# INTERGOVERNMENTAL FINANCES, BUDGETING, AND TAX ADMINISTRATION IN UKRAINE

**FINAL REPORT**

*Bureau for Private Enterprise*
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*Prepared for:* *NIS Task Force*

*Prepared by:*

| | |
|---|---|
| *Jorge Martinez-Vazquez* | *Georgia State University* |
| *Eileen Browne* | *Consultant to Coopers & Lybrand* |
| *Malcolm G. Lane* | *Consultant to Coopers & Lybrand* |
| *Charles McLure* | *The Hoover Institution* |
| *Dale McOmber* | *Consultant to Coopers & Lybrand* |
| *Andrew D. Pike* | *The American University* |
| *Sally Wallace* | *Georgia State University* |

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Although the Team is grateful for assistance in the preparation of the report received from the Government of Ukraine, the USAID regional mission in Kiev, and USAID's Office of Economic Restructuring in Washington, responsibility for the content of the report, including any errors of omission, commission, or fact are the sole responsibility of the members of the Team.

# FOREWORD

The objective of this report is to propose a plan for technical assistance to the Government of Ukraine in the areas of intergovernmental fiscal relations, fiscal policy design, information systems and revenue forecasting, tax administration, budgeting at the central and subnational levels of government, and computerization of tax administration and budget processes. This work was initiated as a result of a request by the Ministry of Finance of the Government of Ukraine to the United States Agency for International Development for technical assistance in these areas.

The report is based on discussions held by a team of experts with Ukrainian officials during a visit to Ukraine July 11-23, 1993. During this visit, the team aimed to design a program for the longer run, but it also provided interim technical assistance in budgeting, computerization, and decentralization of fiscal relations. The mission provided Vice Minister of Finance Ilyin with detailed comments on the draft Budget Law for 1994.

While in the Ukraine, the team members benefitted greatly from interviews with officials from the Department of Budget Planning and the Department of Analysis and Control of the Ministry of Finance; the State Tax Inspectorate; the Commission on Planning; Budget, Finance, and Prices of the Supreme Rada; the Ministry of Economy; the Ministry of Statistics; the Department of Finance of the Ministry of Education. The team also conducted field work and also benefitted greatly from interviews with officials in the departments of Finance and State Tax Service offices of the City of Kiev, Kiev Oblast, Cherkasy Oblast, Korsun Shefchenkoski Rayon, Chirnigiv Oblast and Kaziliev Rayon. We are most grateful for the hospitality shown to us.

The report presents in the first section a summary and overview of the technical assistance program. The next section of the report provides an assessment and preliminary recommendations regarding the system of intergovernmental relations in Ukraine. The remaining five sections are full technical reports in each of the areas targeted for technical assistance. Because of the overlapping nature of the areas studied some issues are inevitably addressed in more than one report. I edited the full report and am responsible for the overall conclusions and recommendations.

The entire team is grateful for the support provided by the Ukrainian Government and USAID. Debriefing meetings were held in the Ministry of Finance and USAID/Kiev at the end of the July mission.

Jorge Martinez-Vazquez
Chief of Party
October 28, 1993

## TEAM COMPOSITION AND ATTRIBUTION OF WORK

Section I was written by Jorge Martinez-Vazquez. In Section II, the Revenue Asssignment and Design of Intergovernmental Transfers was written by Charles E. McLure, Jr., the Expenditure Assignment by Jorge Martinez- Vazquez, and the appendix on Local Taxes by Sally Wallace. The statistical work in Section II was done by Sally Wallace. Section III was written by Sally Wallace, Section IV by Dale McOmber, Section V by Eileen Browne, Section VI by Andrew Pike, and Section VII by Malcolm Lane.

# EXECUTIVE SUMMARY

Ukraine is undergoing a radical transformation of its budget and fiscal structure. Decentralization of the government finances has been a major plank of the Government economic policy program since independence. A more decentralized system of public finance will be a way to consolidate democracy and, at the same time, realize gains in social welfare, via a more efficient and accountable government.

These are hard times for reform. Ukraine is presently confronted with serious economic instability bordering on hyperinflation, brought about primarily by the monetization of increasingly runaway budget deficits. But these hard conditions make it even more imperative that Ukraine modernize its public finances. This modernization should include policy issues, such as the decentralization of the public finances, and institutions, such as developing a capability to analyze the impact of fiscal policies and improving its budget and tax administration systems.

The objective of the program of technical assistance proposed here is to assist the Government of Ukraine first, in the design of a decentralization plan for intergovernmental fiscal relations, and second, in strengthening the public sector ability to formulate and implement fiscal policy. This latter will involve improving the government's capability to formulate fiscal policy and forecast revenues and expenditures, improving the budget processes at the central and subnational levels of government, strengthening tax administration, and concurrently computerizing many tax administration and budgeting procedures.

## Problems and Issues with Intergovernmental Relations

The reform of the system of intergovernmental relations will require: the review of the current assignment of expenditure responsibilities and functions among the different levels of government, changes in budget formulation procedures and budgetary rights of subnational governments, the design of a new system of tax assignment and revenue sharing among the different levels of government. Granting some autonomy to subnational governments to raise their own revenues is a critical step for attaining efficient government operations and for holding subnational officials accountable to taxpayers.

Two other important pieces for reforming the system of intergovernmental finance, currently missing in Ukraine, are a transparent and stable arrangement for intergovernmental transfers, and a system to finance long-term capital expenditures at the subnational level.

## Revenue and Expenditure Forecasting and Fiscal Analysis

Ukraine's central government and oblast governments presently lack adequately trained personnel to carry out fiscal analysis for the design of decentralized system of governments and revenue and expenditure forecasts.

Ukraine also lacks a modern fiscal information system. While many data are available, they are not unified in a systematic fashion, nor are most sources computerized. The result is that the MOF lacks the methodology and data bases necessary to formulate informed fiscal policy.

The Central Budget System of Ukraine

This is an area of fiscal management of clear importance given the difficulties Ukraine has had over the past two years in controlling the level of public expenditures and the runaway budget deficit. The current budget system suffers from the lack of well trained and experience personnel and it is in need of reform in the following areas:

- distribution of budget responsibilities
- use of extrabudgetary funds
- budget preparation process
- budget execution and control
- budget classification
- accounting and reporting systems
- evaluation and audit systems

Subnational Budgeting and Financial Management

Although recent legislation grants unprecedented budgetary powers to subnational governments, the current budget system at the subnational level is still unchanged from the times of the former Soviet Union. Not surprisingly most of the problems with budgeting and financial management at the national level are repeated at the oblast and rayon levels.

Tax Administration

The State Tax Inspectorate (STI) to a large extent still has the organization, structure and procedures inherited from the former Soviet Union. However, this framework is becoming increasingly obsolete. Even though at some point in the future the Government should consider the development of independent oblast and rayon tax administrations, at the present time the best way to proceed is likely to be the development of a stronger and modern central government tax service which will remain in charge of the collection of all types of taxes. The accomplishment of this task will require extensive training of STI personnel and reforms in the following areas:

- general organization and procedures
- taxpayer registration and control
- auditing and taxpayer compliance
- collections
- taxpayer information services
- transfer of information within STI

## Computerization of Tax Administration and Budgeting

The modernization of the fiscal administration apparatus of Ukraine will require the computerization of tax administration and budgeting procedures. Several main problems will need to be addressed:

- Lack of trained personnel in the central and field offices.
- Lack of a computerization plan and strategies in the Computing Center of the Ministry of Finance and the Tax Inspectorate's Computer Department.
- Lack of adequate hardware and software. There is at present no central computer powerful enough to consolidate data and the software developed so far is "first generation."
- Lack of a working taxpayer identification system.
- Lack of computerization of the budget process.

Technical Assistance Program

A three year technical assistance program is proposed to upgrade the design of intergovernmental fiscal relations and other fiscal policy areas and to modernize the budget and tax administration systems at both the central and subnational levels of government.

The proposed program will have the following individual activities:

- To provide the Ukrainian Government with the necessary technical expertise and background work to examine the consequences of different possible reforms of the system of intergovernmental fiscal relations.

- To develop Fiscal Analysis Units within the Ministry of Finance and the Supreme Rada with trained personnel to carry out technical studies, including budget review, fiscal planning, and impact analysis of fiscal policies.

- To develop within the Units a fiscal management information system and accompanying analytic models.

- To develop fiscal analysis units in one or two selected pilot oblasts supported by information systems, analytical models and training similar to those for the central government. Solutions and findings in the pilot oblasts could be transferred to the rest of the oblast.

- To modernize the Budget System by developing the forecasting capabilities of the MOF, improving budget preparation, classification and budget evaluation techniques, assisting to develop a Treasury function within the MOF to control the execution of the budget and the runaway deficit, and developing budget evaluation and ex-post audit functions. Similar assistance and training will be carried out in the pilot oblast(s).

- To assist in the modernization of the State Tax Service by developing procedures and training programs in internal management and audit, identification and control of taxpayers, measurement and collection of taxpayer arrears, procedures and manuals for office and field audits and the selection of audit files, and taxpayer education and information programs. Most of these activities will have a an oblast component to be carried out in the pilot oblast(s).

- To assist, in coordination with the IMF pilot project for the VAT, in the computerization of the State Tax Service at the central office and coordinate activities in the pilot oblasts in several areas including taxpayer identification with the design and implementation of a TIN (taxpayer identification number), automated taxpayer information and auditing systems, bank payment and revenue reporting, and hardware and software acquisition. To assist also in the computerization of budget procedures in the MOF and pilot oblast with the goal of establishing a comprehensive Integrated Financial Management system.

## TABLE OF CONTENTS

**TABLE OF CONTENTS** (continued)

**TABLE OF CONTENTS** (continued)

**TABLE OF CONTENTS** (continued)

**TABLE OF CONTENTS** (continued)

# SECTION 1: CONCLUSIONS AND RECOMMENDATIONS FOR TECHNICAL ASSISTANCE

## I. INTRODUCTION

Ukraine is undergoing a radical transformation of its budget and fiscal structure. Decentralization of the government finances has been a major plank of the Government economic policy program since independence.

A more decentralized system of public finance will be a way to consolidate democracy and, at the same time, realize gains in social welfare, via a more efficient and accountable government. Moreover, these gains in welfare will accrue without necessarily using any additional economic resources. However, decentralization reforms in Ukraine have not been able to free subnational governments from the extremely centralized system inherited from the former Soviet Union. Important obstacles remain which prevent subnational governments from realizing the gains in efficiency associated with decentralized systems of government.

These are hard times for reform. Ukraine is presently confronted with serious economic instability bordering on hyperinflation, brought about primarily by the monetization of increasingly runaway budget deficits. Although massive unemployment has not yet occurred, economic restructuring in the industrial and mining sectors will strain the public budget further with increases in expenditures in the social safety net.

The present hard economic conditions make it a harder challenge to embark upon economic and institutional reform, but the present conditions also make it even more imperative that Ukraine modernize its public finances. This modernization should include not only the policy and institutional issue of how to decentralize the public finances, but also the technical side of the public finances: how to formulate more informed fiscal policy and how to improve and modernize the budget system and tax administration.

The objective of the program of technical assistance proposed here is to assist the Government of Ukraine first, in the design of a decentralization plan for intergovernmental fiscal relations, and second in strengthening the public sector ability to formulate and implement fiscal policy. This latter will involve improving the government's capability to formulate fiscal policy and forecast revenues and expenditures, improve budgeting processes at the central and subnational levels of government, strengthen tax administration, and computerize many tax administration and budgeting procedures.

We believe that each of the components in the Program for technical assistance being proposed here will play an important role in the success of the implementation of the other components. Therefore the Program should be viewed as an integrated package. Furthermore, it would be possible to implement some of the Program components in isolation from others. The objective of this first section of the report is to present a comprehensive view of the issues and to propose a Program for technical assistance. The section is organized as follows. The next six sub-sections provide a summary of the most salient issues and problems in each of the areas of technical assistance. The balance of this first section of the report proposes a Program for technical assistance, a description of the general approach for this assistance, a list of activities in each of the areas of technical assistance, and a preliminary estimated level of effort in each of these areas.

## II. EXPENDITURE ASSIGNMENT AND DESIGN OF REVENUE SHARING AND TRANSFERS

As Ukraine moves toward a market oriented economy, one of the most important factors for setting up the right economic institutional framework and the consolidation of democracy will be the redesign of its system of intergovernmental relations. This will require a re-examination of the assignment of expenditure responsibilities and functions among the different levels of government, changes in budget formulation procedures and budgetary rights of subnational governments, a new system of tax assignment and revenue sharing among the different levels of government, and the formulation of a system of intergovernmental transfers for equalization and other purposes.

Problems with the Present Assignments. Ukraine has recently passed legislation giving subnational governments unprecedented rights to formulate their own budgets and the share of public expenditures going through the subnational budgets has steadily increased. All these trends are positive but significant problems remain.

The assignment of expenditure responsibilities among different levels of government for the most part is that inherited from the former Soviet Union. This assignment agrees in theory with the principles of expenditure assignment in public finance. Services with a local dimension, such as primary education, are provided by rayon governments; those with regional dimensions, such as regional hospitals, are provided by oblast governments and so on.

However, many problems remain in this area. First, there is no formal and stable assignment. The central government has been recently shifting responsibilities to local governments due to what appears to be budgetary pressures to control its own deficit rather than as a response to a well thought out strategy about the division of responsibilities among levels of government. A great deal of attention has been given to the proper assignment of revenues and much less to the logical first step: stable assignment of particular expenditures to particular levels of government.

In the past, subnational governments had no autonomy to determine the level and composition of expenditures. All important decisions were ultimately made in Moscow. At present, subnational governments can, on paper, determine their own budgets, but their discretion is limited due to government mandates such as wage levels, local service fees or centrally determined budgetary norms. Budget officials in the subnational governments are still central government employees and the President's representatives in each of the jurisdictions seem to have near veto power over most budget decisions.

The little evidence available shows that the bargaining approach to the formulation of budgets led to substantial disparities in the level of service provision across subnational jurisdictions and even across individual households in any given jurisdiction. Housing, health, kindergarten and other services depended on the individual's place of work. These disparities do not seem to have disappeared at present. In some cases they seem to have gotten worse.

Perhaps the most limiting factor for efficiency in the Ukrainian system of intergovernmental finances is the budgeting process itself. The MOF bargains each year or quarter how much funding is needed to cover a "minimum required budget" with each oblast. The oblasts do the same with their rayons and cities. The minimum required budget was arrived at in the past by the application of a myriad of very detailed norms, mainly to provide funds for the operation of installed capital infrastructure. The availability of this latter was decided separately in the plan. At present the minimum required budget is based more on historical expenditures adjusted for inflation.

The determination of the minimum required budget plays a critical role in the current process of intergovernmental finance. After negotiations, once the minimum required budget is agreed on, the central government makes sure that enough funds are available to cover these expenditures. The sources of funds include the oblast's own revenues, revenue sharing in "fixed" and "regulating" taxes,and subventions or general transfers. This approach has several important consequences. First, all revenue sharing schemes are fairly meaningless. The subnational budgets get funded one way or another. And if some budget surpluses are generated, these can be recaptured in the next period -- the law prohibits direct recapture-- by changing the tax sharing rates then. Second, the approach creates complete uncertainty for budgeting at the oblast, and subsequently at the rayon levels. Rayons go through an identical process with their oblast governments, once the oblast knows its funding in the central budget.

No level of government can initiate its budget preparation in earnest until the higher level of government adopts its own budget specifying the overall expenditure totals and the sharing rates for its "dependent" governments. Third, the process lacks transparency and perpetuates the possible arbitrariness (through bargaining) of the past. Fourth, there is no incentive to collect local taxes from the sources now available.

There are several additional issues that the Government of Ukraine will need to address in expenditure assignment. The most important include the reassignment of social expenditure and social safety net responsibilities, the reassignment of capital expenditure responsibilities, and the divestiture of social expenditure responsibilities by state enterprises.

The current practice for revenue assignment distinguishes between "fixed" and "regulating" sources of revenues. Oblasts keep pre-established shares or 100 percent of "fixed" revenue sources on a derivation basis, that is, of the collections from the tax in the oblast territory. The personal income tax is the only major source of "fixed" revenues assigned to subnational governments. Even though these revenues are supposed to go all the way down to rayons and settlements, in actual practice oblast governments keep part of these revenues.

The sharing rates from the "regulating" taxes may be changed in order to meet the revenue requirements for the consolidated oblast budgets left after taking into account all other revenue sources. The major taxes in this category are the VAT, enterprise profit tax, and excise tax. In the 1993 budget the sharing rates for the excise taxes were 10, 50 and 100 percent; for the enterprise profit tax, 25, 50 and 100 percent; and for the VAT the sharing rates, customized for each oblast, ranged from 22.1 percent to 100 percent. Some oblasts including the Autonomous Republic of Crimea received 100 percent of all these major taxes plus a subvention from the central budget.

Subnational governments have no discretion or control over any other shared taxes. All taxes are collected mainly at the rayon level by a deconcentrated tax administration authority, the State Tax Inspectorate.

Local tax revenues have grown in number with recent legislation but they remain of little importance. Subnational governments have little discretion over the base and rate of local taxes. The lack of privatization has kept discussion of a new property tax on the back-burner. There is little doubt, however, that the property tax, together but to a less extent with the tax on motor vehicles and fees and user charges, should become sizable sources of autonomous revenues for local governments in Ukraine.

However, true decentralization of the public finances in Ukraine will require granting discretion to subnational governments to raise their own revenue either through local taxes such as the property tax or as a surcharge on the personal income tax administered at the national level.

Administrative constraints and the pursuit of national objectives limit what other taxes may be used to grant this revenue discretion to subnational governments. For example, because of its structure it is not appropriate to assign the VAT to subnational governments nor to share on the basis of origin. Similar difficulties exist with the company profit tax. The existence of certain degrees of autonomy to raise additional revenues is critical for efficiency and the exercise of democracy. Revenue raising authority helps to hold subnational officials accountable to taxpayers.

Two other important pieces of subnational finance are presently missing in Ukraine. One is a transparent stable arrangement for intergovernmental transfers. The other is a system to finance long-term capital expenditures.

## III. REVENUE AND EXPENDITURE FORECASTING AND FISCAL ANALYSIS

Ukraine's central government presently lacks adequately trained personnel to carry out, on an ongoing basis, fiscal analysis such as of the design of decentralized system of governments as discussed in this report or of the economic impact of tax changes. Oblast governments also have similar analytical needs, for example in the design of revenue sharing with their rayons and cities or determination of how central government policies may affect them, but no oblast government has the trained personnel to carry out these tasks.

The revenue and expenditure forecasting capabilities at the central and oblast levels of government are similarly limited. The current system of revenue and expenditure forecasting at the central level is still closely related to the planning system of the former system of the Soviet Union. The staff lack the methodology and analytical capabilities necessary to support the modernization of the fiscal system. At the local level, there is even less in the way of planning or analysis.

While many data are available, they are not unified in a systematic fashion, nor are most sources computerized. Although some of the components of a modern fiscal information system exist, many are lacking. What does exist is not coordinated, and in many cases, not used. The result is that the MOF lacks the methodology and data bases necessary to formulate informed fiscal policy.

Perhaps as a reflection of the lack of coordinated data bases, there is currently little coordinated effort within the administration to produce adequate tax policy analysis for the central or local governments.

The main forecasting, estimating, and data issues are as follows:

- There is a lack of computerization at most every level of government. Neither hardware nor software is readily available for analysts in the budget offices nor in the State Tax Inspectorates (STI) offices.

- There is little coordination among agencies receiving statistics so that although data are available, they are not compiled in a useful form.

- There is little work done on long-term fiscal planning. Both revenue and expenditure planning are done for a maximum of one year -- more often, the planning horizon is quarterly. This is due to a number of problems including inflation, data, computerization, changes in tax and budget law and a lack of knowledge of fiscal planning.

- In the central government budget office, revenue forecasting is done using aggregate data. Some local governments use enterprise-level data, but the data are not computerized.

- The task of estimating the effects of tax law changes on central and local government revenue has not been developed.

- The current macro-economic forecasting methodology relies on aggregate indicators and is not well suited to providing an accurate baseline for revenue and expenditure forecasting.

- Personnel within the budget offices of the federal and local governments do not have the necessary training in budgeting and forecasting. The STI also lacks the necessary training to perform fiscal analysis.

- The Supreme Rada has developed its own fiscal analysis unit, but this unit is not equipped with the hardware and skills to perform sophisticated fiscal analysis for the central or local governments.

## IV. THE CENTRAL BUDGET SYSTEM OF UKRAINE

This is an area of fiscal management of clear importance given the difficulties Ukraine has had over the past two years in controlling the level of public expenditures and the runaway budget deficit. The budget system inherited from the former Soviet Union is obsolete in many aspects and otherwise quite inadequate from a modern market oriented economy perspective. The problems with the present system are multiple and extend not only to institutions but also to the lack of well trained and experience personnel.

Problems with the Distribution of Responsibilities. The responsibilities and functions of public administration are distributed among the four levels of government in Ukraine in manner not readily discernable. This makes it hard for taxpayers to determine which level of government is ultimately responsible for the provision of particular services and decreases the responsiveness of governmental units to voter preferences. These problems have been confounded recently by the frequent shifting of responsibilities among the different levels of government, usually to a lower level. The Government of Ukraine should rationalize and stabilize the distribution of responsibilities among the different levels of government as soon as possible.

Problems with Widespread Use of Extrabudgetary Funds. The legal framework for budget formation in Ukraine permits and encourages the use of extrabudgetary funds and their use is widespread at all levels of government. However, the undesirability of extrabudgetary funds is well known because these funds are not subject to the same level of scrutiny as regular budget funds and their use decreases the careful consideration of priorities in the allocation of public resources. With the exception of social insurance and pension funds, which can be justified as being outside the budget, the Government of Ukraine should seek to integrate all extrabudgetary funds into the regular budgets.

Problems with the Budget Preparation Process. Revenue forecasting at the budget preparation stage needs better data and technique systems and better ability to simulate trends. The MOF now lacks the trained staff that can assess the impact of alternative options for taxation and revenue sharing schemes. For budget preparation purposes the determination of sharing rates in each fiscal year is too time consuming and detracts necessary attention from more conventional aspects of the budget process.

The use of detailed physical and cost norms for budget preparation has meant that emphasis is put on the fulfillment of needs as derived from existing capacity rather than using the budget more as an instrument of national policy change. Norms have perpetuated existing modes of expenditure without asking the hard questions of whether some expenditures should be continued or whether there is a more efficient way to achieve the same desired results. Political decision makers do not routinely receive such options and in general there is not enough qualified staff able to produce those options. Budgetary norms also have suppressed the use of performance criteria in budget review.

The budget discussion and approval processes in Ukraine do not provide for sufficient checks and balances between the Executive and the Supreme Rada so that government spending proposals and amendments from legislators come under sufficiently close scrutiny.

Problems with the Budget Execution Process. The current use of the banking system to disburse and control funds raises some significant problems in relating revenues and expenditures on a timely basis, and it creates a cumbersome system for the transfer of funds and cash withdrawal and payment. The MOF needs to develop the new Treasury so that all funds can control from a "general fund", and spending managers rather than banks are given the responsibility for managing the funds within the limits of their accounts. But rules should be adopted to insure a more effective use of funds and to prevent fraud. A set of market procurement norms is urgently needed.

At the local level, there are also important problems with budget control and execution. The expectation still exists from the old regime that additional allocations or credit will come from the central government when budget resources have been exhausted. The central government has little or no knowledge of all the borrowing and credit occurring at any given time.

Budgetary pressures to cut expenditures and the lack of liquidity at all times has often meant the distortion of budget priorities as managers are forced to reduce expenditures without regard for their significance.

A Defective Budget Classification. Budgetary control is also complicated by a defective budget classification which currently is not useful for either macroeconomic analysis or for budget transparency and accountability. Capital spending is scattered in various categories, in some cases as current expenditures, and programs and organizations are interspersed. The budget at all levels should adopt standard economic and functional classifications.

Problems with Accounting, Reporting and Audit. The main failure is the use of information systems and audit only as a way to check conformance with budget limits rather than to monitor how well resources are being used toward the achievement of goals. The incentives now are set to encourage spending up to the budget limits, rather than being efficient in the use of funds. In addition, the audit function is too narrowly defined and is not sufficiently independent. The current focus on conformance with the budget should be de-emphasized in favor of routine checks for fraudulent behavior and corrupt practices in post-audit. This audit function also needs to be independent from the fiscal authorities and currently this is not the case.

## V. SUBNATIONAL BUDGETING AND FINANCIAL MANAGEMENT

Although recent legislation grants unprecedented budgetary powers to subnational governments, the current budget system at the subnational level is still unchanged from the times of the former Soviet Union. Not surprisingly many of the problems with budgeting and financial management at the national level are repeated at the oblast and rayon levels.

Lack of a Rational Sorting of Roles and Responsibilities. This is the mirror image of the identical problem identified at the central government level. Oblast governments have been shifting additional expenditure responsibilities to rayon and city governments without a clear set of criteria regarding what is the most appropriate level of government for particular services.

Breaking the Principles of Universality and Integrity of the Budget. Subnational governments also make ample, although not uniform, use of extrabudgetary funds and their importance appears to be fast increasing. Although they provide the advantage of flexibility, extrabudgetary funds are undesirable because generally they are not subject to the same degree of review and scrutiny, which means they generally lack accountability.

Problems with Budget Formulation and Forecasting. Budget formulation at the subnational level is still generally based on the use of norms which get applied in a cumbersome and detailed process. The application of norms is time-consuming because all calculations at the subnational level appear to be done manually. In addition, the use of norms rigidly mandates expenditures despite the need for budget austerity, at the same time it denies the gains in efficiency attributable to subnational budget independence.

Forecasts at the subnational level are not based on long-range outlooks, economic realities, or well-based methods of costing. The expenditure forecasts do not introduce any fiscal restraint because the norms are routinely adjusted for inflation. The advantage of preparing subnational government over centralized revenue forecasts is that only each subnational government knows the tax advantages and holidays it will be granting in the next period. Subnational governments have limited discretion in the preparation of the expenditure side of the budget because the central government still controls wages and uses other mandates to control expenditures. On the revenue side, even modern forecasting methods will provide little predictability to subnational governments because the sharing rates in major taxes have been altered every year.

Problems with Budget Submission and Adoption. Key decisions about subnational budgets have already been made at the time the radas know the total budget funding available from the higher level of government. Mandated wages and other expenditure mandates leave little discretion for local decisions. Furthermore the ability to mobilize local revenues is quite limited. This mobilization is also discouraged by the general approach to funding since more local revenues easily translates into lower support from the higher level of government. In addition, budgets are passed late, severely limiting the ability to plan expenditures.

Problems with Budget Execution. Subnational governments still use the classification system devised in the former regime, which mirrors the categories of the old central plan. This classification is not sufficiently detailed to be useful in economic analysis or expenditure control and accountability. A good first step would be to introduce the standard economic classification.

Until 1993 the allocation of spending funds was only responsive to the expenditure side and disconnected from whether revenue collections were what had been anticipated. Currently expenditures are not supposed to be authorized unless the corresponding revenues have been collected. But there is little communication between the departments of Finance and offices of the State Tax Service and the Central Bank which has been serving as Treasury. In practice, the Central Bank allows draw-downs to the maximum amount in the budget.

For procurement, there are requirements for competitive bids or legislation on conflict of interest. There are no explicit rules either against fraud, waste or corruption.

The present accounting system is not conducive either to expenditure control. The accounting system displays transactions at the point in time when bank payments are made;

thus none of the previous steps of authorization, commitment and payment order get recorded. International experience shows that public accounting systems can deliver the desirable level of expenditure control without introducing the complex, double-entry, full accrual accounting.

Lack of Budget Evaluation and Independent Audit. At the present time there is no evaluation methodology in the subnational budget system, but experience in many other countries shows that evaluation and feedback on the budget preparation process are critical to sound budgeting. The system also lacks an independent audit function. These units should be created and be made responsible to the subnational radas.

## VI. TAX ADMINISTRATION

The State Tax Inspectorate (STI) to a large extent still has the organization, structure and procedures inherited from the former Soviet Union. However, this framework is becoming increasingly obsolete as the direct linkage between the MOF authorities and economic activity, which before took exclusively the form of state enterprises, dissolves. In order to collect taxes in Ukraine there is a need to rebuild the State Tax Inspectorate from the rayon and oblast offices up.

At this stage, practically all tax collections including those minor taxes exclusively assigned to subnational governments is carried out by the STI. Even though at some point in the future the Government should consider the development of independent oblast and rayon tax administrations, at the present time the best way to proceed is likely to be the development of a stronger and modern central government tax service which will remain in charge of the collection of all types of taxes.

Problems with Organization and Procedure. The current organization of the STI is by type of tax (VAT, individual income, etc.) rather by function (registration, audit, collections,etc.). Besides that, the current procedure is to examine each of the tax returns submitted by taxpayers. This is an inefficient allocation of resources and it will become an impossible task as the numbers of taxpayers grows. The entire STI is in need of automation of most procedures, but the issue of computerization is addressed in a separate section of this report.

In addition, the existing organization makes it difficult to sort out the line of authority within the STI, resulting in inconsistent priorities and standards. There is also an absence of modern management techniques that would permit a more efficient allocation of resources. Currently far too many STI employees are working in the administration of minor taxes for small taxpayers.

The need for a reorganization of the structure of the STI according to functional lines has been recognized by the Ukrainian authorities and reforms are under way with implementation of some of these reforms in a pilot oblast with technical assistance from the IMF.

Problems with Taxpayer Registration and Control. Records of taxpayers are not computerized and are kept in quite different forms in different field offices of the STI. This means that, for example, the records of companies as withholding agents are rarely cross-examined for taxpayers that divide their tax liability among several companies. This points to the basic need of creating a national system of taxpayer registration based on the computerized use of a single unique number for each taxpayer. The need for a taxpayer identification number is also presently being addressed by the STI.

The STI currently also lacks a computerized current account for all major taxes for each taxpayer.

Problems with Auditing of Taxpayer Compliance. Currently, the STI conducts an office audit for practically all the tax returns submitted and it has the goal of implementing a complete field audit of all taxpayers at least every two years. This is excessively time consuming, unnecessary for effective tax enforcement and it will become nearly impossible as the number of taxpayers expands and the complexity of returns increases due to privatization. The training of tax inspectors in modern audit techniques using cross information and audit selection techniques is practically non-existent. Furthermore, there is not much information on the present levels of tax evasion due to non-filing, under-reporting of income, and misrepresentation of deductions and credits.

Problems with Collections. Currently, the procedures used for payment and collection rely extensively on the banking system. This system relies heavily on the close relationships that existed in the past between the government, taxpayers (which were exclusively state enterprises and banks as collecting agents (also state enterprises). As privatization proceeds, the links between taxpayers, banks and the State Tax Inspectorate offices will become weaker. The STI will need to develop computerized procedures to ensure the proper remittance by banks of tax payments made by privatized companies. The training of collecting agents has to start basically from scratch, and procedures to monitor and collect taxes in arrears will have to be developed using market interest rates and higher and more certain penalties.

Problems with Taxpayer Services. The Ukrainian tax system is basically a self-reporting system. But for a self-reporting system to work effectively it is not enough to have effective enforcement through audit and collections, it is also necessary to have well developed taxpayer service systems providing information and educating taxpayers on how to comply with their obligations. These taxpayer services are quite weak in the STI. For example the STI has virtually no written material explaining the provisions in the tax laws.

Problems with the Transfer of Information within the STI. The problems with the exchange of information occur from the top down: there is no guidance from the center on how to apply laws and regulations distributed to the field offices and frequently not enough copies of the laws. They are also from the bottom up: most of the information on taxpayer returns and compliance stay in the field offices making it much harder for the central offices to build effective national programs.

## VII. COMPUTERIZATION OF TAX ADMINISTRATION AND BUDGETING

Computerization of the MOF operations is the responsibility of the Information Computing Center of the Ministry. This office is also in charge of providing training for oblast staff. However, the computerization of tax administration is the responsibility of the Tax Service Computerization Department. The main problems in computerization are common to both offices.

Problem with the Lack of Training. The qualifications of the personnel need to be upgraded in several areas including training in operating systems, open system (Unix technology), database management systems, and software engineering methodologies.

Lack of a Computerization Plan. Both the Ministry's Computing Center and the Tax Inspectorate's Computer Department lack an overall computerization strategy. However, both departments are planning the introduction of general strategies in the near future. Recently, the purchase of 5,600 new computers was approved but is quite unclear whether there is a specific implementation plan to put these computers to use. Of course, the existence of computers without a plan as to how they will be used will not improve tax administration. Applications software must be defined and implemented and the computer systems need to be employed in a multiuser mode. Right now only single-user microcomputers are in use and data can not be shared.

Lack of Trained Computer Personnel in the Field Offices. Currently there are only three to four computer staff in the oblast Tax Inspectorate offices and none in the rayons. The minimum staffing of these offices should include two to three staff per rayon and more trained personnel for oblasts with total size depending on the number of taxpayers in the oblast. The recent approval of an increase in the number of employees in the STI could be an opportunity to fill these needs.

Lack of Adequate Hardware and Software. There is at present no central computer in the MOF or STI that is powerful enough to consolidate data for all oblasts into single files. The software developed so far is "first generation" and does not reflect the new tax laws of Ukraine.

The Need to Proceed with the Taxpayer Identification System. Before computerization can be implemented for particular taxes there is a need to have a system for **uniquely** identifying taxpayers. This unique number is also crucial for making use of outside information in tax audit programs. The STI is fully aware of the need for the taxpayer identification number (TIN), but there may be no sufficient expertise in country to incorporate the lessons from international experience in this area.

Lack of Computerization of the Budget Process. Existing software applications to budgeting are limited to tracking revenues and expenditures and then only in a limited way. The applications only reflect old Soviet legislation; a computerized system of the new budget laws and procedures will have to be implemented. The government should strive for the formulation of an "integrated financial management system" which could be helpful in several of the functions to be performed by the new Treasury. Such a "financial management system" would have a revolutionary impact on budget formulation, expenditure control and budget discipline and expenditure control, but it will take time to be developed and implemented.

## VIII. TECHNICAL ASSISTANCE PROGRAM

A technical assistance program of three years in duration is proposed to upgrade the analytical capabilities of Ukrainian officials in intergovernmental fiscal relations and other fiscal policy areas and to modernize the budget and tax administration systems at both the central and subnational levels of government. The full details of the program should not be specified until the Ukrainian authorities identify their priorities and their willingness to cooperate in specific areas. Some areas of the program will require additional research but most will require hands-on technical assistance. What follows is a first iteration proposal for the technical assistance program.

### Objectives of the Program

The overall objective of this program would be to give technical support to the Ukrainian government in the reform of the system of intergovernmental finances and the modernization of the budget and tax administration systems. More specifically, the proposed program will have the following individualized objectives:

- To provide the necessary technical expertise and background work to examine the consequences of different possible reforms of the system of intergovernmental fiscal relations. The comprehensive review will build upon the preliminary work done in this report.

- The development of a Fiscal Analysis Unit within the Ministry of Finance which will be trained to carry out fiscal technical analyses including the comprehensive review and options for the system of intergovernmental fiscal relations. The Fiscal Analysis Unit staff will also be trained to carry out fiscal planning and impact analysis of other types of fiscal policies including budgeting.

- With the Fiscal Analysis Unit, the Program would develop a fiscal management information system, with analytic models and the necessary training to institutionalize the analytical capabilities in Ukraine.

- The development of fiscal analysis units in one or two selected oblasts. The pilot programs in these oblasts will provide a comprehensive review of the fiscal relations between the oblast government and the rayon governments and offer several reform alternatives to consolidate these relations. The oblast fiscal analysis units will be supported by information systems, analytical models and training similar to those for the central government. Solutions and findings in the pilot oblasts would be transferred to the rest of the oblast at a later date.

- To modernize the Budget System by developing the forecasting capabilities of the MOF, improving budget preparation, classification and budget evaluation techniques, assisting to develop a Treasury function within the MOF to control the execution of the budget and the runaway deficit, and developing budget evaluation and ex-post audit functions. Similar developments and training will be carried out in the pilot oblast(s).

- To assist in the modernization of the State Tax Service by developing procedures and training programs in internal management and audit, identification and control of taxpayers, measurement and collection of taxpayer arrears, procedures and manuals for office and field audits and the selection of audit files, and taxpayer education and information programs. Most of these activities will have a an oblast component to be carried out in the pilot oblast(s).

- To assist, in coordination with the IMF pilot projects for the VAT, in the computerization of the State Tax Service at the central office and coordinated activities in the pilot oblasts in several areas including taxpayer identification with the design and implementation of a TIN (taxpayer identification number), automated taxpayer information and auditing systems, bank payment and revenue reporting, and hardware and software acquisition. To assist also in the computerization of budget procedures in the MOF and pilot oblast with the goal of establishing a comprehensive Integrated Financial Management system.

## General Approach for the Program

The general approach to be taken is to provide technical expertise and international experience in a collaborative effort with Ukrainian counterparts in activities who have been previously selected and approved by the Ukrainian authorities.

The Program will emphasize practical advice by knowledgeable individuals working directly with applicable Ukrainian administrators by providing:

- training in various techniques that would foster improved analysis of government activities and related budgets and their effects on the economy;
- technical support for the development of specific procedures, detailed procedural manuals and explanations of improved techniques for tax administration and audit, and in accounting, procurement, and cash management processes.
- seminars and papers outlining methods for improving fiscal discipline, managerial accountability and forecasting techniques.

To increase the chances of success for the technical assistance program it would be desirable for the Ukrainian government to appoint a Coordinating Committee with membership from the Budget Department and the State Tax Service of the Ministry of Finance, and the Committee on Budget, Taxes and Prices of the Supreme Rada. This Committee would coordinate the activities of the project and those of other donors including the International Monetary Fund and the U.S. Treasury, and oversee the organization and membership of the Fiscal Analysis Units in the Ministry of Finance and the Supreme Rada.

The government of Ukraine has received technical assistance from the IMF and U.S. Department of Treasury in tax policy, tax administration, and budgeting. Officials from various Ukraine government divisions have also received general fiscal and banking training in Germany. Coordination with all these on-going efforts, of course, will be very desirable.

To carry out the technical assistance program, the contractor will be required to maintain a Ukraine office staffed with a team of long-term resident advisors. The team should be headed by a person with a broad knowledge of governmental fiscal affairs. The Ukraine office will arrange and coordinate short-term assignments, home and foreign country training and procure the necessary hardware and equipment.

Specific Activities in the Program

The following activities are proposed for inclusion in the program:

1. **Review of Policy Reform Options for Ukraine's System of Intergovernmental Relations.**

*Technical Assistance on Intergovernmental Finance Reform.* The system of intergovernmental finance in Ukraine is in transition and undergoing continuous reform. This process extends to the three or even four tiers of government if settlements are included. However, most of the recent changes have taken place on an ad hoc basis, in a budgetary crisis climate and without the benefit of careful study and design of options and their consequences.

The Government of Ukraine needs to formulate a carefully prepared reform program for the system of intergovernmental fiscal relations reaching all tiers of government. The leadership for the preparation of the draft legislation and background study could come from either the Ministry of Finance or from a Reform Committee with mixed membership from the Executive at the central level, the Supreme Rada, and representatives of subnational governments. Whatever the final composition of the Reform Committee, this committee will be in need of technical support to carry out the necessary background work.

The USAID Program for technical assistance will provide a team of international experts in intergovernmental fiscal relations who will work with a team of Ukrainian counterparts in providing an in-depth review of the present system and proposing to the Reform Committee several reform options. Section 2 of this report provides the foundations and a good start for this task. The team of experts will undertake the following activities:

- The re-assignment of expenditure responsibilities and public service functions among the four tiers of government. This will include both recurrent and capital expenditures.

- The fundamental reforms in budget process -- in arriving at desired expenditures and overall level of funding-- that will bring and guarantee the desired level of budgetary autonomy or independence among the different levels of government.

- The design of a system of revenue assignments that will vertically balance the assignment of expenditure responsibilities. The assignment of revenues will explore the advantages and disadvantages of revenue sharing of certain major taxes at fixed or pre-announced rates, the pure or exclusive assignment of some taxes and other revenue sources for each level of government, and the use of surcharges or piggy-ride taxes by subnational governments on centrally administered taxes.

- The design of a transparent system of intergovernmental transfers to equalize for regional differences in tax bases, to compensate subnational governments for the provision of mandated services, and to encourage certain desirable activities of subnational governments.

- The design of a system of long-term financing for the capital investments of subnational governments.

- The design of possible special regimes for large cities.

*Technical Assistance in the Introduction of a Property Tax.* Although the support for a new property tax on personal property is not yet overwhelming, this may be the right time to start preparing for the full development of the property tax. This tax has great potential as a significant source of autonomous revenues for local governments. Specific assistance would include the following:

- Training courses in tax policy for local governments. This course could also be a stand-alone course offered to local government finance officers to instruct them in the nature of local taxes.

- Technical training in Ukraine will be needed in the administrative aspects of a property tax. This training would provide assistance in data collection, appraisal techniques, collection, and audit. Two or three local government property tax experts could travel to Ukraine for on-site training in these areas.

- Assistance in the legal framework required to determine ownership of property. This activity should be carried out by a team of international legal experts and Ukrainian legal experts.

- Technical assistance in the development and computerization of a cadastre and in development of methodologies to update the assessed value of properties.

## 2. Development of a Fiscal Information System and Establishment of Fiscal Analysis Units in the MOF and the Supreme Rada.

*The Program will assist the Government of Ukraine in the development of a Fiscal Information System.* These data bases will be necessary to make well informed policy decisions. Part of the Fiscal Information System will be a daily fiscal monitoring system in the MOF and in the finance departments of local governments, which will be instrumental to better expenditure control. Specific activities will include: (i) lending assistance with a detailed survey of the data bases available as well as the current methodologies employed for data collection, dissemination and computerization; (ii) an inventory of the hardware and software available for the central and local offices of the STI, the Ministry of Statistics, the MOF, and the finance departments of subnational governments; (iii) training in data collection and management systems; (iv) software and hardware development. These efforts will be directed toward the Ministry of Statistics, STI, and budget office of the central and local governments.

*The Program will assist in the establishment of Fiscal Analysis Units in both the MOF and the Supreme Rada.* These units will furnish a central focus of the efforts to improve fiscal systems and policy in Ukraine. The units would have two kinds of functions. First, they will serve as a center for the application of revenue forecasting, analysis and simulation of tax policies, and budget assessment techniques. Second, the units will act as centers for the introduction and development of expertise and knowledge of economic analysis and budget techniques. The units will be the main users of the Fiscal Information System and will have an important role in directing the type and format of the data bases to be created. The units will help disseminate the use of data bases and analytical techniques throughout the budget system.

*The technical assistance project will develop action plans for the Units and assist them in getting started by writing unit missions, organizational structures and procedures.* The technical assistance will provide international expertise in the installation and organization of the units, train the staff of the units and provide support during the tenure of the project. Specific activities will include training, computer hardware and software support. The staff of the units will receive specific training in revenue and expenditure forecasting. This will include methods of forecasting using micro-simulation models, sampling, and basic statistical techniques. Expenditure analysis will include training in cost/benefit analysis. Some of this training could also be offered to other officials of the MOF, STI and finance offices of the pilot oblasts.

The fiscal analysis unit to be established in the Ministry of Finance could be an independent department. could be made part of the Budget Planning Department, or could be installed in the new Policy Division of the State Tax Inspectorate. For this unit, initially a staff of around 20 persons would seem advisable. Their educational background could appropriately be in economics although some staff members might also be drawn from accounting or management disciplines. New staffs of this type often have difficulty relating to existing staffs and find themselves cut off from essential information. For this reason, it would be preferable that the unit be made an integral part of the Budget Planning Department or the State Tax Inspectorate. It would also be helpful if some of the staff members of the unit were drawn from existing staffs. Specific activities of the fiscal analysis unit will include:

- Estimation of the revenue implications of changes in tax policy.
- Analysis of the impact on macroeconomic indicators such as investment, employment, prices and international competitiveness of changes in tax policy.
- Analysis of the interregional and distributional effects of tax policy changes.

For the unit in the Supreme Rada one option is to make it a new office. Alternatively, the unit could be made (part of) the staff of the Commission on Planning, Budget, Finance and Prices. An initial staff of 10 to 15 persons would seem to be appropriate. This unit in the Supreme Rada will have a different emphasis from that in the MOF. The unit will concentrate more on the review of the economic and social impacts of proposed budget policies by the Executive. The unit will make policy recommendations for consideration of the Commission and, through the Commission, to the Supreme Rada. Perhaps more significantly, the unit will act as a center for an expanded budget review role of the Supreme Rada which will include systematic review by sectoral Commissions of the Rada and public hearings.

*The fiscal analysis units in the MOF and Supreme Rada will provide direct support to the oblast governments (executive branch and rada, respectively) in training, development of data bases, and models for policy analysis in areas such as assignment of expenditure responsibilities, revenue sharing schemes, or equalization grants and other transfers within the oblasts.* Some of these activities could commence in the pilot oblasts at the same time MOF and Supreme Rada staff are trained. Staff in the pilot oblasts will receive training and coursework in policy analysis to assist subnational governments in developing alternative revenue sources.

3. **Budgeting at the Central Government Level**

The Program will implement the following specific activities in budgeting and financial management at the central government level:

- Training in techniques for revenue forecasting and economic analysis.

- Establishment of a general fund approach for the budget with the integration of most extrabudgetary activities.

- Training in budget preparation and review and assessment of capital investment projects.

- Assisting in the establishment of a Department of Treasury and Debt Management within the Ministry of Finance.

- Assisting in the reform of the budget classification system by introducing clearer and more useful classifications. A first classification would be an economic classification as outlined in the IMF Manual of Government Finance Statistics, and the second classification would be focused on the end results of what is being done in the budget rather than the expenses on inputs purchased.

- Once the classification system is reformed, assisting in the development of a reporting system that provides the necessary arrays for the purpose of budget decision making and policy planning, and to make the budget clearer to the public.

- Assisting in the modification of the accounting system by providing directives and procedures manuals and presenting seminars and providing training on implementation of the new system.

- Assisting in the development of a new Treasury. The IMF has already provided some planning assistance, but the plans have not been finalized. The U.S. Department of Treasury has also lent some assistance in the preliminary planning and discussions.

- Assisting in the configuration, development and implementation of a modern system of external audit to be placed under the Supreme Rada.

The estimated level of effort for each of these activities is presented in Table 1. Overall, the assistance in improving fiscal management at the central level of government will require two long-term advisors. The first will be concerned with the budget system and the second with accounting and other aspects of financial management. The Chief of Party will coordinate with the work in pilot projects at the oblast level.

## 4. Budgeting at the Subnational Level

The following activities will be carried out in financial management and budgeting in the (two) pilot oblast(s).

The first activity should be to choose the pilot program oblasts and rayons. In preliminary discussions in the Chercasi and Chernigiv oblasts (and their rayons) studied in the field visits, officials indicated interest in becoming the pilots for the Program. However, a decision on the pilot oblasts first will have to count on the approval of the Government and second will have to be coordinated with other USAID projects in Ukraine and those of other international organizations.

Assuming for the time being that there will be only one pilot oblast, most of the activities listed below could be carried out by a team of two resident advisors - one of whom should spend half of his time in the pilot rayon within the chosen oblast. This team will be supported by visiting specialists and trainers who will stay in the oblast or rayon during the implementation of a new technique or process, and during training and the preparation of manuals.

The objective of all these activities will be to develop a prototype budget formulation process which then will be replicated in other oblasts and rayons.

*Activities in Budget Preparation and Structure.* Provide assistance to improve the process of budget formulation, submission and approval. The emphasis will be on a system that presents choices to decision-makers about how to use budget resources. The advisors will detail current preparation process for mutual understanding, arrange seminars and workshops in modern budget preparation, arrange for expert training, review iteration with staff, and prepare procedure manuals.

The new approach will analyze investment opportunities and display those choices with (social) rate of return and price tags, to decision-makers. The resident advisors will develop a detailed training and transition plan and experiment with formalizing public hearing and lobbying at the subnational level.

*Activities in Budget Execution.* Provide assistance to strengthen budget classification and accounting for execution purposes, to improve the allocation and disbursement of funds, monitor and control through the introduction of a Treasury division within the Finance department or alternatively hiring the services of the Central Government Treasury, and the introduction of standard procurement procedures.

The allocation models should be built to be responsive to available revenue and inflation factors and be used to ration cash when necessary. The allocation models can be linked with performance standards from the evaluation function of the budget.

*Activities in Budget Evaluation and Audit.* Provide assistance to develop a new budget evaluation capacity in the oblast and rayon comprising the following steps: establishment of a climate that recognizes the benefits of evaluating results of expenditures; building on promised results in budget proposals and assuring that subsequent budget formulations incorporate evaluation results; training of staff in budget evaluation techniques and delivering training manuals.

Provide technical assistance to institute an independent audit capacity at oblast and rayon levels. Different approaches need to be explored here including units that would respond only to the subnational radas. Another approach is to train oblast and rayon staff to audit the budgets of rayons or oblasts other than their own and have them respond to an interoblast, perhaps national authority.

5. **Tax Administration**

The Program will also be effective in providing technical assistance to the State Tax Service (STI). This assistance needs to be coordinated with the assistance now being provided to the STI by the IMF and the U.S. Treasury. However, the level of effort in the assistance being provided by these institutions is far from what will be needed to bring the STI to modern standards for tax enforcement and administration. Failure in tax collections within the Ukraine fiscal system will spell failure for all other components of that system, many of which will be the object of technical assistance under the proposed Program for technical assistance. Consequently, a program for technical assistance by USAID to STI, in coordination with other assistance currently offered, is deemed crucial for the success of the overall Program and the economic stability and development of Ukraine. Most of the proposed activities should be first developed and tried out in the pilot oblasts which could include the pilot oblast where the IMF is already working. These are the proposed activities for technical assistance to the STI (computerization issues are presented separately):

- Providing technical assistance in the establishment of a taxpayer identification number system in coordination with some of the work already initiated by the IMF in this area.

