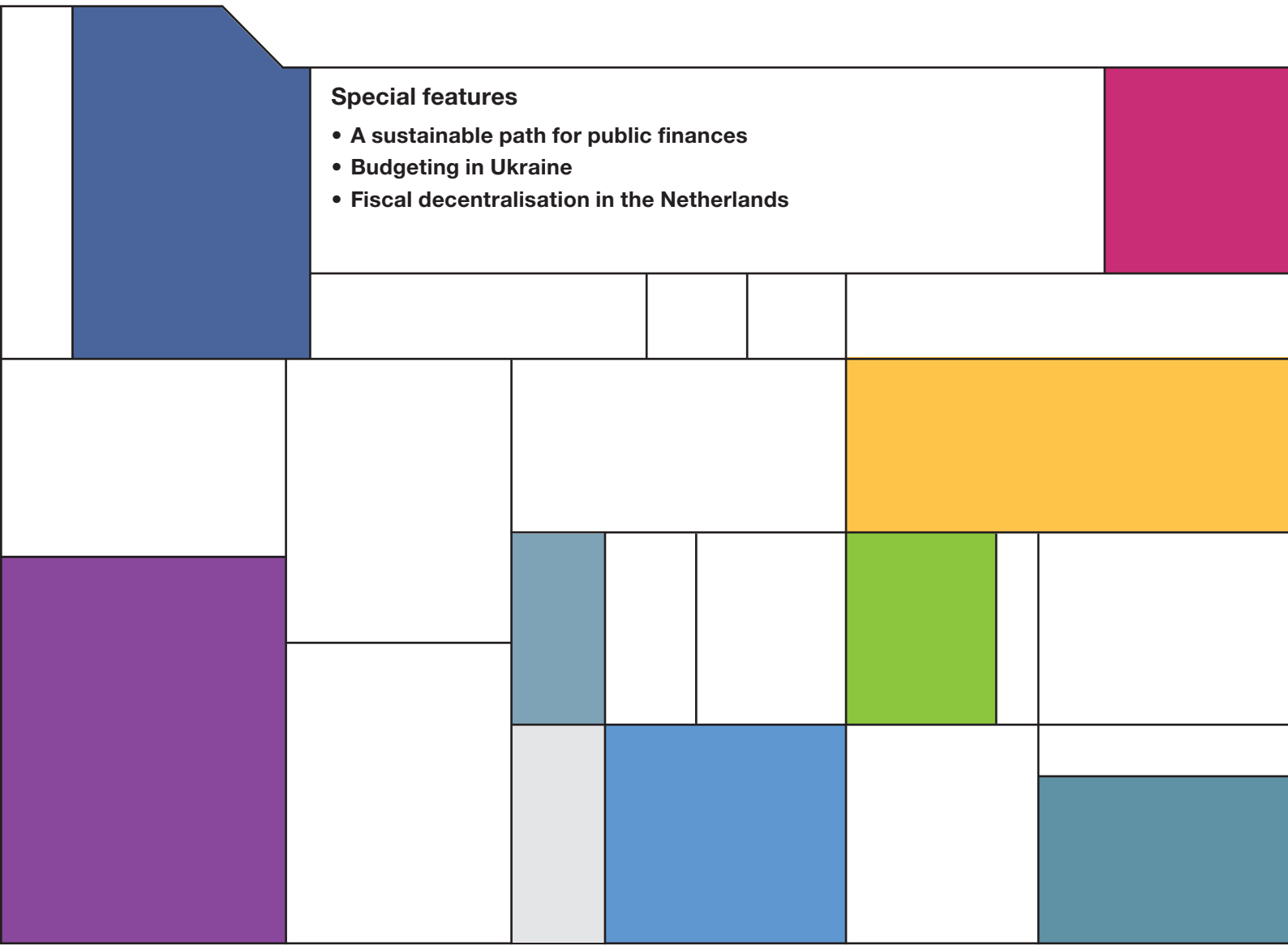
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- A sustainable path for public finances
- Budgeting in Ukraine
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OECD Journal on Budgeting

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Economic theory and four centuries of fiscal decentralisation in the Netherlands

by
Frits Bos*

The history of the Netherlands reveals major shifts from centralisation of government tasks towards decentralisation and vice versa. *In the 17th century, the Republic of United Provinces was the first federal state in modern history. Many transformations later, the Kingdom of the Netherlands became a big centralised welfare state. Since the 1980s, a reverse development has started: the welfare state is being downsized and decentralised. This article describes and discusses this evolution in view of a broad spectrum of economic theories. Four conclusions are drawn. First, the major changes in Dutch fiscal decentralisation arrangements were introduced as policies to overcome a severe economic and political crisis. Second, many other factors – like the increase in communication, mobility, population density, urbanisation and the role of government – also necessitated changes. Third, in order to ensure efficient and financially solid government, the accountability and transparency of central and local government and their interrelationships have been improved substantially. Fourth, current arrangements are not optimal and should be changed. For example, Dutch municipalities should increase further in scale, and the role of Dutch provinces should be reconsidered.*

JEL classification: D70, H11, H70, N43, N44

Keywords: Fiscal federalism, subsidiarity, history of Dutch public finance, Oates, Tiebout, agglomeration effects, Dutch municipalities, Dutch provinces, water boards, spatial planning, infrastructure, local taxes, Thorbecke, local governance, Dutch Republic of United Provinces, multi-order governance, theories of fiscal decentralisation

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Executive summary

Fiscal decentralisation has become a major topic for economic policy and theory. History and economic theory learn that a good division of tasks between the various layers of government is essential for an efficient government and therefore for economic growth and welfare. To be optimal, such arrangements should be flexible over time. This article describes and discusses the history and current practice of fiscal decentralisation in the Netherlands. A large number of tables and graphs are used to illustrate and quantify the major economic, demographic and political changes and their impact on the division of tasks between Dutch central and local government. Also, a broad overview is provided of the various economic theories relevant for understanding fiscal decentralisation.

The history of fiscal decentralisation in the Netherlands reveals major shifts from centralisation towards decentralisation and *vice versa*. The Dutch Republic of the United Provinces was the first federal state in modern history. Due to institutions focused on stimulating trade and growth, it became the richest country in the world. However, after this golden age of the Dutch Republic, the decentralised decision-making system was not able to reform and meet the challenges of wars with France, England and Prussia and the rise of mercantilism and protectionism in Europe.

The French army helped to break up the political deadlock and helped to install a unitary and French-style state with a central government bureaucracy, a constitution, a national tax system and the abolishment of provinces. After the departure of the French, the United Kingdom of the Netherlands started. The power of the King and the loss of political power by cities and provinces made possible a much more efficient routing of roads and canals. However, unsustainable public finances caused the autocratic rule by the King to be no longer accepted. The King abdicated, the Constitution was changed, and Parliament was given more power.

Current fiscal decentralisation still reflects to a great extent the Constitution of 1848. This Constitution was designed by the liberal Prime Minister Thorbecke. It introduced elections for those paying taxes and divided the responsibilities among the central government, provinces and municipalities ("Thorbecke's house"); provinces were reinstalled but given a much less prominent role than in the Republic.

In the period up to 1928, the government wanted to modernise the economy and reduce social problems. Municipalities played a major role, *e.g.* by improving education and infrastructure and by giving poor relief. However, the rising expenditure by municipalities was financed by increasing debt and all kinds of local taxes related to income and wealth. This generated migration by the rich, and the gap between rich and poor municipalities widened rapidly.

In 1929, this problem was resolved by abolishing several local taxes related to income and by introducing a municipality fund organised by the central government. During the next fifty years, a centralised welfare state was constructed. The Dutch central government tried to direct the development of the Dutch economy and society via many new social

benefits and specific transfers to local government, firms and non-profit institutions. During this period, Dutch public expenditure increased to over 60% of GDP. The welfare state had an adverse effect on employment, and the Dutch economy and public finances became unsustainable.

Since the 1980s, the Dutch welfare state is therefore being redesigned into a smaller and more decentralised welfare state. This implies privatisation, deregulation and decentralisation and a greater role for incentives and performance management. Social assistance and public care services have become more the responsibility of municipalities. The number of specific transfers is reduced, while the general transfers to provinces and municipalities are increased.

Since the 1930s, financial supervision of Dutch local government is generally rather strict due to a combination of standards for financial reporting and budgeting, limitations on lending for microeconomic and macroeconomic reasons, and early sanctions on financial misconduct. Major improvements in the distribution formulae of transfers by the central government implied that municipalities could more easily be blamed in case of financial difficulties.

The very limited role of local taxes reflects that the Netherlands is a small, urbanised and open economy with a high preference for equality and therefore limited possibilities and tolerance for differences in local public services and local taxes. Major local public services, like education, health care and police, are organised and financed nationally and not by municipalities or provinces. The limited role of local taxes also reflects that national right-wing political parties do not want (left-wing) local government to be able to increase expenditure by increasing local taxes.

Since the start of "Thorbecke's house" in the Constitution of 1848, the number of municipalities has been decreased drastically, from 1 209 in 1850 to currently 430. Economic theory provides various arguments for enlarging municipalities, like more efficient allocation by internalising more external effects, an increase in efficiency due to larger scale, a rising minimum scale due to more and more complex tasks, and reducing the vulnerability for local lobbies and personal interest.

At present, the major part of the Dutch municipalities is rather small: 10% have less than 10 000 inhabitants, 25% have between 10 000 and 20 000 inhabitants, and for 20% the number of inhabitants is between 20 000 and 30 000. The central government policy to allocate more and more complex tasks to municipalities enforces a further scaling up of municipalities. The scale and geographic delimitation of municipalities and provinces should take account of the major external effects. In urban regions, this suggests scaling up of municipalities or very strong co-operation, like in the current city-region arrangements. The commuting patterns suggest that the 150-year-old boundaries of provinces are not very efficient for spatial planning; it is better for this task to be mainly divided between municipalities and the central government.

