

**Ukraine: Enhancing Local Government Revenue Raising  
Capacity:  
A Way of Reaching More Accountable Local Government**

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## Background

In Ukraine now public resources are used as cheap productive means for small groups to achieve their political and economic short-term interests. Elected local self-governments, who could serve interests of territorial community and be accountable to their citizens do not play decisive role in public services delivery.

Today situation in public sector of Ukraine is determined by coexistence of three interest groups:

"Group of dictating" - uses authoritarian methods to implement decisions and prescriptions.

Activity of this group tends to create dictatorship.

"Group of (not) fulfillment" - (interests of this group are determined by the decisions of the first group) - try to ignore prescriptions, to escape taxes and other duties and responsibilities. Activity of this group creates shadow economy.

"Group of control" - have to control fulfillment of the decisions of the first group by the second one. But they use "dictatorship" and "shadow economy" and create corruption.

Questions, which must be asked, but are not publicly asked, are:

Why groups 2 and 3 permit (agree with) dictate from the side of group 1?

Why groups 1 and 2 permit corruption from the group 3?

Why shadow economy is permitted by the groups 1 and 3?

This can be illustrated by the secondary education services which are responsibility of the central government delegated to the local government; these services are not delivered in a transparent way. Teachers' salary is about UHR 150 - 300 (US\$ 30-60). From the point of view of individual, it is not so much and it means that to survive teachers have to find out some additional incomes. Therefore, arrears in salary are not critical for many of them. From the point of view of number of teachers amount of money, not paid in time, is a huge financial resource (number of people, employed in the secondary educational sector is one of the biggest). This fact can explain not fulfilment of education expenditures and huge debts accumulations – about UHR 40 millions in 2001 for one oblast (Lukovenko 2003). These debts are not only the teachers' salaries, but also other articles. Governance is still centralised in education and local community is not organised enough to require from the central government accountable execution of their responsibilities. Parents do not know how much money they could expect from the government and on what purposes.

But it is only a part of a scheme. Accumulated salaries debts are huge political instrument of manipulation during the elections. And this instrument is used through oblast and rayon administrations, which are not elected and accountable governments, but in the same time has power in allocation budget money (very often doing it against existing legislation). This can also explain, why teachers' salary and normative per pupil are not revised and remain very low – in 2001 plan was a little more then UHR 503 per pupil (less then \$ 100 per year); but in fact even this sum did not reach consumers – they received only 370 during 2002 (Lukovenko and others 2003).

Increase of educational expenditures via permitting local governments to raise their own revenues to educational needs would mean that local government – above other means - had to cut number of teachers and rationalize educational infrastructure. Verhovna Rada cannot pass such a decision, because interested groups will loose these financial resources and political instrument. Perspective to receive thousands of officially unemployed former teachers instead of hidden unemployment of current teachers, low quality of educational services, inefficient infrastructure and securing illegal access to public resources and possibility of political manipulation make such decision “unpopular”.

To understand issues of Ukrainian local governments' low revenue capacity and weak accountability we have to take into consideration political situation in modern Ukraine which embedded in nature of regional disproportions. During the soviet period Ukraine was part of another country with ideology of world leader and its regional policy was determined by the military industrial complex development. Moreover, internal policy of the communist regime was directed against national identity, and population of Ukraine became victims of several genocides, known in history as *Golodomors*, committed by the central communist government of 1922-23, 1931-32 and 1953-54 years. These planned genocides took away millions of lives of common people and had especially dramatic impact on the state of economy and households, deterioration of infrastructure of Western and North-Western Ukrainian territories. On the other hand, soviet period was characterized by outstanding and fast growth of heavy industries on the East and South of Ukraine, which were parts of military industrial complex of the whole socialist state. Consequences of such misbalanced politics till now determine disproportions in regional and local development of Ukraine.

Soviet legacy in sub-national policy caused many hardships and difficulties in Ukrainian social and local economic development. The research proposes to identify three main reasons of these difficulties.

The first one is inherited favorable position of some regional elites, caused by abovementioned regional disparities and ideological biases of the centralized soviet economic planning. Ukraine did not change its top managerial personnel since independence. Those people, who had, due to their positions within communist regime, unlimited access to power and public resources during the last period of the Soviet era, continue to dictate their rules of the game to the whole society. Interests rates in shadow undertakings involving participation of state agencies are much higher than in regular business; to have access to such a “high profitable business” one must be part of privileged group; it is clear, that these groups are closed, they compete with each other and depends on their control over different positions in central and local government and state agencies. In result political life in Ukraine has very little relationship with the interest of majority of population. Manipulative means in governance more and more are in usage now to hide from the common people the real social situation, where some small groups of rich people are fighting with each other for the access to public resources. These elite groups, using state power and mass media in their interests are trying to secure status quo and their privileges by different means, including corruption and buying power, influence on the legislation, neglecting rule of law, human rights and democratic norms and institutions.

The second one is in great share of national sector in the economy, emphasis on heavy industrial manner of economic development. It could be explained –together with the above reason – also by ignorance by the elite groups and central government of the global tendencies of emerging knowledge society and new economy, because they are “people of the past” and their businesses are connected with heavy industries, natural resources, power production, planned economy and closed decision-making. By words government supports innovative economy, competitive environment and integration of Ukraine to international market and political alliances, but in real life one can face continuing government's intervention in the economy by different explicit and implicit ways, increase of shadow capital. Such continuing intervention of state in economy causes unfavorable investments' climate and bad business environment for companies and for individuals.

And the third reason is centralized decision-making and weakness of the capacity of local governments to manage available resources. Existing legislation, regulatory environment and implicit rules of the game create no incentives for local governments to execute their responsibilities of public services delivery properly, defending needs and interests of citizens.

## Abbreviations

ACU - Association of cities of Ukraine  
APU - Administration of President of Ukraine  
AR Crimea – Autonomous republic of Crimea  
BC – Budget Code  
CG – Central government  
CM – Cabinet of Ministers of Ukraine  
EPT - Enterprise profit tax  
GDP – Gross domestic product  
GRP – Gross regional product  
FY – Financial year  
ICPS – International Center for policy study, Ukrainian NGO  
LG – Local government  
MoEEI – Ministry of Ukraine in the affairs of Economy and European Integration  
  
MoES – Ministry of Education and Science of Ukraine  
MoF – Ministry of Finance of Ukraine  
NGO – Non-governmental organization  
OR – Oblast Rada (Council)  
OSA – Oblast State Administrations  
PCA – Partnership and Cooperation Agreement between EU and third countries  
PIT – Personal income tax  
RSA – Rayon State Administration  
RR - Rayon Rada (Council)  
SNG – Sub-national governments  
STA – State Tax Administration of Ukraine  
VAT – Value added tax  
WB – World Bank  
UAH – Ukrainian national currency (hryvnya), exchange rate –5,2-5,5 for US\$ 1