- Providing technical assistance to complement the ongoing efforts of the STI in organization planning and reform, administrative procedures and internal control. The STI can benefit significantly from the experience-- mistakes and successes -- of other national tax services around the world.

- Providing technical assistance in the development of uniform procedures for tax collections and transmittal of computerized information from banks and other collection agents (under withholding systems), the establishment of current accounts for taxpayers to identify stop-filers and late-filers, and the monitoring and collection of payment arrears.

- Training and the development of manuals and procedures in all areas of office and field audit. This assistance should include the development of an audit plan for each fiscal year, internal control and management systems for auditors, the development of external cross-information systems, the training of trainers and the establishment of a continuing education program for tax inspectors.

- Development of taxpayer information and education services as a distinct division within the STI operation in oblast and rayon offices. The technical assistance will provide training and assist in the preparation and dissemination for the first two years of written materials and direct help lines to taxpayers.

## 6. Computerization

The IMF has been developing a pilot computerization project for tax administration in Darnitsa, a rayon of the Kiev oblast. The project is supposed to be completed in one year and then it would be imitated nationwide. The technical assistance that follows would be coordinated with the IMF efforts. However, the needs for computerization in budget and tax administration go well beyond the scope of the IMF project. Training remains the most critical area in the computerization of the MOF. As a general approach, it would be desirable to put in place "Computerization Steering Committees" with participation of high level policy decision makers.

- Development of a computerization plan for the Ministry of Finance and the State Tax Inspectorate to guide all future computerization. Standards for hardware, software, "platform," database, configuration management, programming, documentation, quality assurance, and training will be specified.

- Recommending desirable technologies, which should be simple to use and reliable. These technologies will be applicable to networking, operating systems, databases, CASE (computer aided systems engineering), and hardware.

- Providing general technical training in the areas set forth in the computerization plan and in the specific areas of computerized tax administration systems, budget systems, and expenditure control systems.

- Providing technical assistance in the computerization of accounting and budget preparation. Once procedures in accounting and budgeting are defined, pilot computerization projects can begin. A plan for a future integrated financial management system should be developed as part of this activity.

- Providing technical assistance in the computerization of tax administration. Pilot projects are the best approach to computerization for these applications. All such pilot projects should be coordinated with the IMF pilot project at the rayon level.

- Providing technical assistance for a system of bank payment and revenue reporting. While some banks at present are computerized, there is no standard method of providing computer media to the Ministry. The use of automated payment recording in banks could be considered for use in the Ukraine.

- Providing assistance with the acquisition of hardware and software. There must be a very specific request for proposal (RFP) developed and issued for acquisition of hardware to be funded in the Program. Proposals must then be evaluated and the best vendor selected to supply the required hardware and software.

**Table 1**
**Estimate of Needed Resources for the Technical Assistance Program**

| Activity | | Person Months of Effort Resident Advisors | Short term Advisors |
|---|---|---|---|
| 1. | Review Intergovernmental Finance Reform Options, Chief of Party | 12 | 6 |
| | Property Tax | 36 | 12 |
| 2. | Fiscal Analysis Unit and Information System | 36 | 6 |
| 3. | Budgeting and Financial Management Central Government. | | |
| | Integrated General Fund | 4 | 0 |
| | Budget Review, Forecasting | 8 | 2 |
| | Execution and Control, Treasury | 8 | TBA |
| | Classification | 5 | 1 |
| | Accounting, Reporting | 16 | 3 |
| | Audit | 18 | 4 |
| 4. | Oblast Budgeting and Financial Management (assumes only one pilot oblast) | | |
| | Budget Preparation and Review | 16 | 2 |
| | Budget Execution and Treasury | 24 | 4 |
| | Budget Evaluation and Audit | 18 | 5 |

**Table 1** (continued)

| Activity | Person Months of Effort Resident Advisors | Short term Advisors |
|---|---|---|
| 5. Tax Administration (assumes one pilot oblast besides the central office) | | |
| Taxpayer Registration | 18 | 6 |
| Organization and Procedures | 12 | 3 |
| Audit, Training and Enforcement | 48 | 8 |
| Tax Collections and Arrears | 24 | 6 |
| Taxpayer Information Systems | 8 | 2 |
| 6. Computerization | | |
| Computerization Plan | 4 | - |
| Networking, Operating Systems CASE Tools | 14 | 4 |
| Quality Assurance Expert | 4 | - |
| Configuration of Standards and Distribution | | 4- |
| System Analysts and Case Experts (many of these could be local hire) | 132 | - |
| Forms Design, Collections, Audit, Budget Computerization Experts | 18 | 2 |

## SECTION 2: INTERGOVERNMENTAL FINANCE IN UKRAINE

This section of the report studies the system of international relations currently operating in Ukraine, and outlines options for reforming this system. The Section is organized in two parts. The issues of expenditure assignment among the different levels of government are discussed in Part A. Revenue assignment and the design of intergovernmental transfers are presented in Part B of the Section. The specific problems related to local taxation are discussed in an appendix to this section.

## PART A: THE ASSIGNMENT OF EXPENDITURE RESPONSIBILITIES

### I. INTRODUCTION

The Government of Ukraine is pursuing the decentralization and modernization of its public finances. Several pieces of legislation have been recently approved, most notably the Law on Self-Government and the Law on the Budget System, giving subnational governments much more autonomy and freedom than they had in the former regime.

Despite the progress to date, Ukraine still lacks a clear decentralization strategy. On the one hand oblast and rayon governments have been give autonomy to formulate budgets and spend their funds any way they wish. This is a practice similar to what is done in a federal system. But on the other hand, revenues tax revenues and the overall level of budget are determined by the central government as in a unitary state. Politically, oblast and rayons have their autonomously elected legislative powers, the radas, as in a federal system. However, the executive branch of government at the oblast and rayon levels are headed by the President's Representative appointed by the central government and representing it, which is an institution of strictly unitary states.

Economic instability with hiperinflation and important institutional changes in many areas of economic policy presently being considered for introduction such as health, social security, and tax reform, also will have a direct impact on decentralization policy. Local governments play an important role in several of these areas. Uncertainty about the final outcome in these policy areas adds to the state of flux of fiscal decentralization in Ukraine. The present degree of confusion has been aggravated by some times a failure to distinguish between deconcentration and decentralization of government activities, and the lack of clearly defined objectives for decentralization.

A stable and meaningful decentralization of the government finances will require first, an unambiguous and well defined institutional framework in each of the tiers of government. Second, it will require three fundamental steps: (i) the assignment of expenditure responsibilities among the different levels of government and budgetary autonomy to cover the assigned responsibilities at each level; (ii) the assignment of tax revenue sources among the different levels of government; and (iii) the introduction of a fiscal equalization mechanism to take care of the different revenue raising abilities of subnational governments, so to guarantee minimum levels and more equal provision of services across local jurisdictions. The institutional framework appear to be in transition.

If there is to be true decentralization of the subnational finances the heads of the executive branches of government at the subnational level will have to respond directly and exclusively either to the oblast electorate or to the subnational radas, rather than being appointed by the central government. There also seems to be some confusion at the central government level between (geographical) deconcentration of central government activities and decentralization of government powers. In the former case the central government delegates implementation of programs to regional offices and local governments but without relinquishing ultimate decision powers and budgetary controls of these programs. In the case of decentralization, local governments are devolved ultimate decision powers and full budget responsibility for the programs. In this latter case, central government financing may be present and it may be conditional to certain standards of performance by the local governments. To the extent that ultimate budget decisions are made by the President's Representative in the oblast and rayon government, these jurisdictions should be considered deconcentrated organs of the central government rather than decentralized governments. Ukraine still has to decide whether to retain the strong features of a unitary state, in particular retaining the figure of the President's Representative or truly decentralize some powers to subnational governments.

The decentralization process in Ukraine will be made more difficult by the existence of significant differences in the level of economic development across regions, different levels of unemployment with some areas facing massive economic restructuring, and politically sensitive regional issues such as Crimea and the ethnic differences between the eastern and western parts of the country.

Decentralization is proceeding slowly in Ukraine. At a practical level, very little has happened in Ukraine over the past year that can be considered as important steps toward a decentralized government structure. Perhaps, the most significant development is that oblast and municipal governments for the first time in 1992 had limited autonomy to formulated their own budgets. And yet the decentralization of government functions represents a fundamental step in the consolidation of democratic institutions and a full open market economy in Ukraine. In addition, the gains in efficiency associated with the decentralization of government functions will bring increases in individual welfare without the use of additional economic resources.It is for these reasons that decentralization policy should remain a priority item in the Government's reform agenda.

## II. STRUCTURE AND RELATIVE IMPORTANCE OF SUBNATIONAL GOVERNMENTS

Subnational governments represent an important part of Ukraine's economy. For 1993 (at June prices), the consolidated budget for all subnational governments represented 44 percent of all revenues in the public sector and 39 percent of all expenditures. The consolidated budget figures for 1993 are presented in Table 1 with a breakdown of central and subnational government budgets. Although the actual budgets have been periodically updated for inflation during the year, the relative share of individual items in the budget is pretty much maintained in the adjustments.

The vertical structure of government is organized in four tiers counting the central government as the first tier. At the second tier of government are the 24 oblasts, the Republic of Crimea, and the cities of Kiev and Sevastopol which are given oblast status. Oblasts have elected legislatures but the head of the executive is appointed by the central government. The sources of funds for oblasts include their own tax and non-tax revenues, shared taxes with the central government and subsidies or transfers from the central government. At the third tier of government are rayons and cities which are subordinate to the oblasts but they also have a democratically elected legislature which ultimately decides the composition of budget expenditures and the head of the executive is appointed also by the center. At the fourth tier of government there are rural settlements and small villages which are subordinate to rayon governments but still have their own budgets. With the average municipality having around 20 settlements.

## III. THE ASSIGNMENT OF EXPENDITURE RESPONSIBILITIES

The relative size of the public sector in the economy has not decreased as rapidly in Ukraine as in other economies in transition despite Ukraine's Government familiar pronouncements in all economies in transition of moving the country toward a modern market economy. Massive privatization of state and local enterprises presently involved in what can be basically considered private economic activities still has not taken place. In the medium term, only those services and activities that private markets will not supply efficiently-- either because of difficulty of charging a price or because of joint-consumption benefits-- or those with desirable redistributional value should remain in the public sector.

Then, there still remains the question of expenditure assignment, that is which level of government -- rayon, oblast or central -- should be responsible for the specific functions and activities that do belong and will remain in the public sector. While the Budget Law and several pieces of legislation address in depth the question of revenue assignments, the question of expenditure assignment so far has not been explicitly addressed any where in the

**TABLE 1**
**Consolidated Budget of Ukraine for 1993**
(in millions of coupons)

| **Subnational** | | **Central** | |
|---|---|---|---|
| **Revenues** | **Total** | **Budget** | **Budgets** |
| VAT | 1,995,226 | 1,054,062 | 941,164 |
| Enterprise Income Tax | 1,346,095 | 600,317 | 745,777 |
| Excises | 808,103 | 369,935 | 438,168 |
| Land Tax | 610,302 | - | 610,302 |
| Individual Income | 554,834 | - | 554,834 |
| Vehicle Tax | 15,740 | - | 15,740 |
| Lumber Tax | 3,523 | - | 3,523 |
| Stamp Tax | 10,083 | 2,751 | 7,332 |
| Taxes on Foreign Trade | 1,005,592 | 1,005,592 | - |
| Mineral Extraction | 115,000 | 115,000 | - |
| Water Tax | 9,373 | - | 9,373 |
| Self-employment | 400 | - | 400 |
| Property Tax | 82,592 | - | 82,592 |
| 50% from Enterprise Privatization | 650,000 | 650,000 | - |
| Economy Restructuring | 73,020 | 73,020 | - |
| Military Property Tax | 50,000 | 50,000 | - |
| Chernobyl Enterprise Tax | 611,300 | 611,300 | - |
| Non Tax Revenues | 180,062 | 100,450 | 79,612 |
| Total Revenues | 8,121,248 | 4,632,428 | 3,556,886 |
| Subventions | - | - | 68,066 |

| **Subnational** | | **Central** | |
|---|---|---|---|
| **Expenditures** | **Total** | **Budget** | **Budgets** |
| Social Welfare | 1,859,817 | 621,925 | 1,237,892 |
| Education and Culture | 2,634,031 | 686,552 | 1,947,478 |
| Science | 178,568 | 177,708 | 860 |
| Capital Investment in Economic Reconstruction | 414,760 | 292,961 | 121,799 |
| National Economy | 1,326,394 | 1,282,795 | 43,599 |
| Subsidy to Families | 133,541 | 20,201 | 113,340 |
| Defense | 547,121 | 544,256 | 2,865 |
| Tax Service | 384,463 | 324,610 | 23,852 |
| Economic Development | 405,592 | 405,592 | - |
| Chernobyl Relief | 611,300 | 611,300 | - |
| Other | 608,959 | 647,826 | 65,201 |
| Total Expenditures | 9,104,546 | 5,615,726 | 3,556,886 |
| Deficit | 983,298 | 983,298 | |

Source: Ministry of Finance

Ukrainian decentralization process. The murkiness and confusion about the responsibilities of different levels of government and the potential mismatch between assigned revenue sources and expenditure obligations is a problem that Ukraine shares with other countries in transition including Russia.

A convenient way to examine the adequacy of expenditure assignments in Ukraine is to see how well the present assignment of responsibilities fits the fundamental rules for the ideal assignment of responsibilities in a decentralized system of government.

Rules for Expenditure Assignment

There is no absolute best way for deciding which level of government should be responsible for particular public services. The adequacy of any assignment has to be judged in terms of how well it achieves the goals or objectives set up by the Government in its decentralization strategy. The fact that it is up to the government to set these objectives should not be interpreted to mean that a murky assignment is acceptable. Clearly, without a specific assignment of expenditure responsibilities it will not be possible to assess the adequacy of the revenue and tax assignment to different levels of government, or the need and effectiveness of a system of intergovernmental transfers. Commonly accepted objectives for fiscal decentralization include those of an efficient allocation of resources via a responsive and accountable government, an equitable provision of services to citizens in different jurisdictions, and preserving macroeconomic stability and promoting economic growth. These objectives are also incorporated in the European Charter of Self-Government to which the GOB in principle, although not formally, subscribes.

The efficient provision of government services requires that government satisfies the needs and preferences of taxpayers as close as possible. This is best achieved by keeping the provision of services at the lowest level of government compatible with the size of "benefit area" associated with those services. The benefit area for sanitation services is clearly the local community but for air traffic control the benefit area is the entire national territory. Leaving the supply of public services with wider benefit areas to smaller units of government is likely to result in the inefficient underprovision of services; e.g.,a tertiary hospital providing regional services is solely finances by a single municipality. Efficiency in the provision of public services is enhanced if consumption benefits are linked to costs of provision via fees, service charges or local taxes. Expenditures undertaken by government for equity or income equalization reasons, such as social welfare, low income housing, is generally thought should be the domain of the central government. Local or regional governments will not be able to sustain independent programs of this nature because they will attract the needy from other areas while they will have to tax their (potentially mobile) residents more heavily. While funding for these expenditures should be a central government responsibility, implementation can very well be left to local government which may have informational and other comparative advantages. Expenditures undertaken for the stabilization of the economy such as massive investment or unemployment compensation are by their scale naturally ascribed to the central government.

The application of these rules largely facilitates the assignment of expenditure responsibilities to different levels of government. However, the rules do not always yield an unequivocal answer all the time. Some public services, e.g. primary education and primary health services, may be of a local nature by the size of their benefit area, but because of their relevance in welfare and income redistribution they may also be consider a responsibility of the central government. It is in this sense that it is not meaningful to talk about the best assignment of expenditure responsibilities. What is considered the best assignment is likely to change over time with changes in costs and technological constraints, as well as changes in preferences. However, there is a need at a any moment in time there to have a concrete assignment of expenditure responsibilities among the various assignments that could be considered optimal. Failure to have a concrete assignment may lead to instability in intergovernmental relations and to the inefficient provision of public services.

## Assignment of Expenditure Responsibilities in Ukraine

The current assignment of expenditures responsibilities is summarized in Figure 1. This assignment system to a large extent has been inherited from the previous regime with central government agencies specializing in the "economic" sphere or sector and subnational governments specializing in the social and cultural sphere. Overall the fundamental rule for assigning expenditure responsibilities according to the size of the "benefit area" of the public service is overall respected. By large, the functions allocated to the central government have a national dimension. These include defense and internal security, the justice system, foreign relations, research in health and education. Expenditures with macroeconomic and redistributional implications such as unemployment compensation are also the responsibility of the central government. Correspondingly, most of the expenditure responsibilities of municipalities involve services with local "benefit areas" such as primary education and health care, fire protection, sanitation,and so on. Expenditures on social services -- education, health, culture and social welfare -- represent over 90 percent of subnational government expenditures.

Although Figure 1 gives the impression of a definite expenditure assignment for each of the expenditure categories, there are several important services for which expenditure responsibilities are not clearly assigned such as in health, education and capital investments across most areas of responsibility. Furthermore, over the past two years additional responsibilities that have been shifted to subnational governments some times without adequate funding.

The central government also establishes standards of provision through norms and fixes service tariffs for subnational governments in expenditure areas fully assigned to the subnational governments. In these ways subnational government act more as deconcentrated agencies of the local government than as autonomous budget units.

Another feature of the assignment of expenditure responsibilities in Ukraine is its frequent fragmentation at different levels of government. For example for basic education, the construction of schools is carried out by oblast governments, while the wages and salaries for teachers is the responsibility of rayon governments and the salaries of supporting staff and maintenance are the responsibility of villages and settlements. However, the fragmentation of responsibilities within a particular public service is likely to cause confusion lead to inefficiencies. All public inputs for education should be simultaneously decided by one single authority. A relative disproportion of funds may be spent on salaries and much less on other operation expenditures; similarly, maintenance may be reduced to a minimum by settlements

**Figure 1. Expenditure Assignment in Ukraine in 1993**

| Expenditure | Federal | Oblasts | Rayons | Settlements |
|---|---|---|---|---|
| Defense | - 100 percent | - | - | - |
| Justice/Internal Security | - 100 percent | - | - | - |
| Foreign Economics Relations | - 100 percent | - | - | - |
| Education[1] | - All university and research institute expenditures<br>- Technicians (secondary ed.)<br>- One technological institute<br>- Two pedagogical institutes | - Several special vocational schools<br>- Schools for orphans and the handicapped<br>- Construction of schools and other buildings | - Wages of teachers | - Salary of support staff and operational maintenance of primary schools |
| Culture and Parks[2] | - National museum<br>- National theater | - Some museums with oblast significance | - Some museums<br>- Zoos<br>- Musical school<br>- All recurrent expenditures of all sport and park facilities and all other cultural facilities | - Village clubs |
| Health[3] | - Medical research institutes | - Tertiary hospitals, psychiatric hospitals, veteran hospitals, diagnostic centers, and special service hospitals (cardiology, etc.)<br>- All capital expenditures in health | - Operations of secondary hospitals<br>- Primary health clinics<br>- Medicines | - Paramedics and local clinics |
| Roads | - Construction of all roads<br>- Maintenance of federal roads | - Maintenance of oblast roads | - Maintenance of rayon and city roads | - Maintenance of communal roads |
| Public Transportation | - Highways, air, and rail transport<br>- Subsidies for other facilities | - Some public transportation facilities (earlier assigned to federal government) | - Some transportation facilities | - |
| Fire Protection | - | - Most fire protection services | - Voluntary, military and enterprise services possible at this level | - |
| Libraries | - | - | - Most local library services | - |
| Police Services | - National militia | - Road (traffic) police | - Local security police (since 1991) | - |

Figure 1. (cont'd)

| Expenditure | Federal | Oblasts | Rayons | Settlements |
|---|---|---|---|---|
| Sanitation (garbage collection) | - | - | - Part of garbage collection | - Part of garbage collection |
| Sewage | - Infrastructure capital investment | - | - Most of the operational expenditures | - Some operational expenditures |
| Public Utilities[4] (gas, electricity, and water) | - | - Capital structures | - Subsidies to households (not enterprises) | - |
| Housing[5] | - Building and development | - | - Maintenance and small scale building | - |
| Welfare Compensation[6] | - Pension | - Family allowance | - Children allowance | - |
| Environment | - National environmental issues<br><br>-Chernobyl Fund | - Local environmental problems (for example, the preservation of forests) | - | - |

Based on fieldwork conducted in early/mid-1992.

(1) Some schools are being built by collective farms. Technicians which are secondary technical schools are also paid for by some state enterprises. Public enterprises also build schools but typically do not operate them. They frequently operate kindergarten services.

(2) Some enterprises build sport facilities.

(3) Some enterprises build hospitals and in some cases also operate them. Social insurance mostly financed by enterprises pays for health services of those covered.

(4) Prices of services are controlled by the central government.

(5) Enterprises have been important builders of housing and continue to be so in Ukraine. In 1993, 5 percent of all new housing had to be reserved for the military.

(6) The Pension Fund and the Unemployment Fund are extra-budgetary funds.

and villages for as long as the oblast government has the responsibility of replacing the structure. When services are fully decentralized to a lower level of government, the upper level of government still can influence the level and standards of provision through the use of grants, such as categorical grants which cannot be used for any other purpose or matching grants which cover a stated share of the expenditures undertaken by the lower level governments.

The lack of clear assignment of expenditure responsibilities were of a less practical consequence before independence from the Soviet Union because all government budgets were much more integrated with the federal budget and additional resources could be counted on when there was an unexpected shortfall. On the other hand, any unspent funds were funneled back to the federal MOF. Since 1992 all subnational governments have autonomous budgets and can in principle run surpluses not subject to extraction by the central government. Therefore, the failure to establish by law a clear assignment of expenditure responsibilities for each government level is likely to become a source of conflict between the central, oblast and rayon governments with each level accusing the other of unduly jettisoning expenditure responsibilities.

More importantly, the lack of specific assignments will condition the adequacy of any tax revenue assignment and any accompanying fiscal equalization mechanism. Clearly, both systems will become obsolete as soon as expenditure assignments are significantly changed. The experience of other economies in transition, in particular Russia, shows that without a specific expenditure assignment Ukraine runs the risk of having revenue availability dictate the responsibilities of each government level will take on leading to institutional instability and to the inefficient provision of public services.

There is an obvious need for a policy decision on concrete assignment of expenditure responsibilities between the central government and the oblasts and between the oblasts and their rayons and cities. The explicit and systematized assignment of functions and expenditures to the different levels of governments should become a priority in Ukraine's strategy for decentralization. The specific assignment would protect local government budgets by making the ad hoc transfer of responsibilities from the central government harder and help guarantee the continued provision of services which may otherwise be inefficiently supplied or simply neglected at all levels because of convenience and budgetary pressures. This specific assignment, of course, should not detract from the flexibility needed to adapt government budgets to major changes in policy. However, the changes should be less frequent and should need approval by the Supreme Rada rather than administrative decision.

## IV. SPECIFIC CHALLENGES IN THE ASSIGNMENT OF RESPONSIBILITIES

Besides the general lack of concreteness in the assignment of expenditure responsibilities in Ukraine, there are several other specific issues that will require special attention from government authorities.

### Role of State Enterprises in the Provision of Social Services

State enterprises historically have contributed in several different ways to the provision of social services outside the regular government budgets. The provision of services has been more important in housing, health, education, infrastructure and culture. In the case of health care, for example, public enterprises specially large ones have played a significant role in the provision of primary care. Typically, enterprises have provided the care facilities and covered their operation costs, and in many cases, enterprises also provided medicines free of charge. These enterprise clinics have provided health care for the entire population of a particular area, including those that were not employed or in other way related to the enterprise. State enterprises often have also made "voluntary" contributions for the provision of municipal services. At present, contributions of public enterprises to the provision of local public services are rapidly disappearing as public enterprises are affected by the budget austerity, lack of sales, and try to get ready for privatization and restructuring.

The discontinuation by public enterprise of the provision of public services on behalf of the subnational and central governments is overall a positive step. It will increase the transparency and efficiency of government budgets. State (public) enterprises, if they remain as such, should contribute to the provision of public services in the same way private enterprises do, exclusively through the payment of taxes and user charges.

However, the discontinuation of expenditures on public services by public enterprises means that these expenditure responsibilities would have to be picked up by the central government or local government budgets. Because most the services provided by public enterprises are those that are assigned to subnational governments in Ukraine, it would most appropriate for oblast and rayon governments to take over those expenditure responsibilities. However, this means that the assignment of taxes to subnational governments and the computation of transfers, will have to take into account this additional increase in expenditure responsibility. Taking over the expenditures of state enterprises in the social area by public enterprises is one of several ways in which the process of privatization of public enterprises will affect the budgets of subnational governments. On the plus side, privatization will improve the budgets of subnational governments by eliminating subsidies to those enterprises operating with losses.

The Assignment of Capital Expenditure Responsibilities

In the former Soviet Union all types of capital investments were centralized under Gosplan. Since independence an increasing level of capital expenditures in the public sector has been taking place through local budgets (see Table 1). But despite this, it appears that the responsibility for decisions about public investments remains highly centralized. Oblast (and rayon) governments get the funds to finance the projects approved at the center either as part of their regulating revenues (that is, their sharing in the three main central government taxes including VAT) or from outright special transfers from the central government.

Subnational governments in the medium run need to take full charge of the planing, financing and execution of all capital projects in the sectors or services that are their responsibility. That is, the assignment of capital expenditure responsibilities among the different levels of government should be the same as for recurrent expenditures. The reasons for the decentralization of capital investment decisions are the same as those behind the decentralization of recurrent expenditures: the increase in efficiency associated with being closer to the needs and preferences of taxpayers and with government becoming more accountable and responsive to them. It is unrealistic to proceed on the assumption that the

BOX 1

The Determinants of Local Public Expenditures in Ukraine

There appears to be some consensus in Ukraine that public expenditures in the past were not equally distributed among all geographical areas of the country. In particular, the generalized impression appears to be that social and infrastructure expenditures were lower in those areas of the country that are poorer. There are also questions as to how funds are presently being allocated within the territories of oblasts.

The perceived inequity with which public funds have been allocated is more than an issue of historical interest for Ukraine. Understanding the regional allocation of economic resources under the previous regime should facilitate the assessment of relative needs of subnational governments at present. One of the major policy issues in decentralization policy will be how to address the regional disparities in public infrastructure that now exist between different regions in the country. The question that has not been documented adequately is how important those differences are. Fairness in the regional distribution of public funds will also be an overriding consideration in the development of a sharing formula for transfers from an equalization fund.

In order to account for all government expenditures in different regions it would be necessary to go beyond the long run profile of central (and local government) budgets. Under the planned socialism of the old regime, public funds were systematically used to develop public enterprises in industry and other economic sectors. These public enterprises, in turn, contributed at varying rates to the provision of local public services, and these contributions most often did not appear in an identifiable form in the central government or local government budgets. Unfortunately, historical data were not available at the time of the mission, and probably some of the data on total regional investment may never become available.

Using budget data for expenditures per capita in 1993 seem to confirm that disparities in public expenditures per capita do exist between regions and that higher expenditures per capita are positively correlated with higher levels of per capita income as proxied by wages per capita. For example, the regression of expenditures per capita (in coupons) on wages per capita measured in thousands of coupons gives the following results:

$$\text{Expenditures per capita} = \underset{(5.31)}{36{,}725} + \underset{(5.55)}{25.9}\ \text{wages per capita}$$

R-squared: 0.55 (t-statistics in parentheses)

These statistical results indicate a mild degree of regressivity in expenditures per capita across oblast. Nothing is said about how expenditures per capita are distributed within each oblast.

central government has the necessary information to make the right decisions in multiple aspects of the life of hundreds of subnational governments. At the same time these capital investments responsibilities are shifted down, subnational governments, and also the central government, should move to a multi-year planning horizon -- three to five years. This will help bring into focus the budgetary implications, current and capital, for subsequent years of capital projects started in the present year and increase the efficiency in the use of scarce investment funds. This issue is of special importance in Ukraine given the high number of unfinished capital projects. Before the transfer of full capital budgeting responsibilities to the local government is implemented, it will be necessary to carry out an intensive training program for local budget officials in multi-year budgeting, project evaluation techniques, tendering, contracting and other related subjects.

Another significant benefit of the transfer of full responsibility of some capital investment to local governments is the integration of the maintenance and the capital investment decisions will be. The separation of these two types of decisions in the past --new capital investment and replacement were the responsibility of the central government while maintenance and operations were left to the subnational governments-- led to waste and the inefficient use of resources. It was in the interest of local governments to allocate too few funds for maintenance of infrastructure for as long as the if the central government responded by replacing the infrastructure at an early stage. This type of perverse incentives were probably of a lesser consequence at the time when local budgets were virtually part of the central budget, and local officials had quite limited discretion, than is the case now with the increased budgetary autonomy of subnational governments in terms of expenditure composition. The maintenance of local infrastructure has become a priority policy issue. The severe budget austerity of recent years has had a deleterious effect on capital investment and maintenance, with the central government cutting the funds available for replacement and local governments giving priority to expenditures on wages and salaries over other recurrent expenditures.

In the case of public utilities, all construction now is supposed to be self-financed, in contrast to the full financing of all public utility by the central government before. However, present tariff charges do not appear to include any cost recovery element, and no money is presently being put aside for the replacement of facilities. To aggravate things further, basically there are no capital markets in Ukraine where public utilities or local governments could borrow long term funds for capital construction. So far no specialized lending financial institutions have been developed either that could perform similar long term financing functions.

## V. THE IMPORTANCE OF BUDGETARY DISCRETION TO DECENTRALIZATION POLICY

Success for the decentralization policy of the Ukrainian government eventually will be measured by the efficiency gains in the provision of local public services. These gains in responsiveness and political accountability of government to the needs and preferences of voters will be difficult to quantify, but it is important to remember that they are the main goal and justification for decentralization policy.

However, the promotion of efficiency and accountability at he local government level requires more than the decentralization of expenditure responsibilities and revenues. It will require that local government officials have a high degree of discretion in the formulation of the budget and expenditure policies, and that this discretion is used effectively.

At present there exist multiple obstacles to the exercise of budgetary discretion by subnational officials. Besides the overwhelming presence and significance of the President's Representatives in each subnational executive branch of government already discussed, other obstacles to local autonomy include practical limitations born out of traditional attitudes in the local sector itself, limitations originating in the legal framework enabling decentralized governance, and multiple regulations and practices of the central government toward subnational governments. Each type of limitations is examined in the following paragraphs.

First, there is a lack of decentralized tradition in Ukraine. In most cases the local officials in charge of putting to work the newly attained autonomy are to a large extent the same bureaucrats, budget officials and others, that worked for decades as local agents of the central government. Actually, at the present time oblast and rayon budgets officials still have dual subordination; they answer to the subnational governments but they still remain central government employees hired and fired by the MOF. The most important decisions in the former regime were made in Moscow so that the lack of experience some times cover the central government authorities in Kiev. Because of this lack of experience and decentralized tradition, most budget officers could upgrade their skills by getting additional training in budgeting and accounting. Given the scale of the problem the Ukraine government should consider the introduction of formal training programs for budget officials at all levels. The initial training, perhaps involving exchanges with western schools, could be initiated under a

USAID project. Several other countries with economies in transition --Hungary and Poland-- are planning large scale training programs with international support.

There are also limitations to budgetary discretion in the law. Perhaps the most serious limitation is the lack of a more permanent and stable method of financing for subnational governments. Oblast governments get most of their funds from revenue sharing and subventions from the central government and these are determined anew each year in the Budget Law for the central government approved by the Supreme Rada. The ability to raise their own revenues is, as discussed in other chapters of this report very limited. Similarly, rayon and city government do not get to know their revenues until the oblast government decides how to share its revenues received from the central government. Oblast governments have considerable discretion on how to share revenues with lower level governments and even those revenues that are mandated in the law to be passed on to lower level governments such as the individual income tax, in many cases it appears are partially retained by oblast governments. This was the case in 1993 in Chernigiv and Cherkasi oblasts visited by the mission. The revenue uncertainty associated with this system of subnational government financing reduces the budgetary autonomy of local governments by reducing their ability to plan and ultimately to act independently of the MOF. An additional source of revenue uncertainty has been central government arrears and budget cuts to oblast governments. In a decentralized system of intergovernmental relations, the central government should not systematically count on subnational government budgets as an additional degree of freedom to maintain equilibrium for its own budget. Privatization and the additional government obligations that may come from taking over state enterprise responsibilities in the social sector will become an additional source of budgetary uncertainty.

On the expenditure side, the Budget Law specifies what item categories are "protected "and therefore should receive priority financing in subnational government budgets. These include wages and salaries and food and medicines. These issues are discussed in more detail in the two chapters of this report dedicated to budgeting issues. The point here is that the present budget process also reduces the expenditure discretion of subnational governments, even though the Law on Self-Government states the sovereignty of oblast and rayon governments in this area. In a similar vein, the Law on Self-Government guarantees subnational government the right to keep any budget surplus realized at the end of the fiscal year, but that surplus can be easily taken back by the immediately higher level of government by for example reducing enough the sharing rates for the "regulating" taxes in the next fiscal period.

This type of possibility, of course, gives subnational governments very little incentive to increase local revenue mobilization. This is an important problem which needs to be understood and addressed by the central government right away.

Another practice limiting the budgetary discretion of local governments is the use of "mandates." These mandates take different forms and shapes but substantially they are orders from the central government to local governments to undertake expenditures in some area without full compensation, or without compensation at all. One possible source of mandates is the fact that the majority of local government employees are subject to national wage scales controlled by the central government. Increases in salaries mandated by the central government should be completely covered by updating of oblast budgets followed by an increase in central government funds transferred when needed, but the timing and the amount have not always been adequate. Another type of government mandate has consisted in the decentralization of certain services at the same time the central government has reserved itself the power to set the level of fees or charges for those services as is the case with public utilities. Local governments do not have the authority to set even garbage collection fees or charges for sellers at market stalls. The exception has been public transportation for which local governments,including Sofia, are free to set tariffs. However, local governments have been reluctant to do so for fear of the negative impact on the poor and old, and because of fear of a strongly negative popular reaction.

## VI. SUMMARY AND CONCLUDING COMMENTS

The Government of Ukraine needs to review the current assignment of expenditure responsibilities between the oblast and the central government. The same exercise needs to be taken in each oblast for the division of responsibilities between the rayon governments and the oblast government. These will be data intensive exercises and USAID could provide technical assistance with international expertise and several seminars for high level government officials in the executive and legislative branches. For oblasts the preferred approach will be to use two pilot oblasts and consequently disseminate the information and experiences to other oblasts. The central government could set fiscal incentives to entice other oblasts to adopt changes in the present division of responsibilities within the oblast.

For capital investments there will be a need to train oblast and rayon government officials in capital budgeting, multiyear budgeting techniques and project appraisal methodology. These are all areas in which a USAID project could provide technical assistance in coordination with the technical assistance to be provided in the general area of budgeting and discussed in other chapters of this report. The development of financial intermediation to provide adequate long-term funds for capital investment projects at the subnational level is an urgent need. However, the technical assistance that would be required would involve banking and financial intermediation expertise which may fit better into other technical assistance projects being offered by USAID to the Ukrainian government.

The USAID project on intergovernmental finances could provide technical assistance for several pilot studies on pricing policies for public utilities on how to establish cost recovery.

It is not very clear at this stage what to do about the problem with social services brought about the privatization of state enterprises. More study needs to be done on several fronts. Would the issue of whom eventually will assume responsibility slow down the privatization process? Will there be need for some bridge financing to help subnational governments absorb the additional responsibilities? The USAID project could help with technical assistance on the surveying techniques and the evaluation of results and policy options. Finally, the USAID project could provide technical assistance for the review of current limitations to subnational government budgetary discretion and what the policy options may be.

## PART B: THE ASSIGNMENT OF REVENUE SOURCES AND THE DESIGN OF INTERGOVERNMENTAL TRANSFERS

### I. INTRODUCTION

As Ukraine makes the transition to democracy and free markets, some of the most important problems it will face involve intergovernmental fiscal relations -- the vertical and horizontal relations between various units of government. These include the assignment of expenditure functions and revenue sources among levels of government, the use of intergovernmental transfers to avoid vertical fiscal mismatch and horizontal fiscal disparities, and limitations on the borrowing power of subnational governments.[1]

As an example, the assignment of revenues contained in the Draft Budget Law is problematical. The Draft Law proposes the following national/oblast division of revenues from five major types of tax:[2]

| Tax | National | Oblast |
|---|---|---|
| Value added tax | 70 | 30 |
| Enterprise profits tax | 0 | 100 |
| Individual income tax | 50 | 50 |
| Excises | 50 | 50 |
| Natural resource tax | 0 | 100 |

[1]The term "subnational" is used here to refer jointly to what is called state and local in American terminology and is translated from Russian and Ukrainian as "local." For the most part the term "state" is used only in discussions of fiscal institutions in countries with federal systems in which intermediate governments are actually called states (or the direct equivalent in another language), such as the corporate profits taxes levied by American states or the Brazilian state value added tax. (By comparison, in discussing Canada and Russia, references to these governments are to "provinces" and "oblasts.") Reflecting the fact that much of the literature on this topic has developed in the conceptual framework of a federal system, the term "federal" is sometimes used to connote the top level of government; in the Ukrainian context of unitary government the term "central" might be more appropriate.

[2]Throughout this report, the term "oblast" is used to include the Republic of Crimea and the cities of Kiev and Sevastopol.

In each case this assignment of revenues can be expected to be problematical. In some cases the problems are conceptual and economic: for example, the enterprise profits tax does not satisfy one of the cardinal principles of revenue assignment to subnational governments; it does not reflect benefits of public services and it can lead to tax exporting to non-residents. In several cases severe administrative problems can be anticipated: these include the value added tax and the enterprise income tax. In general the technique chosen to divide revenues (tax sharing) is inferior to other techniques (e.g., subnational surcharges) because it fails to provide subnational governments needed fiscal autonomy. In the case of natural resources there are strong (but not unanimous) reasons to assign revenues to the central government. On balance, it seems that several taxes assigned in part to the oblast level should be reserved for the central government. This suggests both that where possible, revenues should be assigned to the oblast level in order to minimize vertical fiscal imbalance and that both remaining vertical fiscal imbalance and horizontal fiscal disparities between oblasts will probably make it necessary to transfer substantial amounts of revenues from the center to the oblasts in order to reduce revenue gaps and equalize fiscal capacities.

The four major questions in the first paragraph involve myriad detailed and difficult smaller questions. While the questions are inherently political, they also involve essentially technical issues, such as the feasibility of assigning particular taxes to subnational governments and the design of intergovernmental transfers based on formulas. This report is an attempt to provide some of the expertise needed to start answering these technical questions in the area of revenue assignment and intergovernmental transfers. Besides employing both conceptual and analytical approaches, it draws on relevant experience in other countries. Familiarity with foreign experience is especially useful in helping decision-makers in Ukraine avoid mistakes that have been made elsewhere.

The structure of the report is as follows: Section II explains that present budgetary practices in Ukraine render the question of revenue assignment largely irrelevant. Section III explains the conceptual objectives of revenue assignment, Section IV discusses the meaning of revenue assignment and the feasibility of using various techniques to achieve it, and Section V describes limitations on various types of revenue assignment imposed by administrative realities and other considerations and evaluates the assignment of particular taxes. Section VI discusses the nature and purpose of several types of intergovernmental transfers, and Section VII discusses limits on subnational borrowing authority. Section VIII indicates how the Draft Budget Law and the revenue assignments proposed here would alter the amounts of revenues available to various oblasts, and Section IX brings together the most important conclusions.

Primary attention is on long-run relations between the central government and the next level below it--the central and oblast levels in the Ukrainian context. But much is equally applicable to relations between these levels and the local level.

## II. THE IRRELEVANCE OF REVENUE ASSIGNMENT IN THE EXISTING BUDGETARY ENVIRONMENT

If the question of revenue assignment is to be of any relevance for Ukraine--budgetary practices must be revised.

Current Budgetary Practices

Although Ukraine has a unitary system of government, in some respects its governmental structure resembles that of a federation. It has four levels of government: the central government; the oblast level, which includes the cities of Kiev and Sevastopol and the Republic of Crimea, as well as the 24 oblasts ("oblasts" in the terminology of this report); the rayons within each oblast; and the cities, villages, and settlements.

The current (mid-1993) budget practice of Ukraine, carried over from the Soviet system, distinguishes between "fixed" and "regulating" sources of revenues. Oblasts receive set fractions of revenues from fixed sources. By comparison, oblasts are allowed to keep larger or smaller shares of the revenues from the regulating taxes collected within their territory, depending on their need for revenues, compared to the revenues expected to be derived from own and fixed sources. (Revenue requirements are, in principle, determined by applying national norms to various expenditure categories; in fact, they appear to be determined by carrying forward past expenditures, adjusted for inflation.) If the revenues an oblast receives from regulating taxes, together with revenues from own and fixed sources, are not adequate to cover expenditure norms, the central government may provide subventions to the oblast.[3] Revenues in excess of those required to cover actual expenditure, along with donations and certain fees, can be placed in an extrabudgetary fund.

The personal income tax is the only major tax that is assigned entirely to subnational governments; it is a "fixed" source of oblast revenue. Revenues from this tax go to the oblast

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[3]Oblasts are entitled to subventions up to the amount the central government receives from regulating taxes collected in the oblast. Beyond that, subventions are granted at the discretion of the central government.

of employment, in the case of a worker who does not live where he or she lives. Oblasts also collect a variety of minor own taxes.

Ukraine uses the value added tax (VAT), enterprise profits (or income) tax, and excises as "regulating" taxes.[4] In principle, oblast retention rates for these taxes can be as low as zero (if revenues from fixed sources are adequate to cover expenditures based on "norms") and as high as 100 percent (if all revenues raised in the oblast are required to cover expenditures based on norms). In fact, in the proposed 1993 budget, sharing rates exhibited the following patterns: VAT, a range of 22.1 to 100 percent; enterprise tax, 25, 50, or 100 percent; and excises, 10. 50, or 100 percent.

The following summarizes the system described above:

Expenditure Needs (based on "norms")

| | |
|---|---|
| Less: | revenues from own and fixed sources (e.g., individual income tax, oblast share of enterprise income tax, etc.) |
| Equals: | amount to be covered by regulating taxes (i.e., the VAT, enterprise profits tax, and excises) and, if necessary, transfers from the central government. |

Revenue Assignment in the 1993 Budget

Under present practice, each oblast has a sharing rate for each of the "regulating" taxes--the VAT, the enterprise profits tax, and excises. Table 1 indicates oblast shares of each of these taxes proposed in the 1993 budget, as well as the aggregate sharing rates (the

[4]Ukraine has recently vacillated between using an income tax (which allows no deduction for costs of labor), levied at a rate of 18 percent, and a profits tax (which does allow such a deduction), levied at a rate of 30 percent.

weighted average of the sharing rates for all three taxes). Oblast shares of revenues from excises are 10 percent, 50 percent or 100 percent, and oblast shares of enterprise profits tax revenues are 25 percent, 50 percent, or 100 percent. By comparison, in the case of VAT there are 19 different local sharing rates, ranging from 23.1 percent to 100 percent.

In the 1993 budget 9 of the 27 oblasts would retain all the revenues from all three taxes raised on their territories. These are the only oblasts allowed to retain all the VAT and the only ones granted subventions. An additional 5 oblasts would retain all the enterprise tax. These 5 oblasts also retain from 62 to 96 percent of the VAT; four would retain 50 percent of excises, but the other all revenue from excises. Nine oblasts would retain 50 percent of revenues from the enterprise tax, and four would retain 25 percent. The former group's shares of retained revenues from the VAT range from 23 to 77 percent; all but one of these would also retain 50 percent of excises. (The other would be allowed to keep all excises.) Oblasts that would retain only 25 percent of the enterprise tax would also retain low percentages of the VAT (22 to 36 percent) and excises (10 percent in three cases, but 50 percent in the other).

This table clearly shows systematic patterns. Oblasts that have high sharing rates for one tax tend to have high sharing rates for the others. Aggregate sharing rates fall into several classes. First, there are the nine oblasts that keep all revenues from regulating taxes; these oblasts also receive subventions. A second group of 6 oblasts have aggregate sharing rates that fall within the range of 74 to 86 percent. Three oblasts have sharing rates of 63-64 percent and another six have rates of 41 to 51 percent. The final 3 oblasts have sharing rates well below the others, in the range of 30 to 36 percent.

Table 1
Oblast Sharing Rates for Regulating Taxes

| Oblast | VAT | Profits | Excises | Aggregate |
|---|---|---|---|---|
| Vinnichkaya | 89.7 | 100.0 | 50.0 | 74.32 |
| Volunskaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Luganskaya | 35.7 | 50.0 | 50.0 | 51.70 |
| Dnepropetrovskaya | 24.3 | 25.0 | 10.0 | 35.99 |
| Donetskaya | 22.1 | 25.0 | 10.0 | 33.66 |
| Zitomirskaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Zakarpatskaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Zaporzhskaya | 60.3 | 50.0 | 50.0 | 62.91 |
| Ivano-Frankovskaya | 68.9 | 50.0 | 50.0 | 64.12 |
| Kievskaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Kirovgradskaya | 95.7 | 100.0 | 50.0 | 83.51 |
| Crimea | 100.0 | 100.0 | 100.0 | 100.00 |
| Lvovskaya | 38.6 | 50.0 | 50.0 | 51.02 |
| Nikolaevskaya | 62.1 | 100.0 | 50.0 | 78.42 |
| Odesskaya | 41.1 | 50.0 | 50.0 | 50.24 |
| Poltavskaya | 35.6 | 25.0 | 10.0 | 30.73 |
| Rovnenskaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Sumskaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Ternopolskaya | 90.7 | 100.0 | 50.0 | 74.10 |
| Charkovskaya | 27.1 | 25.0 | 50.0 | 41.84 |
| Chersonskaya | 74.2 | 100.0 | 100.0 | 86.04 |
| Chmel'nitcha | 63.6 | 50.0 | 100.0 | 82.49 |
| Cherkasskaya | 76.5 | 50.0 | 50.0 | 63.06 |
| Chernovitchkaya | 100.0 | 100.0 | 100.0 | 100.00 |
| Chernigovskaya | 23.1 | 50.0 | 50.0 | 44.54 |
| Kiev | 36.1 | 50.0 | 50.0 | 49.54 |
| Sevastopol | 100.0 | 100.0 | 100.0 | 100.00 |

Sharing rates are inversely related to per capita wages. Even so, both revenues and expenditures are positively related to per capita wages; for each additional Kup. 1,000 in wages per capita, revenues and expenditures increase by about Kup. 25. On average, subventions go to oblasts with below-average wage levels; thus they provide some equalization. (Sevastopol is a clear exception; it receives subventions, despite having the highest per capita revenues of any oblast, in the absence of subventions.) Despite these general patterns, one should not lose sight of the fact that sharing rates reflect the results of ad hoc negotiations, not the application of principle.

## The Irrelevance of Revenue Assignment

Under present budgetary practices, the central government transmits to each oblast a fixed "minimum" budget, based on prior expenditure levels. If an oblast's revenues from own and fixed sources, including extrabudgetary funds, exceed this minimum budget, the oblast is free to spend the excess as it wishes. For these oblasts the questions of revenue assignment discussed here are extremely important, for they determine the ability of such oblasts to exercise fiscal autonomy. There are no such oblasts. If own and fixed revenues are not adequate to finance this minimum budget, the central government adjusts shares in regulating taxes and transfers enough funds to the oblast to meet the projected shortfall. For these oblasts, the present discussion is largely irrelevant, unless budgetary procedures are changed; they do not exercise fiscal autonomy. Changes in own revenues resulting from reassignment of revenue sources will simply be offset by equal and opposite changes in shared taxes and transfers from the central government.[5] This implies that if the present discussion is to be useful--and, indeed, if the entire question of revenue assignment is to be of any relevance--budgetary practices must be revised to give oblasts essentially complete control over, and responsibility for, the size of their budgets and marginal sources of revenues to finance it. Such a revision in budgetary practices is assumed in what follows. Section VIII discusses this matter further.

## III. REVENUE ASSIGNMENT: CONCEPTUAL FOUNDATION

In a democratic society people should be able to influence the decisions of government that affect them. They should get the public services they are willing to pay for and they should pay for the services they receive. These seemingly simple dicta have powerful implications for government finance, including intergovernmental fiscal relations.[6] Following an explanation of these implications, several other conceptual issues are discussed.

### Subnational Use of Benefit Taxes

Advantages of Decentralization. Decisions on government activities should be the made as close to the people as possible. Decentralization of decision-making increases the

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[5]This reasoning is admittedly somewhat circular, since the reassignment of revenues will, to some extent determine whether an oblast does or does not have enough own revenues to cover its minimum expenditures. If, however, the reassignments proposed here are implemented, no oblast would have enough own revenues to cover its budget, in the absence of revenue sharing. See also Section VIII.

[6]While these implications may appear to be more applicable to a federal system than to a unitary state such as Ukraine, they are also relevant for the latter.

likelihood that the provision of public services accords with the desires of citizens and is done efficiently. (The principle that decentralization is to be preferred over centralization is commonly called "subsidiarity" in discussions in the European Community.) This is one of the primary benefits of decentralization. It is the intention, as specified in the Law on Local Self Government and the Law on the Formulation of Budgets, that subnational governments be given considerable fiscal independence and autonomy.

Whether a given level of government should be responsible for a particular activity depends on the geographic extent of benefits of the activity--whether there are spillovers between jurisdictions--and the existence of economies of scale and scope in providing the service(s).[7] It makes sense for local governments to issue dog licenses, because there are few spillovers and economies of scale are insignificant. By comparison, national defense is inherently provided by national governments.

Advantages of Benefit Taxation. It is generally appropriate that those who use public services pay for them, to the extent possible. As in the market sector, resources will (within limits) be allocated most efficiently if this rule is observed; if it is not observed--if public services are seen as costing little or nothing -- there will be excessive demands for them and resources will be wasted in providing them. It is also fair that users pay for the public services they use. This is the basic rationale for governments to rely on user charges and taxes related to benefits received to the extent possible. (For expositional convenience such

[7]Economies of scale exist when it is not necessary to increase inputs (and thus costs) proportionately in order to realize an increase in output. Economies of scope exist when it is cheaper to provide several services jointly than to provide them separately.

terms as "benefit taxation" are used hereafter to refer to all taxes and charges intended to collect revenues from those who benefit from public services.)

