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REPORT ON THE USE OF SPECIAL FUNDS IN UKRAINE[1]

In recent years the budget system of Ukraine has experienced a large number of innovations. Separation of budget funds into general and special funds became the major innovation of 2000 Budget. The practice of separation of budget funds between general and special funds has been continued in the 2001 Budget and the draft 2002 budget. The new Budget Code permits use of such separation in future budgets. However, Article 33 of the Budget Code requires that "…Guidelines of the Budget Policy for the Next Budget Period must contain … justification for the separation of the budget into the general and special funds…." This requirement reflects the growing concern over the rapid growth of the relative size of special funds in the total budget. The number of revenue sources that goes entirely or partially to the special fund has grown from 14 envisaged in the 2000 Budget to 33 envisaged in the 2001 Budget. The number of expenditure items financed from special funds increased from 14 to 27, respectively, in the 2000 Budget and 2001 Budget. In 2001 these special funds represent about 22.5 per cent of total revenue.

In the draft 2002 Budget the number of proposed special funds has grown incrementally to 31 ignoring the seven sectoral lending programs that are also included in the budgetary category of special funds. Since the draft 2002 Budget fails to provide a rationale for the group of special funds it contains, this report raises, and tries to answer the following set of questions. What is a special fund and what is its intended purpose? According to what criteria can one distinguish between a desirable and undesirable special fund? What countries in the world use special funds, or their equivalent, as a part of normal budgetary practice? What reasonable judgement can be made concerning the appropriateness of the special funds included in the draft 2002 budget?

What is a Special Fund?

Neither previous budget legislation nor the new Budget Code provides a formal definition of a special fund. However, Article 13 of the Budget Code stipulates that a special fund is to be formed from specifically determined revenue sources and to be used for financing specifically determined purposes. Therefore, special fund is a classical case of earmarking in which particular types of revenue are dedicated to the financing of particular kinds of expenditure.

However, separating the budget into general and special funds was not originally intended to introduce earmarking into the budget system of Ukraine. Special funds have been introduced for purposes of accounting for public funds that were earlier earmarked in numerous off-budget funds. Therefore, the special fund has been designed as a substantial step towards achieving more transparency in the use of public funds.

Introduction of special funds accompanied another measure aiming at stopping weakly controlled proliferation of off-budget targeted funds of different government bodies. The Law of Ukraine on the State Budget, 2000, article 2, eliminated a substantial number of targeted owned by government agencies. The Law reinforced requirements that the government bodies should be financed only by the state budget. Those targeted funds that were not eliminated but were accounted for in the budget as a special fund are still in compliance with the Law.

[1] By Victor Chepenko and Wayne Thirsk.

[Furthermore, the Article one of the Law stipulates that "… payments at the account of special fund should be made within funds received by special fund for a specified purpose". On one hand, it looks as if only larger receipts of revenue earmarked for specific purposes may stimulate larger expenditures for these purposes. On the other hand, since the Budget Code stipulates a possibility (by amending the Law on State Budget or respective decision of local government) for redistribution of funds between general and special funds during a year, the tight connection between revenues and expenditures of a special fund may not exist.]

When is earmarking Appropriate?

Public finance theory suggest that earmarking is appropriate if:

(1) earmarked revenue is the sole source of funding for a set of particular expenditures;

(2) a close benefit link exists between the earmarked revenue and use of such revenue to finance additional expenditures.

A close benefit link can be established only in the case where a consumer of a public good or service pays for what he gets. In other words, only those public goods or services that can be excluded from consumption of people who do not pay can show a strong benefit link. On the other hand, it is not always feasible from the administration point of view to charge directly for services provided even if they are excludable. A good example of this is a network of public roads. It is often not feasible to levy direct user charges for road service consumption in the form of road tolls. Many countries resolve this problem by earmarking gasoline excise tax revenue to pay for maintenance and construction of public roads. Gasoline is complementary good consumed during use of public roads. Therefore, one who does not want to buy gasoline and pay the excise can not use public roads. However, those who are willing to make the purchase are sending a clear signal to the public sector about the intensity of their demand for roads and their willingness to pay for their provision.

Earmarking is clearly inappropriate in the absence of a direct benefit linkage. Consider, for example, the earmarking of tobacco excises to exclusively fund primary education, a practice that has occurred in several Latin American countries. There is no relationship between people's craving for nicotine and their demand to have their children educated and, therefore, no reason to believe that primary education will be adequately financed by such an earmarking scheme. If people became more health conscious and gave up smoking this should not be a compelling reason for closing elementary schools and firing school teachers.

