Whither “Decentralization?”

Local Government Finance Reform,

and the Restructuring of Ukraine’s Public Sector

2014 to 2016

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October 2017

This paper is a summary of a report written for the Ukrainian Ministry of Regional Development in June 2017. The report, “Caught Mid-Stream: Local Government Finance Reform, and the Restructuring of Ukraine’s Public Sector 2014 to 2016” was co-authored with Jasmina Djikic and financed by the Swedish International Development Agency under the project “Support for Decentralization in Ukraine”. The report is based on the analysis of three years of subnational revenue and expenditure data drawn directly from Ukraine’s Treasury system and covers in much greater detail the evolution of the country’s intergovernmental finance system since 2014. Neither the report, nor this paper could have been written without the technical support and comments of Katya Maynzyuk, Yurij Dzgyhr, Ieva Kalnina, Jan Herczynski, Kostya Gavrylov, and Anatoli Tkachuk. All errors of fact and interpretation, however, are our own and the views expressed do not reflect either those of the Ministry of Regional Development or SIDA.

**Introduction:**

In May 2014, Ukraine’s newly elected president Petro Poroshenko, declared that his government would put “decentralization” at the top of its political agenda. This declaration followed Russia’s annexation of Crimea and --more immediately-- it’s fomenting of armed separatism in the Donbass. Indeed, it was a direct response to those at home and abroad who -following Moscow- argued that the only way to resolve the crisis was for Ukraine to federalize.

Seen in this light, Poroshenko’s turn towards “decentralization” was essentially a tactical move designed to take the question of federalism off the table[[1]](#footnote-1). But it was also the return to an issue that has haunted Ukrainian politics since independence.

In the following, I briefly sketch the history of “decentralization” in Ukraine before examining the more important achievements and problems of the reforms that have been implemented since the end of 2014. On the one hand, I argue that these reforms have significantly changed the structure and functions of Ukraine’s subnational governments. Most importantly, power and money has been shifted towards cites and newly consolidated gromada (villages/small towns), both of which should be considered fully-democratic local governments.

They have also dramatically reduced the power of oblasts (regions) and rayons (districts) –levels of subnational government that have never been fully democratic, and whose (dual and confused) subordination to the national government has always been extremely problematic. As such, the reforms of the last two years have strengthened local democracy in Ukraine and hold the promise of improving the quality and accountability of local public services. This is good news. On the other hand, however, a combination of legislature failures, conceptual confusions, and tactical compromises have not only left the reforms in mid-stream, but have trapped reformers in a discourse about decentralization that shows increasing signs of becoming self-blocking.

The biggest political failure concerns the inability of the government to push through legislation requiring the amalgamation of the country’s 10,000 gromada into larger, more viable units of democratic governance. As a result, reformers have been forced to rely on a voluntary process of jurisdictional consolidation that will be hard to extend across the nation. This voluntary process is also seriously flawed because it allows rural and small-town gromada to self-sort into separate jurisdictions, a self-sorting that undermines both the financial and functional viability of many of the newly consolidated units.

Equally importantly, the inability of Ukrainian reformers to clearly articulate what they mean by “decentralization” has led them to advertise what they are doing almost entirely in financial terms. Indeed, over the last few years, virtually the sole argument that the government has used to justify what it has been doing, has been the massive amount of money it claims to have transferred to local governments. Unfortunately, once inflation has been taken into account, this simply isn’t true. Instead, total subnational revenues have remain stable, but significantly more of it is now going to cities and newly consolidated gromada and less to rayons and oblasts.

This is a good thing. It is also probably what most involved in designing the reforms want to see, but which they rarely discuss publically lest the discussions prompt further opposition. So instead, they have focused on all the new money all subnational governments are supposedly getting. But this discourse masks the real shifts in power that the reforms have brought about. And it is creating expectations that will be difficult to maintain going forward. Indeed, plans to create a single-payer health care system will require the national government to reduce subnational budgets, potentially making the government’s current discourse about “decentralization” self-blocking.

# II. The History and Context of the 2015 Financial Reforms

Ukraine inherited from its Soviet past a highly decentralized fiscal structure: Since independence, subnational governments have controlled –at least nominally— almost 40% of all public expenditure. On paper, this makes Ukraine one of the most “decentralized” countries in Europe.[[2]](#footnote-2)

### Figure 1. Subnational Revenue as a % of GDP and Total Public Revenue in European Countries 2015 (Ukraine 2016)

As such, Ukraine’s problem with decentralized governance has never been strictly or even primarily financial. Instead, three other problems have haunted the country’s efforts to create a viable system of subnational governance: Extreme jurisdictional fragmentation at the village (gromada) level; the ambiguous governance structure of oblasts and rayons; and the maintenance of centrally controlled expenditure norms.

Like many other post-communist countries, Ukraine allowed every town, village, and hamlet to become independent local government in the 1990. This policy was pursued in the name of “bringing democracy as close to the people as possible.” [[3]](#footnote-3) But while understandable in the wake of communism’s collapse, the policy also produced extreme jurisdictional fragmentation. So much so, that Ukraine has more than 10,000 village-level local governments (gromada). These village governments have an *average* population of about 1500 inhabitants and are too small to organize, finance, or deliver basic public services. As a result, the rayon level governments above them have remained responsible for providing many of their basic public services.

