase the number of the very poor, it is unrealistic to think that most OTH can be made fiscally self-sufficient. In short, the equalization system will have to be expanded if large numbers of OTH are to be expected to provide the public services they have been assigned at a reasonable level.

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IV: Trends in Investment and Education Spending

The single most reliable indicator of the relative financial position of local governments is the share of investment spending in their total expenditures. In short, local governments that can devote a high share of their expenditures on investment are clearly better off than those who cannot. Table 6 (below) presents the investment spending of Kyiv, all other COS, and all OTH in billions of 2018 hryvna, as a share of total expenditure without Social Welfare Transfers³¹, and in per capita terms between 2016 and 2018. As can be seen from the table, Kyiv has done extremely well over the last three years: It has been able to increase the share of its investment spending from 33% to 40% of its total expenditures, while increasing per capita investment from 4,000 to 6,700 hryvna. It is also worth noting that the total investment spending of the Capital City (19.6 bn hr.) in 2018 –where 7.5% of the country’s population lives—was equal to 64% of the total investment spending of COS (30.86 bn hr.) –where 45% of the country’s population lives.

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³¹ Social Welfare Transfers have been eliminated because local governments have little control over these funds. Because OTH are not responsible for making these transfers, the elimination also brings the basic structure of their budgets more in line with those of COS and Kyiv, and thus serves to standardize the indicator “Investment as a share of total expenditure” across types of local government.

Table 6: Investment by Kyiv, COS, and OTH 2016 – 2018 (bn 2019 hr.)

	Kyiv			COS			OTH		
	Bn. Hr.	% of Total Expend (w/o Soc. Wel.)	Per Capita	Bn. Hr.	% of Total Expend (w/o Soc. Wel.)	Per Capita	Bn. Hr.	% of Total Expend (w/o Soc. Wel.)	Per Capita
2016	11.86	33%	4,080	28.44	26%	1,640	2.36	33%	1,702
2017	16.81	37%	5,784	31.03	24%	1,793	4.58	26%	1,465
2018	19.63	40%	6,711	30.86	23%	1,793	6.90	19%	1,229

Meanwhile, investment spending as a share of total expenditures has fallen in both COS and OTH since 2016. In COS, investment spending remains above 20% of total expenditure, and has not declined in per capita terms. Nonetheless, per capita investment spending in COS was equal to only 27% of that of Kyiv. The trend in OTH is more problematic.

In 2016, newly formed OTH were able to devote a third of their spending to investment. This is a very healthy level but was driven primarily by the investment grants that the national government provided to incentivize amalgamation. By 2017, however, the value of these investment grants clearly deteriorated in relation to the number of new OTH that were formed, a trend that continued in 2018. As a result, investment spending by OTH has dipped below 20% of total spending and fallen by almost 30% in per capita terms (from 1,700 to 1,220 hr. pc.) In short, it should be clear that the ability of both COS and OTH to make investments did not improve in 2017 and 2018, despite the fact that it was in these years that the GoU most significantly increased the overall funds in the intergovernmental finance system.

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Tables 7 (below) presents select indicators on COS organized in quintiles based on their relative wealth as measure by their per capita PIT revenues. The 1st quintile contains the poorest COS, while the 5th contains the richest. Social Welfare Transfers have been subtracted from total expenditures because local governments have little control over these funds and Wages have been combined with Other Operating Costs in order to standardize these expenditures across the period.³² The first column for each period contains the percentage of the total urban population living in each quintile as well as Kyiv, and the last column for each period contains the relationship of total revenues per capita in each quintile to the 5th quintile.

³² As discussed earlier, in 2017 the GoU required that wages expenditures in Health be reported as other Operating Costs in anticipation of the contract for service payment system that will be introduced with reforms in the sector.

Table 7: Expenditure Indicators for COS in Quintiles Organized by Relative Wealth 2016 & 2018

	2016							2018						
	% of Pop.	Wages & Other Operat. Costs pc	Wages & Other Operat. % of Total	Invest pc	Invest % of Total	Total pc	Total as % of 5th Q	% of Pop.	Wages & Other Operat. Costs pc	Wages & Other Operat. % of Total	Invest pc	Invest % of Total	Total PC	Total as % of 5th Q
1st Quintile	6%	3,479	74%	558	12%	4,718	61%	8%	4,483	77%	626	11%	5,801	61%
2nd Quintile	9%	3,639	71%	795	15%	5,146	66%	9%	5,043	74%	925	14%	6,820	71%
3rd Quintile	12%	3,764	67%	1,044	19%	5,604	72%	10%	5,189	72%	1,170	16%	7,221	76%
4th Quintile	37%	3,640	57%	1,774	28%	6,439	83%	36%	4,856	59%	1,942	24%	8,203	86%
5th Quintile	22%	4,156	54%	2,411	31%	7,742	100%	23%	5,516	58%	2,561	27%	9,554	100%
Kyiv	14%	5,583	44%	4,080	32%	12,565	162%	15%	8,118	48%	6,711	39%	17,085	179%
Total	100%	4,035	55%	1,990	27%	7,274	94%	100%	5,501	59%	2,507	27%	9,395	98%