Earmarking in other countries

Countries everywhere practice some form of earmarking. They differ only in the degree to which they rely on earmarking. Countries with an English budgetary heritage such as Canada are less likely to employ earmarking than countries with a either French or Spanish history. In the United States, for example, earmarked revenues of the federal government constitute about 25-30 per cent of total revenue. In that country the federal Department of Transport depends on earmarked revenues of various types for about three-quarters of its total revenue. In short, the amount of earmarking in Ukraine, in aggregate terms, is not out of line with experience in the rest of the world.

An Evaluation of Current Earmarking in Ukraine

Table 1 presents an analysis of the strength of the benefit link between expenditure items of the special fund of the State budget and respective sources of financing in 2000 and 2001. Each special fund is appraised in terms of whether its benefit link is strong, partially strong, weak or non-existent. This analysis identified 17 expenditure items out of total 31 that exhibit a strong benefit link with the revenue earmarked for financing those expenditure items. For example there is strong and obvious benefit link between receipts from the UN secretariat for use of the Ukrainian contingent for peacekeeping operations and financing participation of Ukraine in peacekeeping operations. Similarly, receipts of payment for consular actions should cover the cost of providing these services through Consular Service of Ukraine.

Table 1: Benefit Link Analysis for Special Funds Established in the State Budget in 2000-2001

Expenditures	Financed by	Benefit Link	Notes
Special Funds of 2000 only			
Operational costs for state agencies of assay control	5) payment for assaying and marking articles and alloys of precious metals;	Strong	
Social unemployment security Fund	9) fee for compulsory social unemployment insurance;		
Execution of Fund for social insurance expenditures	12) payments the Fund for social insurance;		
Organizing air traffic	13) aeronavigation dues;	Strong	
Special Funds of 2000-2001			
[1] Geological prospecting works financed from the deductions payable by mining enterprises	1) duty for geological prospecting work financed by the State budget	Partial	Not all payers of the duty may utilize results of prospecting work
[2] Operation of the Consular Service of Ukraine	2) 10% of funds received for consular actions outside Ukraine according to the procedure determined by the Cabinet of Ministers of Ukraine	Strong	
[3] Planting and looking after young orchards, vineyards, berry and hop fields	3) receipts of funds from the duty for the development of viniculture, horticulture and hop-gardening	Strong	
[4] Needs of the Armed Forces of Ukraine and other military formations and law enforcement bodies formed in line with the Legislation of Ukraine according to the budgets approved according to the established procedure	6) receipts of funds from the sale of excess armaments, military and specialized equipment, other property of the Armed Forces of Ukraine and other military formations and law-enforcement bodies formed in line with the legislation of Ukraine	Weak	Creating property for further sale is not a primary objective of either Armed forces or Interior
	17) 98% of proceeds from the privatization of enterprises under the management of the Ministry of Defense of Ukraine	Weak	This source of revenue has been added in 2001
[7] Aviation activity and participation of Ukraine to international aviation organizations implemented by the Department for Aircraft Transportation of the Ministry for Transportation of Ukraine	10) 80% of receipts of the State Specialized Fund for Financing National Budget Payments for Aircraft Activity and Participation of Ukraine in International Aviation Organizations	Partial	
[8] Marine and river transportation activity and participation of Ukraine to international organizations for marine and river transportation implemented by the Department for Marine and River Transportation of the Ministry for Transportation of Ukraine	11) 90% of port (administrative) levy collected by ports other than fishery ports	Partial	
[11] Financing, according to the established procedure, of state capital investments at launching units of Chornobyl construction program consistent with inventories	13) 90% of proceeds from privatization of unfinished construction items constructed according to the Chornobyl construction program	Requires further study	