Several other proposals for improving fiscal decentralisation in the Netherlands are also made, for example:

- Municipal taxes should be extended by incorporating the central government's taxes on owning and buying a house.
- The current complex and arbitrary formula for the general transfer to municipalities and provinces should be replaced by a link to GDP; like with the current formula, at each new

period of government the size of this transfer can be reconsidered and can be subject to budget cuts or an increase in expenditure.

- The number of earmarked transfers should be limited and they should not to be defined too strictly.

1. Introduction

The division of tasks between the government and the market is one of the classical issues in economic analysis. A relatively new issue is fiscal federalism or fiscal decentralisation, *i.e.* what should be the division of tasks between the various layers of government? The right design of fiscal decentralisation is crucial to economic growth and welfare:

> "For the last three centuries, the richest nation in the world has almost always been federal. The Dutch Republic from the late sixteenth through mid-seventeenth centuries; England from the late seventeenth or early eighteenth and mid-nineteenth centuries … and the United States from the late nineteenth to the present. Similarly, modern China, a *de facto* federal state, has also experienced sustained rapid growth. India grew very slowly for many decades, but has experienced high growth in the last. In contrast, the large Latin America federal states of Argentina, Brazil, and Mexico, and modern Russia have all fared much more poorly. How do we account for such large differences in economic performance?" (Weingast, 2009, p. 290).

All over the world, political events have drastically changed fiscal decentralisation: there is often more decentralisation (*e.g.* the disruption of the Soviet Union and the increased autonomy of regions in Belgium and Italy) but sometimes also more centralisation. In some countries, local government has been drastically reorganised. For example, in 2007 Denmark reduced the number of municipalities from 271 to 98 and replaced the 13 counties by 5 regions.

In order to better understand the economic consequences of such political changes and to improve policy advice on fiscal decentralisation, international organisations (the World Bank, the OECD, the IMF and the EU) have initiated a large amount of research (see, for example, Ahmad and Brosio, 2006; Boadway and Shah, 2009; McKay, 2001; Prud'homme, 1995; Rodden *et al*., 2003; and Ter-Minassian, 1997). This research tries to take stock of the wide diversity in country practice by giving answers to basic questions like: What are the arrangements? Which seem to work and which do not seem to work at all? To what extent does this depend on specific economic or political circumstances?

According to Tanzi (2007, p. 17), there are three large gaps in the fiscal decentralisation literature:

- the big contrast between the theory and practice of fiscal decentralisation;
- the link of views on fiscal decentralisation to historical development;
- the *de facto* creation of a layer of government above the national government.

By analysing the history and current practice of the tasks and financing of Dutch local government in view of economic theory, this article addresses two of these gaps. From a Dutch perspective, the third gap refers in particular to the relationship between the European Union and national governments. Recently, this major issue was addressed by a conference and a book by the CPB, the European Commission and the Dutch Ministry of Economic Affairs (see Gelauff *et al*., 2008).

The tasks and financing of local government constitute a hotly debated topic in the Netherlands (see also Table 1). The sustainability of Dutch public finance may be served by cuts in transfers by the central government to local government and by decentralisation of the provision of social security and publicly financed care services. However, more centralisation may also be needed. For example, in order to reduce congestion, more central planning and decision making could be a solution. Similarly, financial risks of the general government could be reduced by obliging local governments to bank with the central government. Reorganisation of local government may also be necessary for improving the efficiency of public services, *e.g.* by abolishing district water boards and transferring their tasks to the provinces.

Table 1. **Major current policy issues on tasks and financing of Dutch local government**

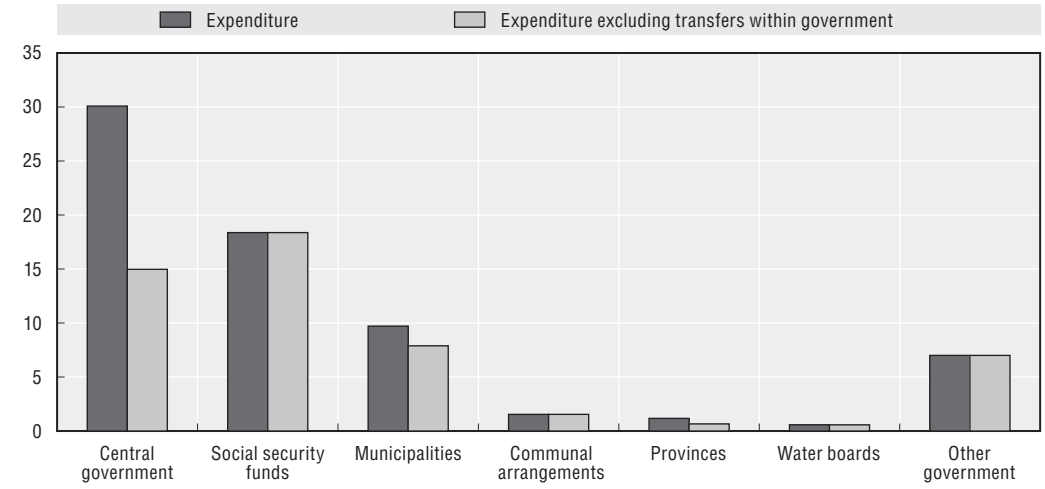
Major issues about tasks	
1.	To what extent should municipalities organise public care services? Is this an effective tool for containing rapidly rising public expenditure on care of the elderly?
2.	In addition to social assistance benefits, should municipalities also take over the payment of unemployment benefits? Would this increase the effectiveness of (local) labour market policy? Should municipalities also take over payment of social benefits to widows and orphans?
3.	Who is responsible for solving problems of poor quarters in cities? What should be the role of the central government, municipalities and private non-profit parties, like social housing corporations?
4.	Should small municipalities be merged with other municipalities in order to increase their efficiency, *e.g.* in view of their increasing role in new and complex tasks like public care services and labour market policy?
5.	What should be the role and tasks of provinces? Should they be abolished or should some tasks be transferred or even forbidden (*e.g.* social policy)? Should they be transformed into three or four big regions? Should they take over all the tasks of district water boards?
6.	How many government layers should be responsible for one issue? A maximum of two?
7.	How should spatial planning and new infrastructure be organised? What is the responsibility of the different layers of government?
Major financing issues	
1.	How to determine the size of general grants of central government to municipalities and provinces? Are cuts needed and, if so, how big?
2.	How to distribute grants over individual municipalities and provinces? Should this take account of their wealth?
3.	Should the role of local taxes be increased? And to what extent are differences in local tax rates acceptable?
4.	Should the role of general transfers be increased and the number of specific grants be decreased?
5.	Should local governments be allowed to arrange their own financing? Are they allowed to speculate with equity stock?
6.	What should be the role of local government in meeting national fiscal targets, *e.g.* the EMU criteria on government deficit and debt?

Some key statistics can give a first impression of Dutch fiscal decentralisation (see Figures 1 and 2). In 2009, Dutch public expenditure amounted to 51% of GDP. The major part is spending by the central government and social security funds (45% of GDP). This includes contributions of 1% of GDP to supranational government (in particular the EU) and international organisations (*e.g.* NATO). Transfers by the central government (14% of GDP) are a major source of finance for expenditure by other Dutch government entities, *e.g.* social security funds (3% of GDP), municipalities (5% of GDP), provinces (0.6% of GDP) and all kinds of functional government bodies like police, regions, private subsidised primary and secondary schools, public employment services, universities, and national museums.

The 430 municipalities are by far the most important type of local government. Their expenditure amounts to 10% of GDP; this includes transfers to other local government units. The expenditure of the 12 provinces only amounts to 1.2% of GDP. Joint arrangements – *i.e.* arrangements between various government units to take care of specific activities like garbage disposal and social workplaces – amounts to 1.5% of GDP. In terms of expenditure, the 27 district water boards are responsible for 0.6% of GDP.

Figure 1. **Expenditure by the various types of Dutch government**

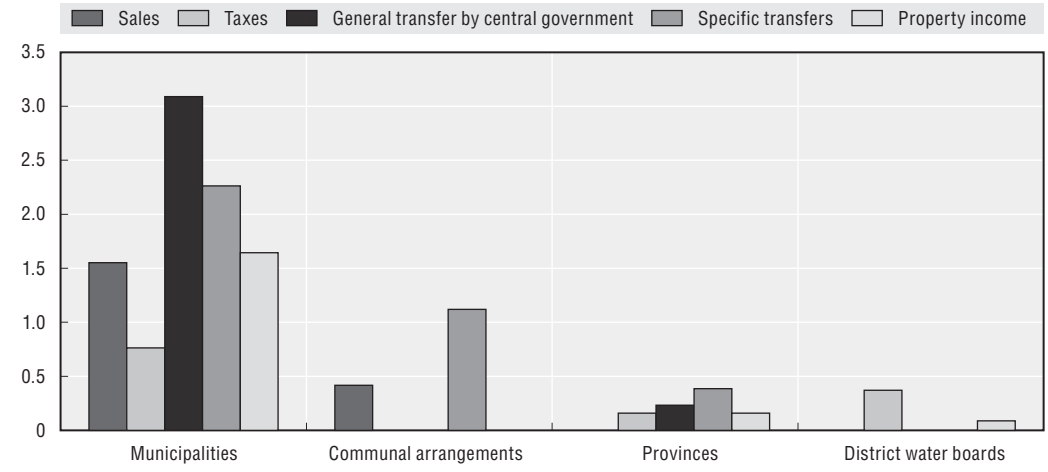
Per cent of GDP, 2009



Source: Statistics Netherlands national accounts.