Subnational Use of Benefit Taxes. Because of the nature of the services provided at the national and subnational levels, the benefit principle is more easily implemented by the latter. Indeed, the greater feasibility of benefit finance is one of the most important advantages of subnational government. If the politicians and bureaucrats responsible for the provision of public services by subnational government do not provide services equal in value to taxes paid, they can ideally be replaced by others who will do so.

Relation to Expenditure Assignment. If benefit taxation is to be implemented, the assignment of expenditure functions and revenue assignment must be closely linked. The government that provides a service (e.g., a toll road) should receive the payments for its use (the tolls). If this rule is violated, the jurisdiction supplying the service (but not paying for it) will want more than the optimal amount of service and the jurisdiction financing provision of the service will be reluctant to provide the optimal amount of financing.

Benefits of Tax Competition. Under some conditions tax competition exerts a positive influence on the decisions of governments. For example, if the benefits of public services provided by a particular jurisdiction are not worth the taxes an enterprise must pay to operate there, the enterprise has an incentive to locate (or relocate) in a jurisdiction with a more attractive fiscal environment. In order to attract (or retain) the enterprise, the jurisdiction may be forced to reduce business taxes to a level commensurate with the value of the services it provides, to alter the package of services it provides, or to provide services more efficiently. In this way tax competition between subnational governments operates like competition between firms in a market economy to help guarantee that business gets what it pays for, as the benefit principle demands, and that services are provided efficiently. To the extent that the residential decisions of individuals depend on economic considerations, tax competition also encourages the use of benefit taxes and user charges.

Benefits of Subnational Autonomy Over Tax Rates. If decentralization is truly to provide autonomy to subnational governments and if tax competition is to be effective, each jurisdiction must have the power to set its own tax policy independently, especially regarding rates. If tax rates are dictated centrally, subnational governments will have little latitude to set the level of taxation to accord with local preferences for public services. Moreover, competition between taxing jurisdictions will be limited, and self-interested politicians and bureaucrats will be able to take advantage of citizens, just as business takes advantage of customers in the case of a cartel or monopoly in the provision of goods by the market.

Benefits of Coordination of Tax Bases and Administration. Independent subnational choices and definitions of tax bases are much less important for subnational autonomy than is subnational control over tax rates. Foreign experience shows that excessive subnational independence in these matters can cause unnecessary administrative headaches, while adding little beneficial fiscal autonomy. Similarly, while independent subnational tax administration is a worthwhile objective, it is extremely difficult for some taxes (e.g., the value added tax), and even where independent administration is possible, uncoordinated and/or duplicative administration often wastes scarce resources. There are various ways to overcome these problems, without sacrificing fiscal autonomy. Subnational governments can cooperate with each other and with the central government or they can be assigned revenues from taxes they do not collect for themselves but whose rates they determine, such as a surcharge on a tax of the central government. Section IV discusses these and other important difference between various forms of revenue assignment.

Importance of Focus on Incremental Sources of Finance. It is important to distinguish between incremental or marginal sources of revenue and aggregate sources of revenue. First, in judging the fairness of a fiscal system, it is primarily who provides the money (i.e., the source of total revenues) that matters; it generally seems fair that beneficiaries pay the cost of providing the services they use, but there may be reasons, such as lack of fiscal capacity to provide minimal services, to deviate from this rule. Second, in judging the economic efficiency of a system of intergovernmental finance, it is much more important who provides the funding for incremental spending. Efficiency requires that beneficiaries of public services pay for increases in services or pay lower taxes, if benefits are reduced.

While these two statements may appear to be saying the same thing, they are not. Consider the finance of a service deemed to be the right of all citizens. The central government may provide a lump-sum subvention to all jurisdictions intended to allow them to provide the minimum level of service.[8] Thus subnational governments do not pay the entire cost of the service. But if a community wants to provide a higher level of service, it must finance the increased activity itself; that is, it is responsible for incremental spending. As explained further in Sections IV and V, this distinction is extremely important for the choice of subnational revenue sources, as well as for the design of intergovernmental transfers.

<u>The Importance of "Own" Incremental Finance</u>. If subnational governments are to be responsible to their constituents, it is important that they have their own sources of revenue; it is unrealistic to expect politicians to exercise responsibility in spending someone else's money. Moreover, lenders are vitally interested in knowing whether a government has its own sources of revenues.

It is not always easy to identify own and other sources of revenue. Clearly if a subnational government levies and collects a tax, the revenue is its own. The same would seem to be true of surcharges levied by another level of government. But what if it is uncertain whether funds from a surcharge will be remitted on a timely basis? What if the money takes the form of a grant from a higher level of government? It seems reasonable, for at least some purposes, to consider surcharges, shared taxes and revenues, and grants to be own revenues, if funds are available with certainty on terms known in advance.

Combining the last two points suggests that what is really important for autonomy and fiscal responsibility is that subnational governments have their own sources of incremental

[8]This may not be a very efficient way to achieve this objective. That is not relevant for the purpose at hand, which is to illustrate the nature and importance of incremental funding.

finance--that they are financing marginal activities from funds they raise themselves. Thus revenue sharing funds may be considered to be own revenues, but they are not a source of own incremental finance. By comparison, revenues from tax sharing would be own incremental revenues.

Environmental Fees as Benefit Taxes. Throughout the world there is growing interest in collecting fees from those responsible for damage to the environment. This approach has the advantage of raising revenue by charging those who do something bad (e.g., pollute), instead of something good, such as the earning of income or consumption. Thus it contributes to economic efficiency, as well as revenues. Such charges are appropriately seen as benefit taxes--charges for use of the scarce capacity of the environment to assimilate waste. The failure to levy such charges should be seen as a subsidy to pollution-prone activities, much like failure to charge for other benefits. Unfortunately, difficult issues of monitoring pollution and placing values on the damage it does limit the immediate applicability of this technique, except in the simplest cases. Never-the-less, given the serious on-going degradation of the environment in Ukraine, consideration should be given to using environmental charges as a source of future revenue. As with other benefit charges, the jurisdiction where damage occurs should receive the revenues from such charges.

A National Common Market. If a nation is to have a unified foreign economic policy and a common internal market, subnational governments should not be allowed to levy taxes that unduly impede the flow of labor, capital, goods, and services within the nation or between it and foreign countries. Most obviously, they should not be allowed to levy tariffs on imports or exports from the rest of the nation or the rest of the world (or to use other fiscal devices that have similar effects, such as simultaneously taxing consumption and subsidizing production). But they should also not levy taxes whose administration unduly impedes trade or flows of factors (labor and capital).

Seen in this light, regional development policies implemented by subnational governments are problematical. They represent an effort to interfere with the market allocation of resources (namely capital) that may be as pernicious as tariff protection of local producers from outside competition.

Failure of Enterprise Profits Tax to Reflect Benefits. It is important to note that the enterprise profits tax is not an appropriate technique for the implementation of benefit taxation.[9] Most public services are provided to households, not enterprises. Even for services that do benefit enterprises, there is no reason to believe that only profitable enterprises receive benefits or that benefits increase with profits. (Section V discusses administrative problems with subnational taxation of enterprise profits.)

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[9]The present discussion does not consider in detail the assignment of revenues from the enterprise income tax (a tax that allows no deductions for labor payments), a form of taxation that does not exist in the West, that is universally agreed by Western tax experts to be inappropriate for use by any government, and that should be repealed. The income tax can be seen as a combination of a tax on profits and a tax on non-deductible payments to employment of labor. As a source of revenue for subnational governments, the part of the tax on profits is flawed for both conceptual and administrative reasons (explained in Section IV). As explained further in the discussion of generalized benefits below, it seems more appropriate to tax labor where it lives. Thus neither part of the income tax rates high as a benefit tax. It is not an appropriate subnational tax, even if it continues to be used by the central government.

Property Taxes as Benefit Taxes. Subnational property taxes are sometimes justified as benefit taxes. This a gument is most convincing in the case of taxes on residential property, which on average may reflect benefits of public services such as education and streets. (In the United States the property tax is the most important source of financing for primary and secondary education.) Even then the link between taxes and benefits is rather weak; some households have more children than others. It can be argued that it is fair that elderly couples whose children have left home should pay school property taxes to compensate for educational benefits realized earlier. Fairness aside, such an arrangement creates incentives for the elderly to vote against spending on education and to concentrate in communities with low educational spending.

The benefit argument for property taxes is weak in the case of much business property. Relatively few public services are provided to business, compared to those provided to households.

Distortion of Locational Choice. When subnational jurisdictions levy taxes on property that can move (directly, via a property tax or indirectly via a profits tax) that exceeds the value of benefits provided, there is an incentive for the owners of the property to move it to another jurisdiction, as noted in the discussion of tax competition. This produces an inefficient geographical allocation of capital.

Such incentives to relocate do not exist if the taxes of all jurisdictions uniformly exceed the value of benefits provided to business, as they might under centrally mandated tax rates or other cartel-like arrangements between governments. While the geographic neutrality of such a system is desirable, this advantage is purchased at the cost of losing the benefits of tax competition. It is better to rely on the pressures of tax competition to force the use of taxes more closely related to benefits, which also eliminates distortions in locational decisions.

Difficulty of Subnational Income Redistribution. Subnational governments generally find it difficult to engage effectively in progressive taxation intended to redistribute income. (This does not mean that the taxes cannot be implemented--only that they are unlikely to have the intended distributional consequences.) This is a corollary of the effects of tax competition. Jurisdictions that attempt to levy taxes not related to benefits of public services face the prospect of the most productive individuals and the most profitable enterprises locating where taxes are lower, or at least more closely related to benefits. If this happens, it is workers who are unable to move easily (through lower wages) and owners of capital that cannot be moved who are likely to bear the burden of the taxes intended to increase progressivity.

Taxing Natural Resources. The subnational taxation of important natural resources that are geographically concentrated within the country can interfere with economic efficiency. Except as needed to reflect extraordinary costs of public services or damage to the environment, taxes on natural resources cannot be defended as benefit taxes. If the availability of abundant revenues from natural resources makes it possible for resource-rich jurisdictions to set other taxes below the level needed to pay for public services or to pay "dividends" to residents, public services may be over-expended or too much capital and labor may be attracted from other parts of the country.[10] This suggests that, from an economic point of view, taxes on important natural resources should be reserved primarily for the central government. (Part C of this section considers other factors in the assignment of revenues from natural resources.)

The Efficiency of Taxing Immobile Property. One way to avoid the locational decisions involved in some forms of taxation is to rely heavily on taxes on immobile property. Taxing these resources is good, to the extent doing so makes it possible to avoid using other taxes that distort economic decisions. But in the long run only natural resources and land are immobile; capital is immobile in the short run, but it can be moved in the long run. The desirability of taxing natural resources involves more than this one issue, as noted elsewhere. Moreover, both natural resources and land are owned primarily by the state.

Tax Exporting. Throughout the world subnational governments want to export their taxes to non-residents. They use such techniques as payroll taxes on commuters, hotel taxes that are paid by tourists, profits taxes on enterprise owned by non-residents, business property taxes, and taxes on natural resources in the attempt to export taxes. To the extent that taxes simply cover the costs of providing public services, there is nothing wrong with tax exporting; indeed, it is required for rational allocation of resources. But when taxes not

[10]Subsidies to the exploitation of natural resources--including the failure to reflect environmental damage in costs--can have similar effects. The level of taxation should be measured net of subsidies.

related to benefits are exported, both equity and efficiency suffer. It is not fair to export taxes in excess of benefits. Also, if a jurisdiction can export the taxes it uses to finance incremental spending, it will over-expand its public sector. This provides a strong reason not to allow subnational governments to employ non-benefit taxes that can be exported.

Identifying Exported Non-Benefit Taxes. It is often difficult to identify taxes that can be exported. Sophisticated economic analysis may be required, and the degree of exporting may depend on the circumstances in which a particular tax is imposed. This is yet another reason for subnational governments to rely as heavily as possible on benefit taxes.

Some non-benefit taxes are more likely to be exported than others. Taxes on enterprise profits and business property may be exported to non-resident owners, at least in the short run, and taxes on natural resources may be exported to non-resident owners. In the case of natural resources owned by the central government and state enterprises owned by any but the taxing subnational government, it makes sense to consider these governments non-resident owners for purpose of deciding whether tax exporting occurs.

Paying for Generalized Benefits[11]

Because of the difficulty of identifying and charging beneficiaries of some public services, it is difficult to rely solely on benefit taxes and user charges to finance subnational governments. It is generally necessary to utilize sources of revenue that are less directly related to benefits received, such as individual income taxes, sales taxes, and payroll taxes.

Ordinarily payroll taxes are collected where people work, but subnational individual income taxes on labor income are often paid to the place of residence, at least in countries with essentially universal filing of tax returns. Retail sales taxes, being based on consumption, are paid where people live, except for cross-border shopping, tourism, and purchases by mail. By comparison, revenues from single-stage sales taxes levied at the manufacturing-import stage go to the jurisdictions where production and importation occur. Whether producing or consuming jurisdictions get revenues from the value added tax (VAT) depends on whether the VAT is levied at the place of origin or the destination of goods and services.

If people work primarily where they live, it may not matter whether subnational governments employ employment-based payroll taxes or residence-based income taxes (except for such important differences as coverage of non-labor income, tax thresholds, exemptions,

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[11]Given the predominance of housing and "public" services, such as education and health services, provided by enterprises for their employees, this discussion is currently less relevant in Ukraine than in societies where housing is privately owned or rented and more services are provided privately or by governments. It is now most important in the larger cities, where private employers are providing fewer such services and substantial commuting occurs between jurisdictions. Since new private sector firms cannot be expected to provide housing and these services and privatization of state enterprises will result in housing and many such services being "spun off " it is important for Ukraine to consider this issue in framing policy for the future.

and rate structure.) But if there is a substantial amount of commuting to work across jurisdictional boundaries of subnational governments, there may be important differences in the division of revenues from employment-based payroll taxes and residence-based income taxes. Similarly, the more inter-jurisdictional trade there is in taxed goods and services, the more it matters whether consumption or production is taxed. The smaller the jurisdictions involved, the more commuting and trade occur and the more important this issue is.

Although benefit taxes cannot be employed directly, the reasoning of the benefit principle can help guide the choice between direct taxes based on employment and on residence and between indirect taxes on production and consumption. It is often possible to distinguish between public services that are consumed where people live and where they work. For example, parks may be provided in both places, for the enjoyment of those on their lunch break from work and for the enjoyment of families in evenings and on weekends. Depending on whether public services are more closely related to employment and production or to residence and consumption, the payroll tax and production-based indirect taxation or the individual income tax (with revenues going to the place of residence), retail sales tax, and destination-based VAT are more appropriate.

It seems likely that most public services are provided where people live, not where they work (or will be, once more services are actually provided publicly, instead of by employers). This suggests the importance of taxing labor income where people live. Alternatively, it suggests that indirect taxation (e.g., sales taxes) should be based on consumption, rather than production. In practical terms, this suggests that the destination principle of collecting a value added tax is to be preferred over the origin principle.

Similarly, from the point of view of paying for generalized benefits of public services, a retail sales tax is to be preferred over a sales tax on manufactured goods and imports collected where goods are produced or enter the country. (There are, of course, other considerations, including ease of administration and compliance, in choosing among these alternatives; they are the topic of the next two sections.)

## Other Conceptual Issues

It is customary to distinguish between three functions of government in discussing public finance: promoting efficiency in the allocation of resources, reducing inequality in the distribution of income, and macroeconomic stabilization. The discussion to this point focusses almost entirely on issues of resource allocation; although the difficulty of using profits taxes on enterprises and progressive taxes on individuals to implement redistribution has been mentioned, nothing has been said about the use of tax policy to further macroeconomic stability. The remainder of this section discusses the last topic and adds to the discussion of the first two, especially as it relates to the taxation of natural resources.

Macroeconomic Stability. The maintenance of high employment and stable prices is the object of macroeconomic stabilization.[12] (Stabilization of the exchange rate is sometimes

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[12]This discussion focusses on the use of tax policy to achieve cyclical stability. There is little disagreement about the need to use some combination of tax and expenditure policy to produce an acceptable budgetary position (deficit or surplus); large budgetary deficits generally cannot be sustained without inflation.

included as a separate objective. This seems inappropriate, since price stability and the value of the currency are closely related. Economic growth can also be treated as a separate objective. But it seems more sensible to think of it as a question of resource allocation between consumption and investment, including that in human capital and research and development. That approach is followed here.) Traditionally it has been thought that tax policy can contribute to macroeconomic stability in two ways: as a built-in stabilizer and as an instrument of exogenous policy.

Built-in stability is the more reliable of these. As output or prices rise, tax revenues automatically increase, taking purchasing power out of the economy and mitigating expansionary effects (unless, of course, the tax revenue is spent). Automatic increases in revenues are commonly greatest for the enterprise profits tax and the individual income tax.[13]

Revenues from the enterprise profits tax respond strongly to a change in output or prices because profits change more than proportionately when output or prices change.[14] In the case of the individual income tax, it is the personal exemptions and graduated rates that give a high elasticity of revenues; this is especially true if exemptions and the rate structure

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[13]In technical terms, the elasticity of revenues with respect to changes in output or prices is highest for these taxes. The elasticity is the percentage increase in revenues induced by a one percent change in the monetary value of output.

[14]This statement is based on experience in market economies; it may not carry over to economies in transition from socialism without modification. Factors that should be considered in judging the applicability of this experience include the prevalence and pattern of price controls, wage bargaining under inflationary conditions, and the availability of credits to enterprises.

are not indexed for inflation. Payroll taxes, because they commonly do not contain these features, exhibit less built-in stability. Because consumption is relatively insensitive to changes in real income, revenues from sales taxes are less responsive to macroeconomic conditions Consumption of goods and services that are commonly subject to excises, and thus revenues from excise taxes, are generally even less sensitive to changes in income than is general consumption; this is especially true of specific excises (those for which tax is stated as a given amount of money per unit of production or consumption). In short, individual income and enterprise profits taxes are generally good built-stabilizers, but sales taxes and excises are not.

In theory, tax rates can be changed exogenously to counteract cyclical tendencies. That is, taxes can be increased to reduce inflationary pressures, and they can be reduced to lessen contractionary tendencies. This theory now has substantially less support than earlier. Whether it is generally valid, or valid for Ukraine, is not at issue here. If it is valid, it is important to know which level(s) of government should undertake exogenous stabilization policy; if it is agreed to be invalid, there is no policy to assign.

Macroeconomic stability is almost universally assigned to the central government. First, relatively little of the effects of a stabilization policy pursued by a subnational government will be felt within that jurisdiction; rather, they will "leak" out to other parts of the country (and, indeed, the rest of the world) through changes in trade. Thus there is little incentive for subnational governments to pursue such policies.

Second, both reliance on built-in-stabilizers and pursuit of an of exogenous stabilization policy can be expected to produce changes in tax receipts and (for a given level of expenditures) the state of budgetary balance. Most subnational governments lack the means to cope with the changes in the budgetary balance, especially increased deficits, implied by a policy of stabilization. They generally cannot issue money (and should not be allowed to do so) and their power to borrow is (and should be) generally limited (discussed in Section VII).

Together with the difficulties of implementing progressive taxation for distributional reasons discussed earlier, this leads to the conclusion that subnational governments should not rely heavily on the progressive individual income tax and the enterprise profits tax, the taxes that are the most important built-in-stabilizers. By comparison, payroll taxes, flat-rate individual income taxes, sales taxes, and excises are much more attractive to subnational governments, because of the relative stability of revenues.[15]

It is important to emphasize that nothing said above implies that the individual income tax should be assigned only to the central government. The negative conclusions reported above about assignment of the individual income tax to subnational governments concern only progressive income taxes; flat-rate individual income taxes have fewer of the problems identified (the tendency to drive out productive individuals and cyclically unstable revenues) and can be an attractive source of revenue for subnational governments. This is discussed further below.

[15]Revenues from ad valorem excises increase with inflation, but those from specific excises do not. If specific excises are to be used, tax rates must be indexed for inflation in order to maintain their real value.

More on Taxation of Natural Resources

The discussion of the assignment of revenues from taxation of natural resources in part A of this section focussed on economic efficiency. There are, of course, other considerations in settling this important issue.

Difficulty of Taxing Rents. The taxes subnational governments levy on natural resources are commonly based on the volume or value of production. In some American states property taxes are imposed on the value of natural resource deposits. Taxes on production generally distort decisions on the manner and extent of exploitation of resources. Property taxes artificially encourage the exhaustion of reserves. Both types of taxes should be avoided.

Subnational governments are unlikely to be able to levy taxes on economic rents, which, from an allocative point of view, are generally the best base for taxes on natural resources, because they do not affect decisions on exploitation.[16] To calculate rents it is necessary to know about activities occurring outside the subnational jurisdiction, as well as those occurring within. This makes administration difficult and costly for subnational governments, if not impossible. If nationwide rents are apportioned on the basis of a formula,

[16]Economic rents are the amounts received in excess of what is necessary to induce supply of a good or service. This definition explains why rents can be taxed without affecting economic decisions.

as in the corporate profits taxes of the American states, the tax does not actually apply to rents.[17]

Instability of Revenues. The natural resource sector is notoriously unstable, being buffeted by developments in international markets. Thus revenues from resource-related taxes are unstable. This is especially true of taxes on resource rents, which fluctuate more than either prices or output. But subnational governments need revenues that are stable and predictable. This suggests that revenues from taxes on natural resources are best assigned to the central government.

The Entitlement Issue. It is often argued that subnational governments are entitled to tax natural resources located within their boundaries, in order to turn a physical inheritance into a financial one. But why is it the subnational government, and not the central government (acting on behalf of the entire country) that is entitled to this inheritance? This raises a fundamental question about the nature of the country.[18] Is it a loose grouping of geographic areas, each of which has the primary right to tax the natural resources found there, or does that right belong to the central government? If primary allegiance is to the subnational area, as it might be in a loose confederation, it may be appropriate that the

[17]Following Ukrainian terminology in order to avoid possible confusion in translation, the term "profits tax" is used in this report to designate what is commonly called an "income tax" in the United States.

[18]Note that arguments that subnational governments are "entitled" to tax natural resources because the resources are their "heritage" begs the question of whose heritage it is and who is entitled to tax it.

subnational government receive the revenues from taxes on natural resources. But if primary allegiance is to the nation, the central government should receive the revenues.

Fiscal Disparities and Fairness. Where important natural resources are distributed unevenly across a nation, subnational taxation can create large fiscal disparities between jurisdictions. It may be thought unfair that only some jurisdictions have access to revenues from natural resources. This depends on what is seen to be the geographic "domain of concern" in evaluating equity in a particular country. If the domain of concern is the entire nation, national taxation would seem appropriate. But if the domain of concern is the subnational jurisdiction, nation, subnational taxes on natural resources would not be seen to be unfair. Like the entitlement issue, this raises fundamental questions of the nature of the nation.

The Politics of Taxing Natural Resources. In some countries (e.g., Russia) economic and philosophical arguments may not carry much weight in decisions on the assignment of the power to tax natural resources. Resource-rich regions may simply threaten to withdraw from a federation if not given the majority of revenues from the exploitation of natural resources located within their boundaries.[19]

[19]During the energy crisis of the 1970s and 1980s the fiscal disparities that resulted from the high prices of oil, gas, and coal created great animosities between the "have" and "have not" states of the United States and provinces of Canada. While these well-established federations were able to withstand the resulting centrifugal forces, nations newly emerging from socialism may not be more vulnerable.

## The Need to Develop the Individual Income Tax

The VAT (25 percent) and the enterprise profits tax (17 percent) currently account for roughly 41 percent of total revenue in the consolidated budget; by comparison, the individual income tax accounts for only 7 percent. One would expect this to change over time; in OECD (Organisation for Economic Co-operation and Development) countries the comparable breakdown for 1989 is VAT (or comparable general sales tax) -- 29 percent of total tax revenues, profits tax -- 8 percent, individual income tax -- 29 percent, and social security and payroll taxes -- 24 percent.[20]

The development of a modern individual income tax is especially important, for several reasons. First, the ability to tax individual income at graduated rates will reduce somewhat the inequalities of income being created in the transition to a market economy.

Second, a flat-rate individual income tax, perhaps levied as a surcharge on the tax of the central government, is one of the most attractive sources of revenue for use by subnational governments. Given the conceptual and administrative difficulties that plague subnational use of alternative sources of revenue--especially the VAT and the enterprise profits tax--it is crucial to develop the capacity to implement a modern individual income tax. Section V discusses the desirable characteristics of such a tax.

# IV. THE MEANING AND FEASIBILITY OF REVENUE ASSIGNMENT

[20]These figures are not totally comparable, since the OECD figures are percentages of tax revenues, while the figures for Ukraine are percentages of all revenues. Moreover, Ukrainian taxes are not easily allocated among the categories employed by the OECD. Even so, there is no doubt that Ukraine relies far more heavily on the enterprise profits tax, and much less on individual income and social security and payroll taxes.

There are several different techniques of dividing the revenues from a given source among various levels of government. These include independent subnational administration of independently legislated taxes; subnational surcharges on a national tax, administered by either the national or subnational government; national administration of subnational taxes; tax sharing; and revenue sharing. (These distinctions are sometimes blurred, for example, between national administration of subnational surcharges and of subnational taxes.) These alternatives are worth considering in greater detail, since they have different implications for costs of administration and compliance and the autonomy of subnational governments.

Subnational Legislation and Administration. The technique that provides subnational governments with the greatest autonomy is subnational legislation and administration. Because of duplication of effort, it also involves the greatest potential costs of administration and compliance, if there is no separation of revenue sources between levels of government.

In the extreme case the subnational government chooses the tax instrument, defines the base, sets the rate, and administers the tax; it may or may not have administrative assistance from higher levels of government and it may or may not cooperate with other subnational governments in administering its taxes. This is essentially the situation in the United States, where neither the constitution nor federal law imposes important restrictions on the tax policy of subnational governments.[21] Most states utilize information provided by the federal

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[21]The only important constitutional restrictions are that state (and local) taxes cannot interfere with international and interstate commerce and cannot contravene due process. The most important practical restriction is the Supreme Court's unreasonable ruling that state sales taxes cannot be applied to most goods shipped into a state by a mail order firm located in another state. Perhaps more problematic is the wide latitude the states have in taxing

government and cooperate with other states in implementing their individual income and corporate profits taxes. But each has its own administrative apparatus; this creates substantial duplication of effort. Most of the states also levy their own retail sales taxes; there is no federal sales tax to provide information on which they can rely.

Subnational administration works much better for some taxes than for others. It works well for most license fees and certain excise taxes, notably those on motor fuels. (But note the difficulties that arise if tax rates differ markedly between jurisdictions.) It also works well for residence-based individual income taxes, but only if all taxpayers file returns, there is cooperation with a higher level government, and definitions of taxable income are similar. It would be extremely difficult for subnational governments to implement a residence-based tax that includes interest and dividends, in the absence of information available from tax returns filed with the central government. Payroll taxes levied at the place of employment are much easier to administer than those levied at the place of residence.

Independent subnational legislation and administration of the corporate profits tax and the VAT are problematical. Cooperation between subnational jurisdictions can reduce the administrative problems of the corporate tax; it is more difficult to do so in the case of the VAT. The next section discusses these issues in detail.

Surcharge: Subnational Administration. In order to simplify administration and compliance, some U.S. states levy surcharges on the individual income and/or corporate profits taxes of the national government. (Whether the subnational tax is a percentage of the

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corporate profits; this allows the chaotic situation described in the appendix.

national tax liability or the national tax base need not concern us. Obviously, the latter allows somewhat greater latitude for subnational governments to tailor their tax by deviating from the federal base.) For this approach to be workable, the subnational government must relinquish substantial autonomy over details of the calculation of tax liability. But it retains total control over the tax rate, and perhaps some control over the base.

Again, this approach is more easily applied to some taxes than to others. It obviously works well in the case of a global individual income tax levied by the jurisdiction of residence, since liability for subnational tax can be based on data from the federal income tax return. It also works well in the case of payroll taxes levied at the place of employment. By comparison, it is problematical for the corporate profits tax. Since there is no need to calculate the jurisdiction where profits originate in completing in the federal return, this calculation must be made by (or for) the state fiscal authorities. This raises most of the problems of separate state legislation and administration. (See also Section V.)

If the central government levies a retail sales tax, it is a relatively simple matter to implement a subnational surcharge. The primary difficulty is the division of sales between jurisdictions, an issue that does not arise for the central government. Assistance from the central government would greatly facilitate dealing with this issue.

In the case of the VAT the very concept of a subnational surcharge administered by subnational governments is murky and open to different interpretations. It is not to be recommended.

Surcharge: National Administration. An even simpler approach is for the national government to collect surcharges which it remits to subnational governments. This requires substantial conformity of the two tax bases, if not total identity; thus it implies loss of subnational autonomy in the choice of base.[22] In principle, subnational governments can retain substantial discretion over the choice of tax rates.

National administration of residence-based subnational surcharges on the individual income tax is relatively simple, since the addresses of taxpayers are known. (It might be necessary to monitor the accuracy of addresses, if subnational tax rates differ greatly.) National administration of subnational surcharges on a retail sales taxes would also be simple; indeed, in many U.S. states, the states collect surcharges for local governments.

National administration of subnational surcharges on the corporate profits tax is far simpler than separate and uncoordinated subnational administration. The only reasonable interpretation would be adoption of the federal base by subnational governments and acceptance of a standard formula (or other technique) for the division of the profits of firms operating in several jurisdictions. Subnational surcharges on a federal VAT would require a clearinghouse mechanism to record the origin and destination of all sales between jurisdictions. Though relatively simple in concept, no country has yet implemented such a clearinghouse.

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[22] In principle, it would be possible to have a national surcharge on a tax administered by subnational governments. This is generally a bad idea. Even if the tax base were defined uniformly, differences in subnational administration--which one would expect to be rampant, in order to benefit local interests--would undermine revenues, equity, and neutrality. This is, in essence, the situation in China and Russia, although both are defined as tax sharing--in China national sharing of a tax administered by subnational governments.

National Administration of Subnational Tax. A slightly different approach is for the national government to administer the tax of the subnational government. In principle, this might allow greater discretion in the choice of base, but as a practical matter only minor differences in the base are likely to be tolerated. In practice the two options are probably best seen as one.

Most of the provinces of Canada have exercised the option to have the central government collect their individual income and corporate profits taxes. In the United States no state has taken advantage of federal legislation providing a similar option.

Tax Sharing. In tax sharing one level of government collects the revenue from a tax and shares it with one or more other levels of government. The most common form of sharing involves central government collection and sharing with subnational governments. But the contrary system is found in Germany, where the laender collect the VAT, which is shared with the central government, and in China.[23]

Tax sharing has several disadvantages. It involves total subnational loss of autonomy in the choice of both tax base and rate. Moreover, if the sharing rate is too high, the government administering the tax may have relatively little interest in administration; indeed,

[23]The situation in Russia (and perhaps other republics of the former Soviet Union) is confused. In principle, three important taxes (individual income, enterprise profits, and VAT) are collected by the Russian Federation and shared with the subnational (republic and oblast) governments. In fact, regional tax administrators have considerable subnational loyalty and little loyalty to Moscow. In several of the republics the full federal shares of revenues are not being remitted to Moscow. Similar behavior helped hasten the demise of the Soviet Union.

it may seek to avoid sharing by enacting new taxes that are not shared. In principle, centrally administered subnational surcharges also have this problem.

Tax sharing has another unfortunate macroeconomic effect. If tax revenues increase endogenously because of economic expansion or exogenously because the central government raises rates to reduce a budget deficit to combat inflationary pressures, subnational revenues also increase. From a macroeconomic point of view, such additional revenues of subnational governments ideally would not be spent. In fact they are likely to be spent, offsetting the contractionary policies of the central government. Conversely, if revenues from shared taxes fall in a cyclical down-turn, it could pose serious problems for subnational governments. Most forms of surcharges have similar effects (as would taxes administered by subnational governments, if levied on a similar base).

Almost by definition, tax sharing implies that revenues are shared with the subnational jurisdictions where they originate. (Unfortunately, there is no agreement on terminology in this area. This report uses the term "revenue sharing" to refer to sharing of revenues on the basis of formulas not intended to return revenues to their origin.) In some cases this raises administrative problems similar to those involved in subnational administration of the tax.

Revenue Sharing. In the case of revenue sharing the revenues from one or more national taxes is shared with subnational governments on the basis of a formula. Such formulas are commonly designed to equalize the fiscal position of subnational governments. Revenue sharing leaves subnational governments no autonomy in the choice of tax base or the setting of tax rates. If the revenue sharing pool includes all major sources of potential revenue, this approach limits the possibility of shirking on administration of shared taxes or legislating around tax sharing rules.

## V. ADMINISTRATIVE CONSTRAINTS

This section considers administrative and economic problems of selected taxes. Because of their revenue importance and the severe administrative difficulties the sharing of revenues from them entails, the VAT and the enterprise profits tax receive special attention.

The previous section shows clearly, if in general terms, that the conceptual discussion of tax assignment must be tempered by a strong dose of administrative reality. Some types of taxes do not lend themselves to administration by subnational governments; where this is true, it is generally also problematical to attempt to share revenues with subnational governments on an origin basis. The VAT is the best example of this type of problem.

Subnational administration of certain other taxes, while less difficult, can lead to chaos, in the absence of substantial coordination; the U.S. corporation profits tax is an example where this has happened. Such taxes should be administered by the central government; if sharing on the basis of origin is thought appropriate, it should be implemented through uniform application of a formula. If these taxes are to be administered by subnational governments, it should be subject to strict rules that assure national uniformity in many respects other than the rate.

On the other hand, revenues from some taxes are appropriately left to subnational governments--substantially, if not entirely. These include individual income taxes and excises. Given the difficulty of identifying taxes that can be varied on an oblast-by-oblast basis, in order to promote accountability, there is much to be said for assigning as much of these taxes to oblast governments as possible. (This might be called subsidiarity in revenue assignment.)

Value Added Tax

The draft budget law assigns 30 percent of the revenues from the value added tax (VAT) to the oblast level, as does current law. Although not stated explicitly, the assignment of oblast revenues is to the oblast of origin.

For administrative reasons, it is not appropriate to assign the VAT to subnational governments or to allocate VAT revenues (or a portion thereof) to such governments on the basis of origin. This is best explained by reviewing the experience of Brazil (which has a state VAT), the European Community (whose members levy VAT), and Russia (which, like Ukraine, has also assigned part of revenues from the VAT to subnational governments).

The states of Brazil were among the first jurisdictions in the world to introduce a value added tax (VAT). Unfortunately, it apparently was not realized at the time that the VAT is not a satisfactory tax for imposition by subnational governments--or is not satisfactory in the absence of conditions that have never yet been achieved in any country. Those issues were first exhaustively examined by the Neumark Commission of the European Common Market (ECM) in the early 1960s.

The Problem of Intranational Trade. The basic problem is what to do about interstate trade. International trade is almost universally handled by levying the VAT on imports and applying a zero-rate to exports (which implies refunding tax collected before the export stage). The result of these "border tax adjustments" or BTAs, which are allowed by the General Agreement on Tariffs and Trade (GATT), is that imports are taxed and exports are not. This system is called the destination principle, to distinguish it from the origin principle, under which imports are not taxed and tax on exports is not rebated. Whereas the aggregate tax base of a destination-based tax is consumption, the base of an origin-based tax is production. Because of its treatment of international trade, the destination principle is vastly more popular with business than the origin principle, though in principle a shift from one to the other could be largely offset by movement in the exchange rate in the long run and thus have no great real effect.[24]

In order to implement the destination principle, it is generally thought necessary to have border controls for the implementation of BTAs.[25] This is not a major issue where international trade is concerned, because border controls exist for other reasons, including the collection of import duties. But border controls are problematical in the case of trade within a nation or common market, since fiscal border controls impede the free flow of goods. We return below to the feasibility of destination-principle systems that do not require BTAs.

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[24]Within one country regional movements in price levels would be required to accomplish the same thing. This is much more difficult to envisage.

[25]In theory it is possible to implement the destination principle without internal border controls, relying instead on the books of account of enterprises for the implementation of BTAs. Interstate exports to registered taxpayers would be zero-rated, and thus there would be no VAT to claim as a credit on interstate imports by business. In fact, because of justified fears of tax evasion, Brazil has been reluctant to take this step.

In its early deliberations the ECM decided that its members should adopt the "restricted origin principle," under which BTAs are allowed for trade external to the Common Market, but not for trade within the ECM. But this would work only if all member states adopted the same tax rate. Otherwise, the origin-based tax levied within the Common Market, being a tax on production that is not related closely to benefits provided by the taxing government, would distort the location of economic activity.

If tax rates are different, the origin principle also creates incentives to misstate where value added occurs. It is thus necessary to have border controls under the restricted origin principle, unless rates are uniform. Such border controls must be much more stringent than under the destination principle, because of the need to value all goods moving between jurisdictions--a task that is especially difficult in the case of transactions between related firms. The European Community (EC, the successor of the ECM) still has not implemented the restricted origin principle, because its members are unwilling to give up the power to set their own VAT rates. The power to set tax rates is crucial for the fiscal autonomy of subnational governments.

There is an additional problem with using the credit method to implement the origin principle, including the restricted origin principle, with unequal state rates. A state may be required to give credits for tax paid on business inputs that have been taxed at a higher rate by another state. Or it may be able to give credits for taxes lower than its own. In either event the result is not satisfactory. Contrary to the description given above, such a tax is not really levied on production or on value added occurring within the state.

This can be seen by considering a two-stage process in which some production occurs in a state that levies a 10 percent VAT, the goods are shipped to another state that levies a 20 percent VAT, where further processing occurs, and then the goods are consumed. The second state collects 20 percent VAT on the total value of the goods up to the point of consumption, less credit for the 10 percent tax paid to the first state, not 20 percent of the value added within its jurisdiction. Reversing the assumed flow of goods, we see that the state with the low-rate VAT would be called on to give credit for the 20 percent VAT on production occurring in the high-VAT state, even though it levies only a 10 percent VAT on sales to consumers.[26] In an attempt to deal with this problem, Brazil requires that the rate applied to interstate sales is well below the rate on intrastate sales. Of course, this aggravates the administrative problems caused by non-uniform rates mentioned earlier.

In theory it would be possible to implement the destination principle on trade between oblasts without internal border controls, relying instead on the books of account of enterprises for the implementation of BTAs. Interstate exports to registered taxpayers would be zero-rated, and thus there would be no VAT to claim as a credit on interstate imports by business. Brazil has been reluctant to take this step, because of justified fears of tax evasion.

Another promising approach to implementing the destination principle on internal trade involves state surcharges on a national VAT. In this scheme the national government would collect both its VAT and the VAT of the state to which sales are destined. Purchasers of business inputs would get credit for all taxes paid, so only the VAT of the state where final

[26]This problem could be avoided by employing the subtraction method to implement the VAT, instead of the credit method. But that would create another group of serious problems, and is not to be recommended.

consumption occurs would ultimately matter. Invoices would show the states of origin and destination of interstate shipments, and tax returns would report liabilities and credits for state taxes. by state, as well as federal tax. The national government would then use a "clearinghouse" arrangement to channel net revenues to the appropriate states, producing the same result as a destination-principle VAT implemented in the conventional manner.[27]

This approach was suggested in Canada as a means of reconciling national and provincial taxes of value added, but it was rejected by the provinces, which (aside from Quebec) prefer to retain their own retail sales taxes. It has also been endorsed by the EC, but has not been implemented, apparently in part because the fiscal authorities in certain of the member countries do not have sufficient confidence in their counterparts in other member countries.

This scheme requires computerized processing of substantial amounts of data. In principle, the accounting and bank clearing system established under the previous regime of central planning in Ukraine should be able to provide and process the information needed to implement such a clearinghouse arrangement; in fact, this is unlikely. While this approach also deserves further attention, it is unlikely that Ukraine should attempt to implement it under present conditions.

Brazil discovered yet another problem with the restricted origin principle. In the deliberations of the ECM it was assumed, at least implicitly, that trade flows of each of the

[27]Such a scheme could, in principle, also be used to implement origin-based sharing of the VAT, as proposed in the Draft Budget Law of Ukraine. It would, however, not address several of the problems of an origin-based VAT described above, including manipulation of transfer prices and triangular trade.

member states would be more-or-less symmetrical--that imports from outside the Common Market would essentially balance exports to non-members. In Brazil the trade flows are very unbalanced. A disproportionate part of the nation's imports come in through the more developed South and a disproportionate part of its exports leave through the less developed Northeast. As a result the rich South collects most of the compensating VAT on imports and the poor Northeast rebates most of the tax on exports. This unsatisfactory state of affairs has been the source of controversy for years. A complicated and controversial system of interstate payments is intended to compensate for these difficulties in an ad hoc manner.

The Experience of Ukraine and Russia. Ukraine and Russia have encountered some of these same problems, by assigning a portion of revenues from the national VAT to the oblasts and municipalities on the basis of origin of revenues. Ukrainian oblasts are given the power to vary the rate of VAT. This would be appropriate if the destination principle were applied to trade between oblasts. It is less appropriate under the restricted origin principle, which may be the best way to describe the Ukrainian system. If exercised, this option raises the type of problems caused by non-uniform VAT rates discussed above. (One would not necessarily expect the option to be exercised. Under the restricted origin principle, with valuation of goods crossing boundaries of oblasts, lower VAT rates would stimulate production; in that case the option might be exercised. But if the lower rate in oblast A, producing for export to another oblast, simply reduced the VAT credit available in the importing oblast B, oblast A would needlessly be transferring revenues to oblast B, without stimulating production by its own enterprises; one would not expect that to be done knowingly. In fact, it is not clear what are the ramifications of oblast reductions in rates. They depend on how trade between oblasts is treated.

As in Brazil, asymmetrical trade threatens to create a situation in which exporting jurisdictions (in Russia largely where oil and other natural resources leave via pipelines and ships) are, in effect, asked to rebate a share of value added tax collected before the export stage, commonly in another subnational jurisdiction. Similarly, because of the sharing arrangements, subnational jurisdictions where imports occur are, in effect, able to collect part of the VAT on goods bound for consumption in other jurisdictions. Such an arrangement is obviously unfair and distortionary and has no advantages.

It is important to know which oblast experiences a revenue gain (because of its 30 percent share in revenues from the compensating import tax) if a good is imported through a port in oblast I for consumption in oblast C, and which oblast experiences a loss of revenue (because it shares in the cost of the export rebate) if a good produced in oblast P is exported through a port in oblast E. In both Ukraine and Russia, the law seems to be somewhat murky on the treatment of imports and exports. Some members of the tax service in Ukraine (as well as in Russia) believe that the answer depends on the legal question of whether a transaction occurs in the oblast containing the port city. Given the mechanics of the VAT, this is probably the way the law is being implemented.

Based on this interpretation, it appears that if the export legally occurs in the port city in oblast E, that oblast and the port city must provide 30 percent of the funds needed to pay the export rebate, even though, by assumption, all the tax being rebated has been collected in oblast P, which keeps 30 percent of the amount collected. By comparison, if the second good is legally "exported" from the city in oblast P where it is produced, only passing through the port city in oblast E without a transaction, it is oblast P that must, in effect, pay 30 percent of the export rebate. Similarly, right to the VAT on imports would depend on whether goods are legally deemed to be imported into the port city or only into the interior place of destination.

The second result is obviously more satisfactory than the first, but that is not the point of this discussion. The opportunities for abuse, with consequent adverse implications, are obvious. The government of oblast P could establish an enterprise in oblast E containing the port city--or encourage enterprises located in P to do so--for the sole purpose of completing a transaction in E, and thereby shifting to oblast E the obligation to share in the burden of the export rebate. If this were done, oblasts containing port cities would have little VAT revenues, if any. Similarly, the oblast where imports are consumed has an interest in encouraging importers not to make a taxable stop in the port city in another oblast, in order to maximize its own revenues.[28] By comparison, oblasts containing ports would have an incentive to prevent this. The result could be serious impediments to trade.

The import side of this problem could, in principle, be overcome by adopting a system in which VAT on imports by business firms is suspended until the first transaction after the import stage. It is unlikely that this would provide a workable solution in Ukraine. Given

[28]In the extreme case an inland city P could export through E, with a transaction occurring there, and then reimport the same goods, with title passing in P instead of E. The net result would be a transfer from E to P of an amount equal to 30 percent of the value of the goods involved in the round-trip transaction.

the weakness of tax administration and the relative ease of collecting VAT at the point of import, it seems risky to rely on such a system at present.

In principle, it might be administratively possible to prevent the type of manipulations and abuses described here. Again, that is not the point. The point is that all the problems described above (and probably others) are inherent in the sharing of VAT revenues with oblasts on the basis of origin (and, of course, in independent oblast imposition of a VAT). This is not to say that the VAT should be shared (or implemented independently by the oblasts) on the basis of destination. That is also problematical, because it involves internal border controls or a complicated clearinghouse mechanism, as noted above.

Retail Sales Tax

The retail sales tax (RST) suffers from well-known defects. It is difficult to limit the base to sales of consumer goods and services to households, as is appropriate in order to prevent the taxation of business inputs. For this reason, it is also difficult to achieve pure destination-principle taxation (no tax on exports and equal taxation of imports and domestic products). Since the VAT can achieve these benefits automatically, it is the sales tax of choice for countries with unitary systems of government. But, as noted above, it is difficult share revenues from the VAT with subnational governments. The RST has benefits for a developed country with a decentralized system that may offset its other disadvantages.

Being a single-stage tax, the RST avoids many of the problems of the VAT related to trade between jurisdictions discussed above. The primary problem of this type, aside from cross-border shopping by consumers, is to assure that retail sales made from one jurisdiction to another (for example, by mail order) are subject to tax by the jurisdiction of destination. This does not seem to be an important issue in Ukraine at the present time nor to be an insurmountable problem; certainly it seems simpler than overcoming the problems of the VAT on trade that crosses subnational boundaries. Cooperation between fiscal authorities of various subnational governments should allow its satisfactory resolution. The RST has the further advantage that it is quite simple to impose subnational surcharge on a national RST or to share revenues between two levels of government; in either event, mail-order sales are automatically handled appropriately. There is no satisfactory solution for cross-border shopping, but it is also unlikely to be important. (The importance of this issue depends on differences in subnational RST rates and the proximity of large cities to jurisdictions with substantially lower rates.)

In Ukraine, the situation is not so optimistic. Where tax administration is weak, it is difficult to collect RST from small businesses, many of which are in the informal sector. The VAT has the advantage in this situation that much of its revenue is collected larger firms before the retail level. This problem may be relatively unimportant in Ukraine in the short run; that depends on the relative importance of large and small enterprises and the relative ease of controlling state-owned and private enterprises. As privatization occurs it will probably become increasingly difficult to collect an RST, at least until tax administration improves and private enterprises grow large enough to have good systems of accounts and to be more easily controlled. (In addition there is the problem of following a zig-zag course, in which the VAT is first introduced and then replaced by an RST.)

## Enterprise Profits Tax[29]

The assignment of revenues from the enterprise profits tax to the oblast of origin is also problematical, at least as it is currently being implemented. It would be more appropriate to assign revenues entirely to the central government. If that is not done, the method of dividing revenues among oblasts must be changed substantially.

In thinking about this problem, it is necessary to think ahead, to the time when the economy of Ukraine is structured more like those of the West. As long as an enterprise operates in only one jurisdiction, there is no unusual problem in determining its tax base in the jurisdiction. But oblasts operating in several oblasts will create problems. Once oblast-level enterprises start to prosper, they will almost certainly want to expand into other oblasts, and they should be allowed to do so. When that happens it would no longer be appropriate that they be taxed only by the oblast in which they began life; each oblast where they operate should be able to tax profits (or receive a share of tax on profits) originating within its borders. Experience of China, the United States, and Canada is especially instructive in this area.

[29]The discussion of this chapter deals with assignment of a profits tax, since the enterprise income tax is deeply flawed and should be replaced. The problems identified here also occur under the income tax, but are compounded by the need to apportion tax resulting from the inability to deduct labor costs among oblasts. The enterprise income tax can be seen as the combination of two conceptually separable taxes on profits and labor costs. Under that conception, the apportionment problem for the tax on labor costs resembles administration of an employment-based payroll tax and is relatively straightforward.

The Present Approach. Ukraine is apparently interpreting the oblast of origin of enterprise profits to be the oblast in which the enterprise is chartered.[30] This is a particularly troublesome approach for any enterprise large enough to have substantial operations outside its home oblast.[31] It is quite inconsistent with any common-sense interpretation of the origin of profits and thus unfair. An enterprise might conduct almost all its business outside its home oblast.

If enterprises are allowed to operate anywhere in the country, no matter where chartered--as they should be--especially if they are allowed to change the locations where they are chartered, another problem will eventually arise. Suppose that one or more oblasts see the advantage of attracting the place where enterprises are chartered by offering lower profits tax

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[30] A similar defective approach is illustrated by the experience of China, which assigns revenues from the enterprise tax to the level of government owning state enterprises. This approach has several problems. There is substantial likelihood that such a policy would create economic distortions. The most obvious problem is that the law applied to the various types of enterprises by different jurisdictions might not be uniform. In principle, this problem could be avoided by having only one law apply to all enterprises, even if were administered by subnational governments. In fact, the law allows subnational governments to provide tax incentives to their enterprises. In addition, experience in China makes it clear that there is no way to force uniform application of a given law. It is to be expected that there would be substantial differences in administration across the country; some might be unintentional and essentially random, but others would probably be systematic and intentional. This would contradict the principle that business tax policy should be uniform across the country, except as required to compensate for costs of public goods provided to business and for environmental costs.