## 1. Introduction

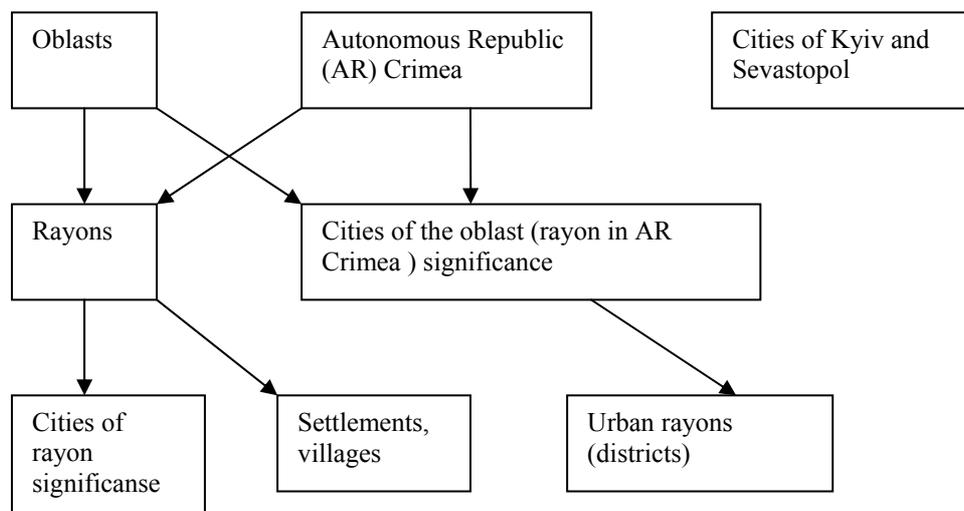
During communist regime all people in Ukraine like in other Soviet republics were forced to work in state sector of economy; communal services were distributed through the industrial facilities and were maintained by them. Therefore, Soviet power did not need local governments for distribution of public services; moreover, local governments in the European sense with their autonomy were dangerous for the communist ideology and menacing for the regime. Power was based on the extremely strong dependence of population from the communist party which replaced all tiers and levels of government and committed unlimited intervention in social life of people within existing closed political decision-making and centralized planned economy. Taxes were collected automatically - though, the socialist economy does not need taxes at all. Nearly all population enjoyed access to the communal services, however, of a very low level, but, nevertheless, almost free for consumers. After the collapse of the Soviet regime these features of social legacy played very important role. They can explain, why local governments, which had to be on the key positions in economic and social development, till now fail to play this role.

The Constitution of Ukraine declares – like supreme laws of other countries who want to be considered as modern democratic nations – that all local governments are equal and no one of it can be subordinated to (nor dominate over) some other. But in real life the responsibilities for providing services by the different tiers of the local governments have not been clearly outlined. Relationships

among the state, oblasts, the different types of localities and consumers of public services are to very great extent still stipulated by traditions, legal acts, and instructions of the Soviet era.

Ukraine has 25 “largest” administrative-territorial units – oblasts and AR Crimea and 2 cities – Kyiv and Sevastopol. The degree of fiscal decentralization did not increase in Ukraine since reaching independence in 1991. *Figure 1* below shows, that only a small part of local governments in Ukraine – oblast centers, and Kiev and Sevastopol (as cities with special status) have no direct subordination to the “upper level” of power. The relations between local governments in Ukraine are inherited from the soviet past, when all territorial-administrative units were included into the vertical subordination.

*Figure 1.* Administrative structure of public sector in Ukraine



Constitution of Ukraine differentiates oblast and rayon level of power from other kinds of the local governments. Oblast and rayon governments redistribute and control public finance; though councils of these levels are elected by population, they have no executive bodies to make them responsible and accountable to their territorial communities. In the same time heads of local administrations, which have much more discretionary power than local councils, are appointed by the presidential administration. As representatives of other – presidential – branch of power they are not accountable neither to the elected councils, nor to the central government, but they play important role in intergovernmental budget relations and distribution of public resources on local level.

Responsibilities of oblast and rayon administrations are not clearly defined and overlap with functions of councils of these levels. Closed structure of these levels of local government make them convenient places for shadow activity of small privileged groups which use hidden vertical subordination of rayon and oblast levels of power to presidential administration. This hidden vertical subordination – in conditions of bad governance and ignorance of rule of the law - makes intervention into the authority of local self-governments possible. Such interventions are widely spread in Ukraine and determine fiscal relations in Ukraine now. Some independent research

(Thirsk 2003) show rough offending of Budget code and State Law of Ukraine on Budget committed by rayon and oblast governments.

According to data of ACU Ukraine has now in total 451 local governments of cities and towns and more then 29.5 thousands of urban and rural settlements (see the *Table 1*).

**Table1. Changes in Administrative-territorial structure of Ukraine**

Years	Autonomous republic	Oblast	Okrug	Rural rayons	Urban (within cities) rayons	Cities and towns total	Big cities and towns	Urban settlements	Rural councils
1950	-	25	13	749	68	261	75	478	16357
1960	-	25	-	604	74	345	86	823	8603
1970	-	25	-	476	90	387	112	865	8592
1980	-	25	-	479	120	412	138	902	8522
1990	-	25	-	479	120	436	145	927	8996
2000	1	24	-	490	122	447	170	894	10260
2001	1	24	-	490	122	451	173	893	28651

Sources – V. Kuibida, 2000, ACU 2001

Low capacity of local self-governments to manage their public finances is caused by intervention of “higher level” administrations engaged in shadow economic activities. Fiscal decentralization contradicts to the private economic interests of small groups which use hidden subordination of governments to reach access to public resources. Concentration of power in hands of oblast and rayon state administrations is a key factor of this illegal activity. It is one of the main issues of Ukrainian political environment and territorial-administrative reform which cannot be solved by mere changing of legislations, as many authors think (Romanyuk 2000, Kucherenko and Kravchenko 2001). For example, *Table 1* shows very fast increase of number of the small local self-governments, especially of the rural settlements; many of them cannot provide public services, they have no own budgets, and incentives to improve revenue base are very limited or almost absent.

This fast growth of number of the local governments with low capacity is reason, why some experts present other data. For example, according to estimations of the Union (Association) of the local self-government bodies, there are only 12 273 local governments in total in Ukraine. Among them there are 10 273 rural and 788 urban settlements councils, 451 local governments of cities and towns, 86 rayons in cities (urban districts) local councils, 488 local governments, which have status of rayon and 25 – of oblast level of power (Lugansk, 2002).

