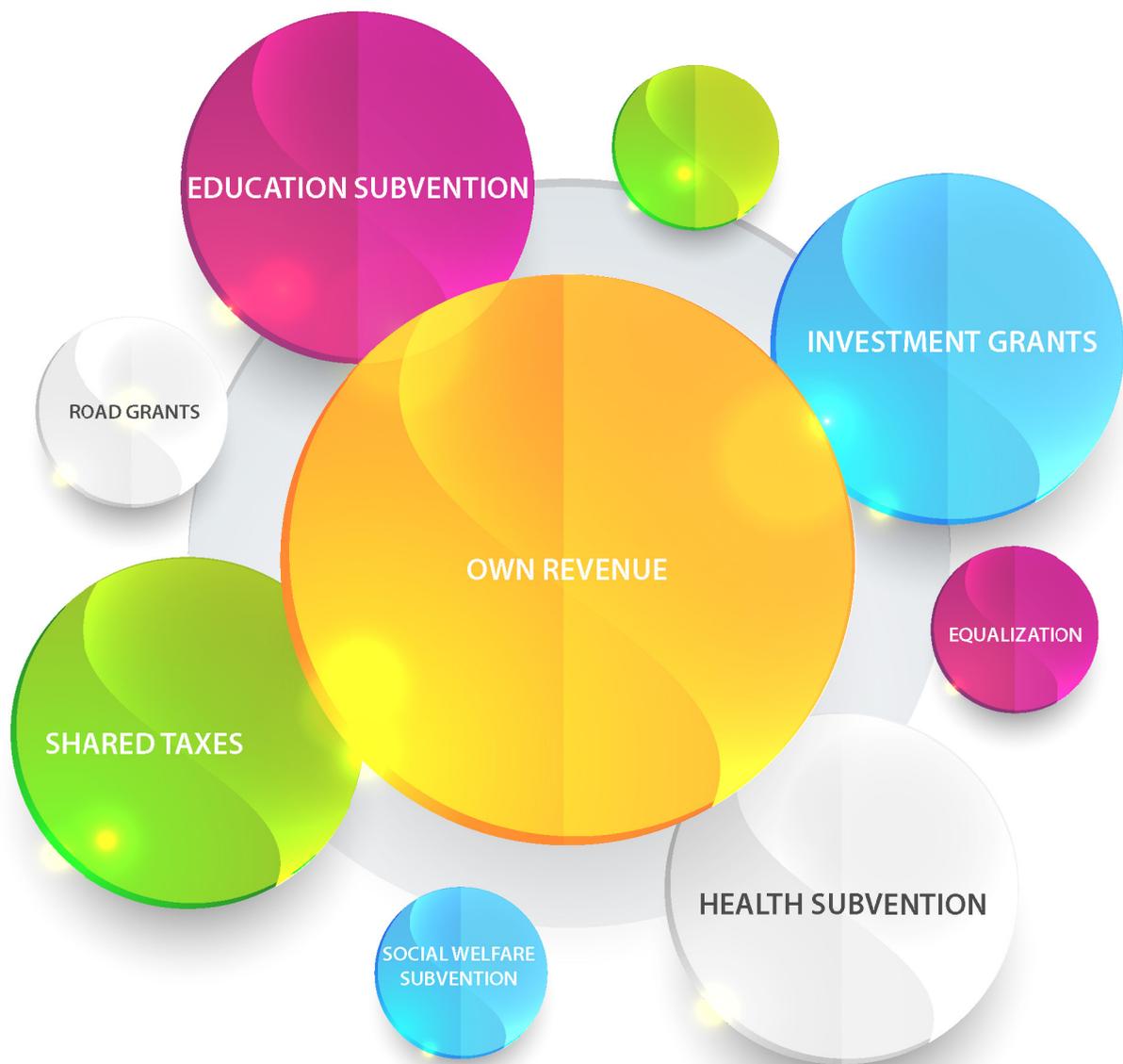


# SUBNATIONAL GOVERNANCE REFORM AND LOCAL GOVERNMENT FINANCE IN UKRAINE: 2014-2018

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KYIV

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

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# EXECUTIVE SUMMARY

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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 schools<sup>1</sup>.
- 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.
- 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.
- 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<sup>2</sup>.
- 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.
- 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 the 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.