Expenditures	Financed by	Benefit Link	Notes
approved by the Cabinet of Ministers of Ukraine			
[13] Expenditures related to the organization of the provision of services, sale of produce and execution of work by budget institutions and organizations, and other expenditures to maintain these institutions and organizations according to the legislation	18) own revenues of institutions and organizations financed by the State budget of Ukraine	Partial	Own revenues include funds appropriated to spending units for conducting special assignments. Some of those assignments has nothing to do with providing services by spending units
[17] Programs and measures for the social protection of the handicapped	22) payments to the Ukraine Social Protection of the Handicapped Fund	Strong	
[18] Measures related to the environment protection	23) receipts of levy for environment pollution payable to the Environment Protection Fund in the part belonging to the State Budget of Ukraine	Strong	
Special Funds of 2001 only			
[5] Subvention to local budgets for financing of benefits and subsidies to the population for payments for electric power, natural and condensed gas and rental/communal services	7) royalty for natural gas extracted in Ukraine	Weak	1) Subsidies are also provided for goods and services other than gas or those that use gas as input 2) Transit of gas and extraction of gas are not directly linked to consumption of gas by households
	8) deductions from payments for transit of natural gas through the territory of Ukraine	Weak	
[6] Measures aimed at the provision of an adequate level of security of flights, aviation security and search and rescue operations	9) receipts to the insurance fund for aviation security	Strong	
[9] Participation in international marine fishery organizations provided by the Fishery department of the Ministry for Agro-Industrial policy of Ukraine	11) 90% of port (administrative) levy collected by fishery ports	Partial	
[10] Measures related to the privatization of state property consistent with 2000-2002 State Privatization Program	12) 3% of funds incoming from the privatization of unfinished construction items which were financed at the expense of centralized capital investments exclusively	Strong	Under assumption that objectives of measures are to make property more attractive for sale
	16) 3% of funds received from the sale of privatization items, including group "Г" (Ukrainian "Ж") Items, consistent with Item 5 of the 2000-2001 State Privatization Program (except for unfinished construction Items) separated from the balance sheets of enterprises	Strong	
	13) 10% of proceeds from privatization of unfinished construction items constructed according to the Chornobyl construction program	Strong	
	14) 25% of proceeds from sale of shares of open joint stock companies according to the list determined by the Cabinet of Ministers of Ukraine for the liquidation of the catastrophe aftermath in sewage facilities of the city of Kharkiv	Partial	
	15) 3% of proceeds from the privatization of State-owned property (except for items for which a separate distribution of funds according to 2000-2002 State Privatization Program is envisaged) and other revenues directly related to privatization process and	Strong	

Expenditures	Financed by	Benefit Link	Notes
	crediting enterprises		
	17) 2% of proceeds from the privatization of enterprises under the management of the Ministry of Defense of Ukraine	Strong	
[12] Financing of expenditures for the liquidation of aftermath of catastrophe at sewage facilities in the city of Kharkiv	14) 75% of proceeds from sale of shares of open joint stock companies according to the list determined by the Cabinet of Ministers of Ukraine for the liquidation of the catastrophe aftermath in sewage facilities of the city of Kharkiv	No link	
[14] Financing of pensions envisaged by different pension programs	19) charges earmarked for obligatory pension insurance which are payable in accordance with legislation in events of sale and purchase of currencies, trade in jewelry made of gold (except for wedding rings), platinum and gems and in the course of transfer of title to automobiles, in case of production and import of tobacco goods, transactions of sale and purchase of immovable property (real estate), cellular mobile communication services (additional charges earmarked for payment of pensions) in keeping with procedure set by the Cabinet of Ministers of Ukraine	No link	
[15] Accumulation (increment) of tangible values of the state material reserve and in other sectors according to the current legislation	20) proceeds from sale of material values from the State reserve	Strong	
[16] Participation in international peace-keeping operations	21) receipts from the UN Organization secretariat for financing Ukrainian contingent	Strong	
[19] Recrediting or extension of transfers for the implementation of development plans	24) loans from international and foreign organizations used by the State for further recrediting or transfers for the implementation of development projects	Strong	
[20] Extension of budget loans as a result of the redemption by the state of guarantee commitments in the event of not meeting by legal entities of their liabilities regarding the repayment of credits extended under state guarantees	25) receipts arising in the event of enactment of State guarantees as a result of the State extending guaranty commitments	Strong	Lending programs by the State might be inefficient
[21] Extension of state privileged credit to individual rural builders	4) interest for the use of easy-term State credits by individual rural builders	Strong	Lending programs by the State might be inefficient
	26) repayment of loans granted from the State Budget of Ukraine to individual rural builders	Strong	Lending programs by the State might be inefficient
[22] Extension of privileged long-term state credit to young families and single young citizens for the construction (reconstruction) of housing	5) interest for the use of state easy-term long-term State credits by young families and single young citizens for the construction (reconstruction) of housing	Strong	Lending programs by the State might be inefficient
	27) repayment of loans extended from the state Budget of Ukraine to young families and single young citizens for the construction (reconstruction) of housing	Strong	Lending programs by the State might be inefficient
[23] Measures related to the repayment of arrears for the purchase of agricultural produce according to the state order (contract) of 1994-1997	28) repayment of budget loans extended for the purchase of agricultural produce according to the State order (contract) between 1994-1997	Strong	Lending programs by the State might be inefficient
[24] Measures related to the purchase of agricultural equipment under the conditions of financial leasing	29) repayment of funds provided for the purchase of agricultural equipment on terms of financial leasing	Strong	Lending programs by the State might be inefficient
	30) proceeds from repayment of arrears on credits raised or guaranteed by the State for	Strong	Lending programs by the State might be inefficient