## 2. Local Government at a Glance

**To what extent the public sector participates in GDP (and/or GNP) and what are the spending by the sub-national government (local government, in particular).**

Shares of different SNG budgets expenditure in general government expenditures are changing in different ways. As the *Table 2* shows, shares of oblast and rayon government budgets increased, while budgets of cities and sub-regional self-governments now redistribute less public resources then it was first years of independence. Alike tendencies can be watched in case with revenue of local governments’ budgets. So, more and more power and resources are concentrated on these levels of power. Such tendency corresponds to the interests of illegal activity of shadow groups,

discussed above, and contradicts to the interests of population and main principles of intergovernmental fiscal relations. Elected and accountable self-governments have less responsibility in public services provision, then administrations, which are mere nontransparent mediators, accountable to the upper level of powers and involved into the hidden use of public resources by small groups.

To stop this central government had to give more responsibility to the local self-government authorities. Instead of doing this way, it accuses self-government in abuse of power and non-fulfillment of their responsibility and continues to support hierarchy of power and try to secure state vertical control over the public services provision at local level. Along with declarative and demonstrative decentralization it gives more discretionary power to oblast and rayon administrations and leads to huge concentration of centralized power (and multiplication of it) on the sub-national level.

*Table 2 Distribution of expenditure between tiers of budget system of Ukraine (without transfers and Pension fund expenditure) (percent)*

Levels of budget system	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
State budget	68.57	62.18	60.49	64.66	52.70	56.36	60.10	51.86	54.58	64.70
Oblast	8.13	11.51	9.44	8.04	17.21	15.42	11.89	16.97	16.74	11.85
Cities of oblast significance	12.63	15.47	18.88	17.78	17.02	15.83	15.82	17.14	14.71	11.95
Rayon	7.43	7.66	7.52	6.28	9.19	8.74	9.01	10.92	10.76	8.72
Sub-rayon total	3.25	3.1	3.67	3.23	3.88	3.65	3.17	3.12	3.22	2.77

Source: S. Slukhai, 2002 Y.Lukovenko 2002

Table 3 also shows strong concentration of power to redistribute public resources on the oblast and rayon levels instead of the real fiscal decentralization.

*Table 3 Share of sub-national government budgets revenue in GDP (without Pension fund and transfers) (in percents)*

Budget types	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Consolidate budget	25.15	24.40	33.47	35.62	30.27	28.24	30.40	28.19	25.20	28.40
State budget	13.60	12.80	18.28	20.64	14.41	14.81	17.27	15.31	15.12	20.12
Total SNG	11.55	11.61	15.19	14.98	15.85	13.44	13.12	12.88	10.08	8.28
Oblast	2.47	3.50	5.44	4.57	7.50	6.42	6.61	6.38	4.87	3.45
Total sub-oblast	9.08	8.11	10.59	10.40	8.35	7.01	6.52	6.50	5.19	4.82
Cities of oblast significance	6.43	5.15	6.87	7.49	5.33	4.38	4.50	4.13	3.22	2.91
Rayon	1.58	2.12	2.94	2.13	2.28	1.94	1.34	1.74	1.45	1.38
Total sub-rayon	1.07	0.84	0.78	0.78	0.74	0.70	0.68	0.63	0.53	0.53
Cities of rayon significance	0.30	0.22	0.20	0.22	0.22	0.25	0.22	0.21	0.19	0.19
Urban settlements	0.29	0.22	0.20	0.21	0.19	0.17	0.17	0.16	0.14	0.13
Rural settlements	0.47	0.40	0.38	0.35	0.34	0.28	0.28	0.26	0.20	0.22

Source: S.Slukhai, 2002.Y.Lukovenko 2002

Taking into consideration nature of the oblast and rayon governments, increase of shares of budget revenue and expenditure of these levels has negative impact on the public service delivery on the local level. Decrease of shares of sub-oblast and sub-rayon level in redistribution of public finance confirms thesis about permanent resistance of interest groups against process of transparent fiscal decentralization in Ukraine

Ukraine lived through great economic recession during transition period lasting all years of independence. The Table 4 shows that external and internal debt was growing, as well as share of budget expenditures to serve these debts.

*Table 4 Ukraine State budget expenditures and share for payments of external and internal debt.*

Years	1994	1995	1996	1997	1998	1999	2000	2001
State budget expenditures (without official transfers), percentage of GDP	29.1	19.5	18.6	22.1	15.6	14.6	20.5	19.6
Expenditures for serving external and internal state debt, percentage of GDP	0.3	1.3	1.5	1.9	2.4	2.4	2.7	2.0
Share of debt expenditures in the state budget, percent	1.0	6.8	7.8	8.6	15.1	16.5	13.1	10.2

*Sources: Lunina, 2000; ICPS, 2002*

Together with the economic decrease, the decline of a level of public revenues was caused by the following shortcomings of the fiscal system:

- Too high level of corporate and private income taxes led to increase of size of shadow economy and enormous expansion of illegal economic activity;
- Privileges and exemptions, opportunity for some enterprises to affect the level of taxation or to avoid taxation in different ways;
- Centralized decision-making and lack of regional and local autonomy reduced stimuli of the local governments to raise revenues.

**The relationship between the central government and sub-national level governments in fiscal issues** are not transparent in Ukraine till now. In many cases oblast and rayon levels of power instead of taking formal and legal responsibility for the control of public resources on the territories, intervene into activity of local governments in directive, administrative style, ignoring rule of law and rights of self-governments. Very often it is done as reaching short-term interests of small groups pursuing their economic or political interests.

Indefinite role of local administrations has its roots in the Soviet past. But it is supported as well by private economic and political interests. Money from the public budget became most attractive productive means for many businesses and enterprises, when financial market is not well developed. Under conditions of absence of rule of law and weak civil society it becomes possible for small interest groups to enjoy illegal access to public resources through different way of “buying power”. This illegal access to public resources results in accumulation and expansion of the shadow capital. Interest groups, involved in this process, use control over public service and decision-making process on the central as well as on the local level in order to secure their privileged positions.

The reason why existing self-government has no real power in Ukraine can be explained by the fact that shadow capital is interested in dealing with unclear but very primitive system of administration. Access to the public finances helps to reach illegal profit, part of which is “re-invested” in the policymaking and legislation process to arrest real changes in the inter-governmental budget relations and regulatory environment. Gaps in the intergovernmental fiscal relations became a source for small interest groups in competition against comprehensive and consistent public approach in this policy area, which, first of all would have to put end to buying of power and corruption and prevent criminal access to public resources by the interest groups. So, perpetual changes of legislation, turbulence in structure, and terms of references and personnel; transfer of responsibilities to the local level and back were done with reasons that are far from interests of common people. It leads to conservation of highly centralized and capricious system of decision-making – so called handy governance - with no place for the real inter-governmental fiscal relations.