Figure 2. **Revenue by the various types of Dutch government**

Per cent of GDP, 2009



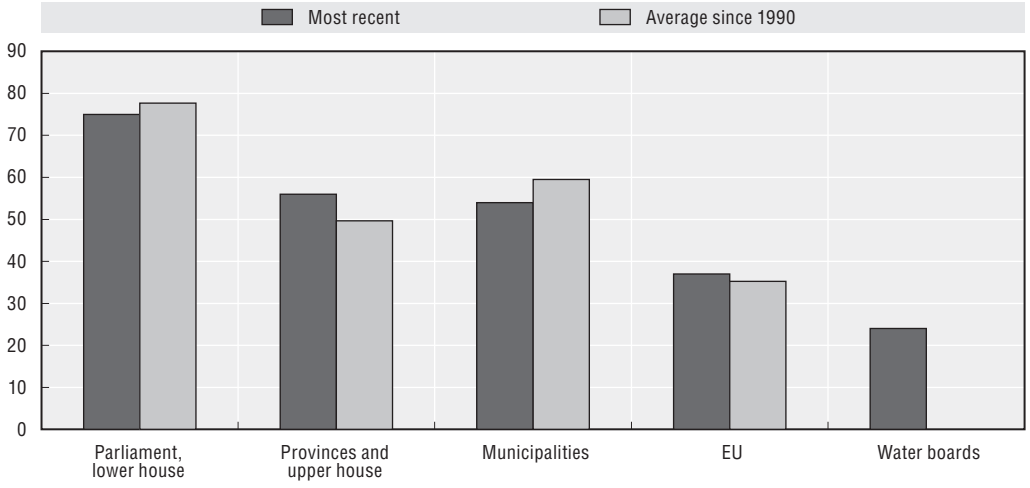
Source: Statistics Netherlands national accounts.

Local taxes are very small in the Netherlands (1.3% of GDP in 2009). They are not only levied by municipalities and provinces but also by the district water boards. These three types of government are subject to local elections, *i.e.* to local political decision making. However, their official head of government – namely the mayor of a municipality, the governor of a province or the count of the district water board – is appointed by the central government.

The major sources of finance for municipalities are the general and specific transfers by the central government. Communal arrangements are mainly financed by transfers from municipalities. For provinces, four sources of finance are important: not only the general and specific transfers by the central government, but also taxes and property income. The latter reflects the very solid financial position of some provinces, in particular due to the (former) ownership of power companies. In contrast, the expenditure by water boards is mainly financed by levies.

Participation in elections differs substantially by type of government (see Figure 3). The most popular vote is for the lower house of Parliament: more than 70% of the electorate decides to vote. Voting for the European Parliament and water boards is less than 40%; these government bodies suffer therefore from a serious lack of democratic legitimacy. The seats in the upper house of Parliament are chosen by representatives from the provinces. Voting for provinces is therefore also a vote for the upper house. In general, participation in municipal elections is about 10% higher than that for the provinces. However, in the most recent election, it was totally uncertain whether the brand new government would also obtain a majority in the upper house. As a consequence, the participation in the provincial election was incidentally much higher.

Figure 3. **Participation rate in the elections for different government layers**



Source: Databank Verkiezingsuitslagen, Kiesraad (Electoral Council), *www.verkiezingsuitslagen.nl*.

The purpose of this article is twofold:

- to provide an overview of the history and current practice of Dutch fiscal decentralisation in view of economic theory;
- to describe and discuss the tasks and financing of Dutch municipalities and provinces in more detail.

In policy discussions about fiscal decentralisation, reference is in general only made to the first generation of theories. Before discussing fiscal decentralisation in the Netherlands, Section 2 provides a general overview of fiscal decentralisation in economic theory. The first-generation theories focus on the trade-offs between preference matching, economies of scale and the internalisation of external effects. The second-generation theories also take account of the insights of a whole mixture of new economic theories, *e.g.* political economy, behavioural economics, agency theory, transaction cost theory, and urban economics. They generally emphasise the importance of institutional arrangements and information flows to ensure the right incentives for good governance.

Section 3 gives an overview of the history of Dutch fiscal decentralisation. This historical overview illustrates the importance of a good division of tasks between central and local government and the need to reconsider arrangements in view of major economic, demographic and political changes. Section 3 also serves as a general introduction to the current arrangements.

The current tasks and financing of municipalities and provinces are described and discussed in Section 4.

2. Fiscal decentralisation and economic theory

2.1. The first generation of theories

The basic question addressed by fiscal decentralisation is: What is the optimal allocation of economic responsibilities between different layers of government? The theories are commonly known as theories of fiscal federalism, as the pioneering papers mainly addressed the division of tasks within a federal system of government (for example, the United States). However, the theories can be applied much more generally to cover all other forms of intergovernmental relations. For example, in China the greater economic autonomy of regions and local communities seems to be one of the major reasons for its economic success (see Rodrik, 2007, and Ahmad, 1997). In Gelauff *et al*. (2008), the theory of fiscal decentralisation is applied to the division of tasks between the European Union and national governments.

The Netherlands is a unitary state and there is no federal government. In this article, the theory of fiscal decentralisation is therefore applied to the division of tasks between the Dutch central government and the Dutch local government, in particular municipalities and provinces.

The ideas of the first generation of theories of fiscal decentralisation are summarised in Table 2. Major contributions were made by Musgrave (1959), Oates (1972), Olson (1969) and Tiebout (1956). They clarify that neither a large-scale centralised government nor a fully decentralised government consisting of many small and local jurisdictions is likely to be efficient. The central government should focus on providing national public services, *i.e.* services whose benefits extend nation-wide or whose provision is subject to substantial economies of scale. Common examples are defence, foreign affairs, national infrastructure, monetary policy, macroeconomic stabilisation, and policies for income redistribution and poverty.

The provision of public services to mainly clear local beneficiaries should be assigned to local government. By providing local public services locally, their quality and quantity can be adjusted to local preferences and circumstances. Local financing of local public services, *i.e.* by local service charges or by locally set tax rates, helps also to adjust to local preferences and circumstances. People and corporations can vote with their feet and locate in the jurisdiction that offers the bundle of public services and taxes they like best. As a consequence, people and corporations distribute themselves across jurisdictions on the basis of their demands for local public services. Simultaneously, jurisdictions compete for these people and corporations by their services and tax rates.[1] Such policy competition stimulates policy learning, preference matching and efficiency. Decentralisation itself may also encourage experimentation and innovation, as individual jurisdictions are free to adopt new approaches to public policy.

Substantial economies of scale and external effects seem to be very strong arguments in favour of centralisation. However, by voluntary co-operation or outsourcing of some activities, jurisdictions may also reap part of the potential benefits of economies of scale. Similarly, some external effects can be internalised by negotiations with neighbouring jurisdictions and asking for contributions. For example, a swimming pool also serving the inhabitants of a jurisdiction close by may be financed partly by an investment grant from that jurisdiction.

Table 2. **Decentralisation *versus* centralisation according to the first generation of theories**

Advantages of decentralisation (smaller jurisdictions)	Advantages of centralisation (larger jurisdictions)
Stimulates preference matching for local public services, in particular when preferences are heterogeneous.	
Public services with limited external effects and geographical spillovers should be provided locally.	Public services with large external effects and geographical spillovers should be provided centrally.
Cross-border externalities of local public services may be partly internalised by voluntary contributions and negotiation.	Cross-border externalities of local public services can be internalised without need for voluntary contributions and negotiation.
Public services that can be financed by charges or land rent tax should be provided locally.	
Local service charges, high local taxes and mobility stimulate preference matching and policy competition.	
Local autonomy of borrowing leads via the capital market to fiscal discipline of local units.	Hierarchy and restrictions on local borrowing can ensure fiscal discipline at a local level.
Economies of scale by voluntary co-operation.	Economies of scale without need for voluntary co-operation; uniform policy serves efficiency.
Policy competition stimulates policy learning, preference matching and efficiency.	Policy learning at central level due to exchange of information and commitment building.
Public services for which costs of information and decision making increase with the number of participants should be provided locally.	Public services for which costs of information and decision making remain low when the number of participants increases should be provided centrally.
Stimulates political participation and helps to protect basic liberties and freedoms.	More efficient taxation and fiscal and monetary policy.
	Uniform level of public services, taxes and social security serves equity and allows redistribution from rich to poor regions and jurisdictions.
	Public services with a redistributive character (*e.g.* education and health care) should be provided centrally.

Decentralisation of tasks is directly linked to the issue of financing these tasks. Taxes and user charges based on the benefit principle are particularly suitable for assignment to the local level, inasmuch as the benefits are internalised to the local taxpayers. Following the ideas of Tiebout, the prices of real estate will be influenced by the local bundle of public services and taxes. For example, providing more and better-appreciated public services will lead to higher real estate prices. As a consequence, a real estate tax can then be regarded (partly) as a charge for such local public services. Similarly, a tourist tax can be regarded as a tax charging tourists for local public services. Taxes and user charges can also be useful to address negative local externalities or to raise revenues by the polluter pays principle. Examples are parking fees and tolls for roads, bridges and tunnels.

Already more than a century ago, Henry George (1879) argued that economic progress, urbanisation and population growth lead to an unfair enrichment of landowners. His slogan "We must make land common property" suggests that land should be nationalised first and then leased to private parties. However, George preferred taxing the uncultivated land value, because this would be less disruptive and controversial. With this "single tax" the government could avoid having to tax any other type of wealth or transaction and could support the poor. Introducing a large land tax causes the value of land titles to decrease correspondingly. According to George, the landowners should not be compensated for this holding loss. In line with Tiebout, it could be argued that the value of land also reflects the value of the local bundle of public services and taxes. Taxing private holding gains on land or selling publicly owned land at higher prices may therefore be an efficient and fair way to finance (new) local public services, for example roads and railway stations.

For various reasons, many types of taxes are not suitable as local taxes (see Norregaard, 1997, p. 54):

- Taxes suitable for stabilisation or redistribution (*e.g.* income tax) should be left for the central government.
- The base for local taxes should not be very mobile (*e.g.* taxes on land and housing), otherwise taxpayers will relocate from high to low tax areas and the freedom of local authorities to vary rates will be constrained.
- Tax bases that are very unevenly distributed among jurisdictions (*e.g.* taxes on major natural resources) should be left to the central government.
- Taxes that can be easily exported to non-residents should not be used as local taxes, as this would weaken the link between the payment of the tax and the services provided.
- Taxes that are fairly easy to administer could be left to local authorities. For a given tax, the more important the economies of scale, the stronger the argument to leave the tax at the national level.