As can be seen from this last column, the relative position of the poorest quintile of COS to the richest has remained stable between 2016 and 2018, while the relative positions of 2nd, 3rd, and 4th quintiles have improved. This is good news and suggests that the equalization system has put a floor under the total revenues of the poorest quintiles of COS.

The other indicators in the table however are less positive. For starters, it is worth noting that percentage of the total urban population living in the poorest quintile of COS increased from 6% to 8% between 2016 and 2018. More importantly for our purpose here is that wages and other operating costs as a percentage of total expenditures has increased for all quintiles, as well as for Kyiv. The growth of this spending as a share of total expenditure has been driven by the substantial increase in the national minimum wage introduced by the GoU in 2017 and discussed earlier.

The rising share of wage and other operating costs in COS budgets has clearly led—with the exception of Kyiv—to a decline in investment rates. This decline has been steepest in the 4th and 5th quintiles, though here investment remains close to or above 25%, a reasonably healthy level. More disturbing, is the fall in investment rates in the first three quintiles, which are now all at 16% or below. Moreover, not only are the investment rates low, but the per capita value of investment spending is radically different between the first three quintiles and the last two, with the 4th quintile spending almost 66% more than 3rd, 100% more than the 2nd and 3 times that of the 1st.

At a minimum, and taken together, these indicators suggest again that Kyiv is overfunded, that greater effort should be made to direct investment grants to poorer COS and the serious consideration should be given to strengthening the equalization system.

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Table 8 (below) looks at a similar set of indicators for OTH for the years 2016, 2017, and 2018. Here, however we include the population numbers for each year in order to track the increase in the number of people living in OTH, as well as the share of those living in richer and poorer OTH. As can be seen from the

Table, the share of the total population living in the two poorest quintiles has increased by 4% since 2016, while those living in the richest quintile has declined by 5%. Whether this trend will continue is hard to say, but it does suggest that richer hromada choose to amalgamate first, and that as time goes on the share of poorer OTH will continue to rise.

Table 8: Expenditure Indicators for OTH in Quintiles Organized by Relative Wealth 2016 & 2018