### **3. Local Government Finance: An Overview**

#### **The structure of revenue side**

In the years of 1996 and 1999 in percentage to GDP revenues of local budgets in Ukraine were close to ones of the OECD countries - 14.9 and 12.7 relatively. It is higher then revenues of local budgets of such countries as Hungary – 12.2, Czech Republic – 11.1 and Poland – 10.1. But in fact, tax power of local governments in Ukraine is very limited. Portion of national taxes and transfers from the central government budget never were less then 70 percent of the total amount of the aggregated local governments’ revenues (Lunina 2000).

The revenues of local governments in Ukraine can be divided into three groups:

1) Own taxes. These revenues are formed on the territories and are assigned to the certain local government. But this list of taxes changes all the time; 2) National taxes, which are re-distributed among central and local budgets. Presumably, oblast level of power and cities with special status enjoy such kind of revenues. But they are not local governments in real sense as it was shown above. 3) Transfers from upper budgets level.

Amounts from the own taxes and national taxes, assigned to the local governments on the long-term basis are very short. So, in fact, the main source of the revenues of the local governments is donations from the central budget.

#### **The structure of expenditure side**

Delegated expenditures are prescribed for the rayons and cities of oblast significance, and they are following:

- On the state management (for cities of oblast and towns of rayon significance, for self-government bodies of rayon significance)
- Education (preschool and secondary, residential schools and other state education programs)
- Health care
- State programs of the social provision and protection
- Implementation of the governmental policy towards child, youth, women, family.

There are changes, introduced by the new budget code (in some regions – since 2001 and nationally wide - in 2002 FY) in expenditure responsibilities of the local governments. There are no expenditure responsibilities of oblast level government; now many services which were delivered for long period through this level of power are considered as state's or ones of the cities of oblast significance.

In general, it worth to be mentioned, that objective criteria for defining budget revenue and expenditure for the local governments cannot not be effectively implemented till there are no transparent and clear rights and obligations of all participants of the intergovernmental budget process.

#### **4. The Political Economy of Local Budgeting Process**

After 1991 functions of distribution of the budget money between local authorities were transferred to oblast administrations. Lack of political and financial capacity of local self-governments of the sub-oblast level makes oblast a convenient place for operation of the informal mechanisms in revenue formation, using advanced methods of political log-rolling and bargaining.

Role of oblast in redistribution of public finances resulted in decrease of share of expenditure of other local governments, like cities, rural and urban settlements and increase of concentration of public finance in the oblast level. In the same time share of expenditures of rayon level did not changed sufficiently – it was 2.42 in 1991 and remained nearly unchanged in 2000 - 2.42 percents of GDP. To compare, share of expenditures of oblast level grew from 2.65 in 1991 to 4.47 in 1999 and 3.30 in 2000 (Slukhai 2002). The share of revenues of cities and towns and other local authorities like urban and rural settlements in GDP decreased more then 2.5 times in average during this period. While share of revenue accumulated on the oblast level increased from 2.47 in 1991 to 3.45 in 2000 (Slukhai 2002).

Increase of concentration of public resources on the oblast level took place together with process of concentration of power on the oblast level. But it was not a real decentralization - it was multiplication of central government bodies at the sub-national level. Willing to secure their access to public resources, shadow interest groups supported such a status quo by all possible means on all levels of decision and policymaking.

Oblast administrations now are not empowered self-government bodies, representing real interests of local communities. They have no heads, directly elected by population. Oblast State Administrations (not local councils) made decisions concerning budget process.

Awareness of this fact was an argument for decision to displace oblast level from intergovernmental budget relations. Last two years central government started implementation of formula based approach in fiscal relations, and redistribution of public resources between local governments is delegated now to the rayon level. But problems, which existed in relationships between oblast and sub-oblast government are still alive; they simply were shifted downwards together with delegation of redistributive functions to rayon level. Relation between rayon and sub-rayon governments reproduces relation between oblast and sub-oblast level.

The problems of multiplying of centralized decision-making power and strengthening of informal vertical administrative subordination on the sub-national level are not solved.

When responsibilities of the government (A) are delegated to it by some other government (B) and if government (A) is subordinated to (B) like to the “upper level government”, the kind of fiscal relations between them is called “Matryoshka” or “budget within budget”. It leads to disparities in expenditure and revenues between governments caused by nontransparent decision-making, concentration and abuse of power and ineffective use of available resources.

Vertical distribution of power in conditions of weak local governments works effectively only in one direction – it can help to limit and to control official personal incomes of citizens. But it cannot prevent expansion of shadow economic activity, unofficial negotiations and inequality in provision of public services (*Tables 5 and 6*)

**Table 5 Coefficient of variation in expenditures on medical services on different budget level, 2000, in percent**

Levels of governments	Number of places	Number of visits
Oblast centers	42	18
Cities of oblast significance	90	63
Rayons and cities of rayon significance	67	66

*Source: ACU, 2000*

While large disparities in provision of medical services exist, - which are results of bargaining and shadow negotiations between levels of government, - there is high degree of limitation of official incomes. Only in big cities of oblast significance variation of salaries and pensions size is relatively high - 52 percent. Local governments of rayon and sub-rayon level have very limited ability to increase sizes of salaries and pensions (coefficient of variation is here 7 and 14 percent).

**Table 6 Incomes of population of the different governments' level, 2000. Average size (UAH) and variations coefficient (percent) (Exchange rate of UAH was 5,4 per 1 US\$)**

Levels of governments	Salary of the employed in official economic activity (coefficients of variation, , and average size)	Pensions amount, adopted by certain local government (coefficients of variation and average size)
Oblast centers, variation coefficient in percent	15	6
Average size UAH	189	72
Cities of oblast significance variation coefficient, percent	52	11
Average size UAH	203	72
Rayons and cities of rayon significance variation coefficient percent	7	14
Average size UAH	114	64,7

*Source: ACU, 2000*

The *Table 7* shows that coefficients of variations of debts of factual expenditure on education were 120 percent in rayons and cities of rayon significance in Lviv oblast and 189 percent in cities of oblast significance in Odessa oblast. It means that there some more successful in personal contacts local governments, who use permanent hidden budget deficit as argument in non-transparent negotiations. It resulted in the fact, that in general, on the sub-oblast level execution of budgets was

chaotic. It is true for all regions and for all levels of sub-oblast budgets. Under such conditions equalization instruments are not effective, especially when the scale of benefits is decided by the central government who does not fulfill his commitments. Central government’s debt to the local budgets on the education expenditures in FY 2000 in Lviv and Odessa oblasts were more than UAH 14 and 23 billion, in Lugansk oblast more than UAH 36 billion, in Kharkiv oblast and AR Crimea – more than 41 and 49 billions relatively (LGI 2002).