[31] Origination appears to be based on separate accounting of income (or profits) for legal entities operating only in one oblast, even in the case of affiliates of enterprises operating elsewhere. Where one legal entity operates in more than one oblast, income (or profits) is apportioned on the basis of the number of employees.

rates than others.[32] (It is presumed that such enterprises could operate in other oblasts; this issue is considered below.) Such "tax shelter" oblasts would undermine the revenue potential of other oblasts; indeed, this tax competition might end only when the profits tax rate was near zero, unless collusion between oblasts, perhaps embodied in national legislation, placed a floor under the profits tax rate.[33] Given the weakness of the conceptual case for oblast level taxes on enterprises, this would not necessarily be a bad result. But it would be better to reserve profits tax revenues for the central government than to have them eliminated by faulty assignment of this revenue source to the oblast level.

It is worthwhile to contrast the situation just described with tax competition in the case of a tax base that more accurately reflects profits earned in the oblast. In that case one would not expect tax competition to result in a tax rate below that required to finance public services

[32]Under current practice, oblasts are allowed by law to vary the enterprise tax rate applied on their territory, within the range of their half of revenues. (Thus, if the income tax rate is 18 percent, an oblast can reduce it to as low as 9 percent, at the expense of its revenues.) They can also provide tax preferences beyond those specified in the generally applicable law; contrary to the situation with rate reductions, these appear to apply to the central government's share of revenues, as well as to the oblast's share.Under the Draft Budget Law, oblasts receive 100 percent of revenues from the enterprise profits tax and can also modify the base of the tax.

[33]In the United States many of the largest corporations have historically been chartered in the small state of Delaware, because its statutes are more lax than those of many other states. Delaware has been able to "sell" this feature of its laws in exchange for corporate franchise tax revenues. But in the American system this does not prevent other states from also taxing the profits of the same corporations, as described below. Thus tax competition is much less likely to reduce tax rates to zero. In fact, 36 state profits tax rates fall within the range of 4-10 percent; the lowest rates imposed by seven states (but not their top rates) fall below that range, two rates exceed 10 percent, and five states have no corporate profits tax. Because the state tax is deductible in calculating liability for the federal tax, effective state rates are about 2/3 the statutory rate.

for enterprises. Even this rate is likely to be low, but it might be well above zero. In either event, assignment of this tax to the central government is more appropriate.

Since oblasts only get revenues from locally chartered enterprises, oblasts might use various means (probably primarily non-tax policies) to discriminate against the enterprises of other oblasts. This could interfere, perhaps seriously, with the creation of a single market within Ukraine. This seems especially likely if the scenario described above were to materialize, since enterprises chartered in tax shelter oblasts and paying little or profits tax could compete unfairly with fully taxed local enterprises. Moreover, there may be pressures to provide special tax benefits, including some not provided in the law, to encourage local enterprises to produce for export to the rest of the country.

Unless prohibited by national law, a multi-jurisdiction enterprise could be forced to establish a new enterprise in each oblast where it wants to operate. This would be undesirable. At the very least, this would create administrative inefficiencies (if the separation were formal, but not real), and it is likely that it would create major economic inefficiencies (if the separation were more complete and potential economies of scale could not be realized). Moreover, this would raise all the problems of determining the source of income of enterprises operation in more than one jurisdiction described below.

The present assignment of revenues from the profits tax entirely to the oblasts undermines the incentives of the state tax service, an agency of the central government, to collect the tax. One would expect administration to focus on taxes the revenues from which are central. To the extent that regional tax administrators actually owe allegiance to the authorities of the oblasts in which they live, there may be some counter to this tendency. But to the extent allocation of administrative resources is directed from Kiev. there is a limit on local discretion in this matter.

Determining the Origin of Profits. It was suggested above that, if the enterprise is not to be solely a revenue source of the central government, the jurisdictions where profits originate should receive (part of) the revenues from the enterprise tax. It should be noted, however, that implementing this objective is also problematical. The problems would be serious for taxes levied independently by the oblasts and insurmountable for taxes levied independently by lower levels of government; it would be difficult even for taxes levied by the central government and shared with the oblasts or lower levels of government on the basis of origin.

The are several difficulties in allocating the tax base of enterprises among the jurisdictions where they operate. First, as long as the profits taxes of the oblasts are not uniform, in application, as well as on paper, enterprises will have an incentive to have their profits taxed in the jurisdiction where it is treated most favorably. There are well-known techniques for shifting profits between jurisdictions. Many of these involve manipulation of the notional prices ("transfer prices") used to record transactions between affiliated enterprises or within a single enterprise operating in several jurisdictions. For example, an enterprise producing machinery in one jurisdiction and selling it in another would either over- or understate the value of the machinery in transactions between affiliates located in the producing and selling jurisdictions, depending on the tax treatment of profits in the two jurisdictions. It is particularly easy to distort the terms of financial arrangements (e.g., loans and leases) between affi ates (or branches of a single enterprise) for this purpose. It is worth noting that the monitoring of transfer prices and the allocation of overhead costs among affiliated firms operating in different countries is one of the most complicated and expensive aspects of the implementation of the enterprise profits taxes of developed countries (for both taxpayers and fiscal authorities). It is not a problem Ukraine should voluntary import into its domestic enterprise tax.

Second, there may be problems even where there is no intent to manipulate transfer prices, simply because activities in several jurisdictions are so closely related to each other that their performance, as measured by profits, is interdependent. This occurs, for example, where affiliated enterprises share overhead expenses or there are other economies of scale or scope. At best, the allocation of profits between affiliated enterprises or parts of enterprises, and therefore between jurisdictions, is to some extent arbitrary. Of course, where there is arbitrariness, there is also room for taxpayers to choose the solution most favorable to themselves.

It is for these reasons that the states of the United States and the provinces of Canada employ formulas to apportion the profits of multijurisdictional enterprises among the jurisdictions in which they operate. In the United States, the situation is chaotic, because the states have excessive latitude in defining the tax base and choosing and applying apportionment formulas.

If one writes the formula for tax liability under an apportioned state profits tax, as it is commonly applied in the United States, one finds that virtually everything is up for grabs.

Thus:

$$T_i = t_i \times P\,[(W_i/W) + (A_i/A) + (S_i/S)]/3,$$

where:

$T_i$ is tax liability in state i,
$t_i$ is the tax rate in state i,
P is the company's taxable profits,
$W_i$, $P_i$, and $S_i$ are payroll, property, and sales in state i, and
W, A, and S are the company's total payroll, property, and sales.

In the United States the tax rate and the ratio of in-state to out- of-state payroll are the only parts of the right-hand side of this formula that have not been subject to considerable controversy. (The law determining the location of employment for purpose of unemployment compensation is commonly used to define the latter; this is not required.) Within extremely broad limits, each state can adopt its own definition of taxable profits; there is no requirement of conformity with the federal definition or the laws of other states. Similarly, states need not treat sales in the same way. Most measure sales at destination, but others measure them at origin. Some (an increasing number) depart from the typical formula, by double-weighting sales. Some states that generally measure sales at destination apply a,"throw-back rule, whereby they also include sales originating within their boundaries that are made to a state that does not tax corporate profits. No effort is made to distinguish between sales made to final consumers and sales to business; thus the tax on the portion of profits apportioned by the sales factor resembles a turnover tax. Double-weighting sales increases this tendency.

Nor is there agreement about the entity to which the formula is to be applied. Some states adopt a strict legal-entity approach. This open the door for abuse through manipulation of transfer prices. Others combine related companies deemed to be engaged in a "unitary business;" but there is no accepted definition of what is a unitary business. Some states apply unitary combination on a world-wide basis, whereas others restrict the use of combination to "the water's edge," apportioning only profits deemed to be earned in the United States. The treatment of intercorporate dividends is particularly troublesome. Dividends flowing between firms filing combined reports are eliminated from the calculation. Some other dividends are taxed, but others are exempt; this varies from state-to-state.

The result of this chaotic situation is inequity, distortion of economic choices, excessive costs of compliance and administration, protracted litigation, and taxpayer uncertainty. Much of the problem could be eliminated by choosing a common definition of profits (ideally the definition used by the federal government), a common apportionment formula, common ways to measure the factors in the formula, a common definition of the taxable entity, and uniform treatment of dividends. Given all this uniformity, it would make no sense to have totally decentralized administration.

These problems are essentially avoided in Canada, because the taxes of most of the provinces are administered by the central government, using a uniform definition of the tax base and a single formula based on sales and payroll. The Canadian approach (though not necessarily the Canadian apportionment formula) is the only one Ukraine should even consider. Even this approach will not be without problems, however.

In addition to administrative problems, formula apportionment creates economic distortions. Basing apportionment on payrolls and property (and on sales of capital goods and intermediate products) attributes most corporate profits to states where production occurs, rather than to the states where consumption occurs. Use of sales in the apportionment formula, while it has the apparent advantage of giving some weight to the consuming jurisdiction, introduces an element of turnover tax into the formula, which does not distinguish between sales of final products to households and sales of capital goods and intermediate products. This is undesirable.

The central government of Ukraine does not have good data on the location of business property. It could, of course, collect such data, but doing this only for the purpose of implementing a system of tax sharing or surcharges on the profits tax does not appear to be a good use of its resources or those of taxpayers. Moreover, it should be noted that there are several flaws in the American way of calculating property values for use in the formula. Property is valued at its historical cost, not its value. This can be important in some cases (e.g., mineral properties). Moreover, no adjustment is generally made for either depreciation or inflation. This can be important if the pace and composition of investment is not the same throughout the country.

This discussion leads to several conclusions (in addition to the fundamental conclusion from section III that there is little conceptual basis for subnational taxes on enterprise profits). It makes no sense to assign revenues from the enterprise profits tax to the oblast where an enterprise is chartered. Second, if revenues from the profits tax are to be divided among the oblasts on an origin basis, an attempt should be made to determine (or at least approximate) the profits originating in each oblast. Third, given the practical problems caused by manipulation of transfer prices and economic interdependence, this will probably require the use of a formula. Fourth, design and administration of the profits tax should be a responsibility of the central government. Fifth, under no circumstances should oblasts be given the authority to implement a profits tax of their own design, without the substantial cooperation in both design and administration needed to assure uniformity. Sixth, oblasts should not be allowed to modify the profits tax law of the central government to favor local activities.

Individual Income Tax

The Draft Budget Law assigns 50 percent of revenues from the individual income tax to local governments.

As suggested earlier, part of the individual income tax is appropriately assigned to the oblast level; this is especially true in the light of the conceptual difficulties with the two most important alternatives, the VAT and the enterprise profits tax.

In the case of individuals who do not work where they live, it is necessary to decide whether revenue should be assigned to the place of employment or the location of residence. Assignment of revenues to the location of employment is simpler; tax can merely be withheld like a payroll tax. But this probably does not cause revenues to flow to the jurisdictions providing most of the benefits to citizens. Serious problems arises in channelling tax revenues to the oblast of residence. For this purpose it is useful to think of three groups: those who file tax returns (filers), those who are steadily employed, but do not file returns (steadily employed non-filers), and those who are not steadily employed (other non-filers).

Oblast surcharges on the income of filers would be allocated to the jurisdiction of residence, as reported on tax returns. For administrative reasons, Ukraine should not attempt in the near term to implement the type of income tax found in many advanced countries, in which the majority of economically active individuals file tax returns. Rather, Ukraine should rely heavily on withholding; only a small minority of the adult population should be required to file tax returns. Essentially these would be those who are in business for themselves, those who have large amounts of income on which tax has not been withheld, and those who have extremely high incomes.

To the extent that the Soviet system of residential registration remains in place, residence-based taxation of steadily employed non-filers should be relatively simple to implement, at least for the few employers whose records are computerized. Employers would be required to divide withheld oblast surcharges on the basis of addresses reported by employees. Random spot-checks might be necessary to verify the accuracy of these two allocations, if inter-oblast differences in surcharge rates appear to be large enough to make falsification of addresses a problem. As labor mobility increases and employers do not know where their employees live, this will become increasingly problematical.

Other non-filers are likely to be the biggest source of problems. Two options might be considered. First, oblast taxes might simply be remitted to the oblast where employment occurs. for most oblasts this would probably be satisfactory. Second, when they are paid, these non-filers might be required to complete and return to the employer a simple form indicating where they live.

Excises

The Draft Budget Law assigns 50 percent of excises to oblast governments. There is a strong case for allocating all revenues from excises to the subnational jurisdictions in which consumption of excisable commodities occurs. (There is no justification for allocating revenues to the jurisdictions in which importation or production of excisable products occurs.) Taxation by the jurisdiction where consumption (more accurately, sale) occurs (as well as by the federal government) is the practice in the United States, where each state levies its own taxes on such commodities as tobacco products, alcoholic beverages, and motor fuels. The question is whether this could be achieved in Ukraine. To some extent the answer may depend on whether oblast taxes are uniform (or nearly uniform).

Motor Fuels. Whether it is feasible for oblasts where motor fuels are consumed to levy different motor fuel taxes depends in large part on the technology of distribution of the fuels. Differential taxation is feasible if pumps at retail fuel outlets have sealed meters. A second alternative is to meter fuel leaving refineries and points of importation and rely on the records of distributors for the distribution of fuels among oblasts. This approach is vulnerable to evasion if rates are not uniform across oblasts.

Alcoholic Beverages and Tobacco Products. A variant of this second technique could presumably be employed in the case of alcoholic beverages and tobacco products, as long as tax rates were uniform. But, because of the high ratio of potential tax savings to weight for these commodities, large differences in oblast surcharges would be quite problematical, because of the incentives they would give to smuggling from the oblast with the lowest excises. In principle, it would be possible for oblasts to employ tax stamps to implement differential taxation. (Such stamps are affixed to the product and must be broken to consume the product. Lack of a tax stamp is prima facie evidence of tax evasion.)

Motor Vehicle Taxes. Registration fees on motor vehicles make an ideal source of tax revenues for subnational governments. They are relatively easy to implement and they can be justified on grounds of both vertical equity and benefits received. Moreover, they are superior to excise duties on vehicles in a country where automobile theft is a serious problem. (Annual license fees can be set to have the same expected value as a luxury excise tax collected at the time of purchase. This reduces insurance costs, since in the case of theft, the full unamortized value of the luxury excise is not lost.)

## The Problem of Achieving Differential Rates

One of the most important strands that runs through the preceding discussion is the list of difficulties that arise when subnational governments levy taxes at different rates. Individuals have an incentive to pay individual income tax to the jurisdiction with the lowest rates, even if that is not where they live; there is an incentive to manipulate the place of charter and transfer prices to place enterprise profits in the jurisdiction with the lowest rates; and there are incentives to minimize excises by buying goods subject to excises in the jurisdiction with the lowest rates and transporting them to the point of consumption. In the case of the VAT the problem is not only one of tax planning and evasion. Differential tax rates make it much more difficult to deal with trade between jurisdiction, and they distort locational decisions if part of an origin-based VAT system; differential enterprise profits tax rates also distort locational choices.

This list of problems is very troubling, as it strikes at the heart of the case for fiscal decentralization. If rates must be equal, or nearly so, subnational jurisdictions have little of the fiscal autonomy that underlies the fiscal case for decentralization.

In this list the retail sales tax is, in principle, a relatively bright spot. With proper cooperation between oblast fiscal authorities, an oblast-level RST could be levied at differential rates, with trade between oblasts causing relatively few problems, aside from cross-border shopping. An even simpler approach would be national administration of oblast surcharges on a national retail sales tax. But the choice of a national VAT may have precluded both these options. The central government seems unlikely to reverse this decision, and it would be very difficult for business to comply with both a national VAT and an oblast RST.

Concluding Remarks on Revenue Assignment in the Draft Budget Law

The first two columns of Table 2 give the assignment of major tax revenues and/or taxing powers contained in the Draft Budget Law.[34] The second two columns contain recommendations of more appropriate revenue assignments, based on the preceding analysis. The recommended assignments are very different from those in the Draft Budget Law. Moreover, whereas the draft budget law anticipates sharing in the case of the VAT, the individual income tax, and excises, the recommendations are for the central government to collect oblast-level surcharges. This seemingly minor difference has the crucial benefit of giving oblast governments fiscal autonomy and making healthy tax competition possible.

Table 2

Revenue Assignment in Draft Budget Law
and Recommended Revenue Assignment

| Tax | Draft Budget Law | | Recommendations | |
|---|---|---|---|---|
| | Central | Oblast | Central | Oblast |
| Value added tax | 70 | 30 | 100 | 0 |
| Enterprise profits tax | 0 | 100 | 100 | 0 |
| Individual income tax<br>Graduated rates<br>Flat-rate surcharge | 50 | 50 | <br>100 0 | 0<br>100 |
| Excises | 50 | 50 | 0 | 100 |
| Natural resource tax | 0 | 100 | 100 | 0 |

[34]In this context, the term "oblast" is used to include the Republic of Crimea and the cities of Kiev and Sevastopol.

Because of the overwhelming importance of the VAT and the enterprise tax, the reassignment of revenues suggested here would result in a substantially different division of total revenues than the division implicit in the assignments contained in the Draft Budget Law. There may thus be a tendency to believe them unacceptable. This view evokes several comments. First, the problems identified with the partial assignment of VAT revenues and the total assignment of the enterprise tax to the oblasts are real, as experience elsewhere demonstrates; they cannot be wished away. It may be necessary to institute a system of revenue sharing to compensate the oblasts for the shortfall in revenue that will otherwise occur. This is discussed below.

If revenues from one of the two big taxes is to be assigned to the oblasts (in whole or in part), it should be those from the enterprise profits tax. But the current approach is not an acceptable means of achieving such an assignment.[35] Rather, efforts should be taken to assure uniform application of a formula intended to approximate the origin of profits, as suggested earlier. The present defective approach should be abandoned.

## VI. INTERGOVERNMENTAL GRANTS AND TRANSFERS

There are at least four reasons that taxes levied by or for subnational governments may not be adequate to finance their expenditure functions, without supplementation by grants or transfers from higher-level governments. Each of these requires a different type of response. In each case a Fiscal Commission comprised of objective experts and respected public figures

[35]Nor, of course, is it appropriate to allow the oblasts to legislate and administer their own enterprise taxes, as in the United States.

may have an important role to play in designing grants (e.g., in determining the formula to use to distribute funds).

It is important to make a central point about all the intergovernmental grants being considered in this section. Grants should be available, with certainty, as a matter of law, on terms known in advance. (A possible exception not discussed here would be the provision of emergency assistance under unusual circumstances.) Good government is not possible if plans cannot be made with confidence that expected grants will be forthcoming. The practice of making ad hoc grants, especially late in the year, should be discontinued, as it impedes planning and rewards fiscal irresponsibility.

The need for certainty implies that the parameters (matching percentages, minimum standards, and other formulas) to be employed in determining grants should be determined well in advance of the annual budget cycle (perhaps by a Fiscal Commission, or with its advice), so that both the central government and (especially) subnational governments can base plans upon them. In order to increase certainty and isolate subnational governments from macroeconomic developments, it might be worthwhile to consider the possibility of basing (part of) revenue sharing grants on revenues of the central government for the previous year (adjusted for inflation). Finally, because of the need to be able to assure creditors of the credit-worthiness of subnational governments, a way must be found to guarantee that expected transfers of funds will occur.

## Revenue Sharing

Because of the desirability of placing responsibility for the provision of public services at the lowest feasible level of government, combined with the difficulty subnational governments have in levying taxes, vertical fiscal imbalance may exist. Where this occurs, the natural response is for upper-level governments to share revenues with lower-level ones on the basis of a formula.[36]

There is no obviously best revenue pool or formula to use in revenue sharing. It does, however, seem reasonable to include revenues from most important taxes of the central government in the pool to be shared. (This would seem to be true even of taxes on bases subject to independently imposed oblast taxes or surcharges implemented by the central government.) It would be a mistake to include only the individual and corporate income taxes in the pool. As noted earlier, a) these are the taxes that are most subject to cyclical influences and b) subnational governments need stable sources of revenues. This consideration also argues against inclusion of all revenues from important taxes on natural resources in the pool. If anything, taxes with more cyclically stable revenues, such as the VAT and excises (if the latter are not assigned to subnational governments), might be over-represented in the pool.

To the extent that revenue sharing is intended simply to reduce vertical fiscal imbalance, the most natural choice might appear to be to return revenues to the subnational jurisdictions

[36]Extreme vertical fiscal imbalance is found in Australia, where the constitution prohibits state use of sales taxes and the central government denies states the use of the income tax. As a result, the central government collects 3/4 of tax revenues, but spends only about 2/3 of what it collects, transferring the remainder to the states, which raise only about half of the money they spend.

where they "originate." But this view is not without its problems.[37] First, and perhaps most important, this would accentuate horizontal fiscal disparities. Second, it is no easy matter to determine the origin of some taxes, as the above discussion of the VAT and the income taxes on individuals and companies should make clear. (See the discussion of VAT in Brazil, the EC, Russia, and Ukraine and the discussion of state corporate income taxes in the United States in Section V.)

Among the candidates for consideration as the basis for a revenue sharing formula (perhaps applied in combination) are population, fiscal capacity, and fiscal effort.[38] Fiscal capacity of subnational jurisdictions can be derived by calculating the yield from applying a "representative tax system" in the jurisdiction. Income per capita gives a rough indication of fiscal capacity. Fiscal effort is calculated by comparing actual tax revenues to fiscal capacity.

These and other factors can be combined in various ways. Determining the details of the revenue sharing formula could be an important task of the Fiscal Commission. It is important, however, to note several features of alternative formulas for sharing revenues. First, differences

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[37]As a purely terminological matter, if revenues from only one tax is being shared on the basis of their origin, it seems more appropriate to refer to the policy as one of tax sharing, rather than revenue sharing. If revenues from more than one tax are being shared, the origin of revenues is the weighted average of the origins of the individual taxes being shared, that is, of a package of shared taxes. In that case it seems more instructive to consider the case for sharing the individual taxes, instead of the package. For these reasons, in what follows, the term revenue sharing will not be used to refer to sharing based on the origin of taxes.

[38]During the period when the federal government of the United States made revenue sharing payments, a state could choose either of two alternative formulas, reflecting a political compromise between the House of Representatives and the Senate. The two revenue sharing formulas included population, tax capacity (the ratio of national per capita personal income to state per capita income), and tax effort (the ratio of state and local revenue to state personal income), urban population, and state income tax collections. Some of these measure are not the ones described in the text. This chaotic approach is not to be recommended.

in fiscal capacity are more appropriately addressed through equalization grants, to be considered below, than through revenue sharing. Second, if one believes that decisions of subnational governments accurately reflect the preferences of constituents and there are no important spillovers to distort decisions, there is no apparent reason to reward fiscal effort. This conclusion may, however, need to be modified in the Ukrainian context, where subnational government have no tradition of fiscal autonomy and responsibility. It may make sense to encourage subnational fiscal effort, at least as an interim measure.[39] Third, dividing revenues in proportion to population has a very egalitarian effect.

Revenue sharing grants based on population and fiscal capacity would be own non-incremental revenues. By comparison, revenue sharing based on fiscal effort would be an incremental source of revenue, since subnational jurisdictions could increase their share of revenues by exerting a greater fiscal effort.

If, as seems likely, subnational governments of Ukraine have only limited own incremental revenues, let alone revenues from taxes they legislate and administer, fiscal effort may not be a meaningful concept. By comparison, fiscal effort would be an important concept to the extent subnational governments have access to revenues from surcharges. (This deserves further study.)

[39]Even this qualification must be qualified. Exported taxes ideally would not be included in a measure of fiscal effort. It is, however, difficult to make scientifically precise adjustments for tax exporting.

Equalization Grants

Where there are large disparities in the fiscal capacity of subnational jurisdictions, it may be appropriate for higher level government to provide grants intended to equalize fiscal capacities. Like revenue sharing, and unlike matching grants, equalization grants are not intended to induce changes in behavior, except by increasing the fiscal capacity of poor jurisdictions.[40]

At least two benchmarks can reasonably be used to interpret equalization: the fiscal capacity of the jurisdiction with the highest capacity and the average fiscal capacity. Which is used is related in part to the questions of how vertical fiscal mismatch is defined and how equalization grants are financed. If vertical fiscal mismatch is defined as an average concept (the average gap between fiscal capacity and some measure of "need"), revenue sharing would be intended to raise the average fiscal capacity, and equalization of fiscal capacity would require transfers from "have" jurisdictions and to "have not" jurisdictions. Germany makes some use of this technique. If vertical fiscal mismatch is defined in terms of the shortfall of the jurisdiction with the highest fiscal capacity, revenue sharing would eliminate no more than this gap. Equalization would then be a one-way street from the center to jurisdictions with low fiscal capacity. Its intent would be to bring the fiscal capacities of all jurisdictions with lower (post-revenue sharing) fiscal capacities up toward the (post-revenue sharing) capacity of the jurisdiction with the highest capacity. Canada uses this approach.

[40]In the jargon of economics, revenue sharing and equalization grants are intended to have only income effects, by increasing the fiscal resources of subnational governments but not the relative prices of public and private activities. By comparison, matching grants are intended to have substitution effects, by also changing the terms on which private goods and services can be exchanged for public services.

Matching Grants

Some activities undertaken by subnational governments may give rise to spillovers of benefits that cross jurisdictional boundaries. Examples include primary education and the treatment of sewage.[41] Activities characterized by important spillovers will be underprovided, if the jurisdiction that experiences only part of the benefits must provide all of the financing. To avoid this, it is often appropriate that higher-level governments provide matching grants to the jurisdictions undertaking spillover-prone activities. Such grants should, in principle, be set to cover a fraction of the costs of providing the service equal to the fraction of benefits experienced outside the jurisdiction receiving the grant and providing the service. For example, if 20 percent of those who receive primary education in a particular jurisdiction are expected to spend most of their adult lives outside the jurisdiction, a grant equal to 20 percent of the jurisdiction's spending on primary education (25 percent of the amount financed from its own resources) would be appropriate.[42]

It is worth noting that matching grants would be incremental own funds in the sense of Section III. That is, they would be guaranteed by law, provided matching funds were spent on certain activities. (Thus the availability of funds would depend on that action of the subnational

[41]Primary education is commonly used as an example of a public expenditure activity that creates spillovers. In the case of secondary education, external benefits may be relatively small; if so, spillovers may also be relatively small. In that case there would be no compelling case for either matching grants or public provision of education.

[42]Unless spillovers were thought to be more likely for one production technology than another, matching grants should be designed so as not to affect the choice of technology. Thus, in the case of schools, the higher level of government should cover the same fraction of both operating costs and the cost of capital.

government.) By comparison, earmarked funds that had no matching requirement would not be incremental.

To the extent that spending creates spillovers, it should be eligible for a matching grant, whether undertaken by a poor jurisdiction or by a rich one. The idea is to provide an incentive to provide the services that are characterized by spillovers, not to redistribute income or to reduce fiscal disparities. (The latter objective is considered below.) But this rule must be interpreted carefully. It only makes sense to make matching grants if doing so can be expected to induce a desirable change in behavior. If, for example, a high-income locality would have supported primary education at an adequate level, simply because primary education is a prerequisite for the secondary education that all the children in the locality will receive for private reasons, there is no need to provide a matching grant for primary education in the jurisdiction. If, however, there are some children in the locality who are at risk of dropping out of school before completing their primary education, it is appropriate to provide matching grants to be spent on retaining those children in school until they -- and society -- receive the full benefits of primary education.

There is little reason to believe that, as matter of principle, matching grants should cover the same fraction of all lower-level spending by a particular jurisdiction or the same faction of spending on a given activity by all jurisdictions. Thus for example, the spillovers of street lighting in a particular locality may be quite trivial. Similarly, spillovers of benefits of sewage treatment may be much greater within a metropolitan area composed of several local governments than in the case of a geographically isolated community. In principle, the matching grants paid to each jurisdiction should reflect these considerations

It should be emphasized that matching grants are not the only way to deal with spillovers between jurisdictions. They are appropriate when a significant portion of benefits--but nowhere near all benefits--are experienced throughout the country (or the next-higher-level jurisdiction). Where spillovers are trivial (e.g., the case of the occasional non-resident benefitting from street-lighting), it is best simply to ignore them. Where spillovers are pervasive, as they would be in the case of "national defense" provided locally, the activity should simply be undertaken by a higher level of government.

One function of a Fiscal Commission might be to evaluate the strength of spillovers in each situation and settle on a matching ratio for each service provided by each jurisdiction. In fact, this conceptually pure approach may be neither economically feasible nor politically desirable. It may not be feasible because the costs of fine-tuning the system may be greater than the benefits of doing so. Moreover, fine-tuning might open the Fiscal Commission to charges of favoritism. All things considered, it might be best to provide the same matching percentage for a given activity undertaken by any jurisdiction, except those seen to be real trouble-spots.

If important spillovers occur between two or more jurisdictions, but do not affect all jurisdictions, an alternative to matching grants may be appropriate. This is the use of "compacts" between the affected jurisdictions. For example, if a river separates two geographically isolated jurisdictions, it may be appropriate for the two to join together to finance construction of a bridge across the river. There is no apparent justification for a matching grant from a higher jurisdiction in this case, because there are no obvious spillovers of benefits beyond the two jurisdictions in question. (The situation would be different if the bridge were on a major regional or national transportation artery.) In the extreme case spillovers between a few jurisdictions may be so pervasive that the only sensible solution is to join the jurisdictions together in one unit of government, instead of relying on a series of compact involving specific activities. This is the usual economic rationale for metropolitan governments.

## Minimum Service Grants

Even with all of the above grants in place, some jurisdictions may not be able to provide minimal amounts of some public services that are considered to be particularly important, for example, because the jurisdictions' fiscal capacities remain too low, even after equalization, because of income distribution considerations, or because the services have important externalities not adequately captured by standard matching grants. The best examples are probably primary education and certain kinds of health care (e.g., for small children and for pregnant and lactating mothers). Efficient grants of this type--those that only fund provision of vital services that would not otherwise have been funded--are incremental sources of revenues for the targeted activities.

It is possible that few oblasts in Ukraine would be eligible for such grants, but that such grants to lower levels of government would be more common.

## Synthesis

It may be useful to bring together the above thoughts on the nature, purpose, and effects of tax surcharges, tax sharing, and various types of intergovernmental grants and transfers, as in Table 3. Note a) that all the revenue sources considered provide "own" revenues, provided they are guaranteed by law and b) that the purposes and effects listed are for schemes structured as suggested is appropriate; and c) that (contrary to what is assumed) any of them will be incremental if it raises the budget of the subnational government to a level greater than would be spent publicly if the same amount were given to individuals in cash.

Table 3
Attributes of Tax Surcharges, Tax Sharing, and Alternative Intergovernmental Grant Mechanisms

| Type of Grant, etc. | Purpose and effects |
|---|---|
| 1. Tax surcharges | Provides incremental own revenues, by allowing subnational choice of tax burden |
| 2. Tax sharing | Provides non-incremental own revenues, by allowing no subnational choice of tax burden |
| 3. Revenue sharing | Provides non-incremental revenues; reduces vertical fiscal imbalance |
| 2. Equalization grants | Reduces horizontal fiscal disparities; not incremental revenues |
| 3. Matching grants | Compensates for spillovers of benefits; incremental revenues for matched spending |
| 4. Grants for minimum service levels | Assures minimum standards; incremental revenues for targeted spending |

The importance of the last sentence is easily overlooked. It has both positive and negative lessons. As long as the sum of grants (made for a particular purpose) are less than the amount a jurisdiction would spend (on that activity) in the absence of the grants, the grant funds should not be considered to be incremental. In wealthy jurisdictions this is likely to be the state of affairs.

On the other hand, if grants (for a particular purpose) exceed the amount that would be spent in their absence, grants are the source of incremental finance. This could easily be the case in the poorer jurisdictions. The expected consequences are not favorable. One would expect to see bloated payrolls and inefficient government, if the people being served are not paying the bills. Those responsible for the design of grant programs (e.g., the Fiscal Commission) should keep this in mind.

## Order of Consideration of Grants

It is important to consider the order in which grants are calculated. The following order seems reasonable:

1. Revenue sharing helps overcome the difficulties subnational governments have in financing their activities because of vertical fiscal imbalance;
2. Equalization grants reduce the horizontal differences that exist in fiscal capacity, even after revenue sharing;
3. Matching grants encourage provision of activities characterized by spillovers; and
4. Subventions are provided to assure the minimal standards in the provision of selected activities.

It is assumed that each of the last three transfers are calculated taking into account all the transfers listed earlier.

## The Fiscal Commission

Earlier in this section several references have been made to a Fiscal Commission. Though a complete discussion of this concept is beyond the scope of this report, several comments can be made.

This Commission would presumably be established as an independent organization. At the least, it would be responsible for providing advice on the desirability, nature, and structure of the various types of intergovernmental grants and transfers discussed above. It might even be granted quasi-legislative authority in this area, to establish the terms of such grants and transfers. Several federal countries have such organizations; Australia's Commonwealth Grants Commission is perhaps the best-known example, and South Africa is considering establishing such an organization.

The Commission might have representation from the legislative and executive branches of the central government and from subnational governments; non-governmental participation would also probably be appropriate. The Fiscal Commission should have a professional staff of Ukrainian fiscal experts; perhaps it should also call on foreign experts, at least during its formative stages. There should, however, be no illusions that the Fiscal Commission could--or would--provide purely technocratic solutions. Inevitably the design of grants and transfers is a highly political matter; even if one uses formulas to divide revenues, the choice of formulas is a political issue. Depending on its mandate and authority (and on the intergovernmental assignment of non-grant revenue sources), the Fiscal Commission could be a very important and powerful organization. Its mandate, selection, and procedures should be decided with utmost care.

## VII. BORROWING AUTHORITY OF SUBNATIONAL GOVERNMENTS

Governments make capital investments, as well as expenditures for current operations. Fiscal autonomy requires that subnational governments finance be responsible for the finance of capital expenditures, as well as current operations. While governments generally should use tax revenues to finance current operations, it is generally not inappropriate for them to borrow to finance capital expenditures. The issue is essentially a) whether tax and other revenues will be adequate to service the debt, that is, to pay interest and amortize the principal of indebtedness, and b) whether governments can be trusted to use revenues in this way.

In some developed market economies of the West, it is customary for subnational jurisdictions to be allowed to borrow with relatively little supervision by higher-level governments, especially if there is an active market in government securities that is assisted by bond-rating services. Actions deemed to be fiscally irresponsible will be punished by reductions in bond ratings and increases in interest rates that must be paid by the offending government. In extreme cases of fiscal irresponsibility, borrowing becomes prohibitively expensive.

Subnational governments are likely to have adequate access to credit markets only if they are believed to have sufficient revenues from own sources (in the sense defined in Section III) to finance their current operations and amortize their debt. The preceding discussion suggests that oblast governments are unlikely to have substantial revenues from taxes they collect themselves. They may not even be able to depend heavily on tax surcharges imposed on taxes of the central government. They may continue to be dependent on shared taxes and intergovernmental grants. Access to revenues collected by the government itself and the terms under which payments of tax surcharges, shared taxes, and intergovernmental transfers are made can be extremely important for the ability of subnational governments to borrow. Only if potential creditors believe that these payment will be made on a timely basis is it likely that subnational governments will be able to borrow at reasonable rates. Experience in Ukraine, in other parts of the former Soviet Union, and in many developing countries gives reason for uncertainty on this score; all too often payments to subnational governments have been suspended when central governments have run into financial troubles.[43]

Revenues from tax surcharges would presumably be the legal property of the subnational governments. The law could--and should--say clearly that the subnational part of revenues from shared taxes also belongs to subnational governments. Finally, the law must make it clear that payments of intergovernmental transfers will be forthcoming. Even this may not provide much comfort to lenders, if grant funds are earmarked for purposes unrelated to the purpose of the borrowing. It should be feasible, and perhaps it is desirable, to provide that, under certain circumstances, part of certain types of revenues flow into custodial accounts that are used first to amortize debt obligations.

While this may seem unexceptionable and clear, the practical problem is to create a credible legal guarantee that these payments will be made. After all, bonds often have amortization periods that may extend beyond the terms of several governments.

Subnational jurisdictions in many countries do not have ready access to capital markets and can borrow only with the assistance of higher-level governments. Such assistance may take such forms as direct lending, loan guarantees, and interest rate subsidies (reimbursement of part of interest payments). Even where there are no explicit guarantees, there may be implicit guarantees, since it is generally undesirable for a higher-level government to allow those lower-

[43]It might be appropriate to create a semi-independent agency empowered to administer some of the taxes of both the central and subnational governments. It is unclear whether this would assure those who worry about remission of revenues to subnational governments.

level governments under its supervision to default on loans.[44] It makes no sense even to consider unregulated borrowing under such circumstances; the higher-level government must be involved in evaluating and approving proposals for borrowing, if it is to cure the disease of soft budget constraints and exercise control over macroeconomic policy. It probably is appropriate to exercise some regulatory supervision even over the borrowing of presumptively sound jurisdictions, if only to prevent inconsistency with national macroeconomic policy. (See also the discussion of macroeconomic policy in Section III.)

It is especially important that Ukraine avoid allowing oblast (and local) governments to own their own banks (or to exercise undue control or influence over local banks). There is nothing to be said for allowing such publicly owned banks, and much to be said against it. Oblast and local governments should be subjected to the discipline of capital markets. If they are allowed to create their own banks (or to dictate the credit policies of local banks), there is a high probability that they will borrow irresponsibly. The central government would then be put in the untenable position of either forcing bankruptcy of the banks or bailing them out. (See the previous footnote.) In principle, this could be avoided by subjecting banks owned (or controlled) by oblast governments to the same supervision as other commercial banks. In fact, this may also be difficult for political reasons. It is better not to allow this situation to arise.

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[44]The experience of Argentina illustrates the problem. Although the central government exercised little control over the borrowing of provincial governments, banks saw the central government as the guarantor of provincial debts. As a result, the provincial governments were able to borrow virtually without limit. The ultimate effect was to aggravate inflationary pressures, because the provincial governments were, in effect, printing money to finance their deficits.

Governments should not be allowed to be shareholders in banks (or to exercise ownership or control of banks in other ways).

## VIII. REVENUE ASSIGNMENT IN A NEW BUDGETARY ENVIRONMENT

As noted in Section II, the assignment of tax revenues is largely irrelevant, if the central government is to continue to determine total budget figures for oblasts; changes in revenues will simply be offset by changes in transfers of equal magnitude but opposite sign. It is impossible both to assign budget totals for oblasts and to have revenue assignments mean anything. But what if there is a shift to a system in which budget totals are no longer guaranteed, and resources available to oblasts are only those provided by assigned revenues? What would be the resulting changes in available fiscal resources? What would be the resulting revenue gaps and fiscal disparities between oblasts? What forms of revenue sharing and equalizing grants could be used to fill revenue gaps and reduce fiscal disparities?

This report cannot provide a complete answer to these questions. That would require far more time and data than is currently available. This section provides preliminary analysis that indicates both the nature and size of the potential problem. In particular, it compares revenues available to the various oblasts under three alternative regimes: present practice, the Draft Budget Law, and the revenue assignment proposed here, combined with a per capita grant to all oblasts. In the last two cases it is assumed that subventions included in the 1993 budget are eliminated.

The results of these simulations can be interpreted in several ways. The simulation results for the Draft Budget Law indicate that sizeable subventions would be needed to allow satisfaction of expenditure norms in some oblasts, while leaving other oblasts with what might be considered to be excessive revenues. The simulation for the revenue assignment proposed here (combined with a per capita grant) is illustrative of one way to combine revenue assignment with a very simple form of revenue sharing. Further work is needed to design a system of revenue sharing and equalizing grants that fill revenue gaps and reduce fiscal disparities to acceptable levels, without involving the pernicious practice of basing grants and transfers on ad hoc negotiations.

## Present Practice

As noted in Section IIB, each oblast is assigned a share in the regulating taxes, the VAT, the enterprise profits tax, and excises; Table 1 reports these shares and their weighted average. Together with fixed revenues (essentially the individual income tax), other "own" revenues, and subventions, these shares of regulating taxes produce a relatively uniform distribution of total budgeted per capita revenue across oblasts in the 1993 budget, as would be expected from the application of national norms in all oblasts; see the first column of Table 4. The size distribution of per capita budgets is shown in the first column of Table 5 and in the top panel of Figure 1. The majority of oblast budgets (15 of 27) fall within the range of Kup. 60-70,000 per capita, and all but two fall within the range of Kup. 55-75,000 per capita.

## Revenue Assignment in the Draft Budget Law

The assignment of revenues proposed in the Draft Budget Law--standard oblast sharing rates of 30 percent for the VAT, 50 percent for excises, and 100 percent for enterprise profits--would produce a much less uniform pattern of per capita fiscal resources available to oblasts; see

Table 4
Comparison of Revenues under 1993 Budget, Draft Budget Law, and Proposed Revenue Assignment (including per Capita Grants)

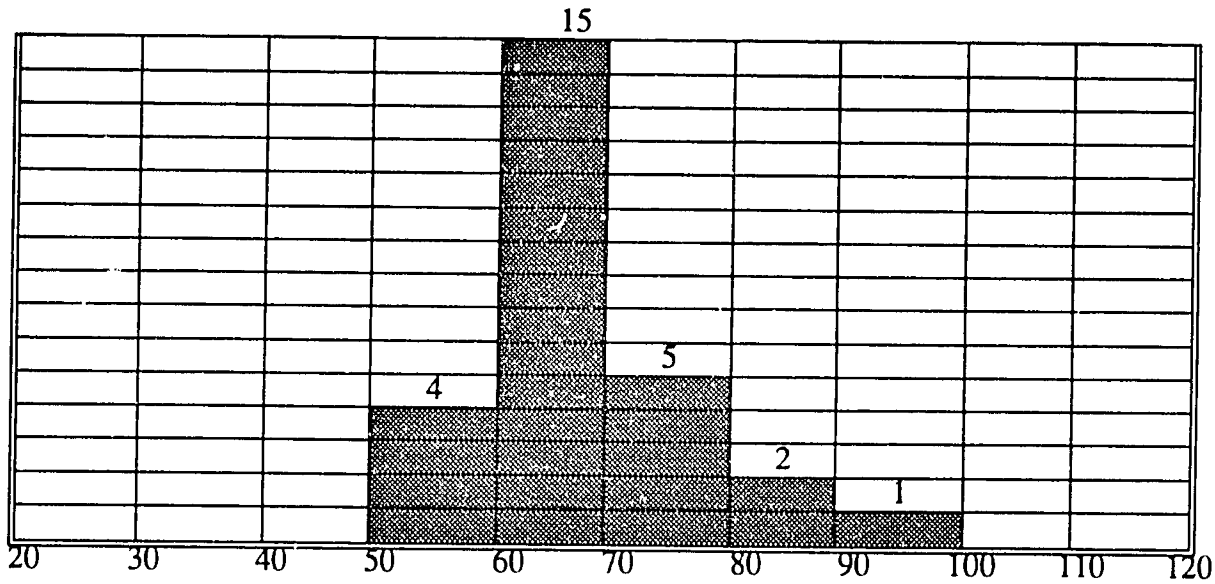
| Oblast | 1993 Budget | Draft Budget Law | Proposal, with Per Capita Grants |
|---|---|---|---|
| Vinnichkaya | 61,721 | 44,339 | 71,154 |
| Volunskaya | 69,001 | 32,546 | 52,545 |
| Luganskaya | 66,496 | 68,510 | 63,800 |
| Dnepropetrovskaya | 85,272 | 111,558 | 87,136 |
| Donetskaya | 68,794 | 96,288 | 71,685 |
| Zitomirskaya | 65,740 | 37,911 | 49,680 |
| Zakarpatskaya | 58,919 | 27,026 | 41,491 |
| Zaporzhskaya | 75,367 | 68,468 | 74,260 |
| Ivano-Frankovskaya | 56,321 | 50,557 | 49,071 |
| Kievskaya | 63,318 | 38,468 | 56,004 |
| Kirovgradskaya | 73,959 | 54,981 | 70,825 |
| Crimea | 70,512 | 37,566 | 53,358 |
| Lvovskaya | 58,882 | 61,472 | 67,734 |
| Nikolaevskaya | 68,072 | 53,850 | 69,988 |
| Odesskaya | 64,585 | 69,945 | 58,584 |
| Poltavskaya | 60,802 | 96,483 | 90,991 |
| Rovnenskaya | 63,587 | 39,593 | 55,969 |
| Sumskaya | 64,429 | 36,625 | 51,877 |
| Ternopolskaya | 68,179 | 48,680 | 76,188 |
| Charkovskaya | 64,205 | 73,276 | 77,958 |
| Chersonskaya | 78,049 | 53,311 | 54,680 |
| Chmel'nitcha | 57,276 | 41,876 | 66,711 |
| Cherkasskaya | 76,630 | 62,931 | 91.574 |
| Chernovitchkaya | 62,599 | 31,565 | 47,126 |
| Chernigovskaya | 60,849 | 64,506 | 91,624 |
| Kiev | 88,660 | 94,102 | 84,090 |
| Sevastopol | 97,778 | 50,114 | 63,303 |
| **Average** | 68,519 | 57,279 | 66,234 |
| **Coefficient of Variation** | 14.19 | 37.99 | 21.67 |

Table 5
Distribution of Per Capita Oblast Budgets
under Alternative Revenue Assignments

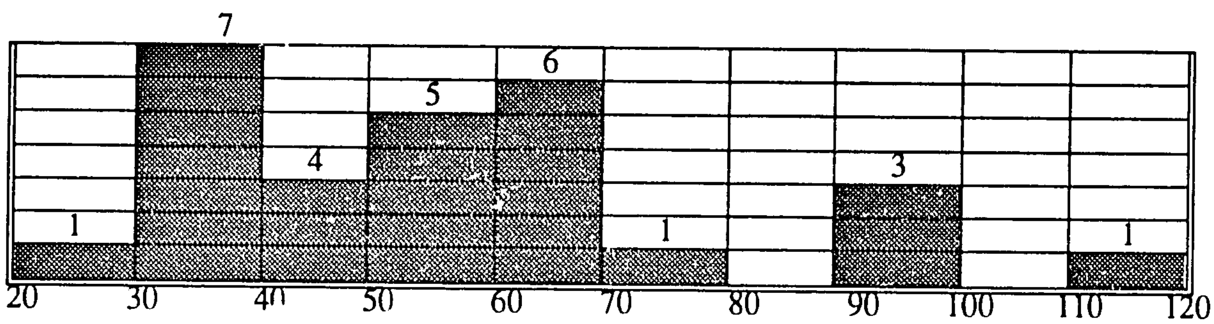
| Per Capita Budget (kupons) | Number of Oblasts | | | | |
|---|---|---|---|---|---|
| | **1993 Budget** | **1993 Budget without Subventions** | **Draft Budget Law** | **Proposal, without Per Capita Grant** | **Proposal, with Per Capita Grant** |
| 15,001-20,000 | - | - | - | 1 | - |
| 20,001-25,000 | - | - | - | 1 | - |
| 25,001-30,000 | - | - | 1 | 3 | - |
| 30,001-35,000 | - | - | 2 | 5 | - |
| 35,001-40,000 | - | - | 5 | 1 | - |
| 40,001-45,000 | - | - | 2 | 3 | 1 |
| 45,001-50,000 | - | 1 | 1 | 5 | 3 |
| 50,001-55,000 | - | 1 | 5 | 2 | 4 |
| 55,001-60,000 | 4 | 6 | - | 1 | 3 |
| 60,001-65,000 | 9 | 7 | 3 | 2 | 2 |
| 65,001-70,000 | 6 | 5 | 3 | 3 | 3 |
| 70,001-75,000 | 2 | 1 | 1 | - | 4 |
| 75,001-80,000 | 3 | 3 | - | - | 2 |
| 80,001-85,000 | - | - | - | - | 1 |
| 85,001-90,000 | 2 | 2 | - | - | 1 |
| 90,001-95,000 | - | 1 | 1 | - | 3 |
| 95,001-100,000 | 1 | - | 2 | - | - |
| 100,001-105,000 | - | - | - | - | - |
| 105,001-110,000 | - | - | - | - | - |
| 110,001-115,000 | - | - | 1 | - | - |
| **Coeficient of Variation** | 14.19 | | 37.99 | | 21.67 |

Figure 1
Size Distribution of Per Capita Oblast Revenues

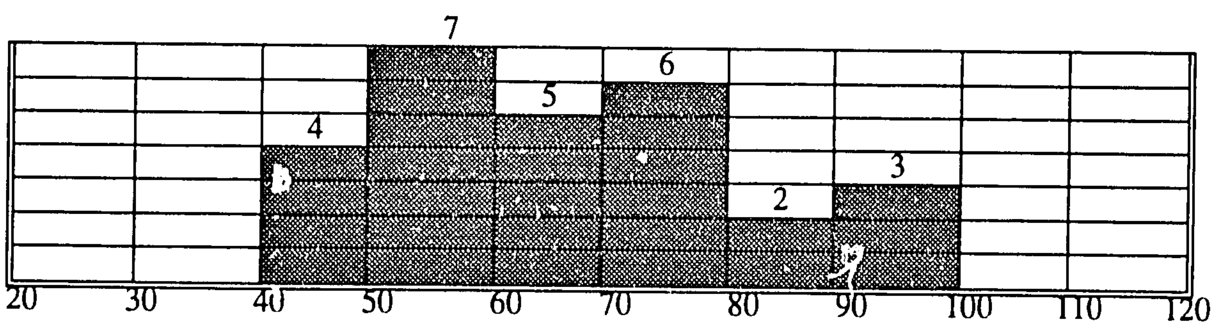
a) 1993 Budget




b) Draft Budget Law




c) Proposed Revenue Assignment, with Per Capita Grants



the second column of Table 4. Moreover, the aggregate amount of fiscal resources available to oblast governments falls by 16.4 percent. This revenue could be used to mitigate revenue gaps.

The dispersion of available fiscal resources increases considerably, as shown in the third column of Table 5. By one measure, the coefficient of variation, dispersion is 37.99, which is greater than the coefficient of variation of the 1993 budget. As suggested above, it is essential to design intergovernmental grants that reduce dispersion of fiscal resources available to the oblasts, under either the Draft Budget Law or the proposed revenue assignment considered below.