At the same time, the governance structures of both rayons and oblasts have remained in limbo with democratically-elected councils but state-appointed executives. The constitution requires that the Council of Ministers appoint rayon and oblast governors. And these governors, in turn, have final say over the hiring and firing of department heads. As a result, both governors and department heads at the oblast and rayon levels are subject to a “dual subordination”, at once responsible to agencies of the national government and their democratically-elected councils[[4]](#footnote-4). This dual subordination has confused of local and national authority at both levels of government. So much so, that neither oblasts nor rayons should really be considered “local self-governments” at all. [[5]](#footnote-5)

Finally, Ukraine’s efforts to decentralize have been seriously undermined by national government’s maintenance of centrally imposed expenditure norms for social sector functions. In the early 1990s, most post-communist countries assigned their newly created local governments responsibility for delivering basic urban services and only later devolved to them --typically limited-- roles in education, social welfare, and health. Ukraine, by contrast, almost immediately made oblasts, rayons, and 170 so-called Cities of Oblast Significance (COS or Cities) responsible for both basic public services and much of the country’s health, education, and social welfare systems[[6]](#footnote-6).

To finance these social sector responsibilities oblasts, rayons, and COS, were given 100% of the Personal Income Tax (PIT) generated in their jurisdictions. But because economic activity differed dramatically from place to place, their PIT shares yielded very different levels of revenue across the country. Indeed, by the end of the 1990s it was painfully clear that while a few well-endowed jurisdictions could finance their social sector responsibilities from their PIT shares, most could not.

In 2001, the government attempted to correct these imbalances by reforming the country’s Budget Code. The new Code required the national government to calculate normative social sector expenditure needs for every subnational government. These need calculations were then compared with the expected yield of PIT in every jurisdiction, and subnational governments whose expenditure needs exceeded their PIT shares were given an equalization grant.

These reforms significantly improved the adequacy and equity of the intergovernmental finance system. But they left a major problem unresolved. In short, line ministries were allowed to require subnational governments to spend money on social sector functions in accordance with standards set by the ministries themselves. These standards were set in completely different ways than those used to calculate the normative expenditure needs –and hence the equalization grants-- of subnational governments (e.g. per capita vs. X UAH per hospital bed).

And not surprisingly, the ministerial requirements were much higher, generating deficits almost everywhere. Worse, ministries exercised these requirements through the state-appointed executives that remained at the oblast and rayon levels –sometimes in line with the wishes of their democratically-elected councils and sometimes opposition to them, but always confusing which level of government was really responsible for what.

In the aftermath of the 2005 Orange Revolution, a team of reformers led by Deputy Prime Minister Roman Beszmertnyi drew up plans designed to make a clean break with the past. These plans called for radically reducing the importance oblasts and rayons, while significantly expanding the power of cities and gromada. Beszmetnyi’s team wanted to consolidate Ukraine’s 10,000 gromada into 1,200 much larger units, while designating cities (COS) and these newly amalgamated gromada (AG) as Ukraine’s most important level of local self-government. COS and AGs would be responsible for all basic urban services, as well as for the finance and management of most schools and primary health care facilities[[7]](#footnote-7).

Meanwhile, rayons would be limited to running general purpose hospitals outside of urban areas, and where necessary some schools, while oblasts would be responsible for specialized health care facilities, some educational institutions, and regional planning. Reformers also expected to amend the constitution in order to allow for the democratic election of rayon and oblast executives and to end their dual solution. Finally, they wanted to reform the intergovernmental finance system by reducing subnational PIT shares, while also introducing new block grants for health, education, and social welfare to make up for the lost revenue. Here, the hope was that the earmarking of social sector funding would eliminate the need for centrally imposed expenditure standards, while also clarifying how much money local governments were receiving to support shared responsibilities. Within each sector, local governments would be free to spend the block grants as they saw. They would also be free to contribute additional money from their general revenues if they so desired.

Ultimately, however, the Yushenko government proved too weak to implement these plans: On the one hand, it lacked the parliamentary super-majority necessary to pass the constitutional amendments that would make possible both the democratic election of rayon and oblast executives, and the designation of COS and AG as the fundamental units of Ukrainian local government[[8]](#footnote-8). On the other hand, the government was afraid of the grassroots opposition that jurisdictional consolidation inevitably provokes --opposition that the more populist forces around both Yulia Tymoshenko and the Party of Regions were (and remain) happy to exploit.

Ukraine’s inability to clearly parse public sector responsibilities between levels of government has ensured that no level of government really considers itself responsible for delivering quality public services. This lack of accountability has depressed performance and facilitated corruption. But most importantly, the ambiguous nature political responsibility for social sector functions has made it impossible for Ukraine to restructure its health and education systems during a period of profound demographic[[9]](#footnote-9). In short, nobody has wanted to be held responsible for the extremely painful task of bringing hospital and school networks in line with the populations they serve. As a result, Ukraine now has significantly more doctors, nurses and hospital beds per 100,000 inhabitants than almost all EU countries. It also has one of the lowest pupil/teacher ratios in the world.[[10]](#footnote-10) Indeed, at this point it is fair to say that the terrifying political and social challenges of restructuring these sectors now pose the greatest threat to Ukraine’s current efforts to decentralize.