**Table 7 Variations in educational expenditure debt in sub-oblast level, 2000 (percent)**

Oblast name and levels of sub-oblast government	Total debt	Salaries debt	Communal services
Rayons and towns of rayon significance in oblasts			
Lviv	120	217	124
Odessa	94	112	103
Lugansk	90	94	108
Kharkiv	83	83	110
AR Crimea	78	89	82
Cities of oblast significance in oblasts			
Lviv	123	160	86
Odessa	189	135	117
Lugansk	106	77	126
Kharkiv	168	173	172
AR Crimea	89	105	99

*Sources: Calculated according to data of FAO, 2000*

Replacement of the distribution of central government budget between local governments from oblast to rayon level cannot solve issue of optimization of the intergovernmental fiscal relations, because some questions remained without answers.

In situation of high degree of shadow bargaining and negotiations, where oblast level till now exercises strong implicit influence on the rayon level of power, exclusion of oblast level from delivering of public services can cause adverse effects.

## **5. Reconsidering the ‘Original’ Local Government Revenue Sources**

### **Structure and volume of the original local government revenues**

There are seventeen revenue sources of local governments, which are not accounted while definition of transfer from the central government to oblast, cities of oblast significance and rayons.

The most sufficient among revenue sources for local governments are the following:

- local taxes and duties;
- 75 percent of land taxes - for cities of oblast significance, and 60 percent of the land tax - for rural and urban settlements, for cities of rayon significance;
- income taxes of enterprises of communal property;
- incomes from selling communal property;
- own incomes of budgetary entities and organizations;

- industry tax;
- taxes on owners of transport means;
- some others.

Articles 64-65 of the new budget code appoint seven kinds of revenues sources, which would be accounted while calculating of the intergovernmental budget transfers, they are:

- PIT (Kiev and Sevastopol – 100 percent, cities of oblast significance - 75 percents and towns of rayon significance, rural and urban settlements - 25 percent of collected on the territories of the certain local authority);
- Shares of state duties;
- Registration fees and commercial patent duty for entrepreneurial activities;
- Incomes from administrative penalties, defined by the related councils;
- Part of unified tax for entrepreneurial activities.

Changes in budget process worked against the increase of own revenues of local budgets. The biggest “income-rich” articles of revenues are taken away from the local level and are replaced to the national one. Among those excluded taxes there are ones, connected with activity of enterprises of communal (municipal) ownership. (The fact, that local government is more interested in this enterprises and is undoubtedly more capable then central government to raise efficiency of using communal property, is fully ignored.)

As a result revenues of the local budgets today mostly depend not on the taxes, collected by local governments on their territories, but on the resources, given by the central budget. In the year 2001 as many as 11 oblasts of Ukraine received from the state budget by 1.3-1.9 time more, then from their own taxes or other revenues (Fomenko 2001).

Several draft laws, which included taxation of real estate, have been submitted to Verkhovna Rada in previous years, but the Rada proceed none of them. Revenues from real estate and land taxes - as experience of other states show - could become a significant and sometimes major own revenue source for the local governments’ budget in Ukraine. But the draft Tax Code, prepared in 2001 does not allow the greater financial independence of the local governments.

### **The methodology of collecting taxes and tax administration**

In many cases low tax receipts were connected not with level of economic development of a region and, accordingly, not with low base of the taxation, but with differences in actual regional tax collection. It means, that interest groups, defending their short-term economic interests, ignore general rules of the game towards tax collection. It becomes possible because of high concentration of power and hidden subordination between oblast and rayon governments, discussed above. Some researchers (AHT 2001) show that the richer regions pay less to the central government budget, then the poor ones. For example, in Dnipropetrovs’k and Zaporizhzhya oblasts, who permanently come to the first five oblasts of Ukraine in total added value per capita, amount of paid taxes in 2000 was 17 kopecks, i.e. it was lower, than country’s average (19 kopecks), and is lower, than, for example, in Volyn oblast, which in 2000 in total added value per capita was on the 21st position. In Lugansk oblast, which on per capita added value is on the 9<sup>th</sup> place, there were collected taxes (without the VAT) only as much as 13 kopecks from each UAH of added value. This is less, than in the Chernivtsy oblast, which occupies the last, 27<sup>th</sup> place on total added value parameter. The Lviv oblast – which by the level of taxation can be included into the first five oblasts - occupies only 18<sup>th</sup>

place by the measure of the regional total added value. In six oblasts of Ukraine the level of taxation did not exceed 70 percent of countries average, i.e. was less than 13 kopecks from 1 UAH of the added value produced in the region, while county's average was 19 kopecks. ( Lunina 2000),

Almost all of taxes are administrated by state tax administration (STAU), which is not subordinated to Ministry of Finance as central government executive body. STAU representatives located in oblast and rayon centers. They work with close collaboration with oblast and rayon state administrations. These two levels of power are not state supervision institutions, serving national strategic interests on the local level. Moreover, oblast and rayon state administrations are entry points for illegal access of small groups to the public resources – above disparities in tax collection illustrates this.

## **6. Original Revenue Sources and Local Public Borrowing**

Budget code of Ukraine insists that oblast's, rayon's, city's rayon and settlements' budgets must be adopted without deficit (Article 72). For covering gaps in execution of budgets, local governments are permitted - after the decision of related councils - to take short-terms loans in financial institutions. Maximum time of crediting is three months and a loan must be repaid within one budget period. Loans from one budget to another are prohibited. Such regulation limits possibilities of local governments to attract additional resources to raise its tax bases by working with real estate, land improvement, constructing new property and doing contributions to the infrastructure and human resources development. Instead, such limitation, preserved by BC, causes perverse incentives and hampers provision of public services and local economic development. Especially it is harmful for poor and small local governments, which have very little other possibilities to develop revenue base and increase welfare of their citizens. Moreover, in conditions of arrears and not fulfilling obligations by the central government, such regulations – prohibition to adopt deficit budget and limitation in using financial market instruments - push local governments to non-transparent negotiations with upper level of power and other shadow and unfair activities.

Adoption of budget deficit would mean first of all formalization of needs, and could be a stimuli to look for resources to cover this deficit, such as borrowing on the financial markets and horizontal cooperation. On the contrary, by such regulation existence of hidden deficit is legitimized, when local governments are interested in showing unreasonably grown up expenditure needs of their budget, trying to have stronger position in shadow negotiations. In fact, the limitation, preserved by the BC in this area pushes LG away from financial management of municipal resources aimed to increase of own revenues, to the old soviet scheme of intergovernmental relations within centralized planning.

Covering of the deficit of the local governments budgets by borrowings is too expensive and not affordable for the local governments in Ukraine now.

## **7. Enhancing Local (Fiscal) Capacity and Democratic Accountability**

Under existing conditions it would be reasonable to suggest new approach in raising revenue capacity and developing accountability of local governments. It would become possible through the more effective organization of the public policy process in Ukraine. Such a new approach must be based neither on the seeking of the “right way” of country's development, nor on the battle with the existing power, but on the *implementation of procedures* of social dialogue. We believe that only by this way Ukraine can be lead to increase of public mutual accountability and social integrity.