Many individual oblasts would experience large percentage changes in available resources; three oblasts would experience revenue gains in excess of 30 percent, and 14 would experience losses of at least 25 percent of their revenue. See the first column of Table 6. Beneficiaries from this assignment of revenues are oblasts that, under present practice, are assigned low shares of revenues, especially VAT and enterprise profits tax. The three oblasts that would gain the most (Dnepropetrovsk -- 30.8 percent, Donetsk -- 40.0 percent, and Poltava -- 58.7 percent) have large industrial bases; these oblasts also receive low shares of regulating revenues (Dnepropetrovsk -- 36.0 percent), Donetsk (33.7 percent), and Poltava (30.7 percent). The nine oblasts that lose the most from this assignment -- in excess of 37 percent of revenues under the 1993 budget -- are those that receive subventions, in addition to retaining all of regulating revenues.[45]

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[45]To facilitate comparison of sharing rates and percentage changes in revenues, Table 6 repeats aggregate sharing rates from Table 1.

Table 6
Percentage Changes in Oblast Revenues, Relative to 1993 Budget, for Draft Budget Law and Proposed Revenue Assignment (including per Capita Grants)

| Oblast | Draft Budget Law | Proposal, with Per Capita Grants | Oblast Shares of Regulating Revenues[a] |
|---|---|---|---|
| Vinnichkaya | -28.16 | 15.28 | 74.32 |
| Volunskaya | -52.83 | -23.85 | 100 (120.3) |
| Luganskaya | 3.03 | -4.05 | 51.70 |
| Dnepropetrovskaya | 30.83 | 2.19 | 35.99 |
| Donetskaya | 39.97 | 4.20 | 33.66 |
| Zitoirnrskaya | -42.33 | -24.43 | 100 (102.5) |
| Zakarpatskaya | -54.13 | -29.58 | 100 (123.3) |
| Zaporzhskaya | -9.15 | -1.47 | 62.91 |
| Ivano-Frankovskaya | -10.23 | -12.87 | 64.12 |
| Kievskaya | -39.25 | -11.55 | 100 (110.6) |
| Kirovgradskaya | -25.66 | -4.24 | 83.51 |
| Crimea | -46.72 | -24.33 | 100 (106.4) |
| Lvovskaya | 4.40 | 15.03 | 51.02 |
| Nikolaevskaya | -20.89 | 2.81 | 78.42 |
| Odesskaya | 8.30 | -9.29 | 50.24 |
| Poltavskaya | 58.68 | 49.65 | 30.73 |
| Rovnenskaya | -37.74 | -11.98 | 100 (107.0) |
| Sumskaya | -43.15 | -19.48 | 100 (103.9) |
| Ternopolskaya | -28.60 | 11.75 | 74.10 |
| Charkovskaya | 14.13 | 21.42 | 41.84 |
| Chersonskaya | -31.70 | -29.94 | 86.04 |
| Chmel'nitcha | -26.89 | 16.47 | 82.49 |
| Cherkasskaya | -17.88 | 19.50 | 63.06 |
| Chernovitchkaya | -49.58 | -24.72 | 100 (114.8) |
| Chernigovskaya | 6.01 | 50.58 | 44.54 |
| Kiev | 6.14 | -5.15 | 49.54 |
| Sevastopol | -48.75 | -35.26 | 100 (104.5) |
| **Average** | -16.48 | -2.34 | |

[a] Figures in parentheses treat subventions as part of oblast shares in regulating taxes.

Proposed Revenue Assignment

The assignment of revenues proposed here produces a distribution of fiscal resources that is quite different from that produced by either current practice or the Draft Budget Law. First, because it assigns revenues from both the VAT and the enterprise profits tax to the central government and assigns the quantitatively less important excises to the oblasts, it reduces the total amount of revenues available to oblasts, in the absence of revenue sharing, by 36 percent. Second, the distribution of resources is again less uniform than under present practice; see the fourth column of Table 5.

Because of the large drop in aggregate oblast revenues, this is not a viable solution to the revenue assignment problem. The third column of Table 4 shows the result of keeping aggregate oblast revenues constant by making per capita transfers to all oblasts. The last column of Table 5 shows that, although there is more dispersion of per capita oblast revenues in this case than under the 1993 budget (a coefficient of variation of 21.67, compared to 14.19), there is less dispersion than under the Draft Budget Law.[46]

Percentage changes in available resources again differ markedly between oblasts, but not by as much as under the Draft Budget Law; see the second column of Table 6. The revenues of five oblasts increase by 15 to 21 percent; the revenues by two (Poltava and Chernigov) increase by roughly 50 percent. Interestingly enough, Dnepropetrovsk and Donetsk experience almost no change in revenues. Seven oblasts experience revenue loses

[46]The difference between the Draft Budget Law and the proposal (with per capita grants) is overstated, by the 16.4 percent reduction in revenues under the latter.

of at least 20 percent. Again the biggest losers are oblasts with 100 percent sharing rates and subventions under present practice.

## IX. SUMMARY AND CONCLUDING REMARKS

If a decentralized system of government is to be responsive to local preferences, subnational governments must have access to incremental sources of revenue they control. The ideal might seem to be assignment of certain taxes to such governments, to be legislated and administered independently. But administrative realities, including the need for coordination, limit what is practical. This is especially true in a country such as Ukraine, where one of the legacies of the socialist fiscal system centered in Moscow is a dearth of experience with both tax administration and tax compliance. Central government administration of most major taxes is likely to be an important part of the fiscal scene in Ukraine for the foreseeable future.

Tax sharing, the present and proposed practice for the VAT, also proposed for the individual income tax (as yet not an important source of revenue in Ukraine) economizes on administrative resources, but is fundamentally flawed, because it leaves oblasts with no control over tax rates and revenues. Moreover, the way shares in the VAT are being calculated in the case of trade between oblasts creates administrative and economic problems and assigns revenues to the wrong oblasts; it is not sustainable in the long run.

Tax surcharges are far superior on this count, since oblasts retain the ability to set rates. Unfortunately, it is not an easy matter to impose subnational surcharges on the VAT; whether VAT surcharges could be administered in Ukraine is doubtful. It may be best simply to assign part of revenues from the VAT to a pool of revenues to be shared by formula.

Assignment of the enterprise profits tax (income tax) to the oblasts violates basic principles of revenue assignment. Moreover, the way assignment to the oblast of origin is being interpreted aggravates the problem. The only sensible way to divide revenues form this source is through the use of a formula intended to reflect the origin of profits (income). Such an approach could be employed to implement oblast surcharges on the enterprise tax administered by the central government.

The Draft Budget Law has several flaws. It continues the previous practice of tax sharing for taxes where this is not feasible--or will not be in a market economy. It creates large revenue gaps and fiscal disparities, with no plan to fill them. In short, it is not a satisfactory means of increasing the fiscal autonomy of subnational governments.

Reassignment of revenues in the way described is intended to increase fiscal autonomy, while taking account of administrative constraints. But, by itself, it would create or aggravate vertical fiscal imbalances between the central and subnational governments and horizontal fiscal disparities between subnational jurisdictions. Per capita revenue sharing would alleviate these problems, but not solve them. It may be necessary to use a more sophisticated system of revenue sharing and equalization grants to overcome these. If so, grants should be clearly specified and guaranteed by law, in order to increase subnational fiscal autonomy and facilitate planning by all levels of government.

## APPENDIX TO SECTION 2: LOCAL TAXES

The current structure of taxation for local governments (oblasts and lower levels) includes fixed sources (sources that are not shared with the central government) and regulating sources. The regulating taxes are: VAT, excise, and enterprise income. The fixed sources include: personal income, land tax, enterprise income tax on enterprises subordinate to local governments, local duties, licenses, vehicle taxes, and natural resources. There are a total of 14 local taxes in addition to the VAT, enterprise income, excise and individual income tax, available to these local governments and each locality may chose to impose all of these taxes or a subset. In addition, the oblast and rayon governments can grant tax preferences and tax holidays to enterprises by reducing the enterprise's tax rate for the equivalent of the portion of revenues expected from the tax by the subnational government.

The actual share of local taxes to total revenue of the local budget can vary widely, and the amount of VAT revenue redistributed to locals is used as the largest regulating source. The land tax can represent significant revenue in some jurisdictions, but the personal income tax is consistently the most important fixed revenue source.

The sharing rates for the regulating taxes for oblast governments are determined once the overall budget is approved and the expenditures for the consolidated oblast budgets have been considered by the central administration. Although some sharing rates between the central government and oblasts are fixed in the annual budget (excise and enterprise income taxes, 50% to the central government and 50% to the oblast), in practice, it appears that almost all sharing is flexible.

One explanation regarding the sharing system was offered by the finance officer of Chernigov. He told us that even though some of the oblast revenues are to be shifted down fully (or shared at uniform rates) with local governments, the sharing rates actually differ because "not all local governments need all of the revenue." The example that he gave pertains to the income tax from individuals. Although this tax revenue "should" go to local governments, the oblast does not distribute all of it to all rayons.

There seems to be little discussion of substantial changes to local taxes. In fact, local governments are not interested in finding additional sources of revenue since they may get a smaller share of the regulating revenues. This is a fundamental problem with the system. As it is now, there is little incentive to develop local sources of revenue.

However, there is draft document on property taxation, which would include the taxation of business property, personal property, and structures. Although the document is in the legislature, the legislation has not moved quickly.[47] The tax rate on property would be relatively low and the rate would apply to the value of property. The rate may be significantly adjusted as its revenue producing potential grows. However, this draft law does nothing to address the lack of incentive for developing local sources of revenue.

In Cherkasi Oblast and Korsun Rayon there is enough information to begin building a database on property location and ownership. In these localities (and most likely in many others), there is a listing of all properties and current occupants in the locality. In Cherkasi, there is also a valuation of the property due to an insurance provision in the law. This

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[47] This is due in part to the slow growth in the number of structures that have been privatized.

valuation is out of date and in the event of full-scale privatization, will not be reflective of the true market value, but it signifies the potential to develop an up-to-date database.

At this time, there is little movement on additional specific local taxes. There is concern at all levels of government regarding the sharing rates for the large taxes: VAT, excise and enterprise income tax. Local governments believe that they are due a larger share of these taxes, while the central government is using the revenue both to balance its budget and promote equalization. There is a need to develop more specific local revenue, and the property tax is one potential candidate. At this time, assistance is needed in the policy area in developing an appropriate property tax. Assistance is also needed in developing the administration of the property tax. Since the discussion of the property tax is at an early stage, this is a place where assistance could make a significant difference in the outcome and success of the tax.

# SECTION 3: REVENUE AND EXPENDITURE ESTIMATION, AND FISCAL ANALYSIS

## I. INTRODUCTION

This section reviews the revenue and expenditure forecasting processes and the fiscal analysis capabilities in Ukraine. The section also develops a plan for technical assistance in the areas of forecasting and estimation and the establishment of a fiscal information system and fiscal analysis unit(s). The overall objective of the section is to examine what will be needed to develop an analytical capability in Ukraine's government structure to carry out, on a permanent basis, analyses similar to that presented in Section II.

## II. REVENUE FORECASTING AND ESTIMATION

Here we review current strengths and weaknesses of the revenue forecasting activities of the central government, subnational governments, and the State Tax Inspectorate separately.

### Central Government

The Ministry of Finance (MOF) is responsible for providing the official revenue forecast for the country. The MOF has a department dedicated to revenue forecasting. Under a proposal developed by the State Tax Inspectorate (STI) to restructure the STI, the work of the revenue forecasting department would be moved to an office of tax policy in the STI, under the MOF. The proposal would create a deputy position for tax policy and one for tax administration within the STI.[48] This work is being assisted by the U.S. Treasury Department.

In the central government, there are limited resources available for revenue forecasting. Forecasting work concentrates on the three main taxes: the value-added tax (VAT, with forecasted collections of 1.995 trillion cupons in 1993), excise taxes (808 billion cupons forecasted for 1993) and income taxes (individual and enterprise 1.9 trillion cupons forecasted for 1993). The revenue forecast including these figures was approved in April of 1993. Due to the high rate of inflation in the country, actual revenues will likely be much higher and revisions to the revenue figures are also likely. Revenue forecasts of all other taxes are made by the MOF, but most of their work is devoted to the three main taxes. The MOF produces estimates of revenue for the country as well as for individual oblasts. They are therefore responsible for the forecasts for the nation, 24 oblasts, Crimea, and two cities of Kiev and Sevastopol. The forecast figures for sub-national government revenue are used in negotiations between the central and local governments to set revenue sharing norms. The oblast governments also produce their own revenue forecasts, and these forecasts are shared with the MOF.[49]

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[48] This proposal was approved in July, 1993.

[49] The oblasts produce their own consolidated forecast and they compare their forecast with that of the MOF. Officials from the MOF and the oblast meet and come to an agreement regarding the differences in their estimates. Based upon these discussions, the sharing rates for regulating revenue sources (VAT, enterprise income and excise) are determined and approved by the Supreme Rada. The oblast and rayon governments then enter into a similar procedure to determine the composition of the revenue sources of the oblast and rayon. In the case of poor oblasts and rayons, the sub-national governments may not have the expertise to develop their own forecast and instead rely on that of the MOF or the oblast.

The whole budget planning process is new to the country and given the daily changes in laws, forecasting is very difficult. There is little in the way of historical data to aid forecasting efforts. Basic revenue forecasting is done using macro-economic indicators from the MOE. These indicators include the following: gross product, wage bill, output and value added by major sector. It seems that many of the indicators (wages, profits, and value added) are determined by growth rates and the growth rates seem to be closely tied with projected changes in oil and gas prices. Currently, there is little use of the Ministry of Statistics' enterprise data or even that of the STI in developing the macro forecast. An overview of the methodology suggests that it is a combination of the old planning methodology (for example, setting the level of wages to be paid by industry) and a true market-oriented forecasting methodology (for example, the inclusion of an inflation factor in the determination of value added).

The macro indicators are produced using inputs from various departments within the government and many departments within the MOE. The distribution of forecasting responsibilities across many departments may lead to an inconsistent overall macro forecast. For example, one department may forecast value added in the agricultural sector, another in the industrial sector, and yet another in the service sector. Another department then compiles these pieces of data and presents <u>the</u> value added forecast. The result is a value-added forecast that has been developed with a number of different methodologies and no oversight regarding the consistency of assumptions and methods. In a meeting with the MOE, the mission was told that the macro forecast methodology is being reviewed and overhauled, although it was difficult to determine the priority of such an effort within the MOE. We could not obtain much specific information on the forecasting methodology from the MOE representatives.

Once the macro indicators are sent to the MOF, the revenue forecasting department begins their work. For the VAT, the revenue forecasting methodology is relatively simple. The MOF takes the value-added forecast, applies the appropriate tax rate and subtracts estimated privileges.[50] The revenue forecasting department within the MOF explained that various ministries helped his office with the estimate of privileges. Other ministries "have reports and accounts about tax privileges" and they pass this information to revenue forecasting department. This department does estimate some deductions using data enterprise data from the Ministry of Statistics (MOS) and tax payment data from the STI. For example, to estimate social sphere expenditures, the department uses information from the quarterly reports that enterprises send to the MOS. However, most of the work establishing the tax base comes from the MOE. The forecasting department in the MOF takes the bases developed by the MOE and applies the current law tax rates. Most of the MOF's work consists of determining deductions from the tax base and enterprise privileges for tax holidays and tax reductions.

The revenue forecasting department is involved in revenue estimation for purposes of advising the government during discussions of tax law changes. They do not use any micro level data for forecasting or revenue estimation. Once their forecast is made, they can make "adjustments" to estimate the potential changes in tax law. There has been little effort

[50] This is one example of where the MOF and oblast forecasts may differ since the oblasts have the ability to provide fiscal privileges independently of the MOF.

to develop the capacity to estimate changes in the tax law, in part because the law has changed so much and in part because the MOF does not have the experience of doing so.

There are 12 staff people in the revenue forecasting department, and there are only 2 computers in the department. It is obvious that little of the work in the department is computerized. Most of the data transfers among the MOE, MOF, and MOS are not computerized. There is a computerized data base in the MOS, but the ability to share and transfer data among the ministries has not been developed. This results in costly and delayed transfers among the ministries, and decreases their staff members' desire for using data that are available.

In summary, the revenue forecasting procedure is an application of current tax rates to the macroeconomic indicators and bases developed by the MOE. While the MOF has some input into the macro forecast, the MOF does not have the trained staff to question the forecast nor develop alternatives. There is no accounting for behavioral aspects or compliance rates to changes in tax rates or tax bases. Most of the forecasting is done by hand, with little use of a computer.

The MOF revenue forecasting department suffers from a lack of trained staff, computers and adequate data. There is no other federal-level office that has the capacity to serve as a check on the procedures and outputs of the forecasting methods of the MOF. There is an analysis unit within the Supreme Rada, but their capabilities are very limited due to a lack of expertise and computerization. At the present time, they do not have the capability to produce their own forecast nor check on that produced by the MOF. Micro-level data on enterprises, property holdings, and individual taxpayers would enable the MOF to produce a more accurate revenue forecast that is build up from a base of taxable income. Micro-level data would also enable the government to develop and evaluate revenue forecasts for each oblast, and to simulate effects of tax changes on the overall revenue base. As discussed below, micro-level data development is crucial to the development of a fiscal information system for the country.

Local Governments

At the local level the revenue forecasts are made using aggregate level data in some cases and micro-level data from enterprises in others. The forecasts are made by officers in the finance departments of the sub-national governments. In larger oblasts, such as Kiev City, there is a staff of two to four people within the finance department dedicated to forecasting (revenue and or expenditures). The sub-national governments forecast their own revenue as an input into their own budget planning and to enhance their chances for more federal revenue sharing in their discussions with the MOF. Although there are significant differences in forecasting methodology among local governments, there are some concerns felt by all local government officials. First, there is basically no computerization at any stage of the revenue forecasting process. Spreadsheet programs are used to finalize information, but the data transfer and actual calculations are typically done by hand. Second, many local officials do not know what the tax law is at a given point in time. Many officers explained that the law changes daily, making estimation very difficult. Finally, there is a problem with the skill level of personnel at the local level. Few staff members have adequate training to help them in any type of analytic work.

The specific methods used to forecast revenues vary from local government to local government. In Kiev city, the revenue forecasting group in the budget department uses a combination of actual data (enterprise profit, output, wages paid, etc. from the MOS data) and macro indicators from the MOE. The forecasting group multiplies actual data on enterprise profits and output and actual wages by the MOE macro indicators. (The city had 9 months of actual data when we visited). Using this process, they are able to forecast basic components of the tax base--wages, output, and profits, to which they can apply to appropriate tax rates. They also use the MOE indicators to grow tax revenues from the latest collection data (which the finance office receives from the banks on a daily basis). This method does not project the tax base, it simply projects the total tax collections. A compromise of both methods is used in the final forecast.

In Cherkasi Oblast and Korsun Rayon. the finance offices use data from the enterprises to forecast most revenues. To collect information from the enterprise, the finance office sends a form to the enterprises. The form asks for forecasted information regarding: sales, wages paid, expenses, and profits. In Korsun Rayon there are 416 total enterprises in the rayon, and 165 large enterprises, and in Cherkasi Oblast there are approximately 8,000 enterprises. A representative from the rayon visits each enterprise to make sure that the enterprises are reporting the correct information. In Korsun Rayon there was no mention of the use of MOE indicators for revenue forecasting purposes.

In Chernigov Oblast, the revenue forecasting methodology uses MOE indicators to grow total tax collections into the future. The Oblast does not project tax bases, as is done in Kiev City.

All sub-national governments forecast revenues or take the forecast of the MOF. However, revenue estimation--the analysis of the economic impact of changes in the tax law--is not done by many sub-national governments. In both Cherkasi oblast and Korsun rayon, there is evidence of some work in revenue estimation. In Cherkasi, the finance office told us that the representative of the President is responsible for estimating the impacts of all tax law changes on the oblast. The representative uses information from the finance office in the oblast to try to determine the effects of tax law changes. It appears that much of the analytic work is actually done by the finance office, but the representative is responsible for the report regarding the effects of the tax law changes. There was no evidence of the use of computerized data.

In both Cherkasi Oblast and to some extent in Korsun Rayon there has been work done on the proposed property tax. In the finance offices of both of these governments there is a listing of property and associated renters (there has been little privatization in these areas). Although neither government has done much analysis regarding the revenue effects of a property tax, both said that they had some idea of the revenue, but did not have figures available.

The local governments in Ukraine need to invest in revenue forecasting and estimating methods as well. Although the country still maintains a centralized level of revenue responsibility in the formulation of tax structure and in administration and enforcement, some of this responsibility will likely shift to local governments eventually. Without the analytical ability to determine tax bases, the analysts cannot adequately forecast nor can they analyze the impacts of various changes to the tax system. If appropriate steps are taken at the central level, data and information can flow from the central level to the local governments. Oblasts would then need assistance in training personnel in the development and use of forecasting models, but some of their data needs could be met by the central government. Investment in computer hardware and software and training of analysts is especially important at the oblast level, where it is likely that more revenue responsibility will reside. While rayons also need analysis, they can couple to the oblasts and use basic information and data provided by the oblast while employing their own models to produce their own forecasts.

In the absence of an overall fiscal information system, some fairly simple advances in data collection can markedly improve the forecasting abilities of rayon level governments. If enterprise data are kept up to date in a computerized form, they can serve as a reasonable source of information for local revenue estimation as well as for local tax administration. These local governments are probably in the best position to capture the data necessary to compile a comprehensive micro data base as well, since they work closely with the rayon STI officials. The oblast offices really need a more comprehensive reform to assist them in developing and maintaining a comprehensive and up-to-date data base and appropriate modeling capabilities. Such reform may begin with pilot programs in one oblast and one rayon. These projects would have their own fiscal advisor to develop revenue forecasting and estimating methodology and software. As mentioned below, the development of a fiscal information system is an important component of developing analysis capabilities at all levels of government. A more detailed account of potential technical assistance is found in the fiscal analysis unit section.

State Tax Inspectorate

The central STI office does not forecast revenue, although there are preliminary plans to restructure the STI and empower the department with revenue forecasting and analysis capabilities. The organizational restructuring was approved in July, 1993 and the implementation and investment is now being discussed within the MOF and Cabinet of Ministries. The effort is to be supported with technical assistance provided by the U.S. Department of Treasury. Dr. Jo Beth Mertens is the Treasury advisor to the STI and she maintains that the real work on tax analysis and forecasting will begin in January 1994.

The STI currently collects data from the oblast STI offices and maintains the summarized revenue collection data. However, many of the data are not computerized and there has been no investment in analysis capabilities. The central STI office does not produce a revenue forecast. They do track revenue collections, but they do not attempt to explain differences between collections and MOF revenue forecasts.[51]

Neither the oblast nor the rayon offices of the STI currently forecast revenue. In the Kiev Oblast STI office, we were told that all revenue forecasting was done by the MOF. Kiev city STI told us that tax policy and forecasting was the job of the MOF and the Rada. In Cherkasi, the STI Oblast office said that they did not make revenue forecasts, nor did they try to track the revenue forecasts of the Cherkasi Oblast finance office. The Cherkasi STI

[51] Since the MOF does not analyze collections data either, there is no attempt to determine why collections are high or low in any particular month, what trends are developing and why, and what collections in one month suggestion for collections in the future. The MOF does communicate with the STI regarding their forecast and the STI notifies the MOF regarding collections. However, the forecast information is basically ignored by the STI and the MOF uses collections information to monitor budget execution.

office told us that the system of taxation is not very stable, and that the officers do not know what to expect from revenues.

At the central level, there is a long list of necessary inputs needed to improve the revenue forecasting and estimating methods. Assuming that the restructuring of the STI continues as decreed in July, the division responsible for revenue forecasting and estimation will be located in the STI. This division would take this job over from the MOF Budget department. Within this new group, enterprise and individual-level data (micro-level data) need to be developed so that analysis can take place using state of the art micro-simulation models. Micro-simulation models allow the analysts to simulate the effects of a change in any component of the tax code. For example, if the individual income tax rates were changed, such a model would determine the change in total tax revenue and would show the effect on individuals by income groups. Aggregate data must be updated and all data must be computerized. Bringing a department up to speed in this area will be time consuming and costly, but by developing analysis capabilities at the central level, data, methods, and information can be shared among levels of government.

Specific technical assistance in this area should take two forms. First, there must be an investment made in the are of database development. While a full-scale information system in not crucial to revenue forecasting and estimation, the more detailed a system that is developed, the better the analytic capabilities become. The technical assistance for information systems development is found in the information systems section below. The second area of technical assistance necessary in modeling, software development and training. In conjunction with the assistance for the development of a fiscal analysis unit (described below), USAID could specify one pilot oblast and one pilot rayon to participate in the fiscal analysis unit training along with the representatives of that unit from the STI. This assistance is described in detail in the fiscal analysis unit section below, but in summary, it would include a series of policy seminars to teach the needs and uses of micro-simulation models, especially for revenue forecasting, development of software that is specific to the needs of the oblast and rayon, and training in the area of forecasting. One foreign fiscal advisor with a specialization in fiscal analysis could be assigned to both the oblast and rayon if they are located close to one another.

## III. EXPENDITURE FORECASTING AND ESTIMATION

At all levels, true expenditure forecasting does not exist. There is no real planning for changes in population, service demands and needs of the constituencies of various levels of government. The official forecast of expenditures is an arithmetically determined level arrived at by using norms or formulas. At the central level, the norms are used to determine "adequate" levels of expenditures.[52] The norms are actually coefficients of expenditures and are now being determined by the Economic Institute of the Academy of Sciences and passed on to the MOE. Departments (health, education, etc.) within the MOF use the norms (coefficients) of spending per hospital bed for example and specific information on the

[52] Educational expenditures appear to be treated separately. The Department of Education works more directly with the MOE on determination of norms and supplemental expenditures. Education has a guaranteed 10% of budgetary expenditures, and discretionary spending is limited.

number of schools and hospitals, etc. to determine the level of hospital expenditures. Wages, prices and other cost indicators are taken from those forecasted by the MOE.

The officials of the MOF calculate expenditures for the entire country and for each oblast. For local governments, expenditures are calculated by the MOF based on an index of cost of living per person, and not by specific norms for each individual type of expenditure (for example, they do not use an individual norm of expenditures per hospital bed, etc.). However, there are few oblast-specific data and expenditure forecasts therefore tend to vary little with specific oblasts. According to the Central Budget Department, the norms are up to date and that they are changed annually.

Officially, local governments also use the expenditure norms provided by the MOE for expenditure planning. However, the city of Kiev and other subnational governments also rely on a growth method -- past expenditures adjusted for inflation (at least as a check on the norm calculations) -- to forecast expenditures. However, norms are still used to a greater or lesser extent. In Korsun Rayon, expenditures are determined by the Korsun finance department by use of the norms. The finance office showed us a copy of the booklet that the MOF sends to local governments to calculate expenditures. The calculation amounts to multiplying the norms (coefficients) by the aggregate number of students, hospital beds, kilometers of roads, etc. In Chernigiv Oblast, expenditures are also determined using the norms, although the finance department has had difficulties due to the rapidly changing prices. Also, expenditure responsibilities are in flux with responsibilities moving among levels of government, making estimation even more difficult.

Under the current economic conditions, it is very difficult to forecast both revenue and expenditures, but as the economy adjusts, the government needs to have an adequate forecasting method available. The expenditure norms may not be adjusted adequately, they may be too comprehensive, they may not consider the costliness of what underlies them, and they do not appear to consider changes in the composition of the population or economy. The norms do not encourage a forward looking planning approach; there is no real future planning for capital expenditures. The expenditure methodology needs to incorporate cost/benefit analysis and an ability to estimate future changes in the needs of the population.

True expenditure forecasting is necessary for the development of a rational fiscal policy. Expenditure forecasting is necessary to be able to access the adequacy of the revenue system of the country. Expenditure forecasts should include the long-run commitments of the budget, as well as the daily expenditures necessary to run the government. The forecast should be sensitive to expected changes in the demands of the population due to changes in socio-economic and demographic composition, world-trade status, etc. A failure to forecast expenditures in light of such changes will leave the government vulnerable to revenue short-falls and fiscal inadequacy. The government also needs to know the effects of expenditure austerity programs and other discretionary changes (such as the effect of changes in the wage structure) to determine the revenue implications of such changes.

Technical assistance for expenditure forecasting is needed both in the area of policy (why is expenditure forecasting necessary and what is its use in the budget planning process) and in the area of methodology. This assistance may be accomplished through a pilot program in one oblast and one rayon. These pilot programs would essentially develop fiscal analysis units within the finance departments of these local governments. If the pilot government offices were located close to one another, one Western fiscal advisor could be assigned to both departments. The specific technical assistance would follow that explained in the fiscal analysis unit section found below.

## IV. FISCAL INFORMATION

At the present time, Ukraine does not have anything that could be considered a fiscal information system. However, a fiscal information system will be crucial to the design and execution of sound fiscal planning in Ukraine.

An information system is comprised of three main elements. The first component is a diverse computerized data base consisting of data related to planned and executed budgets at all levels of government, revenue collections, socio-economic and demographic information of the population, and production and output information by industrial classification. Such data should be available to practitioners in a timely manner and data access and transfer should be available in a computerized form. The data system should be coordinated by a central body so that the information can be easily compiled annually and shared with other central and sub-national government agencies. The second component is comprised of the software programs and computer models that allow the transfer of data among users, analytical capabilities including revenue and expenditure forecasting and estimation and tax burden analysis and database management.

The third component of a fiscal information system includes a system of daily monitoring of budget execution. Expenditure and revenue information should be available in a computerized form so that the finance officers in charge of the budget can assess the revenue and expenditure flows each day. This capacity should be realized at the central government level first in the MOF department of Budget Execution, the Treasury, and then extended to the oblast governments. Below, we suggest an approach to accomplish this capacity. This accounting and control function differs from the analytical, forecasting and policy functions in that the accounting and control function deal literately with daily control over budget execution and would be handled by the Treasury or Budget Execution Department, while the analysis and policy work would be done by a separate unit, perhaps the Budget preparation department or the STI, that is not concerned with daily control. The concern of the latter group is to develop and analyze the effects of tax and expenditure policy for the central and local governments.

Fiscal information systems are used in many industrialized countries such as the U.S., Great Britain, and Germany, and in developing countries such as Guatemala and Jamaica, and their importance in fiscal planning is evident. The system can be used for budget accounting, forecasting expenditures and revenues, and analyzing the impact of changes in tax and expenditure policies. Without such a system, planning becomes a nearly impossible task.

The backbone of the system is the data that are collected. These data may be collected at a macro level (industry or territory) or at a micro level (enterprise or individual). What data are actually collected and at what level of aggregation will determine the uses of the system. In Ukraine, there is a large amount of fiscal information available. However, these data are located in many different offices across the entire country and the process of collecting the data in a central location is left to the MOS. The collection procedure has not been developed as an input into the budgeting process so it is not timely nor is it efficient. The remainder of this section discusses the data that are available and the potential for including such data in an information system.

Tax Revenue Data

In Ukraine, tax collection data are tabulated and summarized by the STI. Tax payments are made by enterprises to banks in one lump sum and the banks split the payments among all levels of government according to the tax sharing formulas determined by the Supreme Rada and the Oblast Rada. The rayon-level STI officers travel to the banks each day to collect actual enterprise payment documents. In most rayon STI offices, these payments are then entered by hand into a ledger book. Each enterprise has its own entry, and a record of each tax payment made. The paper copies of the payments are kept for an unspecified period of time in the rayon STI office.

The rayon office files an aggregated report with the oblast STI office twice per month. These reports include information on total taxes paid by type of tax. They do not include information on tax payments going to different levels of government--simply total taxes by type. The rayon offices also make more detailed reports quarterly and annually. Most of the reporting is made in hard-copy form. One exception is in the city of Kiev, where a total of eight districts transmit their summary data via modem. One of the districts is a pilot in the IMF tax administration program. In Kiev Oblast, only five rayons have computer systems that allow electronic transfer of the data. All other rayon STI offices told us that they transferred data in hard-copy.

The rayon STI offices also receive detailed information on the balance sheets of enterprises once per year. These data are not computerized at the local STI office in any form and the hardcopy reports are kept at the rayon STI offices. Information is tabulated at the rayon office and summarized information is sent to the oblast STI office.

The oblast STI offices compile the receipt information from the rayons. In Kiev city this is done with a spreadsheet program. In Kiev and Cherkassy Oblasts, this is done manually. The oblast STI offices transmit summary information regarding collections by type of tax to the central STI office. At the central office, the main receipt data are eventually input into a computer. There can be sufficient lags in this process so that the central STI office inputs information on collections with a lag of four weeks or longer. Most of the summary data are computerized at the central STI office, but the data are not used for any fiscal analysis. They are used to provide checks of total revenue collections. The STI offices at all levels work closely with the finance officers at the rayon, oblast, and MOF level.

## Budget Execution Data

The budget execution department of the MOF is the central processing office of all government budget execution data. Oblast governments are required to report to this department on a monthly and quarterly basis. Oblast reports consolidate data from all rayons and cities in the oblast. The oblast governments send (most in hard-copy) information regarding actual expenditures and revenue collections by type of account. Most of these data are computerized in the MOF's budget execution office, and there is a formal requirement for the department to produce an annual report of budget execution. This report must be approved by the Supreme Rada by April of the following year.

The computerization and processing of all data is done by the computer department within the MOF. The budget execution department makes consolidated reports quarterly and annually and the consolidated information is given to the MOF, MOS, President, Parliament, all Ministers, and the Commission on Prices.

The MOF's budget execution department receives information regarding central government revenue collections directly through the banks.[53] In the past, the banks also provided information on the expenditures made from each ministry's account. Since August 1992, the ministries themselves report expenditures to the budget execution department. The MOS receives budget execution data from the MOF, all in hard copy.

[53] The Budget Execution Department said that the banks would like to give this responsibility to the new Treasury.

## Wages, Employment, Output

Information on wages, employment and output is collected and kept by the MOS. The STI and some government finance offices also receive similar information, but the MOS consistently collects enterprise data. The MOS uses detailed reports from enterprises to collect data on these economic variables. The enterprise reports are collected at rayon-level MOS offices, and are consolidated at the oblast and sent to the central MOS office. Some oblast offices send their consolidated information to the central office on magnetic tape. Paper copies of the enterprise information are kept at the oblast MOS offices.

The MOS is in the process of computerizing their operations. Currently, there are few personal computers in the office, but they do make use of a mainframe computer for most database related activities. Their mainframe system is connected to the that of the Supreme Rada. This has encouraged data sharing between these two groups. The MOS is engaged in work with other international statistical agencies including that of the United Nations. The MOS appear to be very interested in advancing their skills and their theoretical knowledge of statistical techniques.

## Socio-Economic and Demographic Information

The MOS is the storehouse of all socio-economic and demographic information. The MOS uses a decennial census to collect information on population, income, family size, etc. The last census was conducted in 1989. Interpolation methods are used for population and other information in non-census years.

Census data are processed at the oblast level MOS offices. There, the data are aggregated and then sent to the central MOS office. At the central office, the data are computerized and analyzed. The MOS also conducts a household survey of consumer expenditures. This survey appears to be relatively new and the MOS personnel have not been well trained to conduct such a survey. The MOS plans to conduct another expenditure survey in the near future.

Daily Monitoring of the Budget

There is some variation in the way in which local governments monitor their budgets. In Kiev Oblast, there is a computerized accounting system which accounts for daily transactions of revenue and expenditures. The data are input by one person, and the computer program provides a report of total revenues and expenditures by type and the daily balance. Kiev City also has a daily monitoring system, although it is not as computerized as that in Kiev Oblast. Other governments visited monitor their budgets on a weekly basis without the use of a computer.

The MOF monitors its budget on a monthly basis. The Budget Execution Department of the MOF is responsible for posting an account of total revenue and expenditures to date by month. The banks transfer information to the central government regarding deposits of tax payments to the central government account. The banks also provide information on expenditures by ministries of the central government.

The new Treasury may take over the control and monitoring function from the Budget Execution Office. The Treasury would make all of the central government outlay transfers, and monitor all outlays and revenue deposits of the central government. Currently, the revenue and expenditure outlay data at the central level are aggregated manually and then entered into a spreadsheet-type computer program. There is no electronic transfer of these data between the banks and among the various spending departments within the government (health, education, etc.).

## Summary of Problems and a Plan for Technical Assistance

There is real potential for a fiscal information system in Ukraine. It is hampered by the lack of coordination of information flows, paperwork, and a lack of computerization. At all levels of government, the finance officers are frustrated by the lack of computers and lack of trained staff to conduct daily or weekly monitoring of their budgets. Under the former system, Ukraine officials reported up to Moscow and were not forced to investigate their own budget to any great degree.The MOF has an alarming lack of monitoring and budget analysis. Local government officials spend scarce resources complying with central government reporting regulations. There is virtually no analysis of local government budgets due to time and personnel constraints.

Overall, the transfer of data among various units is cumbersome. Some data transfer occurs quickly. For example, the data transfer from rayon STI to rayon finance offices is done daily in many cases. In other instances the collection and transfer process can lag by weeks or months. For example, the revised STI data are not readily available to the MOF for revisions to its budget. Another example is the enterprise data flowing to the MOS; it may not be collected on a regular basis.

Within the STI itself, the rayon offices are buried under paperwork. The local offices physically collect payment vouchers from the banks, input the information into a ledger by hand and in some cases reproduce this information by hand for transfer to the oblast STI office. Here it is again aggregated and sent to the central STI office. In person-hours alone, this is a monumental task. Simple collection of the data takes so much time and resources that there are few resources left for any real analysis of the data.

The IMF has begun a project to assist the STI in computerizing their system. The specific work so far has been on taxpayer identification and collections for the value added tax in one pilot rayon. The ultimate purposes of this project are first to increase the capability to collect revenue through a taxpayer identification system, development of payment procedures, and reorganization of the STI and second, to computerize the overall administrative work of the STI including the development of a data base.

Data from all sources are vital to the future fiscal planning in Ukraine but there has been little reform in this area. The budget data collected by the MOF are received in hardcopy form, slowing the consolidation process. Data received by the MOS are also not electronically transferred, again slowing the consolidation and processing work that is necessary to make the information useful.

USAID technical assistance could be provided for the establishment of a fiscal information system. Needs include computerization of the central offices (STI, MOF, MOS), assistance in development of data collections (forms and software), and assistance in the development of output (software, reports). Assistance would also be need to sponsor coordination among the agencies and establishing the coordinating office, either in the MOS or in a subunit of the fiscal analysis group with its own staff. A long-term resident advisor should be assigned to oversee the development of the project, with short-term advisors coming in at various times to assist in specialized areas. The specific plan for assistance might be as follows:

- Computerization of tax return data and the development of a micro-level data base.

- Central and local budget data and consolidated budget data (MOF). The first priority for this project is to develop a detailed report of budget execution information for the local and central government. This design should take place with the input from the MOF Budget Execution Department and the new Treasury. This effort should be coordinated with the computer department within the MOF to determine the feasibility of data transfer and database development. At a minimum, the report should contain actual spending by major department and capital spending by category, and revenue by source of tax and non-tax source, including subventions and subsidies. Software should be developed to produce the report in a uniform fashion (in coordination with the work on budgetary procedures, this software could also be developed to produce the report from uniform budget execution data held by the local governments). The final phase of the system would develop PC and modem communication in the pilot rayons and oblasts for data transfer from the rayon to the oblast and from the oblast to the central government. As long as the revenue sharing calculations between rayon and oblast need to be made, the flow of this information is important. The long-term advisor would be responsible for developing the format of an annual report. The report should contain the detailed budget execution data developed in the uniform reports for the central government, oblast and rayons (sample of rayons), and the consolidated budget. The final report may be produced using the resources of the computer department of the MOF.

- Socio-economic and demographic data: The concentration of these data within the MOS necessitates the inclusion of this Ministry in the overall technical assistance project. Also, since this Ministry is currently involved in the advancement of its computer system and methods, they are an innovative group that could benefit directly from assistance in computerization. The MOS is receiving limited assistance in its reforms from the United Nations, and could use more help in training, statistical methods and computerization. The advisor for the overall fiscal information project should inventory the time delays in the processing of data within the MOS immediately. Based on this inventory, additional assistance could be offered to th MOS to develop the capability to collect and distribute the data in a timely manner. This may involve software development and computerization of data and data transfer. A short-term advisor would be required to coordinate the efforts of the MOS once the needs have been detailed. Also, assistance could be extended to the MOS to develop their new household expenditure survey. This would provide the fiscal information system with much more up to date data.

- Enterprise data (revenue, expenditures, output, profits): These data are collected in some form by the MOS, finance offices of local governments, and STI. The MOS receives the most detailed data and so reform efforts in the collection of these data should be directed there. First, the organization of the data should be restructured. These data need to be computerized so the hardcopies should be filed with the oblast MOS offices. A format of data collection should be developed by the fiscal analysis unit and MOS with the assistance of an outside advisor. Second, software development is need for the computerization and transfer of these data from the oblast to the central MOS office. This project could be folded in that discussed above.

- Coordination: The long-term advisor would be responsible for coordinating the efforts of three short-term advisors. This person, in coordination with MOS, MOF, and STI computer staff would develop the software necessary for merging the data bases into a form useful to the MOF and local government analysis units.

## VI. FISCAL ANALYSIS UNIT

### Background

In the field of fiscal analysis, management and policy, the government of Ukraine is handicapped by the lack of a centralized analysis unit. While some individual ministries and departments and the budget committee of the Supreme Rada are undertaking some analysis of their own, there is no think-tank that is responsible for providing information to the administration on fiscal matters. As the country continues to move toward a market economy, it is more recognized that some of the predictability attributed to changes in the old system are gone Officials in the MOF, MCE, STI, and local governments all recognize that they need to develop the ability to analyze the effects of changes in tax policy on economic output, unemployment, prices, income, and revenues. Changes in the former central planning system were often fairly obvious. Now, all governments need to understand how changes in one level of government can trickle-down to affect others and how government policy will work in a market economy.

Fiscal analysis is important to the country for the following reasons. In a market economy, changes in tax policy can affect the level and composition of output and savings and labor supply decisions, which influence prices, employment and wages. All of these responses combine to influence the distribution of income. Thoughtful fiscal policy will consider the effect of tax policy on changes in the distribution of income, output, prices and the overall level of revenue. In a market economy, fiscal policy can be used in part to obtain certain goals, but crucial to using fiscal policy in this way is an ability to understand and analyze the effect of such policy.

Practically, a fiscal analysis unit would fit best in the MOF, under the STI's new tax policy department. The direct responsibility of the unit would depend on its location--but it would most likely be in the Ministry of Finance. Another unit would be useful in the Supreme Rada, possibly under the Budget Committee, expanding on the current staff and resources available there. Although the establishment of two units may seem like unnecessary duplication, each would serve its own constituents as well as serve as a check on the other. In the first case, it is important to recognize that both groups share the need for some identical information, but they also have specific needs. For example, the revenue and expenditure forecasting procedure for budget preparation is very time and resource intensive. The MOF would probably spend more time on this activity, while the Supreme Rada might concentrate its efforts in the analysis of potential legislation proposed by its members. The MOF would analyze proposals as they became more likely candidates for actual legislation. In both cases, the office that took the lead on analysis of the legislation would potentially be challenged by the other office, thus creating an incentive for more careful analysis.

The MOF has an analysis staff in its forecasting department, but none of the information received suggested true revenue estimation analysis. There was no mention of estimating the effect of tax law changes on local governments and much less on the distribution of income or on output and prices. Currently, the budget committee of the Supreme Rada also has an analysis group comprised of 9 staff people. They get some assistance from other government organizations including the MOF and the MOE but cannot carry out all of the analysis necessary for the Supreme Rada.

Responsibilities and Coordination of the Fiscal Analysis Unit

This unit would be the focal point of a new system of fiscal management and responsibility. Regardless of its location, the unit should be responsible for the following:

- Estimation of the revenue implications of changes in tax policy. This analysis should include the effects on revenue for at least two years into the future, effects on the elasticity of revenues, and it should estimate the change in the distribution of the tax burden associated with the new policy.

- The unit should provide an analysis of the impacts of the new policy on the broad economic indicators including: savings, investment, employment, changes in the composition of output, effects on international competition, and prices.

- An analysis of the interregional effects is necessary to understand the extent of the distributional consequences of changes in tax policy. Such work would also aid local governments in understanding the effects of tax policy changes.

- The unit can provide a clearinghouse of data and information to other governmental units.

By performing these duties, the fiscal analysis unit can become an institution that is crucial to the development of tax (and expenditure) policy. Any legislation with serious potential should be analyzed by this unit. This analysis can then be shared with legislators to inform them of the impacts of the legislation. Similar work could be performed by an independent unit in the Supreme Rada.

The fiscal analysis unit should include staff people with training in economics as well as tax law. It is important to have access to individuals writing the tax law to understand its implications. At the very least, tax lawyers within the fiscal analysis group should have access to the lawyers writing the law so that they can consult on tax legislation.

The fiscal analysis group should also be given detailed information on the development of the macroeconomic indicators by the MOE. Once the indicators are produced, the fiscal analysis unit should have review responsibility for the methodology and the output of the macroeconomic forecast. This is crucial to the ability of the fiscal analysis unit to use the macroeconomic data and perform analysis with it. The group should also have access to the budget preparation office in the MOF. Budget preparation will be greatly affected by tax policy changes and the work of the budget analysts could be assisted by knowing how the fiscal analysis group analyzed a particular piece of legislation.

Fiscal information will also be crucial, of course, to the functioning of the fiscal analysis unit. As described above, there is significant potential for the development of a broad-based fiscal information system in the country due to the wide array of data available, although the computerization issues are complicated. The collection of such data could be concentrated within a sub-department of the fiscal analysis unit, but the unit would be better served by an autonomous department. The fiscal analysis unit should be given access to all of the available data, especially micro-level taxpayer information. For this reason, the unit must work with the fiscal information coordinating department as well as the STI so that it receives tax data in a timely manner.

## Summary of Fiscal Analysis Capabilities and Technical Assistance

There is widespread agreement that fiscal analysis capabilities are necessary for the advancement of fiscal policy and management in Ukraine. The Supreme Rada has already undertaken its development with a small staff and resources that include use of data from the MOS. Both the central and local governments can benefit from the establishment of such a unit in terms of budget forecasting, advancement of fiscal policy, and analysis of proposed and implemented legislation. Legislation to restructure the STI to include a fiscal analysis unit currently exists. The development of such a unit within the STI may be assisted by the U.S. Department of Treasury and so any assistance should be coordinated with the U.S. Treasury.

Given that there is interest in establishing the unit, assistance is needed at every level to ensure the success of the unit(s): computerization, data collection and coordination, revenue and expenditure forecasting and estimating methodology, and organizational structure. The unit should include a central analysis department and provide information and assistance to local governments. A detailed description of the technical assistance needs follows.

Central to the modernization of fiscal planning, a fiscal analysis unit should be established in the MOF, perhaps under the tax policy unit of the STI. The establishment of this unit should be determined immediately, as its location could influence subsequent assistance. This unit would carry out analysis of legislation affecting the central and local governments, and contain a department of revenue and expenditure forecasting and estimation. A similar unit should be established in the Supreme Rada to give them more expertise to deal with issues of tax policy and more importantly, budget review (central government and intergovernmental).

There should be a national survey of oblast and rayon finance offices to assess the degree of computerization in the offices and to assess the use of models for revenue forecasting and analysis, and monitoring of the budget. Information from this survey can be used in conjunction with the fiscal information design and development and it can determine areas in which technical assistance in computerization and budgeting are most needed. Pilot projects for budgeting programs could be set up in one or two relatively well-developed oblasts (for example, Kiev and Kiev city). These experiences can then be shared among the Ukrainians.

Once the location of the fiscal analysis unit has been defined, USAID can devote resources to the development of modeling, analytic capabilities and computerization of the unit. While the implementation of this activity would use data developed in the assistance designed for the fiscal information system, model development can begin at any time.

Specific technical assistance for the development of a fiscal analysis unit would:

- Provide training in the area of fiscal analysis. This should be carried out in three segments:

  An academic program in tax policy in a market economy should be undertaken either in Ukraine or in a western university. This education would provide a theoretical foundation for the discussion of tax policy in the country.

  Representatives from fiscal analysis units in industrialized countries should provide a series of seminars to discuss and teach the Ukrainian fiscal policy unit of the uses of fiscal analysis in other countries. The Ukrainians might visit some of these sites as well.

  Courses in specific aspects of fiscal analysis such as revenue forecasting, estimation, micro-simulation models, should be offered in Ukraine, for the fiscal analysis unit. This would require foreign experts to travel to Kiev and conduct one to two week seminars. Other local government officials should be able to attend the seminars.

- Develop a revenue forecasting model for the MOF. This would include software development for forecasting the VAT, enterprise income tax, excise taxes, customs duties, and the individual income tax at the central level (total revenue in the country).

- Provide software that incorporates the ability to allocate revenue to the various levels of government. Software development need not be done in country, but should be done in conjunction with the establishment of the fiscal database and with analysts from the fiscal analysis unit.

- The second part of software development should be to develop revenue estimating capabilities. This would include changes in the tax code and sharing rates. The software should enable the analysts to determine the impact of changes on the distribution and level of federal taxes and local taxes, by region of the country.

- Expenditure forecasting software and methods should be developed in the same fiscal analysis unit. The software should have the capability to incorporate effects of changes in the expenditure responsibility at all levels of government.

- All software development should be done with input from the analysis unit responsible for providing the estimates. Once the software is developed, two short-term advisors should be sent to Ukraine, one for hardware support and one for software use support. In a three to five day seminar in Kiev, the advisors should present a documented demonstration of loading the software and running the models. This seminar should be done with individuals responsible for computer support in the fiscal analysis unit and pilot regional offices and a number of analysts from the same offices. A long-term advisor would then remain with the MOF fiscal analysis unit and provide support for use of the models over a six-month period. This advisor would also be responsible for sight visits and advise to the pilot regions.

In conjunction with the training of a fiscal analysis unit, USAID could offer training to local government officials in the areas of revenue and expenditure forecasting and analysis. This activity could be introduced by a two week seminar on revenue and expenditure forecasting methods used in other countries, the impacts of central government policies on local governments, data needs, computer models, and some basic information on theoretical issues involved in forecasting. The participants would include representatives from the fiscal analysis unit, finance officers from pilot oblasts and rayons, and STI officials. The seminar could be run in Kiev, with experts from industrial countries with modern fiscal analysis programs in the various fields presenting the seminars. The purposes of the seminar series would be to establish some basic level of training for those not available for longer-term study and to lay the ground work for more intensive training for others. Following the introductory seminar, several oblast technicians could be enrolled with the fiscal analysis unit trainees from the MOF and the Supreme Rada.