Nonetheless, and as we have seen, EuroMaidan and Russia’s backing of armed separatism in the Donbas put “decentralization” back on the top of Ukraine’s political agenda in the spring of 2014. And while President Petro Porshenko’s turn to decentralization was clearly designed to cool demands for the federalization of the country, it has proved to be much more than just a tactical maneuver –even if the effort has thus far failed to overcome some of the same problems that have undermined local government reform in the past.

To lead the decentralization effort, Poroshenko appointed the young reformist mayor of his home town of Vinnytsia –Volodymyr Groysman-- Deputy Prime Minister and Minister for Regional Development. Groysman then reassembled many of the architects of the decentralization strategy that emerged after the Orange Revolution and which then had been abandoned. They quickly drafted constitutional amendments to permit the democratic election of oblast and rayon executives and to create new state oversight bodies at the regional level. They also drafted legislation mandating the nationwide consolidation of gromada. At the same time, the Ministry of Finance prepared amendments to the tax and budget codes designed to diversify local government revenue and to replacing the gap-filling transfer system with a one based on social sector block grants.

But because parliament was still dominated by members elected before the Maidan, the government postponed submission of the draft legislation to parliament. Instead, it choose to wait until the fall in the hope that the scheduled parliamentary elections would return a legislature more inclined to support radical change. The October elections, however, returned an almost equally divided parliament. As a result, the government had no chance of putting together the super majorities necessary for constitutional amendments[[11]](#footnote-11). Worse, it could not muster the simple majority needed to mandate the consolidation of gromada because some of its own allies turned against the idea –most importantly, the Self-Reliance Party of Andrii Sadovii, Mayor of Lviv.

Thus, the best the government could do in the frantic closing months of 2014 was to pass legislation that allowed gromada to amalgamate on a voluntary basis, and to amend the budget and tax codes. These amendments significantly changed the intergovernmental finance system in the following ways:[[12]](#footnote-12)

* The lump-sum, gap-filling grant that all levels of subnational government had previously received for their social sector functions was replaced by separate Health, Education and Social Welfare block grants, as well as a small, freely disposable equalization grant. This change was designed to make it clearer how much national support subnational governments were to receive for each of the social sector functions they had been made responsible for, and to reduce the pressure on line ministries to impose their own expenditure norms.
* The normative cost calculations for preschool education and social welfare institutions like orphanages and homes were taken out of the more general formulas used to calculate the expenditure needs in education and social welfare. This signaled that these responsibilities were now to be considered own functions --as opposed to shared ones. And their costs would be paid for solely from the general revenues of subnational governments.
* The Oblast share of PIT was reduced from 25% to 15%, while the share returned to rayons and cities was reduced from 75% to 60%. As result, the national government would retain 25% of the national yield of PIT, monies that it could then use to finance the new social sector block grants.
* To encourage amalgamation, unconsolidated gromada lost their 25% share of PIT while Amalgamated Gromada were assigned the right to a 60% PIT share at the moment of their creation, and at the expense of the concerned rayon(s).
* Oblasts, and the Capital City of Kyiv, were given a 10% share of Corporate Income Tax, as well as a higher share of Environmental Fees (55% up from 10%) while cities and rayons were allowed to retain 100% of certain state duties and administrative fees that had been previously returned to the national budget.
* Cities and both amalgamated and unamalgamated gromada were given a 5% surcharge on excisable goods sold in their jurisdictions. They were also given the right to impose a new area based property tax on land and buildings.

# The Effects of the 2015 Reforms on Subnational Revenues

Figure II below, shows total subnational revenue as a percentage of both total public revenue and GDP between 2012 and 2016. Subnational revenue remained stable as a percentage of both GDP and total public revenues in 2015, before rising fairly significantly as a share of both in 2016. The fact that subnational revenue actually increased as share of public revenue, while the overall size of the public sector fell, is remarkable because countries at war almost inevitably recentralize public finances. Indeed, it is strong evidence that the Poroshenko government was serious about its commitment to subnational governments and that its support for “decentralization” was much more than a rhetorical tactic to assuage demands for the federalization of the county.

### Figure 2: Subnational Revenue as a % of GDP and General Government Revenue 2012-16

But the fact that subnational revenues increased as a share both GDP and total public revenue does not mean that they have gone up significantly in real terms. Figure 3 below, shows total that subnational revenue actually fell in inflation adjusted hryvna in 2015 before increasing slightly in 2016.

### Figure 3: Total Local Government Revenue in Nominal & 2016 UAH (bln) 2014-16

The government, however, has chosen to ignore inflation and instead to advertise the major success of the 2015 reforms in terms of the “hundreds of billions of new hryvna that they have put into the hands of local governments.”[[13]](#footnote-13) We will return to both the reasons for this strategy and the problems with it later on.

Curiously, however, subnational governments themselves have mostly accepted the national government’s claim that their revenues have increased dramatically. The reason for this can be seen in Table 1. As can be seen from the table, inflation adjusted wages fell substantially faster than other expenditure between 2014 and 2016.