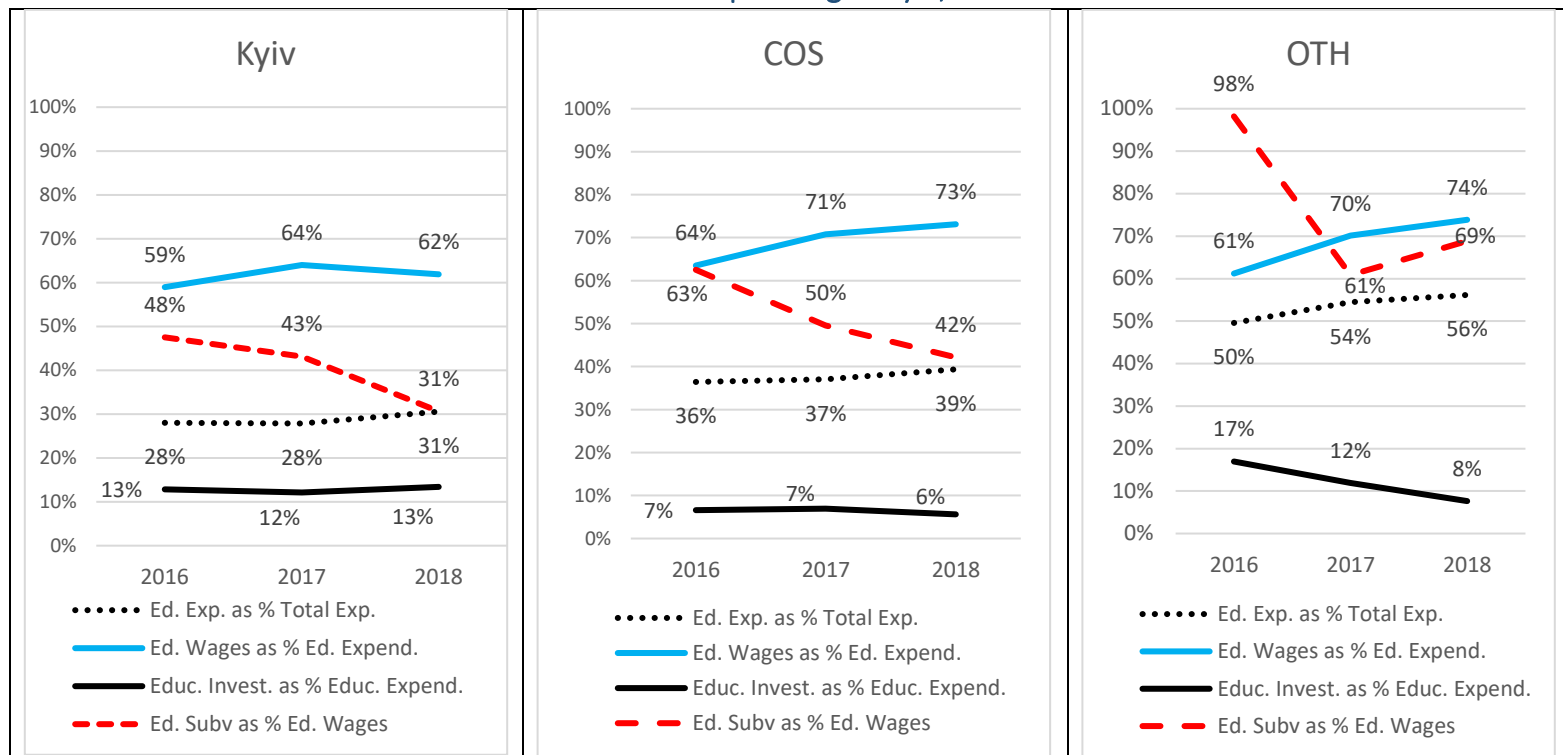
	2016						2017						2018					
	Pop.	% of Pop.	Invest pc	Invest % of Total	Total pc	Total as % of 5th Q	Pop.	% of Pop.	Invest pc	Invest % of Total	Total pc	Total as % of 5th Q	Pop.	% of Pop.	Invest pc	Invest % of Total	Total PC	Total as % of 5th Q
1st Q	0.20	15%	1,308	30%	4,316	61%	0.48	15%	1,004	21%	4,866	62%	0.96	17%	822	16%	5,210	63%
2nd Q	0.23	17%	1,376	31%	4,480	64%	0.56	18%	1,241	23%	5,403	69%	1.08	19%	991	17%	5,985	72%
3rd Q	0.32	23%	1,487	30%	4,890	69%	0.72	23%	1,206	21%	5,715	73%	1.26	22%	1,042	16%	6,315	76%
4th Q	0.29	21%	1,528	29%	5,281	75%	0.71	23%	1,264	22%	5,798	74%	1.19	21%	1,268	18%	6,930	84%
5th Q	0.34	25%	2,504	36%	7,050	100%	0.65	21%	2,516	32%	7,868	100%	1.12	20%	1,981	24%	8,268	100%
Total	1.39	100%	1,702	32%	5,350	76%	3.12	100%	1,465	24%	5,992	76%	5.61	100%	1,229	19%	6,581	80%

That said, the equalization system also seems to be working reasonably well, at least with respect to preventing the widening of disparities between richer and poorer OTH. Indeed, and is the case with COS, these disparities have narrowed significantly since 2016. At the same time, however, and as with COS both investment rates and investment per capita have fallen significantly: In 2018, only the richest quintile of OTH had an investment rate above 20% and investment per capita had declined substantially for all quintiles.

The precipitous decline in OTH investment spending is in large part due to exceptionally large investment grants that were provided to incentivize the amalgamation process in 2016. The value of these grants however, fell substantially in 2017 and 2018 as more OTH were formed. Moreover, the 2017 increase in the minimum wage reduced –as it did for COS–the freely disposable revenue available to OTH, further driving down their investment spending.

Charts 15, 16 and 17 below present select indicators on education spending in Kyiv, COS and OTH between 2016 and 2018. The indicators must be treated with caution because while all three types of local governments are responsible for education, the nature of these functions differ in practice, as do the general composition of their total expenditures. For example, Kyiv and COS both receive more in the Health Subvention than do OTH and correspondingly spend a greater share of their budgets on health care. Indeed, this is probably the single biggest reason that education spending constitutes a significantly smaller share of their total expenditures than it does in OTH.

Charts 15-17: Select Indicators of Education Spending in Kyiv, COS and OTH 2016-2018



Similarly, Kyiv and at least some COS spend money on functions within education that don't exist at the OTH level or which are much less common. For example, Kyiv pays for some university education, and both Kyiv and COS more frequently support teacher training and preschool education than is the case in OTH. These additional wage expenditures are not covered by the education block grant, which is designed to support only the wages of secondary school teachers.³³ As a result, the share of education wage spending covered by the education subvention is significantly lower in COS and Kyiv than it is in OTH. Finally, the 2016 data for OTH on the education subvention as a percentage of education wage spending is suspect, probably because at least some OTH received the subvention but had yet to take over the payment of teachers wages from rayons.