Finally, a policy-oriented seminar series on intergovernmental relations should also be offered to a group consisting of officials from the MOF and local government officials. This seminar series would expand on the seminar already offered, and would encompass a wider circle of central and sub-national government officials. The purpose of this course of study would be to establish a theoretical basis for changes in the system of intergovernmental relations. A more specific policy series could then be run for local officials, with concentration on local revenue sources and budgeting.

A potential stand-alone assistance project within the STI is the establishment of a sample of tax returns for individuals and corporations. This would provide the fiscal analysis unit with the micro-level data necessary to perform simulation analyses. The STI has begun collecting income declarations from enterprises and self-employed individuals. USAID can provide the assistance necessary to capture the enterprise tax returns into a database for use by the STI and the fiscal analysis unit of the MOF. This portion of the tax data project would develop the methodology and software to computerize tax return data at the rayon STI offices. The software would capture the major lines of the tax code, check simple calculations of deductions, exemptions, and tax liability, and update the data base. The software development should be coordinated with the overall computerization effort in the technical assistance program. At the central level, USAID could provide assistance in the computerization and maintenance of this large tax return base. A short-term advisor would assist in sampling techniques and the creation of a file for use by the MOF fiscal analysis unit and local government finance offices.

## VII. SUMMARY AND OF ISSUES AND ASSISTANCE

The government of Ukraine is moving from a central planning system to a market economy. Remnants of this central planning system still remain in its system of fiscal management. The following statements are reflective of the level of work to be done to get the system "up to speed." There has been little work in the area of fiscal analysis. A wide variety of data are available but they are not well coordinated. The system of computerization in all agencies is not up to modern standards. Finance officers and technicians have not been trained to review and monitor their budgets in any detail. While local governments do not have full autonomy, they do have some, but they have not concentrated on developing new revenue sources and they have almost no capacity to analyze such possibilities.

There is potential for a system of fiscal information and fiscal analysis within the country. The fiscal information system could be used by all ministries, local governments, the Supreme Rada, and the fiscal analysis unit(s). However, there are four basic problems to overcome in establishing a new system of fiscal management, which is made up of fiscal analysis capabilities and a fiscal information system. First, there is an almost desperate need for training of analysts at all levels of government. The MOF explained that while their people work hard, they do not have the background nor university training to do their jobs. A quote by the Revenue Forecasting Department of the MOF summarizes the lack of training of the central government staff, "The best people were always sent to Moscow, we need more training."

Second, with regard to an information system, current data collection and transfer is slow and cumbersome. Data for the STI travel through three levels of STI officials before the numbers are "official." The MOF is apprised of its revenue position through the banks, and much later through the STI. Enterprise data (output, revenues, and profits) are also passed through three levels of the MOS. Detailed computerized data are not available by rayon since aggregation occurs at the oblast level. In most cases, data transfer is in hard copy. Third, daily monitoring of the central government budget and some local government budgets does not occur. The central government does not know on any given day what its surplus/deficit position is. This further complicates planning. The new Treasury may relieve this difficulty, but it will likely remain for some local governments.

Finally, there is little movement in the development of revenue sources for local governments. Support for a new property tax based on the value of personal property is by no means widespread. In fact, some oblast and rayon officials did not know that it was even being considered. There appears to be little planning for the tax as well.

Technical assistance is necessary in all areas related to fiscal management. As detailed above, assistance should include policy seminars for tax and expenditure policy, seminars and training in the areas of revenue and expenditure estimation, training in the use of computer software for database management and forecasting, software development, and hardware support. Also, given the scope of these issues, technical assistance efforts need to be coordinated not only within the government of Ukraine, but with other donors as well. Among others, these donors include the U.S. Treasury Department and the IMF, both of whom are currently working in the country.

# SECTION 4: THE CENTRAL BUDGET SYSTEM OF UKRAINE SIGNIFICANT PROBLEMS AND SUGGESTIONS FOR ASSISTANCE

## I. INTRODUCTION

The government of Ukraine has difficult problems. At a time when Ukraine is adjusting its economy to the realities of its independent status, it is modifying the tax system and endeavoring to meet the challenge of a high rate of inflation. At such a time it is difficult to consider improvements in the budget system. However, the problems of the fiscal and budget system are inhibiting the struggle to adjust the economy and fight inflation. Inevitably, fiscal and budget reform must be a part of the great effort needed to attain economic stability and to maintain social harmony. This focuses on the budget process of the central administration of Ukraine.

## II. CHARACTERISTICS OF THE BUDGET SYSTEM AND RELATED PROBLEMS

### Responsibilities for Budgeting

The budget for the central government comprises funds its various organs including the Supreme Rada, the President's Administration, the Cabinet of Ministers and the Ministries, and the Judiciary. The central government budget also includes funding for those functions that are considered to be of concern to the nation as a whole including economic reconstruction, social security, relief for Chernobyl victims and scientific research. These functions are either funded directly or through subsidies granted to lower levels of government or to enterprises. On the grounds of achieving coordination and control, the State budget also finances significant numbers of the administrative heads of departments in the next subdivision of government, the oblast. The President of Ukraine has also established special representatives paid by the State, who perform an executive review function in both the oblast level and in the third level of government, the rayon.

The second level of government, composed of the 24 oblasts, the Republic of Crimea and the cities of Kiev and Sevastopol, are generally responsible for designated functions that are considered to be area specific. They carry out the main operations of government not identified as exclusively of State concern. Their budgets finance legislative, executive, judicial and municipal bodies with exceptions for financing of certain administrative directors as noted above. The oblast budget funds significant parts of the educational system, the health care system, subsidies for agricultural, industrial, transport, trade and other enterprises. The oblast budgets also include amounts for the rayons, their districts. The oblast governments supervise the activities and determine revenue distributions for the rayon governments and divide expenditure responsibilities between the oblast and rayon.

Although the rayons are subordinate to the oblast, they have their own sources of financing and develop a separate budget while drawing on significant funding from the oblast. Their organizational responsibilities parallel those of the oblast with legislative, executive, judicial and municipal bodies. They act, in effect, as administrative districts of the oblast with a division of responsibilities that is somewhat fluid.

The fourth level of government consists of localities such as settlements, villages, and small towns. While technically these localities are under the jurisdiction of the rayon, they are semi-autonomous in the sense that they are expected to be at least partially self-financing and have their own budgets. Their budgets are approved by local councils. They are responsible for some village roads, for local organs of government, and for some schools.

These localities generally pay for staff support (non-professionals) at schools, village clubs, and doctor's offices as well as for security guards and fuel supplies, etc.

A number of extrabudgetary funds exist. At the State level, extrabudgetary funds include: (1) an employment fund for payments to the unemployed financed by a 3% tax on payrolls; (2) a pension fund (for old age, disability and survivor's benefits) and (3) a social insurance fund (for disability,maternity and birth benefits for mothers and young children). The two latter funds are financed by a 37% payroll tax. Each of the subnational governments are permitted to establish an extrabudgetary fund and to use the funds at its own discretion. In addition, locality governments at a basic level[54] are permitted to funnel their fixed taxes (taxes not shared) and other revenues into funds that are also off the consolidated budget.

Problems with Responsibility Distribution. The way functions and budgets are distributed among the four levels of budget causes two kinds of problems. First, the logic of the distribution of responsibilities is not readily discernible. While users in Ukraine may be accustomed to these kinds of arrangements which were inherited from the predecessor government of the USSR, it must be difficult for them to be aware of which level of government is responsible for what function. As a consequence, voters have difficulty in determining which officeholder is responsible and governmental units are less responsive

[54]These "basic" localities refer to "soviets" of cities, towns and villages regardless of their level of government. These localities have been given special treatment by the Supreme Rada ostensibly to provide greater flexibility. (See IMF paper:Ukraine: Reform of Public Finances, APPENDIX VI, November 16, 1992, p.112, para. c. and d.

than they would otherwise be. That lack of understanding is exacerbated by a second kind of problem. Responsibilities are being shifted, usually to a lower level. This second problem of unstable parameters for functions causes more difficulty than the lack of a clear rationale because it interferes with appropriate planning for matching resources with finances and with program effort.

One illustration of the complexity and fluidity of this distribution is found in education. The State and its budget is responsible for financing schools of higher education, vocational schools and technical schools. In addition, the State budget directly finances teacher training schools for the first three grades, orphan schools, certifying of private schools, and incentive programs for encouraging sponsors. The Ministry of Education also oversees the education budgets of the local governments and provides funding indirectly through the governments of the oblasts and rayons. Over 30,000 institutions are supervised.

In these local governments, budget responsibilities are divided depending on the government level that represents all the students. A school district that lies within one settlement is financed by that settlement. But if the children in the school are from two or more villages, the rayon would finance the school. Oblasts also finance a number of primary and secondary schools. Schools for collective farms are financed by the farm enterprises and these expenditures appear under the heading "Agriculture" in Oblast budgets, not under "Education". Some schools are financed by other enterprises and some schools have been transferred from enterprises to localities. Localities pay for school support staff in their schools but rayons pay teacher's wages in locality schools. School principals are subordinate to the Ministry of Education but their salaries are paid by governments of oblasts and rayons. The Kiev city government finances the only medical school and Kiev's own kindergartens.

It is a recognized principle that good fiscal and budget planning require a clear and stable delineation of the functions of each governmental level. This clarity helps voters to pinpoint who is responsible when problems arise. As movement toward a market economy occurs, people are more likely to want to know how tax money is being used. As the Law of Local Self-Governments has recognized, it is also desirable that some governmental functions be controlled from nearby locations so that government might be more responsive. Particular problems arise when responsibilities are shifted from time to time. When this happens, uncertainty discourages appropriate budget planning and inhibits the accountability of the manager to accomplish objectives. It is always difficult to adjust revenue sources to fit spending needs; it is doubly difficult when spending responsibilities change.

As soon as possible, the government of Ukraine should stabilize responsibilities for each level of government and should seek to rationalize their distribution according to more conventional views of the proper role of government. A draft bill to rationalize and stabilize responsibilities has been developed and should be considered further.

The undesirability of extrabudgetary funds is well known. Such funds are not subject to the same kind of fiscal discipline as other funds. It is not unusual for governments to place their pension and social insurance funds outside the budget primarily because the funds come from a dedicated source, are intended to be drawn years in the future and can be demonstrably segregated from other funds. Nevertheless, the practice distorts the effects of governmental activity and inhibits careful consideration of all the needs of the state especially when large proportions of resources are involved.

Establishment of extrabudgetary funds for current, general governmental purposes is even more detrimental. Not only do such funds avoid desirable scrutiny and competition with other funding, but, unlike pension and social insurance funds, they are not earmarked for a specific purpose. This produces an incentive to transfer resources to these extrabudgetary funds thereby increasing pressure on the regular budget. This problem could become particularly acute under current practices in the Ukraine where revenue distribution decisions are based upon the budget demands of the local government levels and where virtually unlimited discretion is permitted in the use of these general purpose extrabudgetary funds.

The existence of extrabudgetary funds also can make it more difficult to use budget data for assessments of economic activity. If extrabudgetary funds must exist, then a data system should permit the aggregation of their transactions with those covered by the budget. No such data system exists in the Ukraine.

## The Budget Preparation Process: Forecasting and Distributing Revenues

Based upon data about current tax collections from the separate State Tax Service and economic forecasts from the Ministry of Economy, the Ministry of Finance (MOF) forecasts revenues for the budget year for each source of revenue. The principal revenue sources are the Value Added Tax (VAT), Enterprise Profits Tax, Excise Tax, Land Tax and a Personal

Income Tax. The first three of these taxes are shared between the central State government and the oblast level on the basis of a schedule in the annual budget law.

The share of revenues that each oblast receives from the overall share specified in law is determined generally by the size of their expenditure budget. Under the law, each local government is guaranteed an amount of revenues equal to a minimum budget less estimated local revenues. The minimum budget has been grounded in budget norms based on population. More recently, past year figures adjusted for inflation also are used to form the basis for the minimum budget. To meet this requirement, revenues collected from within the oblast from taxes are estimated, and divided between the oblast and the State. In 1993, the Enterprise Profits Tax, the Excise tax and the VAT were shared. Decisions were made about the share of each of the two former taxes with the VAT share used as the basis for the final calculation of the amount needed to cover the minimum budget. A similar process is followed in distributing revenues between the oblast and rayon. The law also specifies that the amount of taxes shared with the lower level cannot exceed the amount of revenues the lower level (e.g. the rayon) collects from its own sources (fixed revenues). In the future, the land tax and individual income tax may also be shared with the central government though in 1993 they both were allocated in full to the oblast/rayon budgets.

The State also forecasts and collects revenues from external economic activities (customs and export taxes), revenues from the National Bank and payroll taxes to fund Chernobyl disaster benefits.

Of lesser importance are vehicle, document, forest, water, and natural resources taxes which have also been shared between oblast and rayon governments together with other fees and locality taxes which remain in the original locality.

Problems with Forecasting and Distributing Revenues. It seems evident that revenue forecasting needs better data systems including improved economic and collection trend data, better ability to simulate trends and more training of professional staffs in techniques of tax forecasting. Perhaps even more important, is the need for a trained staff that can assess the impact of the various tax sources on the economy of the Ukraine and identify appropriate options both for tax sources and appropriate rates. These issues are addressed in more detail in Section 3 of this Report.

The use of shared revenues to cover the difference between minimum budget totals and local revenues means that if local revenues exceed estimates, the local government can spend them. Unlike the practice in the former Soviet Union, upper level governments no longer have the right to take any surplus generated by the local governments. However, the fact that shared revenues cannot exceed local-level, fixed revenues discourages consideration of new or expanded sources of local revenue at a time when new revenues appear to be needed. Both the fact that surpluses cannot be transferred and the fact that consideration of new local revenues is discouraged means that the redistribution of resources between geographic areas within an oblast is impeded. As noted in an IMF report, grants from oblasts to rayons seem to be the "only mechanism for redistributing revenue from the richer to the poorer local governments."[55]

From the budget development point of view, the focus on determination of sharing rates is somewhat time-consuming and causes budget instability. When tax shares have to be estimated and shares divided, accuracy suffers. We understand that at this time when the size of budgets is changing rapidly under high inflation and when new tax systems are being imposed that it may be desirable to attribute shares of taxes from within each local government annually to various spending levels. But at some future date it would be desirable to introduce more stability into the system. Several options to achieve this are examined in Section II.

Forecasting Expenditures and Budget Review

Each year an initial budget law outlines the steps and timetable for the budget process, establishes overall revenue sharing rates and specifies general budget classes and organizational responsibilities for budgeting. Under that law the budget for all levels of government is unified (consolidated). However, the budgets of each of the four levels is given an independent status with the right to have their own revenue sources and, even more significantly, the right to determine how funds are used within the overall budget framework.

The Cabinet of Ministers controls the process which normally begins in the spring of the year preceding the budget year. The Ministry of Economy initiates the process by

[55]International Monetary Fund, Ukraine: Reform of Public Finances, Appendix VI, November 16, 1992. p. 112.

issuing guidelines setting forth the basis on which the budget should be constructed in relation to economic goals, e.g. rates of production expected in each of the various sectors. The MOF issues guidelines and norms for the development of the budget by the sectoral and other ministries in preparing their requests. The norms are generally formulae for calculating costs in the budget. Examples include: cost for each bed in the hospital system, cost per numbers of outpatients, health care costs per capita, school maintenance costs per pupil, etc. Another kind of example is the calculation for "Social protection"[56] which, in the 1993 budget, is assumed to equal 37% of wages. The norms are developed in an Institute of National Accounts based on data furnished by the Ministry on Statistics.

The norms are intrinsic to the process of budget estimation. However, in recent budgets norms have generally been adjusted to reflect current costs plus assumed inflation rates. The norms are used also to determine the distribution of budget amounts, e.g. among kinds of schools financed by the State budget. Norms are set at the national level but separate norms are also established to recognize sectoral or geographic differences. The number of norms is sizeable; the listing of national norms given to one oblast for the 1993 budget was 15 to 20 pages long for each major division of the budget. A national wage scale, currently with 29 levels, is also established centrally. Lower levels of government also set their own subsidiary norms to forecast budget details and to determine budget distributions. They must conform to the national norms. Non-financial norms or "natural" norms

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[56]Social protection includes payments for the poor and disabled, pensions, assistance for single mothers with children, price subsidies for medicine, fuel, and transport, school canteen losses, housing subsidies for the elderly, etc.

are also used to establish the quantity of usage, e.g. a norm establishes the number of grams of bread to be available for each hospital patient.

Using calculations based on the norms together with adjustments for inflation, budgets are then developed by the establishments of the central government and submitted to the MOF, normally by late summer. The MOF reviews the proposals basically for conformance with norms and guidelines and with views about general priorities. For example, the 1993 budget sought to keep full funding for wages, pensions, medicines and student stipends while cutting capital repair, equipment purchase, and industrial development. The MOF sectoral staffs review the proposals and discusses them with the staffs of other ministries and negotiates agreements. The proposals are aggregated by the Main Budget Department and submitted to the Cabinet of Ministers. The proposals are reviewed further by the Cabinet of Ministers, revised as necessary and given to the President. Once the President has approved, the budget goes to the Supreme Rada, usually in October or November, for final action. The Rada has no required final date for enactment and does not always complete action before the budget year begins on January 1. The 1993 budget was not enacted until April 1993. Numerous adjustments have had to be made since that time, primarily because of inflation.

Under the Law of the Budget, the capital investment or developmental budget takes precedence over other budgets. The capital budget now equals about 5% of the GNP of Ukraine. The preparation of the capital budget is highly centralized and managed by the Ministry of Economy. Departments of the Ministry identify possibilities for capital investment with advice of the MOF and line ministries such as the Ministry of Education.

Enterprise development, industrial development and development for the social sphere are considered separately though there are no strict criteria for distribution of the budget among these spheres. The Ministry of Education, for example, constructs its own listing of needs to give to the Ministry of Economy. A regular form and a standard methodology is used for feasibility study. Facets of the study include the expected rate of return, profitability and other economic effects, location, staff requirements, fuel supplies needed, etc. Norms exist for rates of return required for industrial development. In the social sphere, rates of return focus on duration of construction like durability of materials. For schools, number and location are related to density of population. Technical cost-benefit advice is obtained on enterprise proposals.

For oblast capital investment projects, separate lists are developed and forwarded to the Ministry of Economy through the MOF. Once the Ministry of Economy has approved the projects for the capital budget, the MOF defines costs and the amounts for the projects are incorporated into the budget moving through the Cabinet of Ministers to the Supreme Rada. After costs are determined and the budget is approved, responsibility of the Ministry of Economy ends and sectoral ministries are responsible for follow-up.

The review of the draft budget is done by the Supreme Rada's Commission on Planning, Budget, Finance and Prices which obtains comments from the Sectoral Commissions of the RADA and advice from MOF staffers. The Sectoral Commissions review the areas of their particular interest in discussions with relevant Ministries. The Budget Commission is composed of 30 members of the RADA and has a staff of 9 economists. The review effort by the Budget Commission includes a major focus on revenue estimating with the staff performing simulations to check on the forecasts.

Within the oblasts and rayons, a similar process takes place with budgets developed by the departments of the government, reviewed and revised by Finance departments, submitted to the executive including the Special Representative of the President, followed by discussion and approval by the respective radas. Norms of the State must be followed. While the oblast budgets are clearly not enacted by the Supreme RADA nor the rayon budget by the oblast Rada, there is considerable surveillance by the next higher finance office because of the system of revenue sharing and provision of subsidies. Finance officers of all levels are also employees of the State Ministry of Finance.

Problems with Expenditure Forecasting and Budget Review. First, the present budget process is not an effective instrument for national policy change. While the system of national norms and indices, capital project approval and Cabinet and RADA review is intended to determine national policy direction, the approach tends to retard policy change and does not develop new ideas in a systematic way. The norms are generally based on existing costs adjusted by expected inflation rates, effect of new populations or other emergent conditions. There is great emphasis on fulfilling needs to the fullest extent. Under the present conditions of fiscal stringency, political officials find themselves forced to make reductions in those kinds of programs that can be easily seen and stopped like construction and equipment purchases. Meanwhile the budget rises inexorably.

The fundamental problem is that the system tends to result in the perpetuation of existing budget trends without any systematic way for basic questions to be asked and answered in an analytical manner. These kinds of basic questions include the following:

- Should government continue to finance this function, program or project or would it be better for society if it were left to the private sector?

- If government should finance the effort, at which level should it be financed?

- Are there better, less costly ways to stimulate production, assist enterprises, encourage employment, etc.?

- Are there better ways to finance this effort?

- What are the consequences of a budget, or a deficit or a tax plan of this size upon the economy of the Ukraine?

- Does everyone who now receives social protection need it?

- Are there some who earn enough that they need not be supported or who need less support?

These are difficult questions to answer though undoubtedly such questions occur to political officials from time to time. But in the Ukraine the budget system does not routinely raise such questions. Staff review is focused on conformance to norms. Political officials do not routinely receive policy options. Such suggestions for options permit explanations to be provided so that discussion is not simply anecdotal but can consider the impact of policy changes in a logical way. An identification of policy options by a politically neutral staff also shields the political official from having to raise questions that seem awkward in a political context. Ukraine lacks staffs that consider these kinds of questions and who have the technical ability to assess and communicate the effects of changes.

A second aspect of this problem is that the budget system does not emphasize performance in its reviews. The norms makes calculation and checking of budgets relatively simple. But conformance to norms tells little about the goals of a particular activity and whether they are being met. While many kinds of transfer payments, particularly those made to individuals, may meet objectives when the benefits are paid, there is a wide range of governmental programs for which attainment of the objective is not as clear. These include operation of the establishments of government itself and the whole range of services, controls and infrastructure provided by government. The Ukraine lacks measures of performance in these functions of government and little attention is paid to missions and goals and to the relationship of costs and benefits. The budget system makes only a limited attempt to modify budget proposals to take into account the effectiveness of governmental activity.

While capital projects apparently are subject to more feasibility analysis than other governmental activities, the existence of simplistic norms for rates of return and the separate path followed in the approval process raises some questions. It is evident that not all costs are taken into account and matched with clearly identified benefits. It also seems difficult for the costs of capital investment to be appropriately aligned with related activities when the decision process and organizational responsibilities for the two kinds of activities proceed down separate paths and when the ultimate decisions are made in detail at the government's center.

Similarly, little emphasis is given to the need for finding the most economical way to accomplish objectives. The system that bases budget proposals on prior fund use often in a way that is quite mechanical, that insures minimum funding of the needs of local governments, and that checks budgets only for conformance to norms does not seek to find lower-cost ways to accomplish the desired ends. The atmosphere of budget review does not place sufficient stress on efficiency. Budget reviewers are not expected to suggest ways to economize. While managers are expected to use money wisely, the budget process is not used well to encourage them to do so.

The ability of the government of Ukraine to cope with fiscal stress is also inhibited by the way the Supreme RADA and the Executive handle their roles in the development of fiscal and budget policy. Most effective governmental systems have evolved over time to recognize that the legislative and the executive functions should "stand apart" in developing tax systems and the budget so that appropriate consideration can be given to reconciling the needs of government and the people with available resources. The legislature acts as a check (a restraint) on the demands of government administrators by forcing them to justify their requests in detail and to demonstrate program effectiveness routinely. The Executive helps restrain the legislators' inclination to agree to constituent demands for more spending by providing assessments of the desirability of added spending and by public explanation of the consequences of added spending. Often too, specific formal mechanisms exist permitting the Chief Executive to reject certain spending actions by the Legislature.

Such approaches help create an atmosphere in which government spending comes under considerable scrutiny. As a consequence, greater fiscal restraint occurs and greater incentives will exist to shift programs and policies so that the nation's objectives can be met with less money.

We perceive that these kinds of restraints are weak in the Ukraine. Neither the Supreme Rada nor the Executive make systematic efforts of the kinds noted above to identify desirable tax and budget policy changes or ways to improve program effectiveness or to lower costs. They lack the kind of staffs that would help identify these kinds of options. The Rada does not conduct a systematic, comprehensive review of budget proposals and their consequences. While questions are often asked of MOF staffs and those of other Ministries, hearings are not held routinely. Little opportunity exists for regular public participation in the process. Under these conditions, budget negotiations tend to be personal and political without much consideration of objective analyses or of public reaction. These approaches result in budget decisions that can often be less rational than they would be if more methodical approaches were used. Above all, a lack of adequate procedures and rational review does not foster an atmosphere of restraint.

## The Budget Execution Process: Allocation and Control

Once a budget has been approved by the Rada of each of the levels of government, funds are allocated to the various establishments. In effect, two kinds of allocations are made. A credit allocation is made to bank accounts of each entity and a "Smeta" or detailed spending plan is issued.

The MOF informs banks of the amounts available for each period. Each ministry allocates credit to bank accounts for each spending unit on a periodic basis, e.g. twice a month for wages; usually quarterly for other accounts. The bank accounts correspond to the legally limited account classification established during the budget process. As such, they serve as the primary instrument for control over expenditures. The applicable spending unit can draw no more than the amount credited to the account. Since the amount credited does not exceed the amount authorized by law or allocated for the period for that account, spending will not exceed the amount provided. In effect, the banking system is used to control budget spending. Ministries of the central government typically have three accounts, one for staff, one for other institutional expenses and one for the substantive functions of the Ministry, e.g. Health Services for the Ministry of Health. Typically also, each subordinate spending unit has a separate account for wages.

In local governments, where funds are derived from shared revenues, banks receive all the shared tax collections and then distribute funds to the respective accounts of the State, Oblast or Rayon in accordance with the legally specified sharing rates. These banks also collect revenues that are not shared. Accounts for these latter revenues may receive revenues in excess of the budget allocation. Under these circumstances, the local spending unit may spend up to the amount of available deposits even though the deposits result in spending in excess of the budget allocation.

The Smeta is developed showing the details for the expected use of funds within each account. The details of the Smeta are negotiated with the Ministry of Finance or Finance Department of the next higher level of government and approved by that office. The Smeta establishes the categories within each account for which expenditures will be recorded and reported. Thus, it provides the budget planning base for discussions of the use of funds. However, under current rules, the amounts detailed in the Smeta within overall account totals do not constitute limits on spending. The manager of each spending unit is free to transfer amounts among the categories detailed in the Smeta within the totals of the account under the manager's jurisdiction. Amounts for wages and investment are prevented by law from being transferred. This flexibility has only been permitted recently and recognizes the need for managers to be able to shift the use of resources under conditions of fiscal stringency and high inflation. For the same reason, funds may be transferred among State Ministries within the same complex[57] of Ministries but not between the complexes.

Funds for wages are not only separately allocated and controlled but control is maintained by ceilings established on the numbers of personnel. In general, funds not used for wages in one quarter are not allocated in the following quarter. The technique is used as a way to save money. This means that if a manager is unable to fill a vacant position for whatever reason, that manager will lose the funds for the position in the following period. Apparently, the manager who then finds a suitable candidate for the position would be required to rejustify the need for funds even though the position and related fund allocations had previously been approved.

Throughout the various levels of government, when spending units run short of funds, they may receive permission to "borrow" from succeeding quarterly allocations. In addition, the Budget Law provides for a reserve fund to the Cabinet of Ministers so that significant contingency needs might be met. Similar reserves are also established within local budgets.

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[57]The Ukraine Council of Ministers includes seven State Ministers each of whom is responsible for a complex of ministries.

Problems of Allocation and Control. The use of the banking system to maintain controls raises some significant questions. As Ukraine moves toward a market economy these questions will become even more important. First, use of such a system makes it difficult for the central government to manage its fiscal affairs and resources so that it can relate revenues and expenditures on a timely basis. Such a system is cumbersome and slow in a way that inhibits modern management of fiscal resources at the center of government. As others have argued, Ukraine needs to develop its new Treasury so that expenditures can be drawn from centrally managed "general fund" accounts which will permit better fund management and improve the ability to relate budgeting and macroeconomic policy. It should also be noted that use of banks creates a cumbersome system in which transfer documents are used to remit money among government establishments or an even more unwieldy system for cash withdrawal and payment. As private market mechanisms develop it will be desirable to consider a way in which remittances are drawn centrally under control of a Treasury. Similarly, distinctions are not made between expenditures and repayments of borrowing. Again, under a market economy it will be particularly important that such distinctions be made.

Control through the banking system poses another kind of problem directly affecting budget management. Spending managers are not given clear responsibility for the control of their resources. While theoretically the spending manager may be expected to manage resources so that priorities are balanced within available funds, the use of an external agent for control does not create an incentive to do so. In the worst case scenario, a spending manager can allow spending to proceed until funds within the account are used regardless of any priority. Then expenditures will be stopped without concern for the fact that some prospective payments are more important than those not stopped or are liabilities due under previous arrangements. In such a case, the manager can avoid concern about exceeding spending limits; that concern is located outside his jurisdiction. A manager who does not have responsibility for continually adjusting expenditures to keep within the fund limits for program accomplishment lacks incentives to use those funds wisely. Responsibility should not be vested in an external organization.

Spending managers should be given direct responsibility for management of the limitations on their accounts. Clear rules should be specified for maintaining those limits. No one should be permitted to exceed authorized limits. Procedures for adjusting those limits should be clearly established in written directives from a higher authority. The limits should only be adjusted by documentation in writing. Adjustment upward should be made only by specified transfers from other accounts, by new authorizations approved by the applicable rada or by borrowing or by the use of other sources authorized under rules of law. General distinctions should be made between receipts generated by enterprise activities directly related to the cost of the enterprise and revenues obtained by general tax laws. Only the former should be used without specific authorization of the applicable rada or by higher-level adjustment under a rule of law.

It is appropriate that spending managers have been given flexibility to move funds within most accounts particularly under present conditions of inflation and budget stringency. But the freedom to manage funds within overall limits carries with it the need to be accountable for their effective use. Managers cannot be free to use funds unwisely or for corrupt purposes. Systems that give managers appropriate authority to make judgements about the way funds are used should also adopt rules to insure that funds are used as effectively as possible. For example, general rules for the procurement of goods and services should be applied to encourage more effective use of funds and to prevent fraud. These rules would include those that: (1) would require purchases only from lowest-cost sources; (2) would require special approval of high cost purchases; and (3) would prohibit purchases from those who have a business or family relationship with those doing the purchasing. Similar rules should cover the use of cash, the hiring of personnel, and the use of funds for travel and other purposes. In the Ukraine, we see an absence of suoh rules and a strong need for them. Again, the need for such rules will become even more important as the economy separates between governmental and private spheres.

There seems often to be an expectation that allocations of credit will be extended to spending entities when needed even when budget authorizations have all been used. In fact, the law requires the central government to cover subnational deficits for the next several years. Overdrafts appear to be common particularly within subnational governments. Subnational governments are allowed to borrow from banks with little effective control or knowledge of higher levels of government. Enterprises may often start projects and expect oblast or rayon governments to provide financing at a later date. When subnational governments exhaust funds, it is expected that the central government will make up the shortage at least for the more protected spending programs. Evidently, much time is spent in negotiating for extra credits. The central government has little knowledge of all the credits, overdrafts and borrowing that can occur at any given time. All of this demonstrates a lack of control and seems to imply that fiscal discipline is loose and not strongly emphasized.

The high rate of inflation is requiring many adjustments throughout the year in budget plans. Despite those adjustments and the looseness of fiscal controls, managers are often faced with fund shortages. These conditions are risking the kinds of repetitive budgeting often found in much poorer countries. That is, spending managers must not only justify an initial budget, but also find themselves repeatedly rejustifying and rearranging budget plans as cuts are made in allocations. In their efforts to meet volatile changes managers are forced to allow payments to be cut off for the last item of the stream of purchases without regard for significance. In the absence of more specific determinations from higher levels of what should be done and what cannot be financed, distortion of priorities is inevitable.

Budget adjustments are apparently made through a complex process requiring much negotiation between key ministries and the Supreme Rada. The process for increasing the budget is not specified in the budget law as it should be.

If funds allocated for wages are reduced automatically when not used in the previous period, as noted, then managers would be impeded from hiring needed personnel who cannot be found readily. This approach suggests that an appropriate correspondence does not occur between personnel ceilings and the funds necessary to finance them.

Many of these problems argue for the development of a robust Treasury function. Such a function could help overcome these difficulties by centralizing management of State finances in two primary ways:

- Debt Management: This function should have at least two main features. First, it should acquire routinely information about all governmental borrowing and other liabilities. Second, it should manage the issuance of government securities to finance the budget deficit and other activities deemed desirable by the nation. Development of debt management should include formation of a body of rules for borrowing by government entities and for relationships between those government entities and the banking system. That development also includes the facility for forecasting debt amounts and interest rates, for analyzing their consequences and for providing related advice in the development of economic and budget policies.[58]

- Cash Management: This function should aim to attain efficient management of the cash resources that become available to the State. One aspect of more efficient cash management, as noted previously, is to provide for the pooling of funds from all sources in a "general fund" managed centrally. Funds appropriated to local governments would be identified as deriving from the general resources of the State without the difficulties now associated with the detailed and cumbersome revenue sharing process. As funds are expended by governmental entities, they would be drawn on the general fund rather than from specific bank accounts.

  The second aspect of cash management involves the assumption that, as the nation evolves toward a market economy, interest would be paid on all bank deposits which is not now the case for governmental entities. Under this desirable development, deposits of State funds would be managed from the Treasury. Central management of cash deposits means that cash can be shifted among depositories so that idle, excess balances will be minimized. This would permit maximizing interest received on cash balances. It would also permit regulating the flow of cash so that demands are met in a way that minimizes interest paid on borrowing.

  Efficient management of cash also means that the Treasury should oversee the development of procedures for the timely recording and deposit of tax and other revenues, for regulating the timing and handling of payments, and for minimizing and control of imprest and similar cash funds.

[58]While this outline of Treasury debt management functions focuses on internal debt management because of its relation to the problems noted, Treasury debt management functions should also include management of the external debt of the nation.

Classification

Budget expenditures are aggregated into a uniform array of categories that extends through the various levels of government. The central aggregation of this structure contains functional categories that have descended from the previous regime. These categories reflect, as they should, the political, social and economic philosophy of government as it has existed. The main categories include the following:[59]

- Social Protection of the Population (including assistance for families with children, aid for the disabled, pensions, housing subsidies for the elderly, social security, invalid homes, homes for aged, and subsidies for price support of fuel, medicines, transport, etc.)
- Social and Cultural Establishments
  - . Education
  - . Culture
  - . Health care
  - . Physical culture and sports
- Housing and Communal Services
- Science
- State Capital investment in reconstruction
- National Economy (including other capital investment)
- Defense
- Housing for former servicemen
- Legislative, Customs and Taxation
- Courts
- Lawmaking and law enforcement

[59]The listing is not complete; other smaller categories are not identified.

- Payments for the consequences of Chernobyl
- External economic activity
- Interest payments
- Circulating cash
- Other expenditures

Below these primary levels, the classification breakdowns specify categories that list organizations; objects of expenditure, like wages and equipment purchases; projects, like specific building construction units, and, occasionally, activities like "ecological protection".

Problems of Classification. The overall aggregate classification of expenditures is neither useful for macroeconomic analysis nor for public understanding of the budget. The parameters of each aggregate are not well defined and cannot be clear. Capital spending is scattered in various categories, not just in those identified as such. Education costs are not just found under that heading. Spending for agriculture is also scattered under various headings. The transparency of the budget must not be evident and must inhibit public explanations of the budget and related plans.

At the more detailed level, the mixture of objects, specific projects and organizations does not readily permit a focus on the kinds of work being performed. Performance evaluation and progress is not facilitated through the use of budget data. Whenever possible, budget classifications should identify categories that represent performance units which can be related to performance measures, e.g. planting of forests can be related to number of trees planted. While this cannot be done in many instances, classifications can, alternatively, identify work processes or activities, e.g. "Prevention of floods" or "Research to improve agricultural fertilizers". The classifications used in Ukraine do neither very well. Further, the use of a single, common classification does not provide the diverse data needs of a modern state to assess the fiscal, economic and budgetary effects of its costs and its efforts. Development of a more rational, more flexible classification of expenditures is desirable whenever extensive data systems and computer applications can be put in place. One possibility would be to use the standard economic and functional classifications outlined in the IMF Manual of Government Finance Statistics.

## Accounting, Reporting and Audit

Budgetary accounting is hierarchical and relatively simple. Funds drawn from bank accounts are recorded and reported as cash expenditures. Along with cash expenditures, another measure is also recorded and reported called "factual expenditures." These amounts are apparently intended to provide a measure of "true" costs when certain adjustments are taken into account.[60] Factual expenditures provide an understanding of the base on which to build the subsequent quarterly allocation or annual budget proposal. The prescribed accounting system does not record commitments (agreements for future payment) or payment

[60]The adjustments to cash expenditures mentioned by interviewees include the following:

- An addition for an amount equal to taxes withheld on wages, (wages paid are net of taxes withheld);
- A subtraction for the amount of goods paid for but not drawn from inventory, (Presumably, when drawn, the cost would be recorded as a factual expenditure.);
- An adjustment for transfers from or to other budget categories or from extrabudgetary funds.

orders. Spending units are responsible for controlling these floats and for insuring that the resulting stream of expenditures does not exceed budget cash limits. Higher levels are not routinely made aware of these commitments and liabilities.

Funds not used in the fiscal year apparently do not lapse by canceling their authorization. Rules on the disposition of such carryovers are not clear. Similarly, rules are not clear on the use of reserve funds established in the various levels of government.

Reports on financial transactions are generally made to next higher levels once a month for major aggregates and quarterly in the detail outlined in the Smeta. Annual reports close out transactions and are unaudited. While the banking system provided account reporting to the Ministry of Finance until mid-1993, all expenditure reporting has now been taken over by government establishments. At least during a transition period, this is likely to exacerbate late reporting of data to the Ministry of Finance. The delay in reporting is said to interfere with the timely aggregation of complete data.

Accounting units at all levels aggregate data for reporting to higher levels and for information needed by other governmental units. Expenditure amounts reported are reconciled with bank statements. Analysis of reports is extremely narrow, focusing on the differences between budget plans and actual revenues and expenditures. Explanations may be sought as to why budget revenues and expenditures failed to reach budget planning amounts or exceeded them. But any evaluation of performance or assessment of progress toward goals generally takes place outside the budget execution framework or fiscal channels. It is doubtful that such analysis takes place very often even within sectoral Ministries and their channels to local governments and State enterprises. Most accounting units seem quite small and obviously are intended to be used only in a limited way. For example, the accounting office of the MOF has less than 10 persons.

While audit units exist in the finance offices of local governments, a central audit unit has been reestablished within the MOF only recently. The definition of auditing by these units is again limited to the reconciliation of actual transactions to account limits. Post-audits of accounts are not performed. It is said that audits rarely discover evidence of fraud or mishandling of funds. Again, there was evidence that existing audit units were short of staff and were often unable to make audits as often as procedures require.

Problems of Accounting, Reporting and Audit. The fundamental problem is the failure to use accounting, reporting and auditing to relate use of fund resources to work efforts and goals. These processes are perceived simply as ways to aggregate data and check on conformance to budget limits. Little attempt is made through the budget execution process to review the effectiveness of government efforts. Because the system emphasizes conformance to budget limits, incentives are to spend up to those limits not on efficient use of funds. Staffs trained to make analytical evaluations of progress toward objectives do not exist.

Information reaching the center of government is highly aggregative. In some instances, according to an IMF study, data are incomplete because expenditures for certain subsidies to enterprises are reported only up to the amount shown in the budget. Any additional payments appear only in bank records.[61] This fact together with the fact that the classification system does not provide the categorization needed results in a lack of data needed for appropriate economic analysis. To satisfy the need for macroeconomic analysis and the need for a viable system of cash management, more data is needed categorized in a number of different ways.

A single array of expenditure (and income) data is not sufficient to handle the needs of a modern state, particularly if it is to encourage the development of a private sector. The kinds of spending data needed include not only cash expenditures but also other arrays that can be used for economic analysis and other decision purposes. As previously noted, one array of data should cover all governmental spending including spending from extrabudgetary funds.

Another example would the development of data that can be related to the Gross Domestic Product (GDP). This involves the compilation of data distinguishing purchases of goods and services, transfers payments, net interest paid, wages and subsidies on the spending side and taxes on individuals and on corporate enterprises and contributions for social insurance for income. This "income and product" data is commonly developed on an accrual basis although government transactions need not be recorded on that basis. While the formation of this data requires somewhat sophisticated techniques, it need not await the establishment of techniques for measuring GDP in Ukraine.

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[61]International Monetary Fund, Ukraine: Reform of Public Finances, November 16, 1992, p. 58.

Still another useful arrangement of data would categorize expenditures in terms of its potential for yielding benefits over time. Basically, this categorization would divide expenditures between investments which yield long-term benefits and those for operating expenses which provide current benefits. Category gradation can distinguish between expenditures that represent investments in physical capital, like construction, and those that yield a different kind of long term benefits, like research and education.

At the spending unit level, a need exists to be able to make agreements for purchases of goods and services for periods beyond those quarterly or annual periods for which funds have been made available. Longer term agreements can save money. The present system which makes no systematic provision for recording such commitments discourages these kinds of agreements. Conversely, commitments for subsequent payment have to be made, at least for short terms. Yet since they are not recorded within the accounting system, adequate attention cannot be given to their effects. A similar float also exists for authorized payment orders not yet paid. Since control is exercised at the payment withdrawal level, there is always the risk that payment orders, validated as required, will not be honored. Relatively simple accounting systems can be devised that can record commitments and control expenditures on the basis of validated payment orders.

The audit function in the Ukraine fiscal system is too narrowly restricted and is not sufficiently independent. An appropriate audit function should not just focus on conformance to budget limits but should also consider whether funds have been used effectively and have not been used for corrupt or other wrong purposes. The audit function should also be one of the sources of information used to determine the need for adjustment of governmental plans and regulations.

Before accounts are finally closed, it is desirable that they be audited, not only for conformance to budget limits, but also to insure that funds have not been used incorrectly. Such a post-audit is not generally made in the government of Ukraine.

While the Ukraine audit activities are generally subordinate to finance offices, many governments have recognized that audit units should be made independent of those responsible for fiscal activity. This is often accomplished by making the audit unit responsible to the chief executive or the legislature of the applicable level of government rather than to the chief financial officer thereby removing them from the supervision of those whom they audit. Independence of the chief auditor is often further assured by their appointment for relatively long terms, often longer than the term for the Chief Executive.

The lack of clear rules for the handling of funds not used within the fiscal year and for reserves creates the possibility of abuse in their use.

## III. SUGGESTIONS FOR IMPROVEMENT AND ASSISTANCE

### Forecasting and Distributing Revenues

The assistance project can furnish help in training in the techniques of revenue forecasting and economic analysis. One of the concerns of the proposed fiscal analysis unit should be the manner in which resources can appropriately be redistributed among geographic areas and among varied groups and sectors. (See Section 2.)

The project would assist in developing a system and procedures for the establishment of a general fund approach toward fiscal management of State resources. This effort should be one of the primary tasks of the resident adviser on financial management.

- Development of proposal including procedures to be followed and draft of section of Budget law.
- Explanation of proposal to officials and legislators.
- Assistance in implementation.

Expenditure Forecasting and Budget Review

The fiscal analysis units suggested above for the Ministry of Finance and the Supreme Rada could act as a focal point for the raising of general budget, fiscal and economic policy questions and for suggesting alternative responses. Under the leadership of the head of the team, the technical assistance project would develop plans for these fiscal analysis and training in forecasting and budget review.

The technical assistance project would identify specific approaches toward improvement of the evaluation of governmental programs. Under the budget systems adviser:

- A plan would be developed which would aim to devise appropriate performance measures where they would be useful, to demonstrate specific techniques for performance assessment and efficiency review, to suggest desirable changes in the way capital investment projects and other discrete programs are reviewed and approved and to identify less costly alternatives for accomplishing certain economic and social goals.
- Short term advisers would be brought to the Ukraine who would conduct seminars for various budget units to explain techniques for performance assessment and for efficiency review.

- A separate short term adviser would also be called upon to give seminars where approaches for meeting the problems of budget shortages and fiscal stress would be described and discussed.

Allocation and Control

We concur with IMF recommendations for the steps needed to convert to a Department of Treasury and Debt Management within the Ministry of Finance.[62] It is hoped that Ukraine can move to centralization of the system for managing its fund resources. As noted above, the technical assistance project would provide help in that centralization. The project would also aid in the development of appropriate procedures for cash management. Under the adviser for financial management:

- Plans would be developed for an efficient system of cash management and for implementation of the system.

- One short term adviser would be used to assist in the development of the plan, identification of useful techniques and plan implementation and explanation.

Because Ukraine needs to have general rules for the effective use of funds along with the flexibility given managers over management of funds, the assistance project could supply model directives for establishing such rules. In particular, rules are needed to require purchases of goods and services to be made from lowest-cost suppliers of acceptable acquisitions and to prohibit purchases from those who have a family or business relationship with those who authorize purchases. Under direction of the budget systems adviser, a short term adviser would:

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[62]International Monetary Fund, Ukraine: Reform of Public Finance, November 16, 1992, p. 76.

- Obtain and modify, as necessary, model directives for the establishment of procurement and other desirable rules and procedures.
- With the assistance of the resident team, seek agreement on procedural rules to be established based on the model directives.
- Develop detailed rules approved by the government of Ukraine.
- Provide seminars explaining the rules to relevant ministry and other key units.

## Problems of Classification

Varied, clearer and more useful classification systems can be suggested by the technical assistance project which would retain the kinds of distinctions desired by the State. Initially, the project should identify disaggregation that would permit expenditure data to be classified in two primary ways. The first is an economic classification of the type outlined in the IMF Manual of Government Finance Statistics. This classification categorizes expenditures between capital and recurrent spending at the initial level. At a second level, the two groups would be distributed among wages and salaries, purchases of goods and services, transfers, investment spending, etc. This classification, which should apply to extrabudgetary as well as budget accounts, would provide a basis for economic analysis as well as for other statistical purposes.

A second categorization would aim to provide a better focus on the end results of what is being done rather than just the purchases, wages or transfers needed to accomplish that result. It would aggregate into major functions across all levels of government and, to the extent possible at the disaggregated level, identify categories related to performance or to discrete activities. This classification would provide the basis for budget decision-making and for the accounts used for budget execution.

Development of a revised classification system by the project would be directed by the resident adviser for budget. In this effort, the budget systems adviser might appropriately be assisted by knowledgeable individuals from the Ministry of Finance assigned on a temporary basis. The effort would take place approximately as follows:

- Development of classification schemes including fact finding, discussion of ideas and preparation of listings and draft legislation.
- Explanation of proposals and negotiation for approval.
- Development of implementation directives.

## Accounting, Reporting and Audit

As discussed above, the technical assistance project can suggest and explain procedures and analytical techniques for assessment of performance. This would include an expansion of the work of budget execution units to review for progress in performance, for the quality of the effort and for cost efficiency. These actions are a part of the effort outlined above.

With changes in the classification system, a reporting system can be devised that will provide the various arrays of data needed at the center of government to make appropriate economic assessments and plans and to make the budget clearer to the press and to the public. Based upon the two main classifications outlined above, two primary kinds of reports would be developed. The first of these would be based upon the economic classification and would identify various aggregations needed for macroeconomic analysis and for other statistical needs. The second, or budget decision classification, would provide the basis for reporting on budget proposals and for budget execution reports. Budget documents would be presented on the basis of this classification. Public explanations of the budget would use the overall aggregates which would represent Government-wide functions. This reporting effort will represent a derivation of the development of the revised classifications. However, some additional effort will be required to modify the reporting system. Responsibility for this effort would be under the budget systems adviser who again could appropriately use assignees from the Ministry of Finance.

- Preparation of report formats in consultation with the Ministry of Finance and other ministries, the Committee on the Budget of the Supreme Rada, the IMF representative and others.

- Implementation including the development of some procedures.

A relatively simple accounting system, which can record and report commitments and outstanding payment orders as well as cash expenditures can be devised by the technical assistance project. Assistance in modifying the accounting system would be under the financial management adviser assisted by a short-term specialist in accounting. The effort would proceed as follows:

- Development of the general details of a revised system.

- Consultation with the Ministry of Finance and variety of accounting units on the validity of the suggestions.

- Preparation of directives and procedures manuals.

- Discussions and seminars on implementation.

Suggestions for legal requirements and regulations covering unused balances, reserves and supplemental adjustments can also be provided. Both the budget systems and financial management advisers would be involved:

- Preparation of draft language for inclusion in the budget law.
- Discussion with officials of the MOF and the Committee of the Budget of the Supreme Rada.

The technical assistance project can develop recommendations for development of a modern system of external audit in the Ukraine. This should include a proposal that the new central audit unit be placed under the Supreme Rada so as to make the function independent of executive establishments. It would also include ideas for broadening the scope of audit activities so that they determine whether funds have been used ineffectively or fraudulently. Post-audit of books before closure would also be suggested as well as ideas for making audit units more independent.

This effort would be managed by the financial management adviser assisted by two short term specialists in governmental auditing. One of these specialists would be primarily concerned with organization and development of the central audit function:

- Development of specifications for the central audit unit including objectives, organizational structure, relationships with other governmental entities, procedures and draft legislation.
- Consultation with relevant officials to gain approval.
- Assistance in implementation.

A second specialist would concentrate on development of audit units and the audit function seeking, ultimately, the creation of a system of independent auditing throughout the central and local levels of government. This effort would include:

- Development of general specifications for an audit unit that could eventually be located in each Ministry, in each oblast and in some lower level units including objectives, organizational structure and procedures.
- Consultation with relevant officials to gain approval.
- Assistance in the initial implementation by installations in one Ministry and in one oblast (preferably under the pilot project recommended.
- Presentation of seminars explaining the audit technique and its utility.