When, for efficiency reasons, most major taxes are to be national taxes, local government will not be able to raise sufficient revenue for local public services, and transfers from the central government are therefore required. In order to better adjust to local preferences and circumstances, general transfers by the central government to the local government are then to be preferred rather than specific transfers. Specific transfers to local government may then only have a role in addressing externalities clearly surpassing the local level (Pigou subsidies). In addition, transfers between central and local government may also serve equity purposes, *i.e.* redistribution from rich to poor regions.

Four levels of fiscal decentralisation can be distinguished (see Table 3), ranging from full fiscal decentralisation to a fiscally centralised government with full fiscal equivalence – *i.e.* the same tax rates and mix and quality of public services is provided in the whole country. Nearly all countries have an intermediate level of fiscal decentralisation.

Table 3. **Four levels of fiscal decentralisation**

Level one	Full fiscal decentralisation: local government is fully responsible for deciding on the size and composition of public services and must finance all its expenditure.
Level two	Fiscally united local government: local governments co-operate to finance the provision of national/supra-local public goods; they are also fully responsible for the provision of local public services.
Level three	A fiscally centralised government without full fiscal equivalence: the central government supports local government by transfers: ● lump-sum transfers (*e.g.* per capita) to supplement local revenues in general; ● equivalence payments, *i.e.* to overcome local differences in tax capacity, local differences in the need for public services or local differences in the costs of producing public services. These transfers can be general (*i.e.* without explicitly prescribing the use and the requirements) but also specific.
Level four	A fiscally centralised government with full fiscal equivalence: the central government sets uniform standards for local public services, and finances all (net) expenditure by local government, *e.g.* of functional government units.

The first generation of theories of fiscal decentralisation has a strong normative message for local services: provision of local services by local or regional government is more efficient than centralised provision and can also serve democracy. However, the big gap between the theory and practice of fiscal decentralisation has stimulated further thought by stressing the relevance of practical issues and by revealing a dark side of fiscal decentralisation with issues like corruption and soft-budget constraints. It has also shed

light on the strictness of the assumptions used for deriving the fiscal decentralisation theorem (see also Oates, 2006), for example:

- Local public goods, like a swimming pool, school, park or theatre, often have interjurisdictional spillovers; by using public or private transport, households can consume the local public goods of various jurisdictions.
- Households consist of various persons and are multiple stakeholders (work, quality of living, specific leisure activities).
- Competition between jurisdictions can stimulate pure imitation instead of specialisation; competition to attract investments may be destructive.
- Jurisdictions provide bundles of public services and have limited possibilities to specialise.
- Equity considerations can imply that a similar minimum set of public services should be available and at rather similar prices/tax rates.
- Like local government, the central government may provide different local public services for different jurisdictions, for example by delegating the provision to local producers or by using knowledge of the local demand for local public goods.

2.2. The second generation of theories

Key assumptions in the first generation of theories of fiscal decentralisation are a benevolent central and local government and political competition between jurisdictions due to a high (potential) mobility of citizens and corporations. In this section, four supplementary theoretical perspectives are discussed (see Table 4):

- political economy;
- behavioural economics;
- agency theory and transaction cost theory;
- urban economics and new economic geography.

Table 4. **Four supplementary theoretical perspectives**

Theoretical perspective	Different assumption or supplementary insight
Political economy	Politicians, voters and civil servants serve their own interest and not the general interest; lobby groups can influence the political process.
	Central and local government are not benevolent.
Behavioural economics	Economic actors are not always rational; their behaviour may therefore not be in their own interest.
	Economic actors may also have non-economic motives.
Agency theory and transaction cost theory	Information is asymmetric and gives rise to adverse selection and moral hazard.
	Transaction costs are determined by frequency, asset specificity and uncertainty. The size and type of transaction costs are crucial for determining the best way to organise transactions, *e.g.* by the market, the central government or the local government.
	Rigid hierarchies and top-down planning are not always efficient; polycentric systems of governance with self-organisation can be more efficient.
Urban economics and new economic geography	Despite falling costs of transportation and communication, proximity has become even more valuable.
	Cities are major drivers of economic growth.
	Subsidies on home-ownership and infrastructure stimulate the abandonment of cities.
	Taxes of urban regions should not serve to stimulate rural regions.
	Social policy should help poor people not poor regions.
	Regional policy often fails to reduce regional disparities; new infrastructure may even increase regional disparities.

By employing different assumptions, these theoretical perspectives lead to supplementary insights on the best way to organise fiscal decentralisation.

2.2.1. Political economy

Political economists like Buchanan and Tullock, Niskanen[2] and Olson do not assume a benevolent central and local government, but investigate the political decision-making process in view of the incentives for participants like voters, politicians and civil servants. This gives a different perspective on the merits of centralisation and decentralisation (see Table 5). A benevolent local government will adjust to local preferences and can in this way increase welfare. However, a local government influenced by local lobbies, personal interest and corruption is much less likely to adjust to the local general interest and to increase welfare. Such a local government may also regard its budget as a soft budget constraint – *i.e.* when local deficits and debts become unsustainable, the central government will in the end always provide additional funding. For personal reasons, local government officials may also oppose institutional reform that would improve local interest (see, for example, Doerner and Ihlanfeldt, 2011). For example, merging with a neighbour city, village or province may threaten their jobs.

Table 5. **Political economy and decentralisation *versus* centralisation**

Advantages of decentralisation	Advantages of centralisation
No central government as Leviathan; no strong central lobbies disregarding local issues.	Smaller role for local lobbies, personal interest and corruption.
Differences in the bargaining power of jurisdictions at the central level do not lead to differences in the provision of local public goods.	No "free rider" behaviour of small municipalities on the positive external effects of public services provided by neighbouring cities and municipalities.
Complementary with other local policy.	Complementary with other central policy.
Accountability at local level.	Accountability at central level.
Local taxes as a major source for financing local public goods: less common pool and soft budget problems; less local rent-seeking behaviour for central government resources.	Local taxes as a minor source for financing local public goods: less tax exporting and false competition by jurisdictions.
	Central government bureaucracies are likely to attract more qualified people, because they offer higher salaries, better careers with greater diversity of tasks, less political intervention and a longer view of issues.
	Too much decentralisation can invalidate and jeopardise sound fiscal and monetary policy.

In his pioneering works *The Logic of Collective Action* (1971) and *The Rise and Decline of Nations* (1982), Mancur Olson stressed the importance of interest groups and "insiders" in the political process. He argues that relatively small groups (*e.g.* committees, advisory bodies and very specific lobby groups) are the most effective in influencing the political process. Big groups are generally rather heterogeneous, and individual members cannot easily influence the group behaviour. In contrast, small groups are much more homogeneous, and individual members can rather easily influence group behaviour. As a consequence, the economic and social incentives for participating in this group are also stronger, and such groups will last longer. Small groups are therefore more effective in influencing the political process, as they can easily focus on specific issues, provide strong incentives for its members and last longer. A major way to influence the decision-making process is to manipulate or restrict the circulation of essential information.

This analysis also seems to imply that lobbies and personal interest are generally more effective at a local level than at a more aggregate level, as media coverage will be smaller, special interest groups can more easily co-operate, and formal separation of powers is smaller. However, capture at the central level may be higher due to the greater importance of campaign finance, more uneven political competition or poorer information available to citizens to evaluate candidates on nation-wide issues (for an overview of the various arguments, see Bardhan and Mookherjee, 2006). If different regions are heterogeneous with regard to literacy, economic backwardness or socio-economic inequality, capture of local governments will vary correspondingly across regions. The extent of capture will be located somewhere between the extremes of standards of governance across regions; more backward and unequal regions will be worse off compared with centralisation, while more progressive and equal regions will benefit. These tendencies are accentuated in the case of central governments elected on the basis of proportional representation rather than first-past-the-post elections.

According to Riker (1964),[3] the strength of national political parties and the relationship between the national and local parties are important for the political incentives of local government. In the case of strong political parties, the career of politicians in local government depends on their party's political and financial support to get re-elected and on the possibility of promotion to the national government. National governing parties, in turn, are interested in supporting local politicians whose policies do not impose significant negative externalities on other jurisdictions and thus on overall national performance. Therefore, strong national political parties which are also important at the local level can provide incentives for local politicians to conduct efficient policies and help to internalise externalities of local policies. Moreover, strong national party systems provide incentives for local governments irrespective of whether local politicians are appointed or elected. Even when local politicians do not need support during elections, career concerns can play an important role.

National parties with clear local counterparts may also have other effects. In the Netherlands, ministers and secretaries of state are often recruited from aldermen in the major cities. Their experience and ideas about topics like infrastructure, social assistance, safety and the financing of local government can then be used to improve decision making at the national level. However, there may also be capture of the national government by local lobbies and interests. For example, Bordignon (2004) finds evidence that local governments of the same party as the ruling one at the national level tend to be more frequently bailed out *ex ante* or through higher transfers *ex post*.

From a political economy point of view, an efficient and fair government can only be obtained by incorporating sufficient checks and balances in the political process at the central and local levels. Examples are independent auditing committees, evaluation and advice by independent high-quality experts in considering reforms, democratic elections, transparent budgeting and decision making, and a strong and free press. The Dutch tradition of mayors of municipalities and commissioners of provinces being appointed by the central government may also be a way to reduce local capture. In selecting experts to advise the central government on reforming local government finance and judging the merits of their advice, the reputation of independence of these experts should also not be overlooked. For example, some consultants and researchers specialised in local public finance issues may be inclined to serve their clientele – *i.e.* defend the interests of current

local government institutions – instead of giving advice strictly based on academic research and facts.