Despite these problems in interpreting some of the data, the Charts below are still important because they show similar trends across all types of local governments. Irrespective of their different budget structures, education spending as a share of total budget expenditure has increased in Kyiv, COS and OTH since 2016. And while education wage spending as a percentage of total education expenditure has increased only slightly in Kyiv since 2016, it has risen quite significantly in COS and OTH and now stands at close to 75% in both.

Meanwhile, investment spending as a share of education expenditure has held stable in Kyiv but fallen in COS and declined more dramatically in OTH. Finally, and probably most importantly, the share of wage spending covered by the education subvention has fallen significantly in both Kyiv and COS, though less so in OTH because they provide less educational functions whose wage costs are not included in the subvention.

³³ Unlike in most countries, secondary school education in Ukraine covers all grades from 1-12.

Nonetheless the main point is that most of the trends lines in these graphs are being driven by the 13% increase in the minimum wage in 2017. This increase affected the wages of most public sector workers – including teachers-- because the minimum wage is used to calculate their base pay. The rise in public sector wages in turn significantly increased the operating costs of local governments in general, and the wage costs of education in particular.

Luckily, some of these rising labor costs were compensated by the fact that the hike in the minimum wage also increase the yield of local government PIT shares. But the compensation was only partial and the overall effect in education -and more generally-- was that rising wage costs crowded out investment spending. In short, the increase of the minimum wage effectively created an unfunded mandate in the education sector which should have been accompanied by an increase in the education subvention but was not.

VI. Conclusions and Recommendations

Since 2014, Ukraine has taken major steps to restructure its local governments and to reform its intergovernmental finance system. Fifty-four percent of the rural population now live in OTH that should be large enough to manage network infrastructure and their school systems. The national government has also done a remarkable job providing resources to local governments despite war and recession.

The 2014 intergovernmental finance reforms also replaced a complicated and non-transparent equalization system with separate block grants for education and health, and a smaller, but clearly calculated revenue equalization grant. The block grants have helped clarify responsibilities in health and education, while the new more efficient and transparent equalization grant has prevented the emergence of radical fiscal disparities among local governments. These reforms also significantly expanded the tax powers of COS, hromada, and OTH and collectively their own revenues grew from 42 to 69 billion hryvna (64%) between 2014 & 2018.

In 2016, the Ministry of Education introduced a new formula to allocate the Education Block Grant which clearly signaled that the maintenance and improvement of school facilities was now to be consider a local government own function, helping to clarify responsibilities in the sector. In the same year, the GoU also adopted legislation mandating the creation of a single-payer health care system, legislation holds that holds the promise of ultimately reducing local governments' financial responsibilities in the sector. Local governments have also rapidly begun to contract out primary health care services with doctors and ambulatory clinics.

Perhaps most importantly, the revenue and expenditure structures of COS and OTH are converging, while the role of rayons is clearly shrinking. The recent announcement by the Zelensky government that it expects to complete the amalgamation process by the beginning of 2020 will accelerate this convergence, as will the extension of the single payer health care system to hospitals. All this bodes well for the larger goal of making cities and towns Ukraine's most important level of subnational governance by assigning them responsibility for most day to day public services.

Nonetheless, critically important decisions remain to be made and implemented by the new government. After the completion of the amalgamation process the most important of these, concern the future status of oblasts. Towards the end of the Poroshenko government, plans emerged to give oblasts new powers

to oversee the legality and financial probity of COS and OTH decisions, while preserving their democratically elected councils.

Unfortunately, these plans leave unanswered questions that have haunted local government reform in Ukraine since independence: Should oblasts be territorial representatives of the national state, or democratically elected regional governments? And in either version, what powers should they retain over the rayons, COS and OTH 'below' them? Hopefully, the Zelensky government will have the political will and the parliamentary majority to clearly answer these essentially constitutional questions.

For our part, we think there are strong national security reasons for transforming oblasts into territorial representatives of the national government, and equally strong public administration reasons to reduce their influence over COS and OTH. But whatever path the Zelensky government takes on these matters, the power of oblasts to review the probity of local government legal and financial decisions should be strictly *ex poste* and subject to judicial review. Similarly, no matter how oblasts are ultimately constructed, they should be prevented from moving money between local government budgets based on who they think is in greater need.