## 7.1. Concept of accountability

Accountability as an interactive process and it foresees existing of two main groups of interests.

7.1.1. Those which initiate and introduce rules, norms (for example new taxes or fiscal policy).

7.1.2. Those whose interests are disturbed by new rules or decisions (See the Picture 1 below).

**Picture 2 Accountability as an interactive process**



## 7.2. State of accountability in Ukraine today

There is no real accountability in Ukraine. Instead of it different palliative forms are used. In real practice we have only monologue of power. Accountability - as report of power to the people - is impossible under such conditions and real accountability is dubious.

As recent “discussion” of the President’s proposals on political reform showed, too small number of population is involved in the policy process.

## 7.3. Own experience and attempts to implement the suggested approach

During 1999-2001 authors of the research undertook several attempts to implement public dialogue procedures to increase accountability of the Ukrainian government. These attempts were undertaken within the following projects supported by international organisations, as well as by some Ukrainian central and local government agencies and NGOs:

Ukraine’s Future: A Plan for the President

Ukraine’s Future: Public Appraisal of the Reforms

Developing Educational Policy for city of Lviv

Discussing the draft State Program of De-shadowing the Economy

Discussing draft Law of Ukraine *On Higher Education*

Discussing the draft Concept of State Regional Policy

Public discussions of Program of Cabinet of Ministers of Ukraine. (with Victor Yuschenko as Prime Minister. However, this process was not accomplished and with retirement of the Prime Minister in 2001 perspective of creation of really accountable government failed.

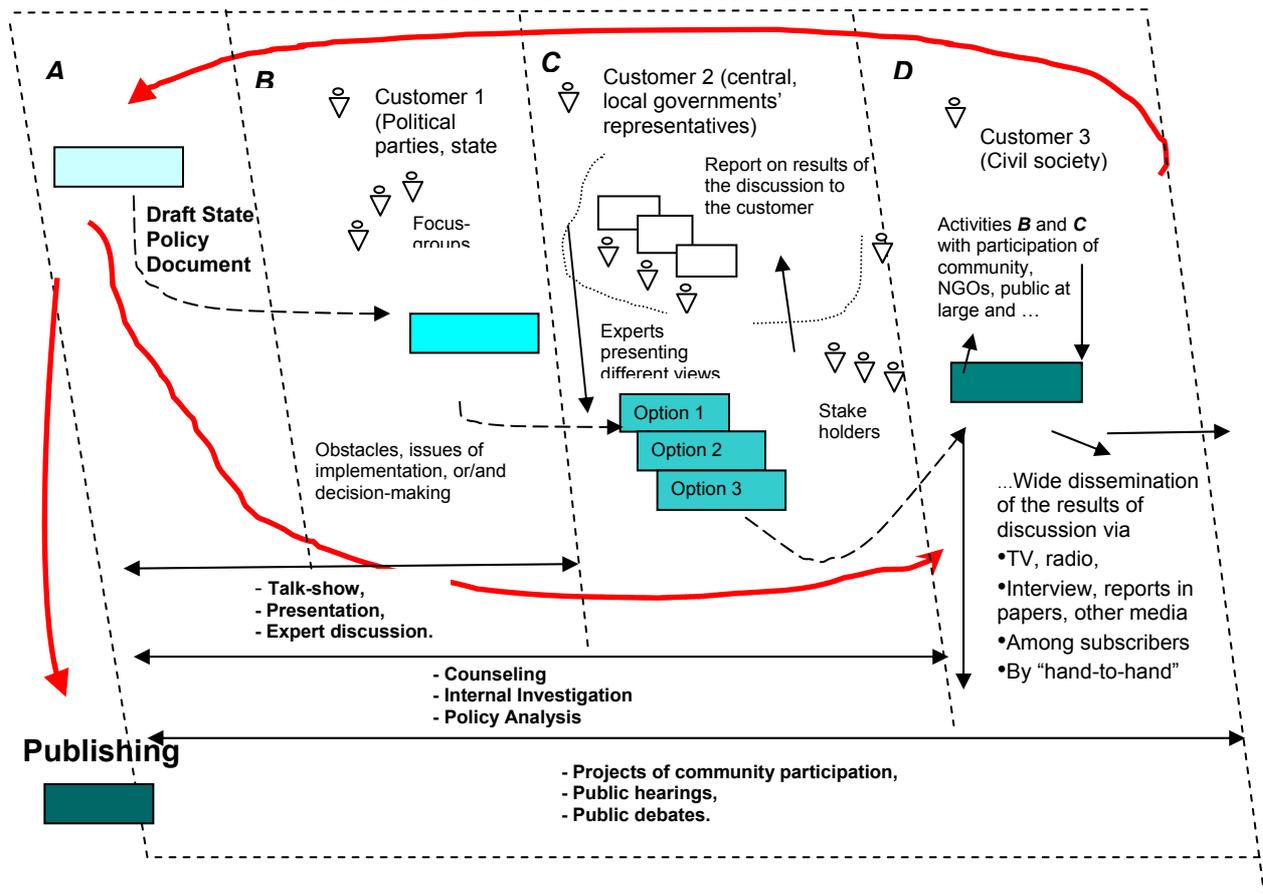
One could call this experience only a demonstrative one. But it proved technical possibility and interest and capacity of Ukrainian people to participate in governmental policy with high level of involvement, responsibility and activity.

Also, this practical experience of attempts undertaken – though they were not very successful in terms of social results of them because of too frequent changes of political environment - gave us opportunity to develop organizational scheme (model) of developing accountability process.

## 7.4. The principle scheme of accountability

Picture 2 presents steps in developing of policy process and provision of accountability of the central and local governments.

**Picture 2 Accountability - Steps A, B, C and D**



**7.4.1. Step A.** Identifies decision-making authority, interested in improvement of policy process. It could be local or central government representatives, dealing with policy documents, policy decisions. It could be - draft project laws, projects of the central or local governments' budget, programs, other kind of documents and legal acts. Also, efforts towards the improvement of the policy process could concern policy in the certain area and deal with already made decisions and adopted, existing documents. In these case subject of analysis would be implementing process, effectiveness of the governmental policy, quality of execution of decisions and assessment of activity of government. In both cases we have 1) decision and policymaking authority and 2) some records of governmental policy – either future or current – which we try to study and find out some issues, to take some lessons and improve its quality.

**7.4.2. Step B** foresees conducting of focus-groups aimed to identify obstacles, possible issues connected with the government decision-making and policy process. This step results in definition (and listing) of opened, not solved problems. Government must be brave enough to face these problems and aware, that there are no ready solutions, even if it seemed before that they already exist, or there is someone who knows what to do. Usually, in case of Ukraine, everything stops on that phase, because government refuses to aware that there are questions without answers. Therefore instead of the policy process on this stage we usually have hiding real issues from itself and from public.