### Table 1: Local Government Expenditure by Economic Category 2014-2016 (2016 UAH, bln)

|  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
|   | **Wages** | **Utilities & Energy** | **Other Operating Costs** | **Subsidies to institutions[[14]](#footnote-14)** | **Transfers to individuals**  | **Capital Expenditure** | **Carry Over** | **Total Expenditure** | **Total Revenue** |
| **2014** | 142.3 | 17.4 | 48.1 | 34.0 | 78.8 | 24.1 | 8.5 | **353.1** | **353.1** |
| **2015** | 118.8 | 18.5 | 44.2 | 20.6 | 74.6 | 38.0 | 14.2 | **328.9** | **326.5** |
| **2016** | 115.4 | 17.6 | 44.2 | 19.1 | 99.0 | 52.5 | 15.4 | **363.2** | **363.2** |
| **2015 as % of 2014** | 83% | 106% | 92% | 61% | 95% | 158% | 167% | **93%** | **92%** |
| **2016 as % of 2014** | **81%** | **101%** | **92%** | **56%** | **126%** | **218%** | **182%** | **103%** | **103%** |

The reason for this is that the national government did not increase public sector wage rates in line with inflation. And falling wages increased the operating surpluses of subnational government, increases that subnational governments then used to finance a dramatic rise in both capital expenditures and year-end carryover. So while the total revenues of revenue of subnational governments did not increase, their disposable income did. And this rise in disposable income largely explains why subnational governments accepted the national government’s narrative about new money.[[15]](#footnote-15)

The “new money” narrative, has in turn served to obscure the fact that the reforms have produced very substantial changes in the relative power and importance of subnational governments. As can be seen in Figure 4 below, oblasts have been the biggest losers. Their revenues fell from 73.4 to 53.1 billion UAH between 2014 and 2016, a decline of 27%. Cities (COS) –where the 48% of the population now lives-- have been the biggest winners. Their revenues increased by 20 bln UAH (14%) between 2014 and 2016, partially because of the way the new transfer system worked, and partially because some health and education functions were shifted to them from Oblasts.

### Figure 4: Composition of Local Government Revenue by Level 2014-16 (2016 UAH, bln)

Meanwhile, rayon revenue fell in 2015 before returning to their 2014 levels in 2016. All of this 2016 growth, however came from an increase in Transfer Payments to Individuals (that can be seen in Table 1). These are national government transfers that flow through subnational budgets, but are not controlled by them in any meaningfully way. As a result, and as with oblasts, the 2015 reforms have reduced the importance of rayons in the provision of public services. Like rayons, the revenues of gromada fell significantly in 2015 before increasing to slightly above their 2014 levels in 2016. But what is completely new, is the 7 bln hryvna (1.7% of all public revenue) that is now going to the 159 Amalgamated Gromada (AGs) that were formed after the passage of the law on voluntary amalgamation in late 2014[[16]](#footnote-16).

The potential significance of the new AGs, as well as the larger shift in the relative importance of subnational governments becomes more visible when we look at the per capita revenues of all subnational governments. As can be seen from Figure 5 (below), Cities are now clearly the most important level of subnational government. Meanwhile, oblast revenues have fallen so sharply that they are now only slightly higher than those of unconsolidated gromada in per capita terms. But the most striking aspect of the figure is the structural similarity between Cities and AGs: Unlike rayons and oblasts, both derive a significant share of their revenues from own-sources. And unlike unconsolidated gromada, both receive significant transfers for the provision of social sector services. Indeed, if the social welfare payments --Transfers to Individuals-- that are currently administered by rayons were shifted to AGs, not only would the composition of their revenues be even more like those of cities, but their per capita budgets would exceed those of rayons.

### Figure 6: Per Capita Local Government Revenue by Level of Government (2016 UAH)

In short, what the Figure suggests is that 2015 reforms have set in motion a process that is perhaps best described as ***the municipalization of oblast power, and the “gromadization” of rayon power.***

# Amalgamated Gromada (AGs) and the Amalgamation Process

As we have noted, the national government was unable to muster the parliamentary votes necessary to pass legislation requiring the amalgamation of all gromada. As a result, it has had to rely on a voluntary process. In 2016, about 1000 gromada voluntarily consolidated into 159 AGs. Together these AGs serve 1.38 million people, or about 3.6% of Ukraine’s population (without Crimea and the occupied territories of the Donbas). Since 2016, another 254 AGs have been created, some of which will only begin functioning in 2018. As a result, soon there will be 413 AGs serving 3.68 million people, or about 9.5% of the total population and about 20% of the population living outside of cities.

This is an impressive achievement. But 80% of the non-urban population still lives in unconsolidated gromada that remain too small to provide basic public services and thus must remain on rayons. So much remains to be done. In this section, we review what has been accomplished through voluntary amalgamation and make three basic points about the process.

The first is simply that while the voluntary amalgamation is still in its infancy, it can be assumed that many of the gromada most intent on amalgamation have already consolidated themselves, and that over time it will be become harder and harder to convince others to voluntarily join-up. As such, it seems unlikely that the process can be carried to completion without the eventual passage of legislation that requires all gromada to consolidate by a certain date.