For rayons there are a similar set of questions. Here, however, the emerging consensus seems to be that the number of rayons should be reduced and that they should be transformed into state administrative units whose main responsibility will lie in overseeing the restructuring of regional hospitals. If the Zelensky government can quickly move forward with this agenda, much will be done to clarify the future structure of Ukraine's subnational order.

The new government would also do well to avoid the financial vagaries of its predecessor. As we have seen, most of the new funds that the Poroshenko government put into the intergovernmental finance system in 2017 and 2018 flowed to oblasts and rayons in the form of discretionary grants. Large equalization payments were also made to rayons, with COS essentially footing the bill. And instead of beefing up the Education Subvention when the minimum wage was raised, the national government created a new facility grant whose allocation was left in the hands of oblasts.

Looking ahead, the Zelensky government should radically reduce the discretionary funds it provides to oblasts and rayons. Instead, it should move these monies into mechanisms that allocate transfers to COS and OTH on a formula basis. In practice this means strengthening some combination of the Education Subvention and probably more importantly the equalization system.

For starters, the national government should abandon the expectation that the completion of the amalgamation process will somehow lead to the creation of a larger share of fiscally self-sufficient OTH. To be sure there are better and worse ways to complete this process, and at a minimum, hromada with exceptionally strong tax bases should be compelled to join with as many of their poorer neighbors as is technically feasible. But it is simply impossible that the consolidation of predominately poor towns with predominately poor rural areas will create large numbers of OTH that don't need fiscal support. On the contrary, the completion of the amalgamation process is likely to radically expand the need for equalization payments.

In this context, policy makers should also abandon the idea that in the best of all possible worlds the equalization system would be self-balancing. Yes, there are good reasons to force Kyiv to contribute to the system. And yes, monies that are currently going to rayons to keep them on life support can be shifted

towards COS and OTH. But even if these steps are taken, it is likely that national government will also have to increase the amount of money it puts into the Base/Reverse Grant system.

How much additional money this should be, is an open question for which there is never an unequivocal answer. That said, it would be good to consider this question alongside some more technical issues that will affect both how money should be reallocated across local governments and the need for additional funds.

The first of these issues is simply whether the equalization system should be based only on PIT per capita, or whether other shared taxes –primarily the excise tax—should also be used in the calculation of Base / Reverse Grants. Here, the answer is almost certainly that other shared taxes should be included in the system because these are revenues over which local governments have no control, and yet whose incidence can have a profound impact on their budgets.

The second such issue concerns whether PIT should continue to be shared with local governments on the basis of where people work, or should it be shifted so that is shared on the basis of where people live. And here too, the basic answer to the question is reasonably clear: Sharing PIT on the basis of place of employment overfunds urban centers at the expense of the surrounding residential communities, while also creating perverse incentives for both cities and OTH to exclude these surrounding communities from their jurisdictions.