Local taxes as a major source for financing local public goods can reduce the common pool and soft budget problem of excessive claims on central government resources. Local taxes can also limit local rent-seeking behaviour for central government resources. According to Chamlee-Wright and Storr (2011), major financial transfers from outside the local community may stimulate the "dark side of social capital": community-based groups may reorient their stocks of social capital away from mutual assistance and toward lobbying and rent seeking. Chamlee-Wright and Storr claim that this happened in the New Orleans post-Katrina recovery. This adverse effect on social capital may also explain the lack of economic success in developing countries or poor regions receiving substantial amounts of development aid.

2.2.2. Behavioural economics

A distinctive feature of behavioural economists like Simon, Kahneman and Tversky,[4] Thaler, and Akerlof and Shiller is that they do not assume rational behaviour and economic motives. Instead, they use assumptions of non-rational behaviour and non-economic motives to understand the behaviour of economic actors (see Figure 4).

Figure 4. **Behavioural economics focuses on non-rational behaviour and non-economic motives**

Rational behaviour	**Non-rational behaviour**
Perfect foresight and information, no transaction costs, well-defined and stable preferences	Short-sightedness, loss aversion, money illusion, unrealistic optimism, bounded rationality, framing matters and animal spirits like confidence, story-telling and anti-social behaviour
Economic motives	**Non-economic motives**
Profit, income and leisure time	Altruism, fairness and identify like culture, religion and way of life

Source: Figure made by the author.

In their book *Animal Spirits* (2009), Akerlof and Shiller argue that imperfections in human decision making are a major cause of the current financial crisis and real estate swings. Such imperfections are also important to understand the behaviour of central and local government and the political decision-making process. For example, taxes that are levied implicitly (*e.g.* as part of the purchase of a good or service) have much less effect on behaviour than taxes levied in a clearly visible and separate way. Citizens can only properly compare the costs of extra local taxes with the benefits of extra local expenditure when these taxes and benefits are fully visible and well understood.

Mental accounting is the set of cognitive operations used by individuals to organise, evaluate and keep track of financial activities. Rational decision making assumes the fungibility of funds. However, mental accounting violates this basic economic principle (see Thaler, 1999). This applies not only to the labelling of revenue – *e.g.* as a transfer from the central government, local tax, dividends or transfer from reserves, or translating the

Table 6. **Behavioural economics and decentralisation *versus* centralisation**

Advantages of decentralisation	Advantages of centralisation
Higher local taxes reduce the fly-paper effect and fiscal illusion of general transfers by central government.	
Local taxes are generally more simple and visible than national taxes.	
Limiting net transfers to other regions and jurisdictions is regarded as fair.	Uniform level of local public services, tax rates and social security may serve nation building and reflects national solidarity.
Local culture and identity are maintained and stressed; intrinsic motivation is stimulated, *e.g.* via volunteer work.	

various revenues administratively into many different earmarked funds – but also to the costs and benefits taken into account in deciding on expenditure and taxes, the frequency with which accounts are evaluated, whether balancing the accounts is defined narrowly or broadly, or whether balancing is only required in the medium term. Economists can play a role in increasing the rationality of decision making, for example by showing the inefficiency of labelling and by showing long-term analyses.

The fly-paper effect indicates that grants tend to stick with budgetary use and thus result in a higher level of public services than would be the case if they were made directly to individuals. This could reflect the fact that political pressures for tax reduction following a grant to the budget are weaker than pressures against a tax increase when the grant is made to individuals. The choice among public services may also differ when financed by retention of an unrestricted grant than when financed by increased taxation. An important implication is that the evaluation of the effectiveness of a specific grant depends on the premise on which it is made. Spending only part of the central government grant for extra local public services seems to be a waste of resources and a violation of central government policy. However, it could also be regarded as a desirable avoidance of fly-paper effects in line with the preferences of local residents.

According to Janis (1972) in his famous study on the failed American invasion of Cuba in 1961, social interaction in a small group of policy makers and advisers may lead to major policy failures. Such a small group leads to "group think" by stimulating over-optimism and narrow-mindedness and urging a consensus opinion. A larger group of policy makers and advisers coming from different backgrounds (*e.g.* different stakeholders, professions, age, nationality or region) may therefore help to improve the quality of decision making. This applies also to fiscal decentralisation, *e.g.* in deciding about major reforms.

Non-economic motives can play a major role in the solidarity between different groups of households and regions, *i.e.* the willingness to pay for other households and regions. As a consequence, the amount of redistribution nationally and locally can be determined by non-economic motives. Non-economic motives may also explain the provision of public services. For example, stimulating national identity can be a major reason for establishing a national system of schooling with a national curriculum. Similarly, a strong local identity and culture can be a reason for a separate jurisdiction and a different curriculum. For example, in the Netherlands province of Friesland, primary and secondary schools also give lessons in the Friesian language.

The existence of non-rational behaviour and non-economic motives can also increase the scope for political economy, *i.e.* the possibilities for persons and lobby groups to influence the political decision-making process for their own benefit, *e.g.* misusing arguments of identity.

2.2.3. *Agency theory and transaction cost theory*

Agency theory stresses the importance of incomplete and asymmetric information for contracts between economic actors, like between the employer and the employee and between the insurer and the insured. The political process can also be regarded as a principal-agent problem: the voter is the principal and the politician is the agent who does not do what the voter wants due to information problems and transaction costs.

Agency theory can also be applied to the division of tasks between central and local governments. The central government can be regarded by the local government as a lender of last resort. This gives the local government a moral hazard problem, *i.e.* an incentive to spend more than is wise for sound local public finance. The design of the transfers by the central government may also stimulate moral hazard by local governments. For example, when some expenditure by the local government is substantially co-financed by the central government, the local government has the incentive to exaggerate the benefits and underestimate the costs and risks. To remedy such moral hazard, the central government could take over activities of the local government. An alternative is to introduce monitoring and independent analysis (*e.g.* of the health of local public finance or of the costs and benefits of specific projects) or to use compensating incentives – for example, fines for providing misinformation about local expenditure, or the introduction of a strict supervisory regime and substantial mandatory increases in local taxes in the case of substantial local budget deficits.

Neo-classical economics ignores transaction costs. In striking contrast, transaction cost economics stresses the importance of transaction costs for the efficient organisation of corporations, the government and the whole economy. Major advocates of transaction cost economics, like Williamson, Ostrom and Dixit, do not start from a simple dichotomy between markets and government and do not look for signs of market or government failure. They stress the variety, complexity and dynamics of the relationships between all kinds of public and private actors and look for specific improvements. According to Dixit (1998, p. XV): "The transactions-costs politics view leads me to argue that the political process should be viewed as … a process taking place in real time, governed and constrained by history, and containing surprises for all parties. In this view, the traditional dichotomy of markets versus governments … largely lose their relevance. Markets and government are both facts of economic life, and they interact in complex ways … The most we can do is to understand how the combined economic-political system evolves mechanisms to cope with the variety of transactions costs that it must face." According to North (1990), transaction costs are even more important for political markets than for more conventional markets.

Major merits and limitations of decentralisation in view of transaction cost theory are summarised in Table 7. According to Williamson (2002), complex and uncertain projects should be organised at a high level of governance. Some of these projects may also be outsourced to private partners with a lot of technical and managerial expertise. However, such outsourcing may be subject to moral hazard, as the private partners can have a strong incentive to leave all major risks for the government and it is very difficult for a government lacking such expertise to monitor and prevent this.

In the Netherlands, the disaster with the new North-South underground railway in Amsterdam illustrates these issues. According to the municipal Committee of Inquiry (2010), the costs for the municipality of Amsterdam will be EUR 1.4 million instead of

Table 7. **Decentralisation *versus* centralisation according to agency theory and transaction cost theory**

Advantages of decentralisation	Advantages of centralisation
Decentralisation should be accompanied by monitoring, benchmarking and incentives to compensate for moral hazard.	Corporations with affiliates in various locations should preferably face the same local rules and procedures for all their affiliates; this reduces their administrative burden.
	Complex and risky projects demanding high technical or managerial expertise should be centralised or outsourced.
Big bureaucracies have high internal transaction costs and suffer from control loss. Decentralisation can keep bureaucracies small and efficient.	
Polycentric systems are more efficient than rigid and hierarchic top-down structures.	
In a large and heavily populated country, decentralisation is more desirable.	In a small country, centralisation is more desirable.

EUR 0.3 million, and the underground railway will be ready in 2017, *i.e.* eight years later than initially planned. Major causes for this disaster are the absence of independent cost-benefit analysis that could have clarified the risks of this project and major alternatives, insufficient managerial and technical experience for such major incidental projects at the municipal level[5] and too much dependence on hired private expertise; such private experts lacked incentives to control the costs and planning and to inform the town council well and at an early stage.

Williamson (1967) also argued that large hierarchic organisations suffer from control loss, as information gets distorted by transferring it from one level of hierarchy to another. This control loss due to distorted information can be limited by limiting the size of an organisation. This is an argument in favour of decentralisation and smaller organisations. However, for decentralised units to be efficient and effective, they must be sufficiently large in terms of population, activities and income.

According to Ostrom (2005a, 2005b), polycentric systems can be more efficient than rigid and hierarchic top-down structures. She studied police service delivery in mid-sized metropolitan areas throughout the United States and concluded that, when it comes to the size of a police organisation, bigger is not necessarily better. Smaller police agencies often deliver more personalised services, have higher clearance rates and are able to deploy a higher proportion of their personnel on the street. Metropolitan areas in the United States are policed by a patchwork of agencies, but have also developed local co-operative networks for delivering public safety across jurisdictional lines. These networks are glued together with an array of formal and informal agreements. Consolidation may therefore be a good solution for some communities, but it is not likely to be a universal cure for improving the performance of police.