The second and the third points relate to the incentives that reformers have used to encourage consolidation. They underscore the first point by suggesting that there have been serious costs to voluntary amalgamation, and that overtime these costs will become less and less sustainable. The most of obvious of these costs concerns the substantial investment grants that the government has been providing to new AGs. As can be seen from Figure 6 above, the scale of these grants has been significant: AGs received close to 800 UAH per capita in investment grants in 2016 --twice as a much as cities, and well over ten times as much as oblasts, rayons and unconsolidated gromada. In short, it is unclear whether these sorts of financial incentives are sustainable for much longer.

Equally problematic is the fact that in order to encourage consolidation the government has pursued a permissive policy with respect to the kinds of AGs that can be formed. This permissive policy has allowed for the establishment of AGs of very different sizes, structures and fiscal capacities. Thus, while on average the 159 new AG have about 8,700 inhabitants, their populations range between 1,600 to 44,000 citizens[[17]](#footnote-17). Moreover, 25% of them have less than 4,000 residents and 94 of them have no central town or economic center.

The small size of many AGs, and fact that almost 60% of them are composed only of rural settlements raises questions about their fiscal and economic sustainability. A better idea of the problems here can be seen from Table 2 (below) which presents the composition of AG revenues in quartiles ranked by their per capita revenues from shared taxes –the best proxy we have for their relative wealth.

### Table 15: AG Revenue Per Capita (in Quartiles ranked by Shared Taxes)

|  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Quartile** | **Population** | **Shared Taxes** | **Land & Property Taxes**  | **Rent** | **Other Own** | **Equaliz.** | **Other Subsid & Investment grants** | **Education Grant** | **Health Grant** | **Total** | **Total as % of 4th** |
| **Q1** | 260,213 | 593 | 84 | 113 | 61 | 456 | 739 | 1,453 | 249 | 3,748 |  **0.53**  |
| **Q2** | 375,250 | 1,163 | 94 | 221 | 107 | 308 | 739 | 1,340 | 191 | 4,164 |  **0.59**  |
| **Q3** | 377,947 | 1,723 | 145 | 308 | 122 | 139 | 804 | 1,081 | 189 | 4,511 |  **0.64**  |
| **Q4** | 372,637 | 3,848 | 186 | 490 | 502 | 42 | 706 | 1,079 | 237 | 7,091 |  **1.00**  |
| **Total** | **1,386,047** | **1,931** | **131** | **297** | **209** | **218** | **748** | **1,220** | **214** | **4,967** |  **0.70**  |

The first characteristic of the Table that is worth noting is that the population living in the quartile containing the poorest AGs (1st ) is about 100,000 less than those of the richer ones. This means that AG in the 1st quartile have an average population of c. 6,500 people, while those of the other quartiles are about a third larger (average population of c. 9,400). The second striking feature of the table concerns the odd way PIT revenues increase as one moves from the poorest to the richest quartile: Between each of the first three quartiles, PIT revenues increase by about 600 UAH for each quartile, before more than doubling between the 3rd and the 4th quartiles (1700 to 3800 UAH)

Taken together, the particularly small populations of the AG in the 1st quartile, and the particularly high revenues from shared taxes of those in the 4th quartile suggests that voluntary amalgamation is allowing gromada to self-sorting into AGs that are primarily rural, and AGs that try to limit themselves to those gromada immediately adjacent to a small town. Exactly how much of this pattern is being driven by self-sorting, and how much of it is simply a product of the fact that in many areas of country there may be so few small towns that rural settlements can only amalgamate with themselves, is hard to say.

Nonetheless, press reports suggest that local politics is driving at least some of this self-sorting, and that the tendencies that can be seen in the tables are the product of more than “objective circumstances”[[18]](#footnote-18). In short, some poorer, rural and less densely populated jurisdictions are resisting amalgamation with nearby towns because they are afraid that that their (political) interests will be ignored (or voted down) by their more urban neighbors. And some small towns with relatively high levels of official employment are resisting amalgamation with the more rural areas around them because they understand that by doing so they will avoid having to spend their tax revenues on their poorer neighbors[[19]](#footnote-19).

To be sure, and as can be seen from the table, the allocation of the equalization and education grants are working to flatten the income disparities generated by the differences in AG tax bases. This is good news and means that the equalization grant is being allocated according to objective indicators of relative wealth (primarily the per capita yield of PIT). It also means that more of the education grant is going to poorer, more sparsely populated jurisdictions where the costs of schooling are higher. As a result, the total per capita income of all quartiles is much flatter than it would be without these additional revenues. Nonetheless, and over time, the more the consolidation process allows gromada to self-sort into entirely rural AGs on the one hand, and richer AGs centered more or less exclusively around a small town, the more it will cost the national government to maintain some measure of horizontal equity between them.

# Whither “Decentralization” in Ukraine

“Decentralization” is not a new problem for Ukraine. Nor has it ever been primarily a financial one. Instead, the major problems have always centered around three questions that remain to be resolved. The first is which subnational governments should really be considered independent local governments, and which should remain territorial arms of the national state. The second question, is which public service responsibilities should be assigned to each type of subnational government. And the third is how to consolidate rural gromada into units large enough to provide basic public services.