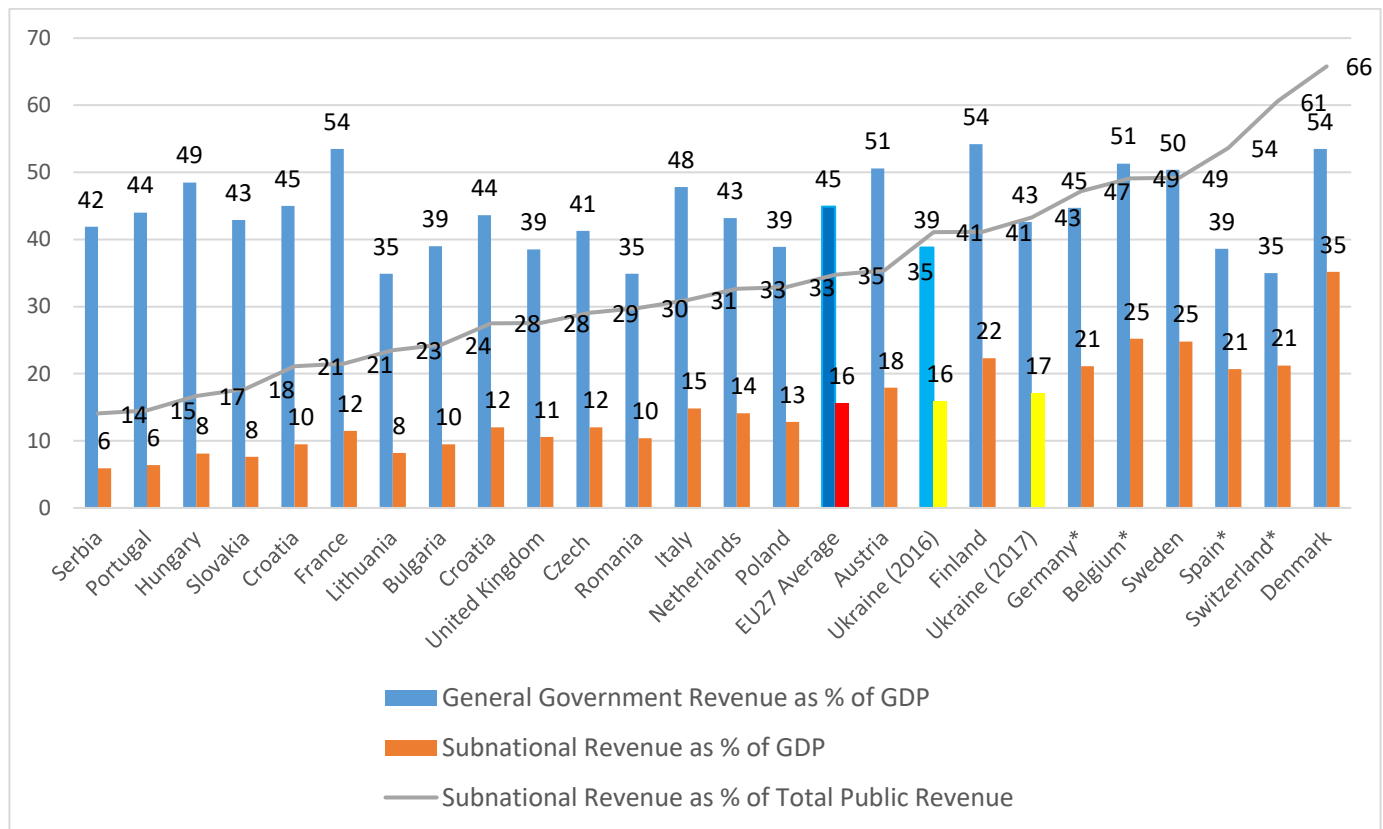
That said, it can be difficult to move to a residential system of sharing PIT for both political and technical reasons. Technically, it can be difficult if the Ministry of Finance cannot easily link the PIT payments that employers make on behalf of their employees, to the home addresses of those same employees. And politically, large and powerful urban centers are almost invariably against sharing PIT on the basis of residence. Nonetheless, almost all countries that share PIT with local governments eventually allocate these shares on the basis of residence and not employment.

But while it would be good to consider these issues as quickly as possible, there is no reason not to begin to adjust the equalization system now. The equalization baseline for COS and OTH should be calculated without rayons and the national government should fully fund whatever all equalization at the rayon level. Removing rayons from the calculation will in turn raise the equalization baseline for COS and OTH. This will increase the number of them entitled to Base Grants, while reducing the number of them obligated to pay Reverse Grants. As such, removing rayons from the calculation of the equalization baseline will raise the overall costs of the equalization system.

Some of these costs should be covered by requiring Kyiv to contribute to the system. But even so, it should be remembered that currently the national government is paying almost nothing for equalization. Instead, over the last two years it has chosen to beef up the budgets of oblasts and rayons by giving them all sorts of new discretionary grants. This does nothing to push forward the decentralization agenda laid out in 2014, and what COS and OTH most need now are stable and predictable revenues that are allocated by formula, and not by the oblasts.

Appendix 1

Chart 1. Subnational Revenue as a % of GDP and Total Public Revenues in Select European Countries in 2016



Source: EuroStat. *Federal states

Appendix 2: Methodological Note on the Treatment of the Data

This Appendix outlines the methodological approach used to clean and consolidate the population, jurisdictional and financial data used in the report. All the financial data derive from the GoU's Treasury System. This system records the complete revenues and expenditures of all public institutions, including those of local governments in accordance with Ukraine's budget classification. Each local government has its own unique treasury code indicating its type (oblast, city, rayon, hromada or AG) and oblast. Revenue data was provided in accordance with the economic classification. Expenditure data was "cross-walked" between both functional and economic classifications.

Treasury system data was not consistent from year-to-year. Some of these inconsistencies were the result of changes in the number and types of local governments. Others concerned changes in the classification of local government revenues and expenditures, as well as estimations of their populations. War and occupation were responsible for some of the changes with respect to the number of jurisdictions and their population estimates. Reform and government decisions were responsible for changes in the classification of local government revenue and expenditures, as well as for other changes in the number and population of jurisdictions, including the formation of AGs, the creation of a few new COS, and the continued

existence of rayons that have no recorded populations –because these are now fully attributed to AGs— but still have revenues and expenditures.

Furthermore, over time a few codes got their names and purpose changed compared to 2014, thus in list of codes provided below we have identical code numbers for different revenues with year in parentheses to indicate the year in which the code was used for a specific revenue.