# SECTION 5: BUDGETING AT THE SUBNATIONAL LEVEL IN UKRAINE

## I. INTRODUCTION AND SUMMARY

Although the Laws on Budget and the Law Local Self-Governance of 1990 altered Ukraine's inter-governmental relations, substantially enhancing the role of local governments in the national economy, the current subnational budgeting system is still largely thrall to the remnants of a central plan. The existing subnational budgeting system seems to consume resources in ways that allow little evaluation of their desirability, effectiveness, efficiency or appropriateness. Some argue that current methods of financing subnational governments undermine stabilization in a variety of ways.[63] The major role of a budgeting system in a market economy -- the effective, efficient funding of most needed services -- is not a formal, routine concerns in the current subnational budgeting system.

The specific purposes of this section are three. The first is to identify all of the elements at the subnational level which will fit into the system of intergovernmental relations presently taking shape in Ukraine by examining the overall current practice and describing components in some detail. The second purpose is to assess the relative strengths and areas of potential improvement of necessary budget elements. The third purpose of this section is to recommend a program of technical assistance and training that can occur in the immediate future to institutionalize optimum policies and processes.

To understand and analyze the subnational budgets in Ukraine it is important to reiterate, from the perspective of those local units, how the formulation of the national and

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[63]IMF Fiscal Affairs Dept report Ukraine: Reform of Public Finances, Kopits and Diamond, November 1992, various citations including Appendix VI, p.78.

consolidated budgets affects them. Therefore, the discussion of the national and consolidated budgets in this section is not intended to restate the section on national budgeting, but to present the law, policy, calendar, process, techniques, instructions, forms, technical assistance and training from the perspective of those at the subnational level.

It is also essential to review the major controls and incentives that were part of the budget system in the former regime and determine if they remain useful to Ukraine as an independent and emerging market economy.

This chapter is organized into several sections. The next section is a short background which will set the various elements of the subnational budgeting system operations. It contains an overview of the Budget Law and the Law of Local Self Governance as the foundations of the entire budgeting process at the subnational level.[64] This section also reviews the roles of the various parts of the government in decision-making and implementation. Subsequent sections will deal individually with subnational budget preparation and adoption; execution and control, including accounting, internal audit and treasury functions; budget evaluation; and an independent audit. In each of these sections, we will first describe the elements of the budgeting as they currently are practiced in oblasts, rayons, cities and smaller areas, then discuss the continued efficacy of extant techniques and suggest possible reforms. Discussion will question the validity of continued use of central planning techniques in the new conditions faced by Ukraine. The

[64] At this time, neither the Constitutional grounding nor relative stable pieces of supplementary legislation has been completely sorted out by Ukraine. Therefore, of the three layers of legal grounding for budgeting that represent international standards, only the Budget Law is supplemented by decrees and administrative rulings at this time.

final section provides a summary of technical assistance in the area of subnational budgeting and finance.

The technical assistance proposed will offer an approach to remedy the larger problems that beset the subnational budgeting processes. Other minor but still pervasive problems such as manual reporting, manual calculating and communications will be addressed throughout the chapter. The problems that emerged at every subnational level that interfere with subnational budgeting playing a positive role include:

- lack of a rational sorting of roles and responsibilities based on a definition of legitimate national interest, subnational interest and common interests;
- budget forecasts that are not based on long-range outlooks, economic realities, or well-based methods of costing;
- expenditures that are not linked to results, efficient returns on investment, or periodic determination of the continued need;
- accounting that is not related to pricing, commitments, or standard classification;
- lack of evaluation and competition for scarce resources;
- lack of independent audit; and
- lack of training and trained staff with analytic skills capable of converting Ukraine's subnational budgeting system into a tool with which to make wise decisions about how to set priorities and move toward stabilization.

## II. BACKGROUND

In the unitary system of Ukraine, the consolidated budget consists of the central budget and the budgets of the 24 oblasts, the Republic of Crimea, and the cities of Kiev and Sebastopol (all called oblast governments for the balance of this report). The oblast budgets consist of expenditures made for the oblast level and an aggregation of the budgets of the rayons subordinate to it. Thus, the 27 oblast budgets consist of an aggregated total of 634 rayon budgets, plus 27 direct oblast budgets. The 634 rayon budgets are also aggregations which include rayon direct expenses and the budgets of the 10,892 cities, towns, settlements and villages under their jurisdictions. Of these four levels, cities (including the peer cities of Kiev and Sebastopol), and towns, villages and settlements are considered at the basic level. As such, they have their own revenue sources; other local governments depend entirely on the tax revenues shared and/or granted by the next higher level of government.

### Legal Foundations

Annual budgets in Ukraine are for the calendar year. The two legal foundations for subnational budgeting are the Law on Budget System of the Ukraine (Budget Law) and the Law on Local Councils of Peoples' Deputies and Local and Regional Self-Government (Local Governance).

The Local Governance Law guarantees that each rada will adopt a plan to provide service and assistance (and the budget to manage it) for its own citizens free of interference from higher levels of government.

### Budget Law

The Budget Law affects the fiscal management of each level of the nation far more directly. It is promulgated each year and drafted by the Ministry of Finance (MOF) at the order of the Cabinet of Ministers for consideration by the Supreme Rada. It outlines the roles and responsibilities of the central, oblast, rayon and local officials.

The Budget Law of 1993 reiterates the intent of the central government to collect revenues and determine redistribution schemes. The Budget Law contains a schedule of requisite submittals and approvals. It asserts the bases on which formulations and sharing will occur. It assigns revenues and expenditures in broad categories and determines the level of aggregation at which appropriations, allocations and accounting will be carried out. It names the taxes to be levied by the central government as well as detailing those which are to be fixed (not shared) and those which are to be regulated (shared between state and oblast). It sets the rates at which each regulated tax will be shared among various levels of budgets.

Unitary Conditions. Further, the Budget Law sets forth conditions that will affect the budget preparation, execution and control, evaluation, and accounting. The Budget Law continues to rely on norms and to centrally set salaries, employee ratios and certain other requirements. It names the Central Bank as treasury. It prescribes a uniform, internationally-acceptable chart of accounts. It calls for a single currency. It calls for a capital budget in additional to an ongoing (operational) budget and it subordinates the former to the latter. It requires that loans or advances used to accommodate cash flow problems be repaid by the end of the budget period. It sets a ceiling on the number, type and rate of taxes, both central and subnational.

Flexibility. Importantly, and very positively, the Budget Law calls for budget preparation, execution and control at the level of appropriation -- thus encouraging local flexibility and resourcefulness. It allows subnational budgets which create surpluses to keep them (except that loans or advances must be repaid and cannot be counted as part of a budget surplus).

Roles Defined. The Budget Law defines roles for the central government: the Cabinet of Ministers through the President proposes a consolidated budget in conformance with the standards set forth in the act previously adopted by the Supreme Rada; the Supreme Rada considers, modifies and finally enacts a Budget Law. Within the executive branch roles for the Ministry of Finance and the Ministry of Economics (MOE) as well as the sectoral ministries are defined.

## Problems with the Budget Law: Budgetary Funding

Beyond very broad functional categories of expenditures to be made by each level of government, there is little clarity of who is responsible for what. Additionally, in the last few years, there has been a trend to move responsibilities for spending to lower levels of government.

Central government revenues are expended directly through Ministries which conduct various programs for the benefit of the citizenry and through inter-governmental transfers to oblasts. For the most part, service is administered at several levels of government on the principle that service is best provided closest to the citizens except where larger or more specialized services are preferable. The budget system is structured on the premise that the central government, enjoying both access to a broader variety of revenue sources and more sophisticated tax administration capability, levies central taxes and distributes portions of the receipts to the oblasts. The central government endeavors to fund whatever shortfall exists in the (central government-approved) oblast-proposed expenditure plan after all local revenues have been applied. This is done primarily through the use of regulating revenues (state levied taxes, the proceeds of which are shared between the state and the oblast) to the extent that central tax collections from that oblast yield the needed amount. Should a deficit projection remain, grants (called subventions) may be awarded. Inter-governmental transfers occur only to the next lower level of government -- central to oblast; oblast to rayon; rayon to town, village, settlement. The law allows subnational governments to borrow from banks without limit to cover deficits and many subnational governments appear to do so -- on a short-term basis for both recurrent and developmental expenses. When bank borrowings are unavailable, subnational governments apply to the next higher level of government for advances or emergency payments.

Through their radas, oblasts develop expenditure estimates for themselves and negotiate and approve those submitted by the rayons subordinate to them. Oblast funding proposals are reviewed by the Ministry of Finance, and by the Supreme Rada as part of the Consolidated Budget. Once the overall funding level is approved by the Supreme Rada (share in regulating taxes and subvention), the oblast rada approves the oblast budget as submitted by the oblast executive. The appropriations are in very broad categories reflecting the major aims of government. Within those categories, oblasts have unlimited flexibility on expenditures except for mandated items and dedicated grants. Oblasts' responsibility to fund rayons greatly parallels the central government-oblast relationship. Likewise, the rayons have parallel budget independence, as do their subordinates.

In 1993 oblast budgets were allocated 39.1 percent of central budget resources.[65] Those central funds provided 44.8 percent of the resources needed for subnational budgets.[66] Relative prosperity varies widely among oblasts. Some are highly industrialized, home to thriving enterprises, like Donetsk and Poltava. Their ability to generate revenues is much stronger than many others. They receive the minimum state regulating revenue share. Nine oblasts (including Crimea and Sebastapol) require the maximum allowable regulating revenue. And five of those require supplementary grants (a subvention) to obtain sufficient revenues to balance their minimum required budgets. Similarly within oblasts, relative wealth varies greatly. Redistribution to an acceptable level of minimum provision is a continuing goal of Ukraine budgeting.

The Budget Law also establishes 14 local fixed taxes[67] and maximum rates at which they may be levied, from which basic level governments may collect revenues. Decisions on which taxes to levy are made by the basic level government. That level also estimates revenues, sending such estimates through the appropriate financial office hierarchy to MOF for consolidation. When determining the amount of central government support to subnational budgets, estimated local revenues are subtracted. Any excess local tax collection may be retained

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[65] "Formation of Local Budgets of Ukraine" a paper prepared and delivered by Stanislav Bukobinsky, MOF at Kharkiv Conference on Financing Local Government June 29, 1993

[66] ibid

[67] 1993 Decree expanded local taxes and fees to allow: hotel fees; car parking fees; market fees; apartment assignment fees; dog licenses; health resort fees; racing fees for participant and on winnings; hippodrome fees; advertising tax; stamp tax; film or TV shoot tax; local auctions, competitions, sales and lotteries; fees for organizing of public services and amenities.

by the basic level government. Further, subnational government may grant tax holidays or reductions to enterprises in their control.

Problems With Budgetary Funds

The budgetary funding system in Ukraine is very complex, quantitatively-focused and replete with redundancy described as control. It requires cumbersome differentiation between revenue sources that are unnecessary for expenditure purposes. It continues to rely on norms as the main inter-regional resource distribution mechanism. Norms, a holdover from a centrally planned economy offer a convoluted base on which to determine the appropriate level of national support to various regions in a market economy. The current use of norms to play this role is flawed because it is neither the fastest, most direct nor the simplest method of determining inter regional equalization. It consumes far too many resources to implement because it uses norms to find sharing rates for regions, relying on extra-budgetary funds, tax holidays and loans to balance inequities. Macroeconomic analysis based partially on demographic data can afford a much more straightforward method.

Additionally, the use of norms in determination of the proposed expenditure plan precludes emphasis on elements recognized internationally to contribute to fiscal stability and wise resource distribution. Because the connection of norms to the purposes for which moneys are being spent are neither universally agreed to nor particularly visible, norms have the affect of compelling compliance in form but without effectiveness. Further, because they substitute for an achievement-based budget request, execution and evaluation cycle, they decrease the ability of the oblast, rayon and district to creatively participate in modeling for public view an alternative service delivery mechanism.

The current methods of budget formulation do not present an array of policy options for consideration to decision-makers, nor do they provide a framework within which to evaluate results. They also fail to fulfill the third major purpose of budget systems -- to give accurate, timely information to decision-makers for broader economic purposes. This is mirrored in the organizational fact of MOF's relatively small staff and its subordination to MOE.

Further, the currently nascent differentiation between capital and operational funding makes it difficult for subnational governments to fulfill their basic purposes. There is only the beginning recognition of the necessity to treat these economically different activities separately. This is a distinction essential in market economies because the financing mechanisms appropriate to these two broad categories of expenditure are vastly different.

As capital projects contain the moneys to build and convert housing, industry and infrastructure, the current legal requirement to cease funding of capital projects in a deficit situation will weaken Ukraine's economy. For the subnational governments, this is especially disabling as housing stock, roads, bridges, dams, sources of electric and water power all lag levels expected in a modern market economy. Budgeting that thus imperils long-term investment while continuing to fund all on-going recurrent costs makes it even more difficult for subnational governments to make strong, positive contributions to the country.

Ukraine needs to reexamine the role of subnational budgets to determine the most appropriate roles and responsibilities for them as Ukraine moves from systems and approaches based on absolute central power to those based on balanced financial management, effective delivery of priority services and efficient investment of government resources in undertakings with a realistically estimated net social return.

These problems are discussed more specifically in the following sections.

## Extra-Budgetary Funding

An unusually large (by international standards) portion of government resources are central extra-budgetary funds, the revenue of which comes from taxes on payrolls of 52 percent. More than one in four Ukrainians receive a pension from this source. Nine of every ten families with children under the age of six receive subsidy payments this way. The Budget Law requires the establishment of one extra-budgetary fund at the basic level: each city, town, village and settlement must create an extra-budgetary fund in which to deposit their local revenues -- local taxes, etc. Extra-budgetary funds are more flexible than budgeted ones because they are not subject to the same open inspection, execution controls and audit requirements. When they represent a large proportion of general government resources and are not displayed as part of the budget information, they also increase the difficulty in using the budget for macroeconomic analysis and balance.

## Problems With Extra-Budgetary Funding

The use of a general fund is widely practiced throughout the world for two reasons: it assures integrity and equality of consideration and because of the improvements it allows in cash management, central distribution of revenues on a variety of bases, increased managerial flexibility and concomitant decreased administrative costs and burdens. Conversely, for the last consideration alone, continued dedication of specific revenues retains the burden of significant non-productive arithmetic paperwork (which in Ukraine's non-computerized subnational budgeting adds hundred of thousands of hours of labor) which does not appear to result in any additional control.

Extra-budgetary funds are more flexible than budgeted funds because they are not subject to the same degree of review, scrutiny, time-consuming approvals. Of course, that means they often lack accountability. Throughout the world, they are formed when such increased flexibility is essential and if their revenue source is directly related to a single purpose. The rationale is that such singleness of purpose makes the competition of a general budget cycle (in which competing needs vie for scarce resources on an annual basis) unnecessary for them. The largest of these funds are the Pension and Social Insurance Fund which is financed by a 37 percent dedicated payroll tax and the Employment Fund which is also financed by a dedicated payroll tax, albeit of only 3 percent. While the relationship of pension and employment services to enterprises who pay this tax is direct, the same cannot be claimed for the various income subsidies.

While many governments use off-budget funding for social security payments to citizens, Ukraine's high proportion increases the cost of goods, making them less able to compete in external markets. Since roughly one third of the general government expenditures for various social services occur through these funds, their separation from a market-oriented budget process complicates priority setting. In a country with an emerging market economy, the need for the central government to be able to understand, track and evaluate all government resource distribution may outweigh the advantage of such dedicated funding.

There is widespread, but not uniform subnational use of extra-budgetary funds. The city of Kharkov operates 8 extra-budgetary funds as well as a currency fund. Since governments at the local level also grant enterprises tax holidays, the existence of subnational extra-budgetary funds may result in substitution of fees which can be retained locally for full assessment of central taxes. Subnational extra-budgetary funds are subject to all the same negatives: inefficiencies of targeted uses despite other needs in time of economic crisis, less openness than budgeted funds and less accountability. In the Donetsk region in 1992 and the first quarter of 1993, regional coal industry enterprises paid more than 50 billion coupons to extra-budgetary funds in ways publicly questioned by the head of the Donetsk Oblast Finance Department in the Conference on Local Government and Infrastructure Finance in June 1993.[68] The peer city of Kiev operates extra-budgetary funds, but displays them for informational purposes with their budget and subjects them to the same audit requirements of all other funds.

Appropriate use of extra-budgetary funds at all levels of government must be predicated on their inclusion as government expenditures for macro-economic analysis and their being subject to an outside, independent audit for accountability.

## III. BUDGET FORMULATION, SUBMISSION AND ADOPTION

Legally, the budget process has a number of steps. In practice, negotiations over the acceptable required expenditure estimate results in a guaranteed funding level. The expenditure forecast is virtually the only portion of the budget process in which there is negotiation and

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[68] Michael Pabat, head, Donetsk Oblast Financial Department in Local Government and Infrastructure Finance in Donetsk: The Current Situation, presented in Kharkiv June 29, 1993.

discussion by multiple levels of government. In practice, once the Supreme Rada approves a minimum expenditure requirement, all other decisions -- tax, their kinds, rates and shares, and subventions will be adjusted to accommodate delivery of the requisite revenue.

The proposed minimum expenditure request go to rayon, then oblast and finally to MOF where negotiations occur at each step. Once the Supreme Rada approves the level of funding (tax sharing and subvention) for each oblast, the oblast finance department reworks the expenditure requirements submitted into a budget for the oblast government. It includes sharing rates and subventions for the rayons. After approval by the oblast rada, a parallel process occurs at the rayon level.

Thus, the single upward flow of information/request is the calculation, according to norms, of the minimum expenditure requirement.

Budget Formulation

Expenditure Forecast as the Foundation. The annual development of the four-level unified budget for Ukraine begins each year with the adoption of a budget law by the Supreme Rada, usually in the spring, which outlines the main purposes as well as the processes to be followed.

The subnational budget process begins with an expenditure forecast which is formulated using norms. Norms are a series of ratios and prescriptions that dictate how much of what kind of resources are applied in many places. Norms cover such diverse things as student-teacher ratios and grams of bread per hospital patient. The norms are developed by the National Academy of Sciences - Economics Institute (except for those for education, which are developed by the Pedagogical Institute). The Academy applies economic formulae to prior year data supplied by the Ministry of Statistics.[69] The norms are approved by the Ministry of Economics and supplied to MOF. There follow negotiations with sectoral ministers and/or subnational governments seeking adjustment. MOF distributes finalized norms[70] and instructions for completion of proposed budget expenditures to the oblasts. Norms for each major expenditure group are 15-20 pages long. Oblast finance departments distribute the full set of instructions to the rayons, offering a training session to aid implementation. Oblasts and rayons may add their own norms so long as they conform to the central ones.

Each level of government calculates the norms individually, negotiating for changes it desires with the next level. Calculations are done manually in all but the largest cities. Even in Kiev and MOF, the computerization used is rudimentary. The process is intensively arithmetic, cumbersome, tedious and time-consuming. It is strictly quantitative. Transmittal to the next level of government for negotiation is accomplished on paper, using carbons or typed or handwritten forms.

The negotiations that occur following submission are the only opportunity for substantive discussion in this process before an expenditure ceiling is set.

Revenue Estimating -- An Arithmetic Exercise. Prescribed expenditure is the controlling criterion in budget proposal development. Indeed, the finance office of either oblast, rayon or

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[69] Enterprises make quarterly reports on paper to MOS rayon offices. MOS oblast offices consolidate those reports. MOS centrally consolidates their oblast reports.

[70] Budget officials at rayon, oblast, MOF and the Supreme Rada indicate dissatisfaction with the norms as they currently exist. There is currently underway a project to revise them - Rada budget staff indicated it may be a 5 - 10 year undertaking.

smaller town, village or settlement estimates revenue collection only to help the central government ascertain what set of inter-government transfers (sharing of certain taxes in varying percentages; subsidy; additional grant) will be necessary to meet the state's commitment to fund the budget.

Control over revenues by the finance offices is virtually non-existent. The State Tax Service (STS), which is the central government's tax administration department is responsible for all tax collections. The Central Bank acts as treasury by dividing taxes among levels of government and by determining the speed of cash flow. The single important function of local budgets over central revenues is the granting of holidays to enterprises within their jurisdictions.

Central Control Through Norms for Wages, Mandated Expenditures. Despite the legal independence of subnational governments' budgets, the effect of centrally controlled wages and employee ratios is to limit discretionary spending considerably. Much of the money that flows from the Republican government to the subnational budgets can be considered funding for national programs to be carried out locally.

Control over these functions is maintained through central determination of the numbers, types and mandated salaries for workers, and feeding allowances (per student or per patient, etc.). These expenditures account for more than 2/3 of most local budgets. For example, Ministry of Education norms determine an amount of money available per child for school lunches, the amounts of teacher salaries and the student teacher-ratio. None of those can be altered locally, but most other categories of expenditures can.

Independent budget formulation then applies to a minority of oblast and rayon expenditures.

Lobbying to Increase Entitlement. Because the real bottom line in subnational budgeting occurs when the expenditure plan level is approved by MOF (with the commitment to fund it), that is where most attempts are made to increase entitlements. Budget officials at the republic, oblast, and rayon levels attempt to secure exceptions, dispensations to the norms from the Cabinet of Ministers, from their own members of the Supreme Rada or others similarly situated. The venue for increasing the central contribution to their bottom line is negotiations over the proper inflation adjustment factors with the next highest level of budget office during the submission of the expenditure forecast.

## Problems With Formulation

Problems With the Expenditure Forecast. There are three kinds of problems with the expenditure forecast as it occurs in the subnational budgeting system:

- it lacks macroeconomic validity,
- it is resource-intensive and quantitative, and
- it is rigid and biased toward increase.

The expenditure forcast is a single year budget estimate of how inflation, increased demand and population will alter the prior year's expenditures. It bears only little relationship to changing market realities and prospects. It employs no modern forecasting techniques. It is not a valuable aid in adding a macroeconomic perspective to budget preparation.

MOF should develop the capacity (in terms of computerization and trained analytic staff) to prepare actual forecasts. The continuation of much of this process under the aegis of MOE, and therefore separate from those who work with the budgets, does not allow for the development of a macroeconomic emphasis in MOF where it is most needed to make the budget a useful tool for domestic price stability and international competitiveness.

The expenditure forecast is based on ratios instead of priorities. Nonetheless, this intensive arithmetic effort to update the norms and translate them onto forms distributed by the finance department of the oblast is of key importance, since it becomes the fundable budget total for the next year, the revenue grand total which the Budget Law promises to match with shared central revenues, subsidies and grants after the locality has applied available local revenues.

The paper-intensive, arithmetic nature of the calculations uses most of the time available from finance department staff for budget formulation. There is no routine procedure at any level of budgeting for reviewing former allocations for effectiveness, continued need, etc. Nor is there any institutionalized mode of setting priorities, considering alternate means of service provision, or assessing efficiency and effectiveness.

Expenditure forecasting theoretically occurs at each level of the subnational structure. In practice, beyond the rayon and city level, there is seldom staff to do the cumbersome calculations and paper work required -- the forms and instructions are issued on paper, calculated manually, and typed with carbon copies for submission to the next higher level. However it does occur independently at the rayon, oblast and central levels. Thousands of hours are spent on the arithmetic. Because they form the basis for negotiating -- staff emphasis is on calculation. Negotiations carried on in such an atmosphere are unlikely to concern benefit-cost analyses, financially prudent investments for net social gain. The time, energy and skill required exhaust the finance staff, form adversarial relationships with program experts and artificially concentrate on arbitrary numbers instead of results.

Ukraine would be much better served by a budget preparation process that arrayed results-oriented programs, services, and investments with their costs. The purpose of such an approach would require no more time or staff, but it would require retraining and perhaps, redeployment. The result would be a series of choices with their price tags from which policy-makers could choose.

The expenditure forecast does not introduce any fiscal restraint. As a resource management technique, budget formulation using norms enjoys limited utility for a government which must meet escalating requests for services with limited financial resources in a fair manner. Since norms tend to be prior year expenses adjusted for inflation, initial stages of budget preparation tend to assume a growth factor.

There is neither instruction nor incentive to analyze services to determine if there are more efficient and effective ways of achieving desired results. In fact, systems structured this way are often indifferent to results. They rely on an implied connection between the norms and desired achievement. Determination of individual and composite entitlement, transfers of funds among levels of government and the size and nature of distribution of the grant pool each tend to reinforce local spending that is unlikely to result in achievement of a well defined set of objectives.

Gradual transition to a subnational budget effort that sets priorities for meeting local needs in the most effective manner, encompasses development by staff of choices for decision-makers among models, and lays out costs and consequences of various approaches will be much more helpful.

Problems With Revenue Estimating. There are several weaknesses in the revenue estimating portion of the current budgeting system in Ukraine:

- it is neither reliable nor long-range in its projections,
- it occurs after policy-setting, and
- it has unintended effects.

Revenue estimation is based on old, unreliable methods. Like expenditure estimating, this process does not meet the definition of modern forecasting. MOF's revenue forecast is an interpolation of MOE's economic forecasts and STS's collections data. It is done for each tax, using very little computerization, thus accuracy and timeliness suffer.

Revenue forecasting can be an important contributor to financial stability. Ukraine should employ more modern methods to assure that a basis exists for cash management. Trend analysis and payment patterns should affect decisions about revenue sharing, collection schedules, and enforcement efforts as well as providing essential timing information.

Current revenue estimation is limited in scope. Without more complete modeling and analysis, revenue forecasts can simply serve a calculation purpose. They need to be more complete in their range and more long-term so that they may be used in the development of a tax policy that is not merely reactive to expenditure estimate. The current process does little to display differing macroeconomic effects of various taxes.

Revenue estimation still provides little predictability for the subnational governments because sharing rates may be altered each year. This is an unstable base on which to build subnational budgets. Although hyper-inflation may preclude multi-year sharing rates now, this should be considered in the future, as less emergency supplement can be demanded by local governments which can build on a stable base.

Further, because collection and cash flow information is handled apart from the subnational budget offices without an adequate communications link, the budget offices do not adjust their spending to avoid borrowing. A better revenue forecast could be updated to be utilized as a useful cash management tool to bring down the cost of borrowings.

Problems With Central Control Through Norms. There are three types of problems using norms and mandates to achieve central control:

- confusion of purpose and appearance of non-support of the Law on Local Self Government,
- rigidly required mandatory expenditures despite economic strain, and
- loss of efficiency achievable through subnational budget independence.

Rather than using a complete set of norms, the government should use a simpler approach to avoid confusion and gain support and public acceptance. Elsewhere in the world there are two separable types of central government funding to subnational governments: revenue-sharing to be used at the discretion of the subnational entity (and usually determined by some demographic analysis of need) and payments for the subnational government to deliver nationally mandated services. For the first type of central support to subnational governments, budget independence will assure efficiency in the use of resources. Such budget independence must eventually include greater subnational revenue-raising capacity.

For payments to the subnational government, the central government would be wise to determine the outcomes required, cap administrative expenses and set service provision standards. This would not be in conflict with budget independence. Nor would a shared proportionate funding, which acts as an incentive for fiscal restraint and efficient, effective administration, be inimical to subnational budget independence in the funding common interests.

The application of norms implies a type of budget rigidity that may be unaffordable during transition. Further, with norms there is no incentive built in for fiscal restraint. Because the norms are externally imposed, they encourage managers to refuse accountability for results, savings, and efficiency -- managers may feel comfortable just sticking to the norms. Norms, as a basis of expenditure forecast formulation, lead to increases to accommodate rising prices and new demands. There is no countervailing force seeking discontinuation of obsolete services, approaches that do not work or subsidies without need. In broader economic terms, neither the portion of the nation's wealth that can safely be devoted to governmental purposes nor efforts to combat inflation are considered.

Continued insistence on maintaining past practices regardless of the new realities may not be desirable or possible. The norms for education funding cited above, for example, gave the result for an oblast of 924 schools with only 1100 classrooms. There is no more expensive way to educate children than in one classroom schools: financially and in terms of educational achievement. A rayon within this oblast has an annual education budget of 600 million, consisting of 83 percent of protected items (67 percent salaries; 16 percent food, medical supplies). The first half year expenditures were 500 million. The remaining 17 percent of the budget allocated for fuel and supplies (paper, pencils, books) could be reduced, but the rayon was not permitted to consolidate schools, share teachers or make other innovative attempts to get better value for their investments.

The application of norms inhibits the achievement of efficiency associated with fiscal decentralization. The substantial independence of levels of government has resulted, worldwide, in the most efficient distribution of resources. By retaining so many mandated expenditures, Ukraine cannot take advantage of the creativity and special knowledge that resides in its regions and localities. Further, the continuation of such mandates entitles the subnational budgets to increases when originally available funding is exhausted, increasing pressure on the central budget.

*De Facto* central control by the retention of mandated expenditures and activities should be decreased. It must be accompanied by a sorting out of responsibilities and accountability. Since Ukraine has not yet clearly sorted out roles and responsibilities, legally-required budget non-interference is confusing. For the independence to be truly beneficial, intergovernmental relations must develop into a sharing of responsibilities that is simple, clear, comprehensive and acceptable to the general public. All levels of government must contribute to fiscal solvency as well as developing the economy in other ways and providing a social safety net.

Until fiscal decentralization is clearly defined there will be those who accuse the subnational governments of having too many resources and too much independence and others who claim inadequate funding and interference. All and none can be right when there is no standard by which to judge.

Many budget outcomes, at least at the subnational level, appear to be due to the lobbying ability of local officials and their representatives. While lobbying for funding occurs everywhere, public policy choices are better informed by lobbying that is substantive, programmatic or qualitative in its appeal. Further, because lobbying exists everywhere, it is generally considered good public policy to create an open forum for it -- to avoid or at least diminish to potential for bribery, fraud, abuse or other corruption. When the forum is available to all, the public choice making is illuminated and there is no preferential treatment.

## Budget Submission and Adoption

Only the rada for each government may accept, reject or modify its budget. No budget proposal is considered by any level of government, until the higher level adopts its budget specifying expenditure totals and sharing rates for those governments in its jurisdiction. Once it is adopted, a budget can only be altered with rada approval. Recent practice has included overdrafts and borrowings with and without rada approval.

Budget adoption occurs in descending hierarchical order. The Supreme Rada passes a budget and sends it to MOF for implementation. MOF translates the legislation back into the sectoral ministry and provides oblasts with the revenue sharing funds adopted in the budget. The same process is repeated at the oblast level vis-a-vis the rayon and city governments.

Every oblast finance office develops a budget proposal, responsive to the needs of its citizens, within the norms, and the approved levels of funding. It is reviewed by the President's representative, who takes the role formerly occupied by the executive committee of the rada. After review, the budget is submitted to the oblast rada.

A similar process occurs at the rayon level after the oblast rada has approved a budget containing its sharing rates and funding levels.

Problems With Budget Submission and Adoption

Key decisions about the budget have already been made by the time it reaches the level of government where elected officials formally consider what efforts most require public funding. The total amount of higher level support and its sources have been determined. Mandated expenditures must be followed. The amount of subnational independence is limited. Discretionary spending decisions apparently affect less than 1/3 of the budget.

Further, the ability to raise local revenue is limited to the types and maximum rates of taxes approved by the Supreme Rada, regardless of local capacity or need. There is also questionable incentive to raise local taxes, as collection up to estimated totals merely decreases central support.

Timing is also an issue. Budgets are passed late. Change seems to occur increasingly frequently -- the ability of subnational governments to plan at all is severely limited. Their uncertainty of what will happen nationally hampers their ability to make local adjustments. Subnational governments express great concern for rebuilding infrastructure to attract private investment capital while meeting peoples' need for housing, transportation and power. Change, especially rapid, unperfected change scares off investors. Without being able to redistribute responsibilities so that government need not handle them all, healthy economic transition cannot proceed.

A budget process that substituted bottoms-up budget proposal submission responsive to expenditure targets would contribute more to fiscal federalism, efficiency and macroeconomic stabilization.

## IV. BUDGET EXECUTION -- CLASSIFICATION, ALLOCATION, CONTROL AND ACCOUNTING

Budget execution in the current subnational budgeting system includes classification, allocation, control and reporting. All of them are geared largely to the attainment of quantitative targets.

### Classification

Budget classification serves two main purposes for governments throughout the world: its summarization provides a framework for making major public policy choices; and it allows for administrative, analytic, and allocation decisions to be based on fair comparisons. It must be sufficiently detailed and it must be applied consistently.

Economic analysis and budget control and monitoring are most efficiently attained with use of a classification that contains both economic and functional breakdowns and that is applied to all government resources consistently -- central, subnational and extra budgetary funds.

Subnational budgeting uses the classification system devised in the former regime. It is functional in nature, that is, it describes the function meant to be accomplished by the expenditure -- national economy, social and cultural, national defense, or state authority and control. It mirrors the categories in the old central plan and adds to them a number of categories of far narrower scope. It has not increased the detail for 'nonproductive services' which include health education and welfare spending and encompass a significant portion of the budget. More detail needs to be added, both to meet international standards and to facilitate future policy choices.

There is no economic classification in the current system. Usually, three levels exist: one which separates operating expenses from capital; a second level that defines economic category, e.g. wages, goods and services, equipment; and a third level of definition.

## Problems With Classification

The current classification scheme is not sufficiently detailed in its functional categories to be of real use in understanding expenditures or for economic analysis. For example, one of the pressing questions facing Ukraine is how communal services currently under the aegis SOEs will be handled with privatization. The current budget classification will yield no easy answers. Likewise, an analysis of the effect of a wage increase on various parts of the economy is difficult to gauge under the current classification system.

Identical execution of capital and operating budgets occurs. This leads to non-standard deficit calculations, inappropriate financing mechanisms, and out-of-context decisions for a market economy.

Although a budget classification cannot be undertaken immediately, a sound first step is to immediately institute the basic level of economic classification. This year's Budget Law separates capital or development budget from recurrent or operating budget, expenditure classification will reinforce this. It is especially important to begin to supplement functional classification with elementary economic classification to begin the lengthy process of redirecting staff energy to important considerations for a market economy.

Budget Allocation and Monitoring

Although budget independence requires that budgets be controlled by the level of government that adopts them, there is considerable oversight by higher levels which shares funds with it. Allocation and monitoring both occur by the higher level of government. Virtually all allocation and monitoring activities are in relationship to the Smeta, or estimate of expenditures by quarter, broken down into fairly detailed spending categories that are in conformance with the budget submission. The expenditure Smeta is developed at the time the budget is adopted. It is accompanied by detailes instructions for implementation.

Budget allocations are made at the oblast and rayon finance offices according to a formula -- 1/4 of the annual budget is made available for expenditure each quarter unless the timing of certain expenses dictates a deviation from that pattern. Budget office staff authorize the banks to transfer moneys to the spending authority's (sectoral department or lower level of government) bank account after the receipt of a request which stays within the aggregate quarterly allotment. The approval of requests for funds within the budgeted amount are routinely approved by the oblast and rayon finance staff. Approvals are not dependent on any other external factors -- inflation, price rises, etc. Until recently, there were no grounds on which the oblast, rayon or even MOF staff denied or delayed allocation requests that stayed within budget for the quarter. In practice, the hyper-inflation of recent times has made borrowing from subsequent quarters almost *pro forma*. To increase expenditure control, there is a new requirement that the finance office may only approve allocation requests if revenues have been collected which will pay them.

Bank reports are received by the oblast or rayon finance staff every two weeks showing cash expenditures. Staff spends most of the rest of their time reconciling agency reports of expenditure with bank draw-downs (manually, after-the-fact) and reporting those on a monthly basis to the next higher level of finance office (manually, after-the-fact, on paper).

Quarterly, spending authorities submit reports on staffing levels to their budget office. Monitoring consists of checking reported hires to the Smeta numbers to determine if there are deviations.

Monitoring activities consist solely of checking to determine if actual expenditures are within plan and justifying deviations when they occur. None of the allocation or monitoring activities at finance offices in the oblasts or rayons extend beyond checking for conformity with the approved plan. Requiring decreases or delays of expenditures were ideas repellent to those oblast and rayon staff interviewed. This is partially because inflation makes the estimates unrealistic, partially because the finance offices see their roles almost solely as bookkeeping and consider financial management intrusive, and partially because staff have not been trained in how to use budget as a control and adjustment mechanism. Perhaps equally important to all the above, the current paper-intensive procedures exhaust even the most dedicated, leaving them with no time to think about what else they might do.

Problems With Allocation and Monitoring

Because the allocation process has been responsive only to the expenditure plan, and then only in a permissive sense, it has not been used to curb expenditures in response to weak revenue collections or changing market conditions. Spending up to the entire year's allocation has resulted in borrowings by many subnational governments and pleas to the central government for additional funds.

The attempt to link revenues to expenditures by the new requirement for revenue to have been collected is, in practical terms, unlikely to be effective -- as neither the Central Bank nor the STS communicate with finance offices at the oblast and rayon levels on a daily basis to inform them of current collections. Further, from our interviews, it appears that the Central Bank fairly routinely allows draw-downs to the maximum amount in the budget. If this new expenditure limitation is to work, more communication will have to occur between those who deal with revenue and those who spend.

Spending Controls

Centrally-mandated wage controls are the most important budget control. Price controls have been lifted.

There are no requirements for competitive bids on goods and services, central buying authority, conflict of interest protections. There is no set of legal contract laws that assure delivery of what is ordered or to guarantee price and quality. There is no requirement for worth, benefit or satisfaction in exchange for payment. There are few internal control procedures in place which can be routinely monitored, except for cash transactions (which require counter-signatures).

Budget officials at each level expressed dismay at the linking of revenue shortfalls to a concomitant expenditure cutback or delay. In each discussion, the budget official's initial response was that the central government must come up with additional moneys to remedy any shortfall, be it caused by emergency, inflation, etc. Thus, budget officials choose to interpret the requirement to balance their budget by year end as making a plea for supplement, subvention, or loan or credit.

In one rayon where expenditures were at 90 percent of the annual limit for the first six months of 1993, there was no plan in place to curb spending. The fact that this rayon had lost its largest land tax payer (and with it 90 percent of its local revenues) had not yet been approached either by the rayon alone, nor with the oblast - except that the oblast carried to the central government the plea for restitution.

The same rayon, however, has clearly made sacrifices. The new rayon office building in which the administrative offices were housed, and where we met, had been "underbuilt" because of budget difficulties; it had no plumbing. In a different oblast, we passed hundreds of unfinished building sites.

All levels of government may plan and approve budget deficits. The new law clarifies that the intent of this is to allow cash management[71] by requiring the budget deficit to be erased by the close of the year.

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[71] The main source of basic level government fixed revenue is the land tax. It is collected in October.

Problems With Spending Controls

The most important spending control -- centrally-controlled salaries -- is one that raises spending levels. There are no spending rules that encourage competition or guard against fraud, waste or corruption, nor is there competitive purchasing regulation which can achieve efficiency and effectiveness. In short, the budget control exercised during budget execution is appropriate to the previous central planned economy and fails to provide needed control in an economy without price controls.

Ukraine needs to develop a new set of spending controls that reinforce the link the economy and the budget.

In light of excess aggregate demand and hyper inflation, all subnational budgets should be required to be in balance for operating expenses. Funding gaps should be addressed through expenditure cut-backs, delays, efficiencies, new revenues or, as in the last case, an emergency grant pleas to the central government (which would have the right to reject or fund it). To make this workable, even as a short-term severe measure to assist the transition to market, each oblast and rayon must also have the authority to determine where to make any and all cuts, savings, and new revenues. The right to fund capital (development) projects through appropriate long-term financing methods should be a first step that will lessen the financial pressure in a positive way.

Accounting

The accounting system used by each level of government currently displays all public financial transactions at the point when bank payment is made. This is supplemented by a modification of the materials management system.

Because it is solely cash transaction based, it records none of the previous step in expending funds: authorization, commitment, and payment order. Neither does it record and display payment processing: accounts payable nor accounts receivable.

The accounting system uses the classifications discussed earlier in this section.

It does not include financial information about the extra-budgetary funds, perhaps because of the six month reporting lag for those funds.

The kinds of procedures for assuring that physical assets are most efficiently procured and prudently kept (the lack of which is noted in the sub-section on budget controls) are often a part of the accounting rules.

Problems With Accounting

Accounting in market economies serves as an important management tool as well as a service. It collects, summarizes and arrays data to manage resources in a consistent way on a daily basis and to display the effects of various transactions on the financial position of the government as a whole from year to year.

The current system does not contain the key elements to do that. It cannot assist with cash management by showing idle balances that might be applied to deficit situations. It does not show various payment process steps, thus signaling short-term liabilities or chances to slow payments or quicken collections to avoid a deficit. It does not contain a set of property acquisition and management rules to minimize fraud and abuse and encourage efficiency.

Ukraine can begin the process of developing a useful accounting system -- the economic classification change of capital versus operating being the best first step. Global experience has shown that government accounting systems can gain the requisite control without engaging in the overly complex process of installation of a double-entry, full accrual approach. Technology today can provide the needed controls in pre-audit and post-audit sampling techniques, computer edits and security that were formerly only available through engaging in ponderous, redundant processes.

## V. BUDGET EVALUATION

### Current Budget Evaluation

There is no formal evaluation methodology in the current subnational budgeting system. Instead the system relies on the purported causal relationship between finding and funding the right set of norms and wise allocation of budget resources to certain activities that respond to public need for services at the best cost. Periodic reassessment of the norms used in formulating and executing the budget, therefore, is the only surrogate for routine reexamination of whether the budget is buying the things the country needs most, and whether its getting the best price.

### Problems With Budget Evaluation

In a market economy, where competition plays a key motivating role, more direct evaluation is both possible and desirable. Behavioral scientists as well as organizational development experts assert that people pay attention to that which is measured. Thus, if the input is what norms measure, staff attention will tend to be focused on input. If, on the other hand, desired outcome, performance, and achievement is measured, more effort will be made to do well according to those criteria. Experience in other countries has shown that budget evaluation is an essential element in sound budgeting.

Ukraine can begin to develop policy, procedures and training that will develop incentives and the capacity to question continued government activities; choosing between alternative ways of achieving desired results; subjecting all public investments to a thorough benefit-cost analysis.

## VI. AUDIT

Internal Control and Outside, Independent Audit

When audit is used in budgeting it refers to two separate but related activities: internal auditing and outside, independent audits of closed books.

Internal audit control is an on-going activity to assist the government finance offices to improve budgetary techniques and decision processes. Internal audit consists of a set of activities designed to show accountability for use of funds. Some of these problems are examined in the section concerning budget execution and a recommendation for a comprehensive internal audit system is made.

The audit functions that do exist occur through MOF and the sectoral departments. The STS, for example, audits enterprises. Ukraine, however, has not employed the principle of control through separation, so staff with operational responsibilities perform the audits.

Ukraine subnational budgeting currently lacks an outside independent audit. The utility of such a function is multi-fold:

- it increases public (domestic as well as foreign) confidence in public financial representations,
- it allows comparability of equity across periods, and

- it allows executive flexibility in administering resources because the accountability is assured through such open, independent, regular audits.

Problems With Audit Function

Without an outside, independent annual audit, Ukraine foregoes the full measure of trust that might otherwise be afforded its financial management. Additionally, at their best, audits highlight good and bad financial results, allowing management to improve the effectiveness of their resources utilization.

In general, governments and other organizations have found that a person who does not report to the entity being audited can supply the most objective assessment. Therefore, optimum fulfillment of the function cannot occur within the executive branch.

Because there are currently no reliable accounting systems in place in Ukraine subnational budgeting, it would be precipitous to call for an audit now. However, as the various budget strengthening activities occur, a reliable auditor should evaluate them in order to assure they will meet required standards.

## VII. TECHNICAL ASSISTANCE

Summary of Objectives and Approach

Subnational budgets in Ukraine can benefit immensely from a 3 year technical assistance program directed toward oblast and rayon finance offices with a focus on three things: understanding the economic principles and relationships at work in a market economy; understanding and contributing to the open, informed discussion of new roles and responsibilities for each level of government; and gaining the skills and supports to use analysis for better budgets.

To accomplish these goals, a variety of methods and techniques can be used to reinforce each other:

- training and hands-on mentorship by individuals with expertise in various areas needing attention in the oblasts and rayons,
- in-depth analysis resulting in papers on problems which need study and exposition before policy is decided, and
- development of tools, procedures and manuals that will assist oblasts and rayons carry out their new responsibilities.

An optimum level of effort for one oblast pilot project would include two resident advisors with one of these spending approximately half of the time in a pilot rayon. If two oblasts are chosen as pilots, then there will be a need for four resident advisors. They would be supplemented by visiting trainers and lecturers, who would stay with an oblast or rayon staff person during the implementation of a new technique or process, as well as those who prepare training and procedural manuals and other helpful materials.

All efforts would integrate training elements designed to overcome the three pervasive problems most susceptible to technical assistance: lack of analytic focus; lack of understanding of economic relationships; lack of automation.

To allow pursuit of all other substantive improvements, automation of labor-intensive calculation and reporting through quick, easy PC-based efforts is needed. In order to concentrate on improving budget processes and procedures, fast, cheap ways of doing much of what consumes current staff time can be implemented. Such efforts are not meant to substitute for the eventual need for more sophisticated automation efforts, just to provide significant, quick relief.

This allows the revitalized budget process to occur without adding staff. An automation expert working with the long-term advisors will be required to accomplish these goals. The major focus will be on:

- updating current norms and submitting them electronically, and
- reconciling spending authority bi-monthly submittals and bank records as well as submission to higher level (rayon to oblast; oblast to Ministry of Finance).

Efforts Linked to Specific Problems Discussed in this Chapter

Technical Assistance to Budget Formulation, Submission and Approval. In the area of budget formulation, a long-term advisor would work with the appropriate oblast or rayon staff to develop a new budget formulation process for the oblast or rayon which presented choices to decision-makers about how to uses budget resources. While the specific plan can be developed to meet specific local needs, it must be based on an internationally-accepted pattern of analyzing all investment opportunities and displaying those choices, with price tags, to decision-makers.

The transition from the current quantitative focus would be graduated, making the change easier to accept and absorb in steps. The advisor would be responsible for developing a detailed training and transition plan, acceptable to the locality, that would show the steps to get from the current process on one that has elements needed for success in a market economy. Elements of this training and transition are purposefully numerous as the change in approach (from quantitative for analytic) and the amount of new economic relationships to absorb would otherwise be overwhelming. A gradual movement from old to new is made by this technique.

- Detailing of current preparation process for mutual understanding;
- Arranging seminars and workshops in more beneficial budget preparation;

- Working with finance staffs to prepare for intensive work on defining elements for better process with budget formulation training expert from states;
- Arranging for expert training;
- Review first iteration with staff, getting needed corrections, comments back to expert;
- Choosing pilot program area -- health or human services -- and preparing appropriate staff for training;
- Arranging for program expert to do intensive joint training with program department and finance staff;
- Resident may do similar effort with another program important to locality;
- Budget head (who may delegate to resident) defines local team with lead responsibility;
- Review first iteration with staff of program results;
- Arrange for expert to conduct intensive workshop with finance (Ministry and local) to develop prototype budget formulation process;
- Review with staff and managers prototype developed and presented by experts;
- Make modifications as needed;
- Get approval and sanction to implement;
- Arrange for return of expert to work through with finance staff the initial implementation of the new process;
- Prepare as alternative budget proposal;
- Get feedback;
- Modify as needed; and
- Determine if leadership wishes to substitute for normative up-date in selected areas, only as an addendum, or for replacement on a phased basis.

Two important areas in this technical assistance will be a thorough understanding of how analyze the social return on each proposed public investment and how undertake capital investments in an accountable manner. It will also experiment with formalizing public hearing and lobbying at the subnational level.

This technical assistance will result in a new budget formulation process which carefully examines the underlying assumptions of budget priorities, seeks alternative service delivery mechanisms, and quantifies results and costs whenever practicable. As solid budget proposals are developed, skills and judgment will be gained both on the parts of those designing them and those reviewing them to allow a lifting of the remaining central control. Economic constraints may delay that.

Budget Execution. Technical assistance in the oblast and rayon for budget execution will focus on ways to strengthen classification, allocation, monitoring and control and accounting. Many of these improvements will take hold through the establishment of a new treasury function.

Papers and seminars will educate local officials about the importance of classification in a market system. Increased knowledge of oblast and rayon finance staff will assist national efforts to add an economic dimension to the classification system. In the short term, they can supplement national classification to better serve their own internal management needs.

Allocation models will be built to be responsive to available revenue and inflation factors. Staff can be trained in various techniques that allow them to use the allocation process to ration cash when necessary. They can also learn to link continued allocation with performance standards.

Budget spending rules will be developed that are appropriate to achieve the goals and desires of the oblast and rayon. These can encompass incentives for efficiency and effectiveness as well as guards against waste, corruption and fraud. Particular rules for procurement and retention of goods can be developed along with other internal control regulation. Appropriate purchasing techniques can be chosen, staff trained and manuals compiled for continued use. Coordinated by the resident advisor this can be achieved by the use of government procurement experts providing training for a short period of time.

Training on accounting in a market economy can occur in oblast and rayon offices. This can and should be supplemented by individual expert practitioners who work side by side by local finance staff as they adopt new processes, one step at a time. The first addition should be accounting for the various pre-payment stages of purchase so that more information is gathered about cash position and short term liabilities.

## Budget Evaluation

The technical assistance will develop an inclusive, iterative joint prototype capacity for budget evaluation in the oblast and rayon pilots. Its components would include:

- establishing a climate that recognizes benefits of evaluating results of expenditures;
- building on promised results in budget proposals;
- training of staff in budget evaluation techniques with:
  - emphasis on results that make a difference
  - means that are cheap, fast and non-intrusive
  - qualitative as well as quantitative;
- delivery of training manual, training sessions, forms with:
  - emphasis on evaluation as natural part of budget cycle

- replacement of strictly bookkeeping analysis
- done by real budget staff, no new separate bureaucracy; and

- assuring that subsequent budget formulations incorporate results.

Independent Audit Capacity. An independent audit capacity should be developed outside the oblast or rayon. One possibility will be to hire the services of the central government Treasury. Another and beneficial approach is to train oblast and rayon staff to audit the budgets of rayons or oblast other than their own. This approach combines a number of positive benefits: the training for audit itself increases the entity's financial management capacity; oblasts learn from each other (rayons, too); it is not so threatening or intrusive as being audited by the MOF also largely decides the funds available to the local government.