Over the last three years, Ukrainian reformers have been trying to answer these questions --with mixed results. As in earlier reform efforts, they have been unable to pass the constitutional amendments that would allow for the democratic election of rayon and oblast executives or for designating Cities and Amalgamated Gromada Ukraine’s basic units of local self-government. Nor have they been able to muster the simpler parliamentary majority necessary to mandate the national consolidation of gromada into AGs.

They have, however, managed to introduce very substantial reforms into the country’s intergovernmental finance system. These reforms have significantly pared back both the revenues and the responsibilities of oblasts, whose budgets have shrunk by close to 30% since 2015. Rayons have also lost power, but less because their total revenues have fallen, than because an increasing share of them - 48% - are now earmarked transfer payments to poor households over which they have no control. As a result, the rayon’s most important function is increasingly the distribution of welfare payments to individuals, a function that could easily be transferred to AGs.

Meanwhile, cities have benefited most from the reforms. Since 2015, their revenues have risen close to 15%, in part because of the expansion of their responsibilities in the health and education sectors and in part, because changes in the transfer system have favored them. Municipal investment rates have doubled since 2014 and now represent 20% of total expenditure. More than 60% of their education spending and 40% of their health spending now comes from their general revenues, and not from the grants they receive from the national government to support these functions. And while they still only raise 17% of their revenues themselves there is no evidence that the increase in the largess of the transfer system has depressed their willingness to collect local taxes fees and charges. Finally, the reforms have not produced any significant deterioration in the horizontal equity of municipal finances, and the relationship between the revenues of the poorest quartile of cities to those of the richest quartile has remained stable[[20]](#footnote-20).

Reformers have also pushed forward jurisdictional consolidation by passing legislation that made the voluntary creation of amalgamated gromada possible. As a result, in 2018 approximately 20% of Ukraine’s non-urban population will live in AGs. The revenue structure of AGs now more resemble the revenue structure of cities than those of the rayons they were once dependent on. Indeed, AG per capita expenditures now exceed the combined per capita expenditures of both rayons and the unconsolidated gromada from which they came --once statutory transfer payments are removed from the picture for rayons. Finally, their investment rate –c. 30% of total expenditures-- is the highest for all types of local government.

Taken together, the 2015 reforms have set in motion a process that is municipalizing oblast power and the “gromadizng” rayon power. These are very significant achievements that undoubtedly reflect the core strategic objectives of Ukraine’s local government reformers. Most importantly, they carry with them the promise of clarifying the allocation of service responsibilities across levels of government and of substantially improving public sector performance and accountability.

Nonetheless, how reformers have gotten to this point, and how they are publicly articulating the purpose of the reforms is increasingly problematic. Most of these problems are directly related to reformers’ inability to push key enabling legislation through Ukraine’s deeply divided parliament. Here, the most obvious example is the failure of the government to pass legislation that would mandate the amalgamation of all gromada by a particular date and according to certain minimum standards.

This failure has forced reformers to rely on a voluntary process of consolidation. And to encourage consolidation the national government has made significant side payments to gromada that have been willing to amalgamate. Similarly, the national government has sought to speed up consolidation by allowing gromada to amalgamate any way they want, a process that seems to be encouraging the dysfunctional self-sorting AGs into two groups: Small, rural, and extremely poor gromada are apparently consolidating themselves into units without any sort of town center because they are afraid that their voices and interests will be ignored if they amalgamate with the more urban settlements. And many of these urban settlements seem to be trying to amalgamate with as few rural gromada as possible because they then won’t have to provide services to their poorer neighbors.

In short, without a clear requirement that all gromada consolidate by a particular date, and that consolidation conform to certain minimum requirements, the voluntary amalgamation process is not only likely to stall, but to produce a large number of AGs that will be unsustainable without continued provision of special transfers –transfers that the Ukrainian state may not be able to afford.

Meanwhile, the government’s inability to pass the constitutional amendments necessary to change either the governance structures of rayons or oblasts, or to declare Cities and AGs Ukraine’s most important levels of local government has also forced reformers into a dangerous ideological corner: Precisely because the government has proved incapable of passing key enabling legislation, reformers have been forced to rely on a reform discourse that conflates “decentralization” with the provision of more money to all levels of subnational government. Indeed, since late 2014, almost all of the government’s public discussion of decentralization has focused on the “hundreds of billions of new hryvna” that the reforms have provided to subnational governments.

As we have seen, this discourse is profoundly misleading once inflation is accounted for. Worse, it masks much of what has actually been accomplished, meaning the shift in power away from oblasts and rayons towards cities and AGs. It is also arguably “politically unnecessary,” at least in as much as the truly remarkable fact of the last few years is that despite war and occupation, Ukraine has not recentralized its public finances.

But most importantly, the one-sided identification “decentralization” with more money is increasingly dangerous and potentially politically self-blocking. The first reason for this is simply that this discourse creates the false expectation that going forward all levels of local government can expect to see their financial positions improve. This is clearly not what happened, despite the fact that all levels of subnational government felt like it did. Instead, and as we have seen, the disposable income of all subnational governments increased –and with it investment rates-- because the national government did not adjust public sector wages in line with inflation in 2015 and 2016.