Number and Population of Local Governments

To ensure the commensurability of the data over the entire period, data for Crimea, Sevastopol and the occupied areas of the Donetsk and Lugansk Oblasts were removed from the files and the populations of these oblasts adjusted accordingly³⁴. The cities and rayons eliminated from the analysis are:

Code	Jurisdiction	Code	Jurisdiction
Donetska oblast		Luganska Oblast	
05201000000	m. Donetsk	12201000000	m. Lugansk
05205000000	m. Gorlivki	12202000000	m. Alchevsk
05206000000	m. Debal'tseve	12203000000	m. Antratsit
05210000000	m. Dokuchaevsk	12204000000	m. Bryanki
05212000000	m. Enakieve	12205000000	m. Kirovsk
05213000000	m. Zhdanivka	12206000000	m. Khrustal'nyj
05214000000	m. Kirovsk	12207000000	m. Sorokine
05219000000	m. Makiivka	12209000000	m. Pervomajsk
05224000000	m. Snizhne	12210000000	m. Roven'ki
05225000000	m. Torez	12212000000	m. Dovzhan'sk
05226000000	m. KHartsiz'k	12214000000	m. Kadiivka
05227000000	m. SHakhtars'k	12301000000	Antratsitiv'skij r-n
05228000000	m. YAsinuvata	12304000000	Sorokins'kij r-n
05301000000	Amvrosiiv'skij r-n	12306000000	Lutugins'kij r-n
05302000000	Bakhmut'skij r-n	12309000000	Novoajdars'kij r-n
05304000000	Volnovas'kij r-n	12311000000	Pereval's'kij r-n
05309000000	Mar`ins'kij r-n	12312000000	Popasnyans'kij r-n
05310000000	Novoazov's'kij r-n	12314000000	Slov'yanoserbs'kij r-n
05314000000	Starobeshiv's'kij r-n	12315000000	Stanichno-Lugansk'skij r-n
05315000000	Tel'maniv's'kij r-n		
05316000000	SHakhtars'kij r-n		
05317000000	YAsinuvats'kij r-n		

The data also required adjustments for the creation of new COS, as well the creation of 159 new AGs in 2016, and an additional 207 AGs in 2017. In 2015, Oblasts 9 and 25 saw the creation of new cities -- Burshtin and Novgorod -- Siverskij. In 2016, new COS's were created in Oblast 16 --Gadyach-- and Oblast 19 --Berezhani and Kremenets'-- while Oblast 5 saw the transformation of COS Krasniy Liman into AG Liman.

³⁴ <http://zakon3.rada.gov.ua/laws/show/1085-2014-%D1%80>

Taken together, all this means that there is not a perfect correspondence for the number of jurisdictions or their populations over the entire period.

In 2018 population data from Min Fin, in Oblast 15 Odessa – there is a gromada Tairove, which can be seen in revenue data, but not in expenditure data.

Consolidation of jurisdictions – local governments

The consolidation of local government finance data was approached in the same way for both revenues and expenditure in order to have comparable data sets. We approached this by not including local transfers that are given directly, and not based on a state grant.

Oblast data contains only the revenues and expenditures of oblast administrations. For the purposes of this analyses, we have not consolidated to the oblast level the revenues and expenditures of all local governments operating within a given oblast. COS data was of two types: COS that are single units and COS that have attached gromada. For the cities with gromada the data was consolidated, and the consolidated city data was used for the analysis.

Rayon data contains only the revenue and expenditure of rayon administrations --without gromada'. The data for (unconsolidated) gromada, we however consolidated at the rayon level.

Revenues

The revenues and expenditures of local governments in Ukraine are divided into two funds, a freely disposable – General Fund (GF) and a Special Fund (SF).

The practice of splitting revenue and expenditures into a Special Fund and a General fund was introduced in 2000 and was designed to reduce the use of off budget funds. This goal was apparently reached but the funds have since evolved into a complicated system of earmarking particular revenues for particular expenditures. The Table below illustrates how the system has evolved since 2014.

	General fund	Special fund	#of revenues earmarked for the special Fund
2014	85%	15%	64
2015	93%	7%	35
2016	93%	7%	41
2017	90%	10%	41
2018	93%	7%	38

As can be seen from the Table the relative sizes of the Funds and the revenues that go into the Special Fund has changed substantially from year to year. Policy makers now justify the existence of the Special Fund as a way to track revenues that are earmarked for particular purposes, such as environmental fees for expenditures on environmental protection. Nonetheless, the most important earmarked funds in the Ukrainian intergovernmental finance system –the Education and Health Subventions—are not included in the Special Fund and are still spent in accordance with their intended use.

From a strictly accounting point of view, it should be just as easy for the Ministry of Finance to track whether earmarked funds are being spent on their intended purposes by comparing individual revenues with their intended expenditure categories.