Agency theory and transaction cost theory also have some clear messages for an efficient design of transfers:

- General and specific transfers by the central government are to be allocated on the basis of objective data and criteria.
- Local authorities have an incentive to misrepresent relevance, costs and benefits of local projects. This argues for monitoring and independent auditing. If this is not effective or very costly, it could also mean that centralisation or general lump-sum transfers by the central government are to be preferred to granting specific transfers to local government.

2.2.4. Urban economics and new economic geography

Due to the work of economists like Glaeser and Fujita and Krugman (*e.g.* Glaeser, 2011, and Fujita and Krugman, 2004), urban economics and new economic geography have been flourishing since the 1990s. These theories stress the importance of location and proximity for producers and consumers, and come up with several surprising insights. The drastic fall in costs of transportation and communication during the past decades would suggest a decrease in the value of proximity, density and closeness and therefore the decline of cities. However, better and cheaper communication does not reduce the willingness of people to meet personally, but actually increases it. Furthermore, technological change has increased the returns on knowledge that is produced by people in close proximity to other people. As a consequence, cities still remain attractive for producers and consumers and have continued to be major drivers of economic growth.

Government policies and fiscal decentralisation arrangements should take account of this important role of the city. From this point of view, tax policy, spatial planning arrangements, the delimitation of jurisdictions and transfers from general government to local government should not deter the growth of cities but be spatially neutral. For example, taxes of urban regions should not serve to stimulate poor rural regions. Furthermore, subsidies on home-ownership stimulate the abandonment of cities, as space is scarce in cities and home-ownership is much more common in rural areas. Similarly, subsidies on infrastructure may stimulate working in the city and living outside the city. Such subsidies on home-ownership and infrastructure can therefore have adverse effects on the financing of cities via local taxes and on economic growth.

Urban economics and new economic geography have also changed the perspective on regional policy (see Brakman *et al.*, 2005). They clarify that regional policy often fails to reduce regional disparities in productivity and income. Core regions tend to be better off than their surrounding peripheries. And core periphery structures are hard to upset since agglomeration advantages pull economic activities to the cores. Policy makers should recognise that disparities between provinces and between regions within provinces are persistent. Regional development funds should therefore be targeted to regional growth poles. But there is an equity-efficiency trade-off here. Agglomeration is positively related to overall productivity and growth, but negatively related to wage equality. Moreover, improving the access of peripheral regions with infrastructure may also stimulate the desire to live, work and produce in the core and no longer in the periphery. For example, in the Netherlands, a new tunnel under the Westerschelde river was intended to improve the accessibility of the town Terneuzen via Goes, another town in the province of Zeeland. However, the effect was that inhabitants of Terneuzen could more easily accept a job outside their town, *e.g.* in Goes. Some corporations joined their employees and Terneuzen became a forensic town instead of a new economic centre.

From the perspective of urban economics and new economic geography, it is much more effective to help poor people instead of poor regions. Poor people can help themselves by moving to regions with better prospects. The government could stimulate this, but in general it should not try to create jobs for poor people in poor regions as this will not work and will be very costly, and part of the benefits will leak to other parties, *e.g.* owners of land or housing. In the Netherlands, the disaster with Blue City illustrates this result. Blue City was a project to revitalise the poor region of eastern Groningen by creating an artificial lake for recreation and building a new village of 1 500 houses for the

rich and elderly. However, despite major marketing efforts and public investments and some success in attracting recreational activities, after several years only 200 houses were sold. Last year, the municipality and province therefore decided to redesign and downgrade the project substantially. According to an evaluation by the provincial court of auditors, the project was based on wishful thinking without serious analysis of the prospects, risks and alternatives.

3. Dutch central and local government in view of history

3.1. Introduction

The history of fiscal decentralisation in the Netherlands reveals major shifts from centralisation towards decentralisation and *vice versa* (see Table 8). Current fiscal decentralisation still reflects to a great extent the Constitution of 1848. This Constitution was designed by the liberal Prime Minister Thorbecke. It drastically limited the power of the king, introduced elections for those paying taxes, and divided the responsibilities over the central government, provinces and municipalities. In the Netherlands, the latter division of tasks is often referred to as Thorbecke's house of three floors.

Table 8. **Dutch fiscal decentralisation since 1500**

Before Thorbecke's house (= before the Constitution of 1848)	
1500-1580	Part of the Habsburg Empire: Efforts by the Catholic kings to impose one tax system and one religion.
1581-1794	The Dutch Republic of United Provinces: A federal state.
1795-1847	A unitary and centralised state imposed by the French; after 1814, the Kingdom of the Netherlands.
Thorbecke's house (= the Constitution of 1848)	
1848-1928	A unitary and decentralised state: More responsibility for municipalities; provinces reintroduced but with a much less prominent role.
1929-1982	A centralised welfare state.
1983-present	A smaller and more decentralised welfare state.

This section starts with two episodes before the construction of Thorbecke's house. Section 3.2 is devoted to the first federal state in modern history, *i.e.* the Dutch Republic of United Provinces. Its successor, the unitary and centralised state imposed by the French, is the topic of Section 3.3. In Section 3.4, Thorbecke's house and its major changes during the past 160 years will be discussed.

3.2. The Dutch Republic of United Provinces[6]

The Dutch Republic of United Provinces was the first federal state in modern history. It started as a revolt against the reign of King Philip II of Spain. The Dutch revolted because of high taxes, persecution of Protestants, and efforts to modernise and centralise the medieval government structures of the provinces. In a legal and formal sense, the republic was a confederation of seven provinces co-operating to serve a common purpose. However, in practice and for major national policy issues, it was more like a federal state, dominated by the richest and by far most populous province (Holland) and its major cities, like Amsterdam. To finance the federal expenditure (*e.g.* on defence), the only federal tax was import duties on foreign trade, and other federal revenues were small. The rest was therefore to be financed by contributions by the provinces. However, reliable and somewhat up-to-date information by province on variables like population, income and

trade was absent. It was therefore decided that the provinces had to contribute in line with the 100-year-old ratios used to finance the regular and irregular tax payments to the Habsburg Empire. This implied that Holland, with a population of nearly 50% of the Republic, contributed about 60%. Despite major uneven economic and demographic developments by province, these ratios were used for the next 200 years; only incidentally were some modifications introduced.

Table 9. **Dutch fiscal decentralisation before Thorbecke's house: The Dutch Republic of United Provinces, 1581-1794**

Major role for provinces and cities.
Very limited central government dominated by the province of Holland and its cities.
Cities have their own law, justice, coin and taxes.
Municipalities mainly financed by excise duties.
Local water boards increase in scale and are subjected to political control by the ruling elite.

The Republic's tax system was not a uniform one. It could best be regarded as a harmonised federal system with regional and local variations – *i.e.* there were clear difference in tax rates and types of taxes but they reflected major regional differences in welfare, urbanisation, and social and economic structure. Such a tax system was much more efficient than imposing one uniform system. In general, due to the important role of excise duties, the poor paid relatively more than the rich. Provinces were also forbidden to introduce taxes (*e.g.* import duties) that could harm trade with other provinces.

There was no national monetary policy in the Republic. During the first hundred years, 14 different national currencies were being used: two from Holland, one in each of the other six provinces, and six from cities in the eastern part of the Republic. In addition, foreign currencies were very important. At the end of the 17th century, the number of national currencies was reduced to two, namely those of Dordrecht and Utrecht. Due to a permanent external trade deficit, a major part of these coins were exported.

The Republic became the richest nation in the world. The important role of merchants in Dutch politics implied that the Dutch institutions favoured economic growth. Religious tolerance encouraged skilled immigration. Economic enterprise was stimulated by clear property rights, an efficient legal system, sound banking, and limited restrictions on international trade. Taxes were high but levied on expenditure rather than income. The independence of the local populations, which acted rather autonomously and were wealthy, kept the Netherlands from falling into the reign of absolutism that struck the rest of Europe with the Habsburgs and Bourbons. This avoided devastating the development of human capital and economic performance. It was a surprise to many that a nation not based on the church or on a single royal leader could be so successful. The Constitution of the Republic was also a major influence on the United States Constitution.

Dutch water boards originate from 1000-1200 and are one of the oldest democratic institutions in the world (see Kromhout, 2006). In order to control water by drainage and by building and maintaining dikes, ditches and barrages, local water boards were established consisting of all local farmers and other owners of property close to water. Each was responsible for proper maintenance of their part. Elections were held, taxes in kind or cash could be levied and, in case of misbehaviour, fines and even death penalties were possible. The job as head of the water board (count of the dike) was financially very attractive, as in

addition to a fixed salary fees could be charged for all kinds of services. Over time, as the scale of water boards increased, corruption became quite common – for example, a farmer could buy off his duty of proper maintenance by paying some money to the head of the water board. Major flooding made clear that to effectively control the threat of water, water boards had to co-operate and merge. The scale of water boards drastically increased, and they became subject to political control by the ruling elite.

But after the golden age of the Dutch Republic, wars to contain the expansionist policies of France burdened the Republic with huge debts. Fierce competition for trade and colonies, especially from England, furthered the economic downturn. The three Anglo-Dutch wars and the rise of mercantilism and protectionism had a negative effect on Dutch shipping and commerce. Long-term rivalry between the two main factions in Dutch society, the Republicans and the Royalists, sapped the strength and unity of the country.

The decentralised decision-making system was not able to meet these challenges. The federal power was too small for major reforms, *e.g.* to introduce a more efficient and fair national tax system and abolish the arbitrary and unbalanced contributions by the provinces. As a consequence, provinces other than Holland could behave more and more like free riders. The debt of Holland was exploding and its tax burden increased to more than 50% of the wage of an unskilled worker. But the Dutch political elite were still not open for major reform, as the massive public debt was a major source of their income. The financial problems weakened the Dutch military power and therefore also the opportunities to protect its international trade. This all led to the economic and political collapse of the Dutch Republic.