# SECTION 6: TAX ADMINISTRATION

## I. GENERAL ORGANIZATION AND ALLOCATION OF RESPONSIBILITIES: RAYON AND OBLAST STATE TAX INSPECTORATE OFFICES

At present, the State Tax Inspectorate of Ukraine is organized in a vertical structure that reflects the general structure of government in Ukraine. The Main Tax Inspectorate is located in Kiev. There are 27 regional tax offices (located in the 24 oblasts, the cities of Kiev and Sevastopol and the autonomous region of Crimea) and more than 700 local offices (located in the cities and in each rayon). The State Tax Inspectorate is responsible for administering all taxes imposed in Ukraine, including both major taxes (i.e., the value added tax, the tax on enterprise profits and excise taxes) and minor taxes of a local nature (i.e., the land tax and license fees). Success in fiscal decentralization programs and other areas of fiscal reform will depend, to a large extent, on the existence of an effective tax enforcement apparatus. The effectiveness of the State Tax Inspectorate will depend mostly on targetd programs directed to both the central office and oblast and rayon offices. This section describes the present status of tax administration and offers a program for technical assistance.

### Organizational Structure and Responsibilities of State Tax Inspectorate Rayon and Local Offices

The local offices of the State Tax Inspectorate employ an organizational structure that is largely carried over from the Soviet era.[72] Each local office of the State Tax Inspectorate is

[72] The discussion in the text reflects the organizational structure in effect at the time of writing. The State Tax Inspectorate has adopted a plan to reorganize along functional lines. With technical assistance provided by the International Monetary Fund, the State Tax Inspectorate is expected to begin a pilot project to implement this functional organization in one rayon State Tax Inspectorate office.

divided into departments according to the type of taxpayer (i.e., large enterprise, cooperative, entrepreneur or individual). Within each department, an inspector is assigned to a group of taxpayers. This inspector generally is responsible for handling all matters involving the taxpayers assigned to her, including: (1) giving advice and answers to questions concerning the proper application of the tax laws; (2) examining the correctness of the taxpayer's tax declarations; (3) collecting unpaid taxes; and (4) proposing sanctions where appropriate. In addition, a tax inspector reviews each tax declaration when it is submitted by the taxpayer, and conducts a detailed examination of the supporting documentation for a substantial percentage of taxpayers. Separate departments within the local office are responsible for accounting and for undertaking tax investigations.

Within the oblasts that were visited, more than 90 percent of the State Tax Inspectorate's employees were assigned to the local offices. Although most of the tax revenue collected in the local offices is attributable to the major taxes collected from enterprises (i.e.,., the value added tax, the enterprise income tax and the excise taxes), the staffing of the different department reflects the practice of examining each tax declaration when it is submitted by a taxpayer.

For example, in one rayon that we visited, more than 50 percent of the inspectors were assigned to the department responsible for the land tax and the tax on citizen's wages, notwithstanding the fact that a these taxes represented a relatively small portion of revenues collected by the office.

The local offices are responsible for most of the interaction between taxpayers and the State Tax Inspectorate. Previously, the regional offices had direct responsibility for tax matters relating to enterprises that were subordinate to the oblast (or city) budget. Increasingly, these responsibilities have been shifted to the local offices.

Responsibilities and Organizational Structure of State Tax Inspectorate Oblast and Regional Offices

The principal responsibility of the regional offices of the State Tax Inspectorate is to monitor and supervise the activities of the local offices. The precise manner in which it carries out these responsibilities is not well defined, and will vary from oblast to oblast. Each oblast and regional office, however, will undertake the following tasks.

First, the head of the oblast or regional office appoints the senior officials for each subordinate local office.

Second, tax inspectors assigned to the oblast or regional office will examine the documentary records of selected taxpayers. In general, these examinations are conducted subsequent to the completion of an examination conducted by a local or rayon office. Sometimes, however, tax inspectors from both the oblast and rayon will participate in a combined initial examination. It is unclear how the oblast and regional offices select the taxpayers for examination.

Third, the oblast and regional offices respond to inquiries from the rayon and local State Tax Inspectorate offices concerning the proper application of the tax laws. If necessary, the regional State Tax Inspectorate office will seek guidance from the Main Tax Inspectorate in Kiev.

Fourth, the oblast and regional offices organize training of inspectors from both the regional and local State Tax Inspectorate offices.

## II. PROBLEMS CONCERNING TAX ADMINISTRATION

### Lack of Functional Specialization

Overview of the Problem. Under the current structure, the State Tax Inspectorate is mainly organized by type of tax or by type of taxpayer. In the next few years, the number of enterprises will increase and the number of citizens who are required to file tax declarations will grow. With the increases in the taxpaying population, the current staff will not be able to adequately, accurately, and efficiently handle the workload under their current structure. To cope with the increased demands, the State tax administration will need to allocate its limited resources in a more efficient manner. Most western advisors have suggested that the administrative structure of the State Tax Inspectorate should be reorganized along functional lines. There are several reasons why greater specialization is needed.

First, the current assignment of administrative responsibilities imposes excessive demands on many local tax inspectors. An inspector assigned to work with a group of enterprises must understand both the technical and procedural requirements of each tax law that applies to the enterprise. The recent enactment (and regular revisions) of numerous new tax laws makes it unlikely that each inspector can master the requirements of each law.

Second, each enterprise and entrepreneur files a declaration and makes quarterly computations of tax liability. At each filing, the inspector checks the taxpayer's supporting accounting statements to determine whether the tax and accounting figures are consistent. This is extremely time consuming. Because the State Tax Inspectorate allocates so much of its personnel to these checks, it cannot perform the full range of its other responsibilities (i.e., explaining the tax laws to taxpayers, investigating the correctness of the tax liability reported on the tax declaration, collecting unpaid taxes) in a complete or efficient manner. Most important, it does not have sufficient personnel to conduct more extensive investigations concerning the accuracy of the data reported on the tax declarations.

Third, as the number of enterprises and entrepreneurs increases each year, the State Tax Inspectorate will be unable to continue to provide intense interaction with each taxpayer. Presently, each enterprise/entrepreneur is checked in depth at their place of business at least once every two years. Once again, as the system grows, this will not be feasible. As a result, it will become necessary to decide which functions will be performed for all taxpayers (such as the basic processing of tax declarations and maintaining records of tax payments) and which functions will be applied selectively (such as in-depth investigations of the correctness of the tax declarations). In addition, it will become necessary to determine which inspectors are best suited people for each specialized skill. This will allow them to concentrate on one functional area of tax administration (i.e. inspection, collection, investigation of violation of criminal sanctions, training, management) and will permit the system of tax administration to respond to changes in the taxpaying population and to changes in laws, decrees and instructions.

Fourth, the existing plan of organization makes it difficult to determine the lines of authority within the State Tax Inspectorate. As a result, different local offices of the State Tax Inspectorate may apply differing interpretations of the laws. In addition, the priorities established by senior management of the State Tax Inspectorate may not be effectively implemented.

Existing Procedures Premised on a Small Number of Enterprises and a Simple Withholding System Will Perform Poorly as Taxpayer Population Expands.

Many of the administrative procedures used in the local and regional offices of the State Tax Inspectorate were developed during the Soviet era as part of the central planning process. These procedures are generally based on the manual preparation of paper records, with little, if any, use of computers. Certain of these procedures were adequate in an era when: (1) the principal taxes were turnover taxes and withholding taxes applied to wages; and (2) taxes were collected from a relatively small number of enterprises. As the complexity of the taxes increase and as the population of taxpayers grows, these procedures will need to be revised.

Overview of Existing Procedures. At the present time, each enterprise must register with the local office of the State Tax Inspectorate. It appears that each local office of the State Tax Inspectorate maintains a register of enterprises located within its jurisdiction, and the local office assigns a number to each enterprise on the register. These numbers are used only within the local office.

The procedures used to store tax declarations are not uniform, with the local offices (and different tax inspectors) using their own systems. For example, in several local offices that were visited, all information relating to a taxpayer is contained in a single folder that is kept in the office of the tax inspector assigned to that enterprise. Other offices used a central system for storing tax declarations.

Currently, the procedures used for the payment and collection of taxes rely extensively on the banking system. After an enterprise submits its tax declaration to a tax inspector, the declaration is sent to the office's accounting department, which records the amount of tax liability (or refund) reported. If a tax payment is due, the taxpayer issues an order to its bank, which transfers the tax payment to the account of the State Tax Inspectorate. The bank gives a receipt to the taxpayer. In addition, it prepares a copy of the receipt for the State Tax Inspectorate office. This receipt is used by the State Tax Inspectorate to verify that the tax liability reported on the enterprise's tax declaration has been paid.

Records concerning payment of taxes by enterprises were generally detailed and carefully maintained. In the local offices that were visited, a separate ledger was maintained for each tax. Within the ledger for a particular tax, all payment activities for a single enterprise were recorded on a single page (or on consecutive pages). The entries made in the ledgers were based on records from the banks indicating that tax payments were transferred from the bank account of the enterprises to the bank account of the State Tax Inspectorate.

If a taxpayer reports a tax liability but lacks the financial resources to make payment, the State Tax Inspectorate will allow the taxpayer to make payment at a later date. Permission to defer the payment of taxes is not allowed, however, if the taxpayer has money in its bank account. If a deferred payment is permitted, the taxpayer is required to pay interest and other applicable sanctions. Under economic conditions existing in the immediate past, however, the rate of interest and the applicable sanctions are significantly less than the rate of inflation.

For records other than records of tax payments, the existing procedures are inadequate. For example, each enterprise prepares reports that specify the wages paid to each employee and the amount of tax withheld from the employee's wages. The local offices made no systematic use of these reports, and several local tax officials admitted that they could not ascertain when a citizen was paid wages by more than one enterprise.

Problems and Suggestions for Change. Many of the procedures used in the State Tax Inspectorate need to be changed. For example, as the State Tax Inspectorate adopts functional specialization, different inspectors will need to obtain the tax declarations for a given taxpayer. Consequently, the system for storing documents and records will need to be revised.

In addition, procedures need to be developed that will allow the State Tax Inspectorate to effectively enforce the laws that have been enacted in the last two years. Investigation of the accuracy of an enterprise's VAT tax declaration is possible only if the taxpayer retains invoices that record the identity of the person that sold goods to the enterprise. Similarly, it will be possible to determine the total income of a citizen only if procedures are developed that facilitate this process. Although computerization will ultimately be used in these tasks, it is necessary to develop and refine procedures that do not use computers.

One of the most important steps is to create a nationwide system for identifying taxpayers. Rather than using the taxpayer's name or birthdate as the basis of identification, a number (a "taxpayer identification number") should be assigned to each individual and to each enterprise. A particular number should be assigned to only one taxpayer in Ukraine. For each taxpayer, this number should be used to: (1) record the payment of all taxes; (2) to store tax declarations filed by taxpayers; and (3) to identify taxpayers who were paid salaries (and with respect to whom taxes were withheld by the employer).

In conjunction with the implementation of a taxpayer identification system, better procedures for processing declarations, information, notices, and payments should be designed. In the districts visited, all information relating to a taxpayer is contained in the same folder. Delay in creating effective procedures, especially in light of known increases in workloads will create problems for the State Tax Inspectorate that will limit its effectiveness for years. Effective procedures also generate economic advantages. Payments, notices, check-ups and the collection of unpaid taxes can be completed on a more timely basis.

A further step is to develop a master file which contains comprehensive information concerning a particular tax. For each taxpayer, this file will contain information concerning the filing of tax declarations and the receipt of tax payments (or the payment of refunds to the taxpayer). The master file would also contain a record of all tax transactions for each taxpayer. Initially, the master file would contain a record of tax payments, tax refunds and penalties assessed against the taxpayer. Eventually, information could be added that would allow State Tax Inspectorate officials to identify which taxpayers should have their tax declarations subject to a detailed examination. The development of a master file can begin using manual procedures, which can be computerized as computers become more widely available.

Given the lack of taxpayer identification numbers and the lack of a master file, tax payments should continue to utilize existing procedures: payments are processed through the banking system, with records maintained on paper ledgers.

As other developments are implemented, the tax collection system should be improved. One step that could be undertaken in the short run is to charge interest on tax underpayments that exceeds the rate of inflation. Unless this is done, taxpayers will have an incentive to underreport their tax liability and to delay the payment of taxes. In the long-term other improvements are possible. By using the identification number, the bank and State Tax Authority will be able to quickly identify late payments and to update the accounts of taxpayers. Finally, as computers become more widely available in the State Tax Inspectorate and in the banks, the bank records concerning tax payments should be computerized, with the information transmitted to the State Tax Inspectorate in a computer-readable form.

Although procedures developed in the United States and other countries may provide some guidance, it is important that the procedures be suitable for the laws, institutions and conditions that exist in Ukraine. After these procedures have been designed, they should be implemented first in a pilot program at one or two rayon tax inspectorates. Problems identified in the test districts can be addressed before the systems are implemented throughout Ukraine. After the revised procedures have been tested, they can be implemented at the remaining tax inspectorates.

It is essential that well-designed manual procedures be developed at this point in time. Even if the State Tax Inspectorate plans to expand its use of computers in the near future, procedures must be refined and implemented before they are incorporated into a large scale computer system. Procedures that need to be revised range from the initial coding of declarations and taxpayer information to the final process of storing taxpayer documents. Critical information needs to be identified and forms may need to be modified to allow quick access to important information.

### The State Tax Inspectorate Needs to Reduce the Percentage of Employees Assigned to Work on Minor Taxes

Currently, the local offices of the State Tax Inspectorate assign a relatively large percentage of its inspectors to work on the tax on individual citizens and the land tax. These taxes generate a relatively small amount of tax revenue. This allocation of personnel is a questionable practice for two reasons.

First, the disproportionate allocation of personnel to the minor local taxes reflects the traditional intense interaction of tax inspectors with the taxpayers. As discussed above, the State Tax Inspectorate needs to adjust to the growing population of taxpayers. It is virtually certain that the State Tax Inspectorate will be unable to audit every taxpayer at least every other year. Instead, the State Tax Inspectorate will need to adopt a selective audit program. In developing an audit strategy, it makes sense to allocate a disproportionately large number of tax inspectors to focus on taxes that generate relatively large amount of taxes (such as the value added tax and the excise taxes).

Second, in the long term it may make sense to allocate responsibility for administering the local taxes (including the tax on property ownership) to the oblast or rayon governments. At present, all of the revenue from the land tax is assigned to the rayon in which the property is located.

In other countries, the national tax service focuses its attention and resources on the taxes that are allocated to the national budget. As a result, administrative issues arising under the taxes assigned to the local government level receive inadequate attention. For example, under a modern property tax, the valuation assigned to the property should be adjusted to reflect adequately changes due to inflation or enhancements of the property. Where the national tax service is responsible for administering the local property tax, these adjustments are likely to be made in a manner that fails to reflect regional and property-specific changes in value.

As more property becomes privatized and as a modern property tax develops, consideration should be given to allocating responsibility for administering the local taxes to the oblast or rayon governments. Given the relatively greater importance that these taxes to the subnational levels of government, and their greater familiarity with local conditions and property values, it is likely that these taxes will be administered with greater skill and attention.

## The State Tax Inspectorate Needs to Revise its Approach to Evaluating the Correctness of Tax Declarations

Currently, each enterprise and entrepreneur files a declaration and makes quarterly computations of tax liability. At each of these intervals, the inspector compares the data reported on the tax declaration with accounting data that contains summaries of the taxpayer's income, expense and benefits for this period. Additionally, the correctness of tax declarations are subject to an inspection at the taxpayer's place of business no less than every two years.

The current practices used to examine the correctness of each tax declaration raise serious concerns. First, the practices of examining each enterprise tax declaration when submitted and conducting universal on-site examinations every two years (if not annually) is extremely time consuming. As the taxpaying population grows, this will become an impossible task. The State Tax Inspectorate will need to develop audit selection procedures to choose which taxpayers will have their tax declarations subjected to an in-depth examination.

One of the biggest concerns raised by employees of the State Tax Inspectorate was the existence of income that is not reported on a tax declaration. Although no official estimates of the magnitude of unreported income exists, the officials of the State Tax Inspectorate believe that tax evasion is widespread. The concerns expressed most often involved income of entrepreneurs, street merchants, individuals working more than one jobs and income concealed in other countries.

All tax systems have difficulty locating unreported income. To a certain extent, information made available as a result of implementing other reforms of the tax administration system will facilitate this process. For example, implementing the taxpayer identification numbers, combined with the existing system for reporting wage income can help identify those taxpayers who fail to file declarations or to identify those taxpayers who do not report all income. This system is cost effective, both from the savings of potentially lost revenue by the State and the ease in which it can be administered. The development of this system would take place at a later point in time, after the development of the taxpayer identification system.

Similarly, information obtained from tax declarations of other businesses may facilitate the identification of taxpayers who are likely to have unreported income. For example, enterprises that report a smaller value added tax liability (relative to the enterprise's sales) than comparable enterprises engaged in the same type of business should be selected for an in-depth examination of their tax declarations.

Further, as the State Tax Inspectorate moves towards a system of functional specialization, training programs will be needed to assist the inspectors in the process of examining the correctness of tax declarations. For certain taxpayers, examinations may be limited to the verification of a limited number of income and expense issues. In other cases, inspectors will need to use techniques that will assist them in discovering unreported income.

Taxpayer Services Needs to be Refocused and Redesigned

Existing Taxpayer Services. Under the Ukrainian tax laws, taxpayers are expected to comply with the law without being compelled to do so by an enforcement action. A tax administration system must make sure that taxpayers can understand complex laws. Taxpayers need to know how to file declarations, what records must be kept, where to get information, etc. Information from other countries has shown that providing taxpayer services improves compliance, increases the confidence in the tax system, and reduces taxpayers' burden in complying with tax laws.

The present level of taxpayer services provided by the State Tax Inspectorate is not well designed to meet the needs of either taxpayers or the State Tax Inspectorate. To the extent that the State Tax Inspectorate attempts to educate taxpayers concerning the requirements of the tax laws, it does not assign these tasks to inspectors who are specialists in taxpayer education. Rather, individual inspectors are expected to provide seminars to enterprises that are assigned to them.

More significantly, the level of taxpayer services provided by the State Tax Inspectorate should be enhanced. Taxpayer service is largely limited to explaining the basic requirements of the tax law (i.e., the dates when taxes must be paid and when declarations must be filed) and responding to specific questions from taxpayers. The State Tax Inspectorate has virtually no written material that is given to taxpayers that explains either the procedural requirements of the law or technical provisions of the tax laws. When asked how a new business can learn about the requirements of the tax laws, officials of one rayon State tax Inspectorate office responded that the business should hire an accountant. We were also informed that the rayon office did not give blank copies of tax declarations to taxpayers, and that enterprises were expected to obtain tax declarations from commercial enterprises in Kiev.

Problems and Suggestions for Change. To meet the demands that will be placed upon it in the coming years, the State Tax Inspectorate needs to expand the taxpayer services that it provides. As discussed above, as the taxpaying population increases the State Tax Inspectorate will not be able to provide personal interaction with each taxpayer that is required to file a declaration and pay taxes. One long-term goal of the tax system should be that most taxpayers will become able to comply with the requirements of the tax laws without the need to either (1) consult with tax inspectors or (2) incur the expense of hiring an expert. An essential element of the process of moving towards this goal is the expansion and redesign of the State Tax Inspectorate's taxpayer services. This is especially true in Ukraine, where the tax laws are relatively new and regulations are changing.

First, given the breadth of each inspector's responsibilities and the rapid expansion in the number of new employees of the State Tax Inspectorate, it is unlikely that the typical inspector will be able to perform this educational function in a satisfactory manner. Tax inspectors will have differing levels of experience and understanding of the tax laws. They also will have varying ability to understand taxpayer inquiries and to communicate the responses in a clear and understandable manner.

Second, different tax inspectorates will allocate differing amounts of time and effort to taxpayer education. Taxpayer education is a time consuming activity. When a taxpayer arrives in the tax inspectorate office to seek answers to specific questions, tax inspectorates are interrupted in their performance of other duties. To the extent that taxpayer education is performed by inspectors with many other responsibilities, it is likely that the quality of advice will vary greatly. Consequently, different taxpayers will receive inconsistent interpretations of the tax laws and advice of uneven quality.

For these reasons, taxpayer education should be assigned to individuals who receive specialized training in taxpayer education. If this is done, taxpayer education will not be viewed as a minor responsibility. In addition, specialization will allow the State Tax Inspectorate to create training programs that will result in a more uniform level of assistance. For example, written materials should be developed that taxpayer education specialists can use to respond to the commonly asked questions concerning the particular taxes that are being discussed.

Third, it is also important that written materials be developed that taxpayers can use to fulfill their responsibilities. At present, the only written materials relevant to taxpayer compliance with the tax laws are copies of the tax laws and regulations, and it is often difficult for taxpayers to obtain copies of these materials.

The State Tax Inspectorate needs to develop materials that explain the requirements of the laws and regulations. These materials should be written so that they will be understandable by persons who do not have technical training in the tax law. In addition, declarations (and directions concerning how the declarations should be completed) should be designed so that many taxpayers will be able to understand how to prepare them independently.

<u>The Large Number of New State Tax Inspectorate Employees and the Rapid Changes in Tax Laws Requires an Expanded Program of Employee Training</u>

The number of State Tax Inspectorate employees has increased at a rapid rate since the end of 1991, and it is likely that this rate of growth will continue over the next several years. Consequently, the majority of State Tax Inspectorate employees will have limited experiences with tax laws and with tax administration. To develop public acceptance of the tax laws and to assure an acceptable level of compliance, it is essential that tax inspectors be well trained. In particular, the State Tax Inspectorate must train new employees and continually retrain existing inspectors. As the State Tax Inspectorate moves towards greater functional specialization, the need for specialized training will increase.

The existing training programs are not adequate. Most newly hired employees are sent to Kiev for 24 days of training that is conducted at the Ministry of Finance. Both of the oblasts that were visited have established agreements with local universities to establish programs in taxation. Unfortunately, there is no assurance that graduates of these programs will agree to work with the State Tax Inspectorate following their graduation from the university. In addition to this formal training, the oblast and local offices have established on-the-job training for new employees.

The State Tax Inspectorate needs to develop training programs in all functional areas of tax administration (such as Financial Investigative Techniques, Auditing Techniques, Internal Security Training, Penalty Application, Balance Sheet Audits, Collection Techniques, etc.) These programs need to reflect Ukrainian laws, institutions and conditions. Consideration should also be given to the development of training that is undertaken by correspondence, audio tapes or other means that does not require physical attendance at a central training location in Kiev. It will be important also to develop a continuing education program for inspectors.

## The Flow of Information Between Different Levels of the State Tax Inspectorate is Inadequate and Must be Improved

At present, there is an inadequate transfer of information between the different levels of the State Tax Inspectorate.

First, the principal information that is systematically passed from the main State Tax Inspectorate office in Kiev to the oblast and local offices consists of copies of laws, decrees and instructions. Little guidance is given concerning the relative priorities that should be given to different tax administration tasks. There is also little systematic distribution of guidance concerning the proper interpretation of the tax laws that is less formal than the official instructions.

Second, even to the extent that official pronouncements are disseminated to the local tax offices, there are insufficient copies for the inspectors working in that office. For example, oblast and local State Tax Inspectorate offices typically receive few copies of tax laws, decrees and instructions. As a result, most tax inspectors do not have copies of the laws that they are required to administer. This also makes it difficult (if not impossible) to provide taxpayers with written materials that explain the taxpayer's obligations under the tax laws.

These shortcomings create three related problems. First, the priorities concerning tax administration are not transmitted effectively from the main office of the State Tax Inspectorate to the local offices. As a result, personnel and resources may not be applied in a manner consistent with the desires of the senior management of the State Tax Inspectorate.

Second, the shortage of basic written materials in the local offices exacerbates the inexperience and lack of training of the State Tax Inspectorate's employees. This makes it much more likely that tax inspectors will both interpret the tax law in an incorrect manner and give incorrect advice to taxpayers.

Third, there is no mechanism to obtain and disseminate interpretations of the tax laws that is less formal and less comprehensive than the instructions. To the extent that the main office of the State Tax Inspectorate provides guidance to a local office concerning the proper application of the tax law, this interpretation is not made available to other State Tax Inspectorate offices throughout the country.

The Interrelationship Between Tax Policy and Tax Administration in Ukraine. It is important to understand that tax policy and tax administration are two highly interrelated areas. The effect of a series of tax laws cannot be evaluated by simply examining the statutory language; it is necessary to understand how the laws will be administered. Similarly, the effectiveness of a country's system of tax administration depends on the administrative burdens implicit in the country's tax laws.

It appears that the ability of the State Tax Inspectorate to administer proposed tax laws is not given sufficient consideration when the tax laws are being developed. As a result, substantial additional burdens have been imposed on the local and regional offices of the State Tax Inspectorate, which has exacerbated the problems of tax administration discussed above.

In particular, the State Tax Inspectorate's ability to administer the tax laws has been adversely affected by the following tax policy developments:

Frequent Changes in the Tax Laws. The Value Added Tax, the tax on enterprise income, the tax on citizen's income and the excise taxes were initially enacted at the end of 1991, and were made effective as of January 1, 1992. Each of the these tax laws have been amended at least once, and several have been subject to multiple sets of amendments. These amendments have been made effective almost immediately after enactment. The frequency of change has required retraining of State Tax Inspectorate personnel and reeducation of taxpayers. As discussed above, these are two areas where the State Tax Inspectorate already faces serious problems.

Extensive Use of Tax Preferences Makes Tax Administration More Difficult. The presence of complex provisions makes it much more difficult to administer tax laws. The Ukrainian tax laws contain extensive lists of preferences and multiple tax rates.

Use of Tax Declarations for Individuals. Under the law on the taxation of citizens' income, each citizen taxpayer is required to complete a tax declaration for the year 1993 that will be submitted to the State Tax Inspectorate. Extension of the system of tax declarations to a large percentage of the population will create impossible demands for the system of tax administration.

In particular, the expanded use of tax declarations will increase the number of taxpayers with whom each local State Tax Inspectorate office must deal. In addition, it will require an examination of wage reports from different employers. The State Tax Inspectorate is not currently capable of performing these tasks.

Steps Already Undertaken by the State Tax Inspectorate Towards Restructuring

The State Tax Inspectorate has taken the initial steps to reorganize its structure by function and to undertake other actions that would improve the system of tax administration. Recently, the State Tax Inspectorate proposed, and the Cabinet of Ministers of Ukraine approved, a draft decree under which:

1. the State Tax Inspectorate would reorganize along functional lines, including: tax examination, taxpayer services, collection of taxes; and tax policy;

2. a system for Tax Identification Numbers would be developed and submitted to the Cabinet of Ministers by September 1, 1993;

3. a working group would be formed with representatives from different portions of the Ukrainian economic and business communities to draft a Tax Code for Ukraine;

4. the staff of the State Tax Inspectorate would be increased by more than 100 percent from 1992 to 1995;

5. training programs would be established at Ukrainian educational institutions to provide training for STI managers and specialists; and

6. an automatic data processing system would be developed for the State Tax Inspectorate.

The changes envisioned in this decree, when implemented, would constitute meaningful and substantial improvements to the Ukrainian tax administration system. When implemented, these changes would improve the ability of the State Tax Inspectorate to administer the more complex tax laws as the taxpaying population grows.

## III. PROPOSALS FOR TECHNICAL ASSISTANCE

The State Tax Inspectorate has received advice concerning tax administration from both the United States Treasury Department Tax Advisory Program and from the International

Monetary Fund. The development and approval of the decree on tax administration discussed above demonstrates that the State Tax Inspectorate understands the need for change.

Approval of this agenda for change is a vital first step. Both the State Tax Inspectorate and outside advisors recognize, however, that implementation of these changes will present many difficult challenges. The United States Treasury Department and the International Monetary Fund have ongoing programs to provide technical assistance to meet these challenges. There are many tax administration problems where additional assistance is both needed and will complement the existing technical assistance programs.

In designing a proposed program of technical assistance in the area of tax administration in Ukraine, it is essential that the proposed program be coordinated with the ongoing technical assistance programs discussed above. The senior officials of the State Tax Inspectorate expressed their strong desire that coordination be undertaken. In addition, given the need for extensive technical assistance, the donor institutions want to avoid duplication of effort and inconsistent strategies.

Technical assistance needs in the area of tax administration that are discussed below generally involve the development and implementation of new procedures that will affect large number of employees and taxpayers. As a general matter, these assistance efforts should incorporate pilot programs in which the revised procedures can be tested and evaluated. Use of pilot programs makes it much more likely that new procedures can be implemented nationwide in an orderly and manageable fashion.

While recognizing that an allocation of tasks among the different technical assistance programs would be needed, substantial amounts of technical assistance in the following areas is urgently needed.

## Training of Functional Specialties

Given the rapid growth in the number of State Tax Inspectorate employees and the recent implementation of the tax laws, most State Tax Inspectorate employees have little training. In addition, there is little experience in dealing with such administrative matters as detailed investigation concerning taxpayer compliance with the tax laws and collection of unpaid taxes. Similarly, training will be needed to enable State Tax Inspectorate offices to develop audit selection procedures to choose which taxpayers will have their tax declarations subjected to an in-depth examination.

Technical assistance can provide training in the different functional specialties. Perhaps of greater importance, technical assistance could assist in the design and implementation of training programs for State Tax Inspectorate employees that will be conducted in the future by State Tax Inspectorate personnel. Moreover, this type of technical assistance can reduce the duplication of training programs that has developed in the oblast and regional offices.

## Taxpayer Education and the Development of Educational Tax Forms and Instructions

Under the Ukrainian tax laws, taxpayers are expected to comply with the law without being compelled to do so by an enforcement action. Taxpayers need to know how to file declarations, what records must be kept, where to get information, etc. Information from other countries has shown that providing taxpayer services is likely to improve compliance, increase taxpayer confidence in the tax system, and reduce the taxpayer's burden in complying with tax laws.

Declarations should be designed in a manner which allows many taxpayers to prepare them independently, without the need to incur expenses for an expert to prepare declarations. At present, both the declaration forms and instructions are designed to be understood by tax law specialists. To assist the non-specialist, other written materials should be developed that will enable taxpayers to better understanding the meaning and procedural obligations under the tax laws.

The State Tax Inspectorate has little experience with these matters, and extensive training would be productive.

## Development of Tax Identification Number System

The success of tax administration depends on the ability to gather, with a high degree of accuracy, information contained in declarations filed by taxpayers and, later, by other parties such as banks and employers for each tax period. Documents need to be processed by a system which allows easy identification, filing and retrieval. Although the International Monetary Fund is beginning a pilot program that would include the issuance of tax identification numbers, technical assistance could be productive in this area as well. For example, specialized assistance concerning the approach to computerization might productively complement the IMF's efforts.

Development of Uniform Procedures

In conjunction with the implementation of a taxpayer identification system, better procedures for processing declarations, information, notices, and payments should be designed. It is our understanding that districts (and sometimes individual inspectors) have developed their own procedures to handle these matters. Particularly as the functional organization of the State Tax Inspectorate is implemented, use of uniform procedures will become essential. In addition, uniform procedures will enable the State Tax Inspectorate to quickly identify taxpayers who have stopped filing tax declarations, and to investigation the reasons for this stoppage. This can lead to increased revenue collections. Technical assistance in this area is needed.

## SECTION 7: COMPUTERIZATION IN THE MINISTRY OF FINANCE OF UKRAINE: POTENTIAL AREAS OF TECHNICAL ASSISTANCE

### I. INTRODUCTION

This section reviews the degree of computerization of tax administration, budget procedures and general administration in the MOF, State Tax Inspectorate, and oblast and rayon Finance Departments. It then recommends a plan for technical assistance which takes into account the technical assistance now being provided by other international institutions.

### II. COMPUTERIZATION WITHIN THE MINISTRY OF FINANCE

Information Computing Center

The Information Computing Center of the Ministry of Finance provides computer support to the Ministry. It has been in existence since 1977 and is the department within the Ministry that sets the standards and priorities for computerization and provides computerization support for the entire Ministry. Until 1990, the Information Computing Center relied on the use of an IBM 360-compatible "mainframe" computer,[73] but its use was abandoned after that.

The years of mainframe use concentrated the input of data that were gathered at oblast and rayon tax offices and sent to the central site. Information maintained in the computer was not timely (accounts could only be done on a monthly basis), for a lot of time was lost waiting for the information that was to be entered. The computer system served primarily as a "storage cabinet," with little or no role in tax administration.

[73] The IBM-compatible mainframe was basically an EC equivalent to an IBM 360 architecture and ran standard IBM operating systems.

Eventually, IBM compatible (PC) computers were acquired by the Ministry, the first ones being equivalent to IBM/XT computers with 640K - 1Mb RAM and 20 Mb disks. The early versions of these computers were Russian-made. Today there are 386SX computers as well as 486/DX33 computers available, with 125 PCs in tax administration and 125 in financial areas. However, much of the commercial software running on these computers is not licensed. The computers operate as single user computers (no networking is in use) running the MS-DOS operating system. Microsoft's Foxpro 2.5 is installed on all computers without appropriate licensing and used for all development.

The Information Computing Center has 140 staff. It is organized into three functional departments. These departments provide various programming support for the Ministry, the oblasts, and the rayons.

- The first department determines ways of introducing computers into the tax system. This department develops programs based on the organization of the tax department, i.e., for oblasts and rayons. It produces programs called "ARMs"[74] for the main tax system.

- The second department supports the central department of the Ministry of Finance. They must modify existing programs (over 100) to meet the new functions and criteria of the new budget system.

- The third department does research for oblasts and rayons.

Each oblast has its own computer department and has a programmer staff. The Information Computing Center provides training to oblast staff in the form of a one-month course. There are approximately 30 students per class. The students are trained about ARMs.

[74] ARM stands for "Automatic Working Place."

Tax Service Computer Department

The Tax Service Computerization Department appears to be autonomous and responsible for computerization of tax administration. The Department has practical experience in MS-DOS and FoxPro 2.5. However, a lot of the existing software was developed by the Ministry's Information Computing Center. The director feels that the current data base is not reliable because sometimes the database becomes corrupted or a data file is "dropped out."

Training is one of the greatest concerns in this department, as it is for the Ministry as a whole. Essentially, there is a need for training in operating systems, open system (Unix technology), database management systems, and software engineering methodologies.

The approach of the Department is that information must be processed at the place where it is obtained. They are very much opposed to extra links within the processing system. This certainly was a lesson learned in their early attempts to use a centralized mainframe computer to process information.

The Tax Service Computer Department recognizes the inefficiency of computerizing small rayons and would like to combine these to obtain a network with 2,000 to 3,000 enterprises. By doing this, they will be able to reduce the cost of computerization. This consolidation has been discussed with the Ministry of Finance and there is a plan to accomplish this with changes in administrative structure. This idea is supported by the IMF. However, these proposed changes are still a long way from being implemented.

There is no computerization plan in place within the Tax Service's Computerization Department or the Ministry's Information Computing Center. The Tax Service Computerization Department would very much like to have some experts travel to Kiev to assist in the development of such a plan. It was emphasized that this expertise is needed in the primary stage of the development and they want very much to complete this plan by the end of this year. This plan will guide future computerization beginning in 1994.

The Director of the Computer Department indicated that more technical staff was needed. Currently there are 3 to 4 staff in the oblasts and none in the rayons. They feel that 2 to 3 technical staff are needed in the rayons. The Central Department has 17 people in computerization. They plan to expand and need three times as many people. Practically all current staff have higher education in programming, with three people on the staff having the highest technical education. These high level staff are used for solving technical problems connected with different techniques used here. All of the technical staff have three to four years experience.

A recent approval for the purchase of up to computers (supposedly 5,600) by the Cabinet of Ministers will provide additional computer resources. However, it is not clear what software will be included with this and if there is a specific implementation plan for the use of these computers. Furthermore, deployment and effective use of these computers will require very careful planning and the plan for this should be a part of the computerization plan.

## III. COMPUTERIZED APPLICATIONS

"ARM" Programs. The Information Computing Center has developed a series of programs called "ARMs" that provide for certain aspects of accounting and budget control using Foxpro 2.5 under MS-DOS. Since each one of these programs runs on a single user PC, no sharing of data between computers is possible. This greatly limits the value of the computer use because much manual consolidation must still be done after the computers are used to produce various reports.

One of the major ARMs is a computerized system for state enterprise tax processing. It provides for the input of tax returns and the support of accounts. It is currently only installed in Kiev, but will expand. This ARM has been in progress for two years. It was originally implemented in dbase but later moved to Foxpro. There are fourteen rayons in Kiev that send data to the oblast for entry.

*City of Kiev.* A review of the ARMs for accounting and budget in the City of Kiev was undertaken through a meeting with a programmer and economist in Kiev. There is an ARM in the accountant department and the budget department. These ARMs were developed in the Ministry of Finance after many years of effort. This review indicates that the accounting software is heavily used, particularly for tracking expenditures. The budget ARM did not seem to be as much a part of operations as did the accounting control ARM. While the accounting control arm was heavily used, and accounting data were in folders with computer reports attached, only 80% of the work is done on the computer. The rest of the work is manual consolidation. Both systems suffered greatly from being single user systems (one is used for revenue and one is used for expenditures). Both are obviously first-generation systems that can be substantially improved. However, it appears that the Ministry has technical personnel capable of implementing software and anxious to be trained in new technology. When asked if the data in the computer were used in any way in the preparation of next year's budget, the answer was "no."

There was also in development locally a program to track interest and repayments on bank loans. It was driven by the entry of the following data: bank code, agreement number, amount, yearly percentage of interest, beginning date, ending date, and the account number. The system provided for a display of the daily rate, the number of days, and total interest for any given loan. This software was not yet in production. While this is a very simple system, it demonstrates the ability of technical personnel in the city level to develop software.

*Cherkasi Oblast.* The Cherkasi Oblast is running the ARM for state revenues that was provided by the Ministry of Finance. The system is used to present an "urgent" report on revenue every fifteen days. Information is received from the rayons via telephone or paper transmittal and entered into the oblast's computer (none of the rayons have computer systems). From these data, the urgent reports are produced. The ARM can also produce monthly, quarterly, and semiannual reports. These reports break revenue down by categories of revenue (e.g., income tax, state enterprise revenue, VAT, excise tax, etc.). While there are four people who can enter data, there is only one computer for the entry of state revenues in the Cherkasi Oblast.

There were two other computers in use in Cherkasi, but there were no production programs in use on them. The observation by the programmer in the oblast is that the Ministry-provided programs were not always suitable for the oblast. He was developing an ARM for wages in the oblast which is used to recommend wages for employees.

Future Plans. On July 15, 1993, the Cabinet of Ministers considered improvement of Tax Administration and computerization program of Tax Administration and agreed to purchase (thousands of) computers. Also approved was a way of obtaining more space for the Tax Service by renting places for tax administration. And there will be 67,500 tax administration employees (growing from 32,000). Before September 1, there will be a table of salaries introduced at same pay level as law enforcement. With the Cabinet of Ministers' approval, the structure of tax administration can now be changed. This demonstrates considerable support of the Tax Service by the Government.

## Observations

The ARMs have evolved over time, but are generally first generation systems based mostly on the old Soviet system. They do not fully meet the needs of the oblasts or rayons. Furthermore, they appeared to have no accounting controls in the entry and verification of data. Any future computerization efforts in budget or tax should review the features of the appropriate ARMs in order to identify specific strengths in the ARMs that should be considered in the design of new software.

The new structure of tax administration will make it even more difficult to identify precisely the requirements of computerized tax administration systems. The additional personnel will increase requirements for computer systems. And merely purchasing computer systems without a precise plan of how they will be used and where they will be deployed will not improve tax administration. Applications software must be define~,onents affecting procurement being completed early in the first phase of the project. This Computerization Plan will serve as a guide for all future computerization efforts within the Ministry.

<u>Tasks</u>. There are many tasks included in the development of the Computerization Plan. The timing on various activities is such that critical decisions that affect other Project tasks are made early in the Project.

1. *Short Term Assistance for Platform, Operating System, and RDBMS Decisions.* The Tax Service (as well as the Ministry) requires short term assistance in determining the standardized platform(s), operating systems, RDBMS, and software development tools. The Director of the Tax Service specifically requested this assistance. The results of this short term mission will provide major components of the computerization plan for the Ministry and Tax Service.

2. *Selection of hardware, operating system, and RDBMS.* The selection of the standard platform for future computer systems must be done early in the project.

3. *Selection of Development Tools.* The development tools include computer-aided software engineering (CASE) tools as well as the database system and fourth generation language to be used for programming. This is another early decision required for other tasks in computerization.

4. *Appoint Computer Steering Committee.* There should be a steering committee for developing the computerization plan and it should include Ministry and tax service computer personnel and all resident computerization advisors.

5. *Computer Steering Committee Meeting.* The initial meeting will establish initial schedules and responsibilities. Regular meetings must be held throughout the project in order to progress towards the completion of the computerization plan.

6. *Review Current Projects.* Any current computerization projects must be reviewed to determine their impact on the computerization plans and standards to be adopted. A resident MIS advisor should take the lead role in overseeing this activity to be certain in progresses on schedule.

7. *Draft of Computerization Plan Format.* The format of the computerization plan should be developed prior to actual writing of the plan. Once this is completed, various steering committee members can be assigned certain components of the Plan to develop.

8. *First Draft of Plan.* The first draft of the Plan must contain information on all major components of the plan. It will be written by Ministry personnel and resident advisors working together.

9. *Review Plan.* The plan must be reviewed and recommendations for improvement identified.

10. *Refine Plan.* Based on the results of such reviews, the plan will be refined and finalized.

11. *Complete Ministry Plan.* The first version of the plan will be a complete plan, but the plan must be updated regularly to reflect changing requirements and changing technology.

## Training

Training courses are need in technical areas, tax administration and budgeting. Most technical courses should be commercial courses available (in Russian or Ukrainian). Custom courses for tax administrators, budget officials, and other Government staff will have to be developed in order to provide training in the use of computerized systems to be developed.

Tasks. Training tasks include course development, acquisition, and delivery. The broad subtasks are as follows:

1. *Review Training Requirements.* All areas of training related to computerization must be reviewed.

2. *Develop Training Plan.* A training plan must be developed for course definition, delivery, and acquisition.

3. *Identify and Purchase Commercial Courses.* Commercial courses that can meet training requirements should be identified as early as possible and arrangements made to contract for these courses. Areas for such courses include:

    Systems Analysis with CASE Tools
    Rapid Application Development with CASE Tools
    RDBMS and SQL
    Unix Operating System
    Networking

4. *Develop Customized Course.* Customized training courses must be developed for the computerized systems to be delivered in both tax and budget areas.

5. *Deliver Commercial Courses.* The commercial cores purchased must be given either in country or students must be funded to attend international courses.

6. *Deliver Customized Courses.* All customized courses should be delivered with hands-on experience. This implies that one or more computer training centers should be available for training central, oblast, and user staff.

7. *Review Training Courses.* Training courses must all be reviewed and improved where necessary.

8. *Revise Training Courses.* Based on review results, training courses should be revised to reflect the needs that were identified.

## IV. BUDGET AND ACCOUNTING COMPUTERIZATION

A pilot project in the budget area is urgently needed. This pilot should extend into expenditure control and accounting as well.

In the area of computerization of budget, expenditure control, and accounting (ultimately to produce an integrated financial management system) the goals and objectives are to:

- produce reliable and auditable information in the areas of government budgeting, debt management and expenditure control;

- improve the timeliness of reliable information flows to allow for more streamlined budget (treasury) operations;

- enhance the autonomy and responsibility of spending agencies in the budgeting and expenditure control process by providing agency-level information systems which are integrated in an overall structured framework.

Approach. Budgeting, expenditure control, and accounting components can be defined once new procedures have been defined and accepted. These components should be phased in their implementation and use microcomputer platforms to allow for their use at all levels, from the smallest rayon to the Ministry of Finance.

One method of quickly introducing budgeting and expenditure control automated systems is to use package software. This might be possible in Ukraine, provided that source code would be available and the software can be modified to run in the Ukrainian language. One of the early steps in this task will be to review alternatives to implementing budgeting and accounting components from scratch.

Tasks.

1. *Review and Revise Budgeting Procedures.* Based on the needs identified in the budget system review, all budget procedures must be reviewed in detail. Revised procedures should be proposed and when accepted by the Government serve as the basis for defining computerization requirements.

2. *Review and Revise Expenditure Control Procedures.* Similarly, expenditure control procedures must be reviewed and new procedures developed, proposed and approved. Computerization requirements must be based on these new procedures.

3. *Review and Revise Accounting Procedures.* Finally, expenditure control procedures must be reviewed and new procedures developed, proposed and approved. Computerization requirements must be based on these new procedures.

4. *Develop Integrated Financial Management System Plan.* In light of the results of the reviews and revisions in 1 through 3 above, a plan for an Integrated Financial Management system should be developed so that the pilot projects can be compatible with this plan and become a part of this system.

5. *Select Approach.* Potential packaged solutions should be identified and compared to customization from "scratch." An approach to the pilot projects will be selected based on an analysis of these alternatives.

6. *Implement Budget, Expenditure Control, and Accounting Pilot Projects.* Base on a phased approach, each of these pilots will be implemented with the following steps:

- Select Application Development Team
- Define Requirements
- Produce Requirements
- Implement and Refine Prototype
- Present Prototype in Workshop for Users
- Design System
- Implement Production System
- Develop Documentation
- Develop Training Courses
- Install system
- Deliver Training
- Accept System
- Begin Production Use in Pilot Site
- Review and Refine Pilot System
- Expand Use to Other Sites

## V. TAX ADMINISTRATION COMPUTERIZATION

While this is a primary area of IMF assistance, it is very unlikely that all of the resources required (personnel, hardware and software) are included in the project and that all of the needs of the Government can be met by this single project. The IMF is funding only one resident advisor for this project. A possibility is that USAID could provide additional experts to work in this area and fully cooperate with this IMF-led effort. One are of assistance that is needed is at the central level where data will eventually be consolidated and analyzed for the entire country. A computer system that provides for easy expansion should be acquired for this use. A possible candidate would be a Unix-based, Intel-architecture multiprocessor system in a networked environment, for this would allow a small system to be initially acquired, but allow it to grow to a much larger system for providing increased capacity and computing power.

Tasks. The tasks of tax computerization are listed below. The exact features we would propose will be specified in a requirements definition via the requirements document and the prototype.

1. *Develop Administrative Procedures.* This subtask is actually a task of Tax administration. It appears here to imply that requirements for Tax computerization can only be fully defined after such procedures are developed.

2. *Review Tax Administration for Potential Pilot Projects.* A review of tax administration at the rayon, oblast, and central levels should be done to identify potential projects that complement the IMF pilot project. A priority should be assigned to each.

3. *Identify Pilot Projects to Be Implemented.* Pilot projects to be implemented should be identified and submitted to the Government for approval.

4. *Implement Pilot Tax Administration Projects.* Each tax administration pilot computerization project will be implemented using the following steps:

   - Select Application Development Team
   - Define Requirements
   - Produce Requirements
   - Implement and Refine Prototype
   - Present Prototype in Workshop for Users
   - Design System
   - Implement Production System
   - Develop Documentation
   - Develop Training Courses
   - Install system
   - Deliver Training
   - Accept System
   - Begin Production Use in Pilot Site
   - Review and Refine Pilot System
   - Expand Use to Other Sites

## VI. BANK PAYMENT AND REVENUE REPORTING

Bank payment and revenue reporting by banks should be reviewed after other procedures for tax administration and budget have been defined. This component should focus on the application of simple technology to provide a standard method of providing pavment revenue data to the Treasury in electronic format. Exact subtasks can only be determined after a review of the requirements for this task.

## VII. HARDWARE AND SOFTWARE ACQUISITION

The exact funding requirements for hardware and software acquisition can only be determined after various applications are defined and the computerization plan is in place. Once they are known, there must be a very specific request for proposal (RFP) developed and issued for this acquisition. Proposals must then be evaluated and the best vendor selected to supply the required hardware and software.

Evaluation Criteria. Careful evaluation criteria must be prepared and specified within the RFP. Evaluation of vendors' proposals must follow these criteria in order to select the best hardware and software for the Ministry's and Tax Service's computer requirements.

Tasks. The tasks for hardware and software acquisition are as follows:

1. *Develop Hardware and Software RFP.* The request for proposal (RFP) will be developed and include all of the components presented earlier. There must be sufficient detail and requirements in order have the proposals from vendors include acceptable solutions to the computerization requirements of the Ministry. The criteria for evaluation should be included in the RFP. The specific needs of all applications to be computerized must be addressed in the RFP.

2. *Issue Hardware/Software RFP.* The RFP must be reviewed by the steering committee. Once accepted and put into final form, the RFP can be sent to appropriate vendors.

3. *Receive Vendor Proposals.* The vendors' proposals will be due by a specific time.

4. *Review Vendor Proposals.* The steering committee must review proposals after technical personnel have advised them on the more technical aspects of the proposals. MIS resident advisors should assist in the review.

5. *Select and Order Hardware and Software.* It may be that, after initial screening, two or three vendors will be invited to present the details of their proposals verbally. After such a presentation, selection of a vendor and subsequent ordering of hardware and software can be done. Hardware and software installation should be phased so the hardware is ready for use when needed for a particular application.

6. *Install Development Systems.* A development system (or development systems) must be acquired in advance of the production system(s). It must include all software development tools, database software, and other software that will be used to implement Ministry and Tax Service computer applications.

7. *Acceptance Testing of Development System.* Acceptance testing must be done for the development system. It will involve testing all the hardware components and the systems software, particularly using tests in applications development. Acceptance tests will be defined as part of the quality assurance to be developed as part of the project.

8. *Accept Development System.* Once acceptance tests are done successfully, the development system can be accepted.

9. *Install Production Systems.* Production systems are installed enough in advance so that they are ready for use when needed.

10. *Acceptance Testing of Production Systems.* Acceptance testing here involves the testing of the systems software.

11. *Accept Production Systems.* Once the acceptance tests are passed, the hardware and software for production systems can be accepted. The Steering Committee and the senior officials from the user departments must also accept these systems in writing.