As such, the Funds neither include the most important earmarked revenues, nor do they really improve the ability of the national government to monitor the use of the revenues and expenditures within them. For these reasons we think they are unnecessary

But the real point is that the national government should seek to reduce and stabilize the number of earmarked revenues in the system, because in general earmarking limits local government autonomy, and changing the number of and type of earmarked revenues every year impedes budget planning.

For the purposes of the report the division between the two funds was ignored in order to present a synthetic picture of local government finances according to the main analytical categories typically used in such analyses (own revenues, shared taxes and fees, freely disposable general grants, sectoral block grants, investment grants and subsidies. Maintaining the division of the funds would both distort these more basic categories and render them as volatile as the annual decisions about the composition of the Special Fund³⁵.

A range of new revenues related to local grants, based on state grants was introduced in 2018 treasury data we received. Each was merged with the state grant data, in order to have a single revenue line that provides information on which local government actually got the funds in the end. The name of the state grant was kept as the relevant one for consolidation purposes. Full list is in Appendix 4.

The way we consolidated specific revenue items into the broader categories used in the report is presented in Appendix 3. Further aggregation of categories was made as follows:

Shared Taxes	PIT, CIT, Excise, Environmental Fees
Own Revenues	Single Tax, Land and Building Taxes, Rents, Land Development Fee, Asset revenues, Other Local Fees and Taxes
Equalization	Equalization and Stabilization Grants
Other grants	Health Related Grant, Vocational Education Subvention, New Ukrainian School
Investment Grants	Investment grants, Donor Grants

For the analysis of quintiles, social welfare related grants were excluded on both revenue and expenditure side. In this year, quintiles instead of quartiles are used to obtain better stratification of data for analytical purposes.

Expenditures

Expenditure data was organized by functional category, and within each function by economic code. Two types of consolidation were made to make usable data sets. The functional categories used in period 2014- 2017 were merged to correspond to the functional categories in use in 2018 as presented in the below table:

³⁵ Even for control purposes, there are probably better ways to monitor the use of earmarked revenues than dividing the budget into two funds. It is also questionable whether the national government should be earmarking what are otherwise (legally) considered freely disposable own revenues.

Functional category	Merged into:
010000/0100 Public administration	0100 Public administration
060000/7000 Law enforcement and Security	8000 Other activity
070000/1000 Education	1000 Education
080000/2000 Health Care	2000 Health Care
090000/3000 Social care	3000 Social care
100000/6000 Housing and Municipal Economy	6000 Housing and Municipal Economy
110000/4000 Culture and Art	4000 Culture and Art
120000/7200 Mass media	8000 Expenses not under other groups
130000/5000 Sports	5000 Sports
150000/6300 Construction	7000 Economic activity
160000/7300 Agriculture, forest, fish and hunting	7000 Economic activity
170000/6600 Transport, roads, communication, IT	7000 Economic activity
180000/7400 Other services connected to economic activity	7000 Economic activity
200000/7600 Environment and nuclear safety	8000 Other activity
210000/7800 Prevention and liquidation of emergency situations and natural disaster consequences	8000 Other activity
230000/9000 Debt service	8000 Other activity
240000/9100 Target funds	7000 Economic activity
250000/8000 Expenses not under other groups	8000 Other activity

Economic codes were consolidated as follows:

Remuneration and Charges on Wages:

- 2110 Remuneration
- 2120 Charges on wages

Utilities and Energy:

- 2270 Utilities and Energy

Other Operating Costs:

- 2210 Items, materials, equipment and inventory
- 2220 Medications and dressings
- 2230 Food
- 2240 Payment for services (except utilities)
- 2250 Expenditure on travel
- 2280 Research and development, some measures on realization of state (regional) programs
- 2800 Other operating expenditure
- 9000 Unallocated costs

Debt service:

- 2410 Service of internal debt
- 2420 Service of external debt

Subsidies and current transfers to enterprises (institutions, organizations):

- 2610 Subsidies and current transfers to enterprises (institutions, organizations)
- 2630 Current transfers to foreign governments and international organizations

Transfers to individuals:

- 2710 The payment of pensions
- 2720 Stipends
- 2730 Payment of benefits to the population

Capital Expenditures:

- 3110 Purchase of equipment and durable goods
- 3130 Capital repairs
- 3140 Renovation and restoration
- 3120 Capital construction (purchase)
- 3160 Land acquisition and intangible assets
- 3210 Capital transfers to enterprises (institutions, organizations)
- 3240 Capital transfers to population
- 3220 Capital transfers to other levels of government

2620 Current transfer to other levels of government

3220 Capital transfe