3.3. A unitary and strongly centralised state imposed by the French[7]

In 1795, a French "liberation" army was invited by "patriots" and helped to break up the political deadlock. William V, prince of Orange and last *stadtholder* of the Republic, fled to England and went into exile. In 1806, Napoleon made the former republic a kingdom with his brother acting as king. This was succeeded by full annexation and incorporation in the French empire in 1810. The Batavian-French period ended with the departure of the French army and the start of the United Kingdom of the Netherlands in 1814.

During this Batavian-French period, the decentralised government structure of the Dutch Republic was replaced by a unitary and centralised French-style state. This resulted in the establishment of a central government bureaucracy with various ministries, a national tax office, a national tax system, compulsory military service, the abolishment of provinces, and a national mining law claiming the ownership of all subsoil mineral resources. It also led to major innovations like a constitution, legal code, population register, land register, family names, house numbers, standard weights (*e.g.* kilo, metre and litre) and a royal academy of science.

The national tax system implied that the rates for excise duties became the same for all provinces. The tax system was modelled after Holland's tax system. Holland's real estate tax was introduced in the other provinces. For the rural provinces, it implied a drastic increase of land tax and new excise duties on necessities, like bread and meat. In line with the ideals of the French Revolution, the tax system was to be made less regressive and fairer for the poor. However, efforts to introduce income tax were not very successful due to massive evasion and collusion with tax collectors. These problems were resolved by introducing several indirect taxes on income, *e.g.* on the number of domestic servants, the

Table 10. **Dutch fiscal decentralisation before Thorbecke's house: A unitary and strongly centralised state imposed by the French, 1795-1847**

Establishment of a central government bureaucracy, constitution and law book.
Provinces become part of central government.
Introduction of a national tax system and abolishment of local excise duties.
National mining law: all mineral resources are the property of the national government.
Water boards supervised by provinces.
Introduction of a national system of primary schools mainly financed by fees.
Central government tries to set minimum standards for the quality of roads and waterways; local government becomes responsible for their proper maintenance.
1814: Departure of the French, start of the Kingdom of the Netherlands.
1814: Creation of the Dutch Central Bank.
1830: Secession of Belgium.

rental value, or the value of the furniture. To ensure sufficient tax revenue, high and uniform excise duties on necessities – like salt, soap, jenever, turf, milling and grinding – were also added. Despite substantial lobbies from the rural provinces, taxing interest from public debt was not considered, as this would make it very difficult to issue new debt. It would also not be fair, as the rich owners of government bonds were already hit by big holding losses. This new national tax system applied for nearly a whole century.

The French mining law of 1810 claiming state ownership of all mineral resources was included in the laws of the new Kingdom. This law in French was only abolished nearly two centuries later, *i.e.* in 2003. Due to this law, the ownership of charcoal found in the Dutch province Limburg and natural gas in the Dutch province Groningen clearly belonged to the central government and not to these provinces or private landowners. As a consequence, the discovery of these major mineral resources did not lead to any regional disparities in the Netherlands. This contrasts with the situation in Canada, for example, where Alberta is by far the richest province due to its mineral reserves.

In 1814, after the departure of the French, William I became king. He was an autocratic and unselfish ruler with hardly any countervailing power from Parliament. He created the Dutch Central Bank, stimulated the construction of roads and canals ("canal king" was his nickname), and granted cheap loans to industries. The power of the King and the loss of political autonomy of the cities and provinces made it possible to choose a much more efficient routing of roads and canals than before 1795. The King could also impose agreement about the allocation of toll revenues to the neighbouring cities.

In 1830, Belgium started a secession war. Major grievances were: under-representation in the Parliament, in the central government and among army officers; the unfair tax system; and the huge interest payments mainly benefiting the economic elite in Holland. The new national tax system was considered unfair because it abolished a lot of import duties protecting manufacturing in Belgium and raised excise duties which drastically increased the cost of living.

After the secession of Belgium in 1830, the autocratic rule by King William was no longer accepted. The public debt was exploding and public finance had become unsustainable.[8] This was caused by high military expenditure (*e.g.* due to the secession war with Belgium), expenditure on canals and industrial policy, lower tax revenue due the abolishment of some excise duties, and higher interest rates fuelled by the rising debt. The King abdicated and the Constitution was changed, resulting in much more power for Parliament.

3.4. Thorbecke's house[9]

Thorbecke's house was constructed more than one and a half centuries ago. Since that time, the demography, economy and political system of the Netherlands have changed dramatically. The population grew from 3 million in 1848 to 17 million, implying an increase in population density by a factor of 5. Life expectancy doubled from 37 years to nearly 80 years. Material welfare measured by GDP per capita increased tenfold. Also, the structure of the Dutch economy was totally transformed. In 1850, agriculture and fishing were responsible for 40% of total employment; their share has now dropped to 3%.

Inventions like the telegraph, telephone, radio, television, Internet, steamships, bicycles, trains, cars and planes have created a whole new infrastructure of mass communication and mass transport. Already in 1892, the neurologist Nordau noted that "due to the enormous increase in communication and mobility, the world of an average villager is larger than that of the prime minister of a country one century before – that villager discusses the famine in Russia, a rebellion in Chili, the scandal with the Panama-channel and the world exhibition in the USA. The correspondence of a maid is currently larger than that of a professor a century ago" (Nordau, 1892, according to van der Woud, 2006, p. 99). In the Netherlands in the period 1850 to 1920, the time needed to travel from one location to another was already drastically reduced by the massive government investments in train and tram. At present, the number of passenger cars corresponds to about half of the Dutch population and, by public or such private transport, people can reach any place in the Netherlands in a few hours.

The role of the government also drastically increased: In 1850, public expenditure was 14% of GDP and – after a peak at 60% in 1983 – it is now 50% of GDP. The expenditure by municipalities and provinces increased from 2% of GDP to 18% in 1983, to currently 12% of GDP.

However, at the same time the number of municipalities drastically decreased, from 1 209 in 1850 to currently 430. In 1850, the ten smallest municipalities all had less than 100 inhabitants (see Ekamper *et al.*, 2003). One century later, the ten smallest municipalities had between 200 and 400 inhabitants. Currently, Schiermonnikoog is the smallest municipality in the Netherlands with 900 inhabitants, and the largest of the ten smallest municipalities now has 6 000 inhabitants.

A similar drastic increase in scale occurred for water boards: the number of water boards decreased from 3 500 in 1850 to 2 500 in 1950, to the current 27.

This increase in the scale of these two types of local government contrasts with the development of the number of Dutch provinces: this was constant and even increased in 1986 to 12 when, due to the reclamation of land, one new province (Flevoland) was created.

Economic theory (see Section 2 above) offers various explanations for the drastic reduction in the number of municipalities and water boards since 1850:

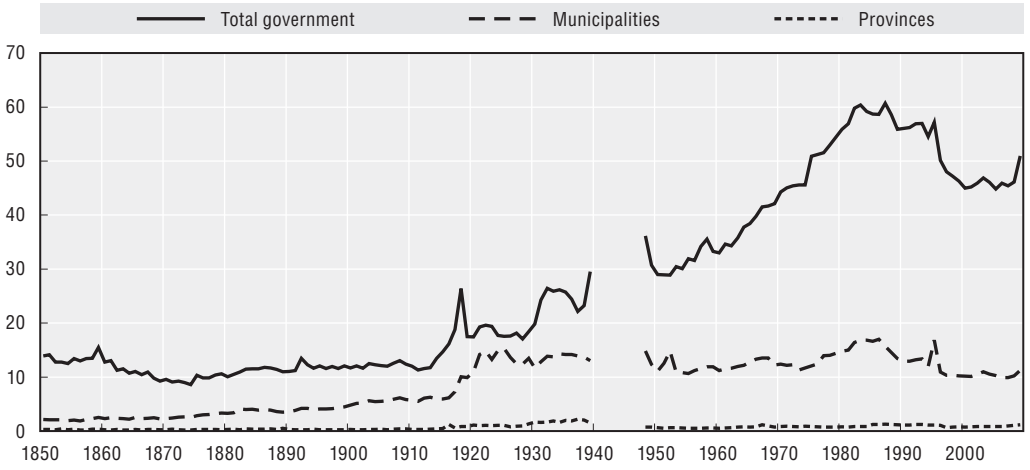
- The increase in the number and complexity of government tasks has greatly increased the minimum scale required for adequately and efficiently performing these tasks.
- The advance of technology has made it much easier to perform such tasks on a larger scale.
- National government policy to ensure that the same set and quality of local public services are provided in the whole country reduces the scope for taking account of local preferences. As a consequence, there has been a great reduction in the potential welfare gains of having many different small municipalities better taking account of differences in local preferences than larger municipalities.

- The increase in communication and mobility, in population density and in urbanisation has increased the positive and negative external effects of public services and private activities.
- The increase in communication and mobility has also changed the identity of people. Many people now live, work or go to school in different places than where they were born and raised, or are even commuting daily. As a consequence, identity has become less local. For example, in the Netherlands, the outcome of local elections is often determined to a very great extent by national policy issues.
- The increase in the tasks of the local government reinforces the need to contain local lobbies and personal interest and to ensure that the public interest is really served. This implies a scale of the municipality in which individual persons or families living in that municipality cannot influence the decision-making process to their own benefit. This requires clear and transparent decision-making and auditing procedures, in particular for small municipalities.

Thorbecke's house is often characterised as a building with three floors: central government, provinces and municipalities. However, in striking contrast with the Republic of United Provinces, provinces play only a minor role in Thorbecke's house (see Figure 5). The latter can therefore better be characterised as a building with two main floors (central government and municipalities) and one intermediate level (provinces).