**7.4.3. Step C** includes developing options of the problems' solutions. Experts, presenting different points of views and interest groups, are working together trying to find out ways out of the problems identified on the previous stage. It is hard task and needs time framework, relevant professional skills and public expertise, well organized communication. This stage results in findings of some solutions which could be presented in some kind of analytical paper or research report containing policy options (recommendations).

**7.4.4. Step D** foresees that results of the previous steps should be presented to the public and wide range of experts would be involved in the process of discussion of the draft project, issues and proposed solutions. Only using of all steps of this approach one can improve policy process (by developing better policy decision, shaping comprehensive and doable, efficient policy document). In case of fulfilling all this stages we could await accountability of the government (local or/and central).

## **8. Summary and Conclusion**

Today’s local budgetary process in Ukraine continues to exhibit unjustifiably low level of own and assigned local budget revenues. Local governments now are interested neither in increasing of own tax base, nor in efficient collection of national taxes.

It was a result of the long period of non-transparent decision making in the intergovernmental fiscal relations in Ukraine, when central government nearly loosed control over the public finances. It happened because of lack of the comprehensive and consistent public policy and attempts to concentrate sufficient power and resources distribution functions on the oblast level.

Now, when many of the responsibilities are delegated to the rayon level of power, interested business and financial groups had succeeded to secure their rules of the game in the intergovernmental fiscal relations. They try to control public finances, using vertical of power represented by the oblast and rayon level which are not pure self-governments. In conditions of low capacity of the other (especially, of sub-rayon ) local governments, it makes possible for these groups to conduct pressure on the central and local governments and manipulate public opinion to reach their private or corporate goals.

Unclear distribution of responsibilities and mixture of function of local authorities creates favorable conditions for buying privileges by shadow capital and for the large-scale abuse of power. It leads to the extremely bad state of social programs, particularly, social protection, medical services and education. It, in turn, hurts social integrity, erodes human capital and makes support by people of government’s reforms very doubtful without core changing people’s attitude to public policy in area of intergovernmental fiscal relations.

## **Appendixes**

### **Appendix 1. “Inter-governmental contract (social agreement)”**

### **Appendix 2 “Policy analysis and human resources development component”**

## Appendix 1. “Inter-governmental contract (social agreement)”

### *Draft Contract Agreement*

To improve situation with own, original revenues of the localities, relationships between central government and different tiers of local governments must be regulated in the terms of **social agreements and contracts**. One kind of such social agreements must concern the execution of delegated and own responsibilities by the local governments. The matter is that people are not informed in details of intergovernmental arrangements. Share of responsibilities between tiers of government and order of execution of budgets are not clear to common people, especially to the elder one. Very often central, oblast, rayon and local governments are arguing about their relations, different interpretation of normative acts and other related documents. All these things create favorable condition for both, central and local governments, not to fulfill their responsibilities in time, or completely. The agreement also must include rules of calling of offenders of agreement to account. Such agreement can be basis for other kinds of contractual relations between central and local governments with NGOs and private sector. The different tiers of governments must be legally, publicly and financially responsible for the executions of budgets and must pay, or be punished in some other way, in case they do not fulfill their obligations i.e. offend the social agreement.

Another type of contractual relationships must be agreement between several local councils in order to improve public service delivery through the implementation of fiscal instruments and other mutually beneficial projects. Such collaboration between local communities must involve participation of businesses with clear definition of roles and responsibilities of each party.

Contracting between local, central government and territorial community would reduce opportunities for informal bargaining and changing the rule during the budget period without consultations with public actors and foresee penalties for the offenders. Under such relations budget hearings and publications of budget proceeding (through the electronic or other media) would become an important instrument of public resources management at the regional and local level. The only legitimate procedure, which can adopt some needed changes during the financial year and confirm execution of the local government’s budget in the end of the year, must be public consultations or hearings.

There could be introduced **horizontal equalization grants between local communities** calculated on the basis of the real budget execution and reflecting existing fiscal disparities between different local governments’ budgets. The aim of these grants is to use more effectively own revenues of the local governments and re-distribute them in the interests of local communities, first of all, meeting needs and interests of the revenue-poorer ones. The second important issue, which could be resolved by this approach, is to provide the opportunity for the local governments to choose by their own other local government for the execution of some needed functions. This recommendation is in line with BC articles, which declare, that transfers may also occur between local self-government budgets in exchange for contractually provided, and mutually agreed upon, public services provided by the transfer recipient. For example, towns, villages and settlements may contract among themselves or with another local government to provide services related to the execution of their expenditure assignments. This may be necessitated by economic factors (economies of scale; more

efficient provision of a service by some other local government etc.). Such responsibilities now are being fulfilled (without any public consultations and discussions about alternatives) by the oblast and rayon authorities, which are by momentum perceived by the local community as “upper level of power”.

Proposed horizontal cooperation approach allows for the territorial community of different administrative-territorial locations to collaborate with each other according to one’s own free will. Oblast or rayon, where this or that territorial community is located, must not be the only one possible agent in the intergovernmental fiscal relations. Moreover, oblast level hardly could be fully empowered agent in general and in providing of equalization in particular, as it is not local government in real sense as it was shown above.

Under this approach local governments, involved in horizontal cooperation, can be not neighbors only, but territorially distant – for example, to belong to different oblasts, or to different rayons within one oblast. They can create new self-government body, or choose among each other one, to whom they delegate responsibilities of using funds, usually now transferred to and/or redistributed by rayon or oblast. They can also combine their resources and create business environment to attract internal and foreign investors in order to develop infrastructure and raise their tax base in nearest future.

(There are some pilot projects pursuing mutual interests of the territorial community, represented by the association of the local governments. For example, the territory of “Big Sudak”, where some “poor” rural local governments combine their resources with richer urban ones. All of them have good potential for the development of services and small businesses, because of favorable location and perspectives of development of tourism. The consideration is that potential of each local government can be used better in case of coordination of activities and combining of different resources – intellectual, financial, material etc. Moreover, such collaboration helps to attract more investments in transport infrastructure development and historical heritage reconstruction, which will bring benefits for all parties. Local governments of this region know well, that poor population conducts illegal capture of lands and undertake non-registered economic activities, which create problems both, for richer, (urban) and poorer, (rural) local communities.)

Such mutually beneficial projects will create important positive social and political environment for the local governments’ activity. Inter-locality grants under these conditions create incentives within “poor” community to use resources effectively and would be accepted with understanding by the population of the “rich” community as temporary measure, which meets the interests of both, the “poor” as well as the “rich” community.