Expenditures	Financed by	Benefit Link	Notes
	purchase of agricultural equipment produced abroad delivered to agricultural producers and other business entities and as a result of settlements for agricultural machinery supplied by the Pivdenny Mahynobudivny Zavod Production Association in the amount of UAH 103,907 thousand and the Ordzhonikidze Kharkivsky Traktorny Zavod Joint-stock Company in the amount of UAH 34,907 thousand		
[25] Redemption of the state debt of Ukraine to Russian Federation and subvention of the city of Sevastopol in line with the concluded intergovernmental agreements	31) payments related to the stay of the Russian Federation Black Sea Fleet on the territory of Ukraine consistent with the concluded intergovernmental agreements	Partial	Direct benefit link exist only in the part of subvention to city of Sevastopol where the Russian Federation Black Sea Fleet has its home hub
[26] Accomplishment of construction of the Ukrainian portion of the Euro-Asian oil-transportation corridor	32) 80 percent of deductions from receipts for oil transportation through main pipelines	Strong	
[27] Financing of works related to the construction, reconstruction, repairs and maintenance of thoroughfares	33) receipts incoming on the top of the annual targets for excise taxes on domestic petrochemicals, excise taxes on imported petrochemicals and imported means of transportation, import duties on petrochemicals, means of transportation and tires	Partial	

Among those 17 items with a strong benefit link to sources of financing there are five items that represent various lending programs operated by the State. While they all exhibit formal strong benefit link there is some concern over the efficiency of direct lending by the state. The issue is whether these lending institutions should be specialized in providing credit only to specific sectors or whether the lending capacity of these institutions should directed to examining credit opportunities anywhere in the economy. This is a question that cannot be answered without a more detailed scrutiny of these activities. Lending of this type, however, is a financial activity and not a budgetary one and it is doubtful whether there is any merit in including them in the budget.

Strong benefit link has been identified also for a number of social protection programs. First, fees financing such programs are compulsory for employees. Second, the programs provide specific service – coverage by the program. Third, those programs provide some degree of a direct link between how much has been paid and value of service to be provided in case an insurable event occurs.. For example, unemployed people are entitled to a certain percentage of their salary to be paid by the state at the first month of unemployment. Because insurance fees are paid as a percentage of payrolls, there is a certain degree of correlation between cost and the value of services provided.

Use of so called own revenue of budget-sustained organizations and institutions to finance services and works provided by such institutions would be also be a case of a strong benefit link if own revenue of such institution consisted of user charges for such services. However, beside charges for services provided, own revenue of such institutions also includes so called funds for execution of special assignments. Those funds as they defined by Cabinet Resolution of June 25, 2001 # 702 are not payments for particular services provided by these institutions to the public. Therefore, on overall, the special fund for financing provision of

services by budget-sustained institutions exhibits only a partial benefit link. A similar situation exists for measures related to the privatization of State property. These measures are financed primarily as a percentage of proceeds from privatization. The benefit link is obvious – better pre-privatization preparation of property for sale would command a higher selling price of the property sold and, therefore, a larger revenue flow.

Some of the special funds appear to be bereft of any obvious benefit rationale. Sale of military surpluses to fund the military makes little sense if the objective of government policy is to downsize the military in the future. Such earmarking also forges a military-industrial alliance with the military advocating more military production in order to create the surplus that can be sold abroad for its purposes. Similarly, tying funding of the sewage cleanup in Kharkiv to proceeds from the sale of joint stock company shares can only be described as a bizarre financing scheme, on a par with funding education from tobacco excises. On the surface, there is also little to be said in favor of partially funding pensions through the imposition of excises on gold and foreign currency transactions and tobacco products as well as on the use of mobile phone services. However, judgment on this matter should be tempered by careful consideration of what the alternative sources of paying for pensions look like. If higher payroll taxes were the main alternative, excise tax funding of pensions may be more desirable in light of the heavy load of payroll taxation that already exists.

Conclusions

- ✓ Reliance on special funds has grown rapidly in recent years but shows no sign of significant growth in the future;
- ✓ Ukraine's reliance on special funds, in total amount, more or less conforms to budgeting practices observed in the rest of the world;
- ✓ Close examination of the nature of the special funds reveals that the majority of them are appropriate and possess a string benefit link; most of the others have at least a partial benefit; only a few of the special funds are of a questionable nature and therefore ripe for reform.