In 2017, however, the national government did raise public sector wages. These increases will reduce the disposable income of all local governments, but particularly those of oblasts, rayons and gromada. And in the name of “decentralization” they will fight against these reductions by demanding more money. Worse, these demands may well be supported by the more powerful cities precisely because “decentralization” has become completely identified with the idea that the national government is simply not providing subnational governments with adequate funding.

The conflation of decentralization with more money also distracts local governments from some of the most important challenges they –and indeed Ukraine-- face. These challenges lie in improving the quality of public sector services while rationalizing school and health care networks, networks that have not been adjusted in line with country’s steep demographic decline. In short, Ukraine cannot afford to have one of the lowest teacher/pupil ratios in the world, or one of the highest ratios of hospital beds to citizens in Europe. And like it or not, local governments must understand that they will necessarily be on the front line of this struggle.

Finally, the “financialization” of Ukraine’s discourse about decentralization is at odds with recently passed legislation designed to overhaul the country’s health care system. This legislation calls for the creation of a single-payer, insurance-based system of finance that would fund both public and private health care providers on a fee-for-service or outcome basis. The creation of a single-payer system will leave subnational governments as the owners of many health care facilities. But it will relieve them of responsibility for financing their day-to-day operations. Instead, the grants that currently go to local governments to pay for the day-to-day operations of health care facilities will recentralized in order to fund the single payer system. As result, the expected reform of the health care system will require substantially reducing subnational budgets –effectively putting health care reform on a collision course with both the way reformers have talked about “decentralization” and how the public has come to understand it.

In short, the national government needs to both accelerate the amalgamation process and change the way it explains “decentralization” to the public. Instead of touting the financial gains of the last few years, reformers need to concentrate on explaining to the public why it is important that each level of subnational government be assigned the public services that it is most capable of delivering. performing. aligning explaining to the public why it is necessary to alignn each level of government the responsibilities it is best suited to provide. refoIt is thus critically important that Ukraine’s reformers change the way they are talking about decentralizationMoving towards a single payer system, and allowing private health care providers to eventually compete with public hospitals is almost certainly a good thing because at the end of the day it is unlikely that COS and AGs will be capable of restructuring both Ukraine’s health and education systems at the same time. Indeed, combined with the local government reforms of the last few years the new health care legislation holds –at least in theory-- the promise of profoundly improving public sector governance in Ukraine: As fully democratic local governments, COS and AGs would bear clear responsibility for providing basic urban services and for reforming the country’s education system. Meanwhile, oblasts and rayons could be left as deconcentrated units of the national government At the same time, assigning responsibilities to those levels of (fully) democratic government best equipped to manage and finance them: By concentrating responsibility for most day-to-day public services at the municipal and AG levels reformers would substantially clarify who should really be responsible for what. And by consolidating gromada, the new AG in the expectation that once this is done, municipalized governments will prove capable of both improving basic public services and restructuring the country’s tragically inefficient school system. And by recentralizing health care finance, they acknowledging that the insurance aspect of health care requires centralization, and that the burden of restructuring of the country’s overbuilt and ineffective hospital system have to be shared between the national government and local governments.

But further progress on this promising agenda will require both a change in the way the reformers articulate this agenda and the consolidation of the country’s deeply fractured elites around it. Whether either is possible remains an open question. But one thing should be clear: The clock is ticking and unless some consensus can be reached about how to move forward quickly and forcefully, the gains of the last few years could unravel.

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1. These considerations are clear from a remark Poroshenko made in September 2017: "So, decentralization does work. It is an effective vaccination against federalization and a solid guarantee of the unity of our Ukraine.”