Such approach would contribute to the territorial administrative reform and definition of status of Rayon Administration and Rayon Rada and Oblast State Administration and Oblast Rada and relationship between them and other local governments. Reason of many conflicts in intergovernmental fiscal relations are connected with uncertain status of these government bodies. Other difficulties are connected with relationships and an overlapping of responsibilities of these governments with ones of the “pure” local governments. For instance, many local governments are not satisfied with the fact of redistribution of public resources in the territory of their jurisdiction by rayon or oblast level of government. But in real practice these issues are rudiments of centralized regional policy which distinguish negatively Ukraine from the democratic countries of Europe and North America, and even from Russia.

Such horizontal equalization would facilitate some positive tendencies in fiscal decentralization in Ukraine. The oblast and rayons powers of related territories would be obliged to clarify their role

and function. Rayons more likely would become local self-governments with all needed prerequisites and responsibilities, to be able to propose themselves in a role of effective partner in different forms of cooperation within intergovernmental fiscal relations. Oblast level tends to become representative of the central government, and control, supervise and consult local governments, defending public interests. (Some departments of Oblast State Administration would become Prefecture and some would be representatives of the central Ministries) The human and intellectual resources, financial infrastructure, accumulated in big cities, must be used in fiscal relations not in directive role, but in organizing of the decision-making process, consultation with community, analysis, training and other intellectual service. And responsibility for distribution of public finances within horizontal grant agreement would be the local government authority.

Obstacles of this horizontal equalization mechanisms implementation would be political resistance against this approach from the side of some representatives of oblast and rayon powers who will try to secure their role of “invisible power” in redistribution of public finance. The response to this could be definite and constant position of the central government, community consultations and discussions, which help to elaborate shared strategic vision on the side of local public and governments and reach community support of the declared policy.

Other instrument of Enhancing Local (Fiscal) Capacity and Democratic Accountability would be **local revenue & expenditure programmes development**. Local communities, which have sufficient tax base and other resources of own revenues, have to established an additional programs of own local government’s expenditures. These local expenditures programs can match (in case of education, for instance) with centrally allocated resources. For these purposes additional taxes or duties could be provided using participatory and community consultation approach.

#### *Contracting agencies*

- Local government
- Territorial community (coalition of NGOs, regional departments of trade unions, parties)
- Central government (MoF, oblast or rayon State Administration)

#### *Subject of contract*

- 1) Creation of the favorable legal and regulatory environment. It can be achieved through the negotiations and adopting of the *agreements about coordination of decision-making activities* during the pilot projects implementation. Such an agreement must be signed between the central government bodies, regional and local powers (rayon, city authorities, local self-government)
- 2) Creation of special network of public-and-private partnership for the support of the activities, planned within the proposed pilot projects. It can be reached by signing of the *agreement on cooperation between pilot project executive organizations and other interested parties*.

Such agreements, adopted by central and local governments’ representatives as mean of support of the pilot projects’ implementation, would foresee, beside others, the following:

a) stability and transparency of the budget process, obtain time frames while preparation, adoption and execution of the local budget and procedures, connected with it. This condition is fully in line with Budget code and Law of Ukraine on budget and that is why it would be possible to sign the agreement and reach this condition\requirement.

б) clear definition and fulfilling by different tiers of power of their responsibilities towards public services delivery in particular sector – as well as some additional functions and special duties within the pilot project implementation. The matter is that Law of Ukraine on Self-government, Budget code permit some flexibility and provide opportunity to establish rules of the game within framework of the existing legislation. Therefore, the task of the agreement should be to fix the existing gaps and contradictions in legislations, to

agree about who do what during the pilot projects’ implementation period and decide conventionally the responsibility of all parties.

b) introduction of new staff positions or\and changing terms of references for the existing positions in the structure of the sector’s management on the local level. Such changes in municipal management by introduction of the new qualification requirements will support implementation of some additional functions, needed to improve services delivery and fulfill local governments’ responsibilities (in general and additionally taken within the pilot project implementation).

r) in order to create incentives for the effective use and economizing of resources there also must be foreseen by the agreement permission of experimental changes in the resources allocation. Such changes - done within the existing financial mechanisms in distribution of public resources would be as follows: 1) giving more ability for consumers to decide how and were to allocate money, distributed to the services; 2) giving more right to the local community (local self-government of the basic level) to check and control use of the expenditures, to impact on allocation of these resources; 3) delegation of the more responsibilities for the strategic development and giving more autonomy to the community level (in, particularly, questions of using economized money etc).

Such rules of the game introduced within the time of the pilot project implementation, and limited by the jurisdictions of the local governments, involved into the pilot projects, would help to develop new instruments and provide mechanisms of legal and regulatory support of their dissemination and further implementation in other regions of Ukraine.

## Appendix 2

### **“Policy analysis and human resources development component”**

Weakness of the central government’s policy helps political and financial interests groups to receive advantages using the gaps in the fiscal decentralization system. Public resources are the most attractive and “cheapest” means in shadow business cycle. Access to these resources through the buying power gives the opportunity to reach surplus profit in conditions of lack of civil society, corrupted government and increasing poverty of population. This situation is conserved by the fact that new documents, developed by or addressed to the government, do not contain analysis of the interest groups and means of their activity. It makes possible for the shadow capital to be re-invested in receiving privileges for interest groups again by buying power. In result, hidden goals and means are not depicted and real analysis is not undertaken. Good intentions of government remain mere declarations, because its implementation is not possible without awareness of mistakes done in decision-making during previous budget cycles.

Therefore abovementioned projects, conducted by non-governmental as well as by governmental organization, must be supported by the improvement of fiscal decentralization policy on the central level:

- Adjustment of the Ukrainian legislation in area of intergovernmental relations to the requirements of European Community (according to PCA). Policy - making and document development projects must be launched, including analytical policy paper development and changing of legislation, connected with intergovernmental fiscal relations (Local Self-government Law, Tax Code, Budget Code, Municipal Service Law, Municipal Property Law, Law on non-for profit organizations etc).
- Consultations with community, independent experts, involvement of the foreign experts into the policymaking process. This project area must include different forms of public consultations, debates, discussions of the draft policy papers and analytical documents, prepared in above project area.

This policy improvement process must include human resources development and trainings module:

- Introduction of education and training programs in the schools, universities and post-graduate training system in order to facilitate community participation in policy process of the improvement of the inter-governmental relations.
- Development of human resources for the needs of above projects areas through the in-service training of municipal, central government, NGO representatives, dealing with the intergovernmental fiscal relations issues in their everyday practice. This project area must be organized like virtual college (distant learning network) involving municipal managers of post-soviet countries. They would create self-organized international teams collaborating with each other in conducting projects in their countries' local governments within cross-regional programs. Professional growth in the related field of public, municipal service or\and political, research, academic careers would be incentives to participate in such human developing aspect of the intergovernmental fiscal relations reform.

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