Decentralization of Power Newsletter, September 2017, Ministry of Regional Development [↑](#footnote-ref-1)
2. The above picture would not change much for Ukraine if the data was drawn from any year since 1992. OECD Territorial Reviews: Ukraine, 2014, pp. 14-17 [↑](#footnote-ref-2)
3. For more on this elsewhere in the region see A. Campbell and A. Coulson (2006) “Into the mainstream: Local democracy in Central and Eastern Europe,” Local Government Studies, 32(5) pp.543-561 [↑](#footnote-ref-3)
4. This confusion is expressed in Article 118 of the Constitution of Ukraine, “Heads of local state administrations are appointed to office and dismissed by the President of Ukraine upon the submission of the Cabinet of Ministers of Ukraine. In the exercise of their duties, the heads of local state administrations are responsible to the President of Ukraine and to the Cabinet of Ministers of Ukraine, and are accountable to and under the control of bodies of executive power of a higher level. Local state administrations are accountable to and under the control of councils in the part of the authority delegated to them by the respective district or oblast councils. Local state administrations are accountable to and under the control of the bodies of executive power of a higher level.” [↑](#footnote-ref-4)
5. This has led to considerable linguistic and conceptual confusion in Ukraine, because Ukrainians use the term “local self-governments” to refer to both oblasts and rayons on the one hand, and Cities and Gromada on the other –this despite the fact that only the latter have both democratically-elected councils (legislatures) and mayors (executives). [↑](#footnote-ref-5)
6. Henceforth we refer to COS as Cities. But it should be noted that many COS have populations under 25,000 people, and that many of them are really towns not cities. [↑](#footnote-ref-6)
7. Victor Chumak and Ihor Shevliakov, “Local Government Functioning and Reform in Ukraine,” Norwegian Institute for Urban and Regional Research and ICPS, 2009. These plans were heavily influenced by the Polish model of decentralization -which in turn owes much to Scandinavia, where public service provision is also concentrated at the municipal level. [↑](#footnote-ref-7)
8. “Local Governance and Decentralization Assessment: Implications of Proposed Reforms in Ukraine,” USAID, 2014. pp.15-16 [↑](#footnote-ref-8)
9. According to the last Soviet census, Ukraine had a population of 51.7 million people in 1987. The 2001 census put the population at 48.4 million people. In 2014, *and before the loss of Crimea and parts of the Donbas*, the State Statistical Agency estimated that the population of Ukraine had fallen to 45.2 million, a decline of more than 10%. Following the loss of Crimea and the occupied areas of the Donetsk and Lugansk oblasts, the population under control of the Ukrainian state has fallen to about 38.5 million. [↑](#footnote-ref-9)
10. In 2005, Ukraine had 868 hospital beds, 302 doctors, and 781 nurses per 100,000 inhabitants. The average for the EU was 644 hospital beds, 262 doctors, and 548 nurses per 100,000. In 2008, Ukraine’s 9.4 pupils per teacher was half the OECD average. World Bank Report #42450-UA, “Ukraine: Improving Intergovernmental Fiscal Relations and Public Health and Education Expenditure Policy” 2008. pp. 1-135 [↑](#footnote-ref-10)
11. To be fair, some of the opposition to reform had shifted: The ceasefire agreements brokered by the EU in September 2014 (“Minsk Protocols), called for giving the occupied rayons of the Lugansk and Donetsk oblasts special powers. On the “right,” this provoked fears that the election of oblast governors would do more to facilitate separatism than reform. Meanwhile, the “left” wanted the new national oversight bodies designed to ensure that oblasts and rayons acted within the law (and for example, did not pursue separatist policies) to be subordinated to parliament and not the president. See Democracy Reporting International, “From Central Control to Local Responsibility: Decentralization in Ukraine” Briefing Paper 59, p 1-8 DRI Berlin [www.democracy-reporting.org](http://www.democracy-reporting.org) [↑](#footnote-ref-11)
12. Dzhygyr, “Fiscal impact of 2015 decentralization reforms on Ukraine’s communities: stress-test to inform targeting under the Community Social Support project” Consultant Report July 2015, pp. 1-28 [↑](#footnote-ref-12)
13. See for example the monthly “Decentralization of Power” Newsletter put out by the Ministry of Regional Development. [↑](#footnote-ref-13)
14. Subsidies to Institutions fell in 2015 because the national government eliminated a transfer to subnational governments designed to provide price supports to public utilities. In 2016, this subsidy was reinstated, but was now directed not to utilities, but to poor households so that they could pay their utility bills. It is this transfer that increases rayon budgets in 2016 and which we discuss below. [↑](#footnote-ref-14)
15. In 2017, the national government significantly increased both public sector wages and the health and education grants that subnational governments receive to help pay for these function. Going forward, it will be important to monitor how these wage increases impact subnational expenditures. [↑](#footnote-ref-15)
16. These units were formed in 2015 but could not begin operations until 2016, and after they had held their first elections late in the year. [↑](#footnote-ref-16)
17. Because none of AGs constituted after 2015 have functioned for a full budget year –and some of them have yet to start functioning at all, the financial analysis that follows covers only the first 159 gromada. But the AGs created after 2016 are slightly more populous, and the average population of all AGs is has gone up for 8700 (159) to 8900 (413). [↑](#footnote-ref-17)
18. See for example some of the accounts of the amalgamation process chronicled in Ukrainian Week <http://ukrainianweek.com/Society/195249> [↑](#footnote-ref-18)
19. In this context, it is also important to understand that the particular way PIT is shared with local governments in Ukraine intensifies the more general pressure that PIT-sharing creates for self-segregation during the amalgamation process. In Ukraine, PIT is shared not on the basis of where employees live –as it is in most of the EU and North America-- but on the basis of the location of the enterprises in which they work. This means that the PIT-shares of people who commute to work in other jurisdictions go not to the budgets of the communities in which they live, but to the budgets of the towns in which they work. This is clearly unfair. But it also creates very strong and perverse incentives for gromada that contain area wide employers to try to separate themselves out from their neighbors. It is also worth noting that these perverse incentives are not limited to AG per se but and can also help block the incorporation of rural areas in cities (COS)> [↑](#footnote-ref-19)
20. Levitas and Djikic, “Caught Mid-Stream: Local Government Finance Reform, and the Restructuring of Ukraine’s Public Sector 2014 to 2016” SIDA, 2017, pp. 18-22 <http://sklinternational.org.ua/wp-content/uploads/2017/10/UkraineCaughtMidStream-ENG-FINAL-06.10.2017.pdf> [↑](#footnote-ref-20)