Figure 5. **Total public expenditure and the role of municipalities and provinces**

Per cent of GDP

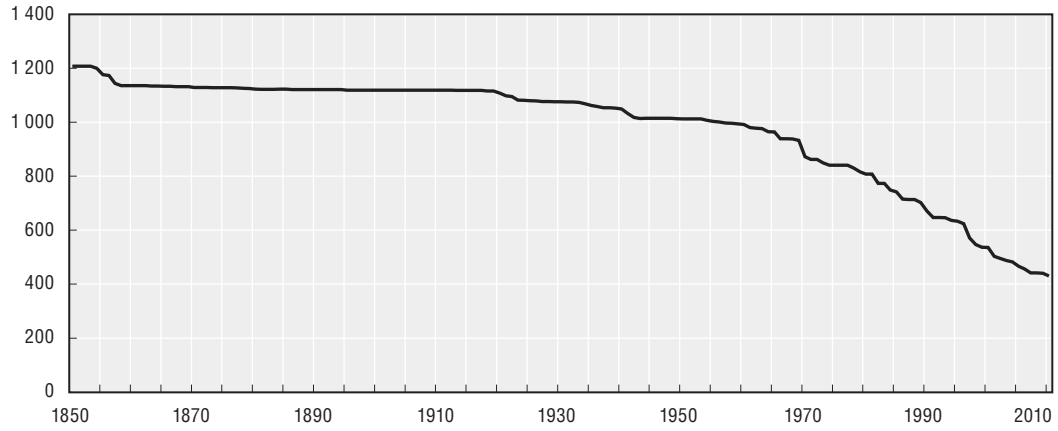


Source: Statistics Netherlands, historical time series on Dutch public finance.

In Thorbecke's house, local taxes have always been relatively small, varying between 1 and 5% of GDP. This reflects that the Netherlands is a small country with a very open economy in which major differences in local taxes are not considered to be efficient or fair.

In terms of public debt, municipalities have played a major role. During the period 1920-37, the increase of Dutch public debt from 50 to 100% of GDP was mainly due to the increase of debt by municipalities; the increase in local taxes was insufficient to finance the rapid increase in municipal expenditure. During the period 1950-70, total public debt drastically decreased, even though the municipal debt increased. As a consequence, in the 1970s the major part of Dutch public debt was that of municipalities.

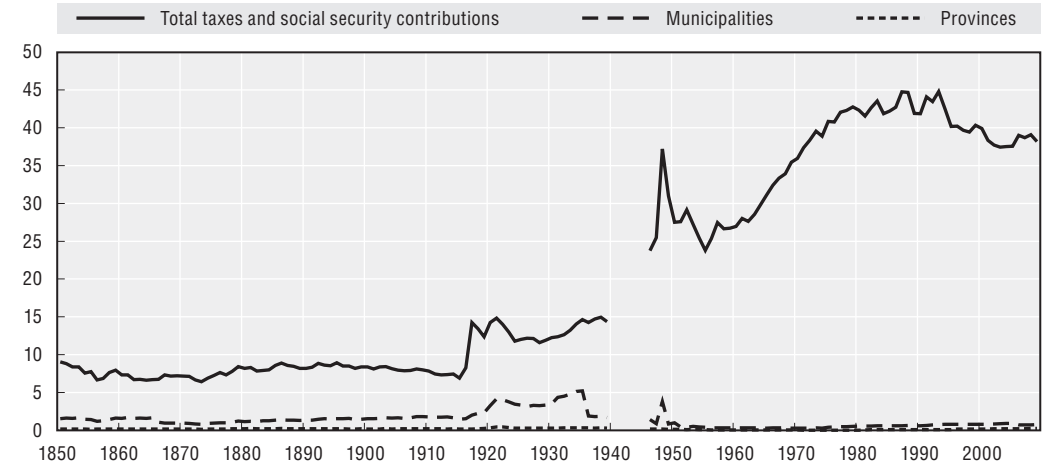
Figure 6. **The number of municipalities since 1850**



Source: Statistics Netherlands.

Figure 7. **Taxes and social security contributions by type of government, 1850-2009**

Per cent of GDP



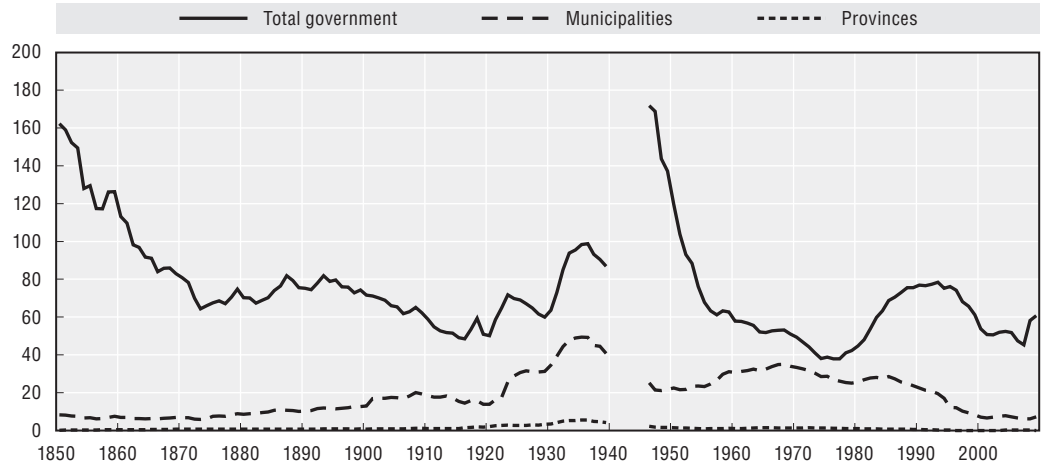
Source: Statistics Netherlands, historical time series on Dutch public finance.

From an economic theoretic point of view, this is not very efficient, as the central government should take the role of macroeconomic stabilisation and its debt should preferably reflect the major macroeconomic and political risks, *i.e.* those of economic crisis and war. The major role of the debt of Dutch municipalities during these two periods reflects major unbalances in the division of tasks with Dutch central government. Since the 1980s, the public debt figures suggest a much more efficient division of tasks.

In the remainder of this section, Thorbecke's house – *i.e.* the division of tasks between Dutch central and local government since 1848 – will be investigated in somewhat more detail. Three periods are distinguished:

- a unitary and decentralised state (1848-1928);
- a centralised welfare state (1929-82);
- a smaller and more decentralised welfare state (1983-present).

Figure 8. **Public debt by central and local government as a per cent of GDP, 1850-2009**



Sources: Statistics Netherlands, historical time series on Dutch public finance; R.H. van der Voort (1994), *Overheidsbeleid en overheidsfinanciën in Nederland*, 1850-1913, NEHA, Amsterdam; J.L. van Zanden (2004), "Historical Debt Estimates for Dutch Central Government, 1850-1900".

Table 11. **Thorbecke's house 1848-1928: A unitary and decentralised state**

Provinces reintroduced but with a much less prominent role.
All municipalities are granted equal rights; no special privileges for cities any more.
1865: Abolishment of municipal excise duties.
1874: Law forbidding child labour under 12 years (but without any inspections).
1901: Law introducing compulsory education for children between 6 and 12 years.
1902: Law for stimulating the quality and quantity of housing.
Rapidly increasing expenditure on education mainly financed by municipalities. Since 1857, public schools are for a small part financed by the central government; since 1917, private (Christian) schools are given the same entitlements for public funding.
Central and local governments invest in infrastructure, public transport, housing and utilities (water, energy).
Increasing expenditure by municipalities financed by more debt and higher municipal income taxes.
Increasingly national water control (1877 Ministry of Water Control).
1914: Creation of the Municipal Bank serving municipalities and provinces.
1917-19: Introduction of the general right to vote.

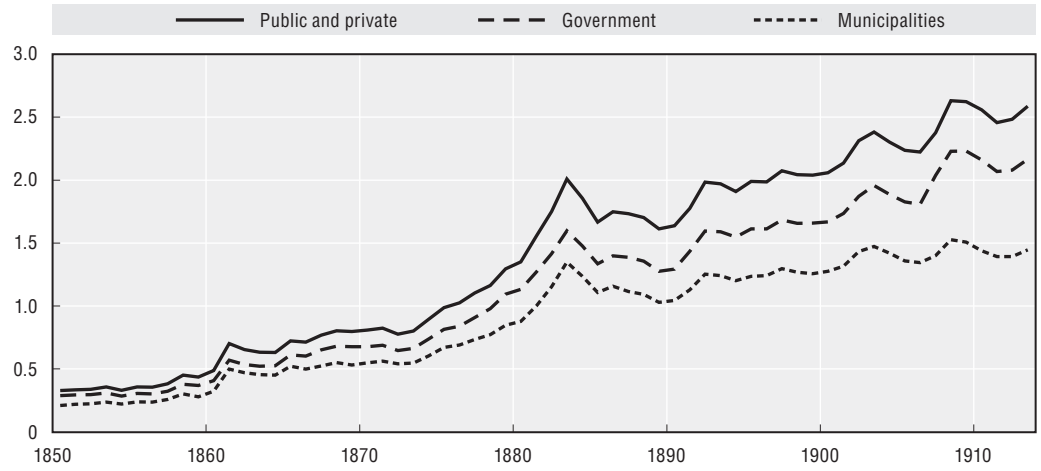
3.4.1. A unitary and decentralised state (1848-1928)

The increase in government expenditure during 1848-1928 reflects that government wanted to modernise the economy and to reduce social problems. Local government played a major role in improving education, housing and infrastructure (roads, channels, sewerage, water and energy supply), in ensuring law and order (police), and in giving poor relief. In this period, private parties like churches and charities were even more important than government to provide poor relief (see Figure 10). The expansion of education served various purposes: to stimulate national identity, to increase the quality of labour, and to fight poverty.

The increasing expenditure by municipalities was financed by increasing the municipal indirect taxes on income and wealth and their debt. The gap between rich and poor municipalities widened rapidly. The poor municipalities could not raise much extra revenue by raising income tax, while they not only faced major increases in the expenditure on education and infrastructure, but also had to spend relatively more on poor relief. Raising the income tax rates in poor municipalities even had adverse effects, as it stimulated the moving of rich inhabitants from poor to rich municipalities. This migration was facilitated by the major improvements in public transport. In this period, the differences between local

Figure 9. **Expenditure on primary education by government and private institutions**

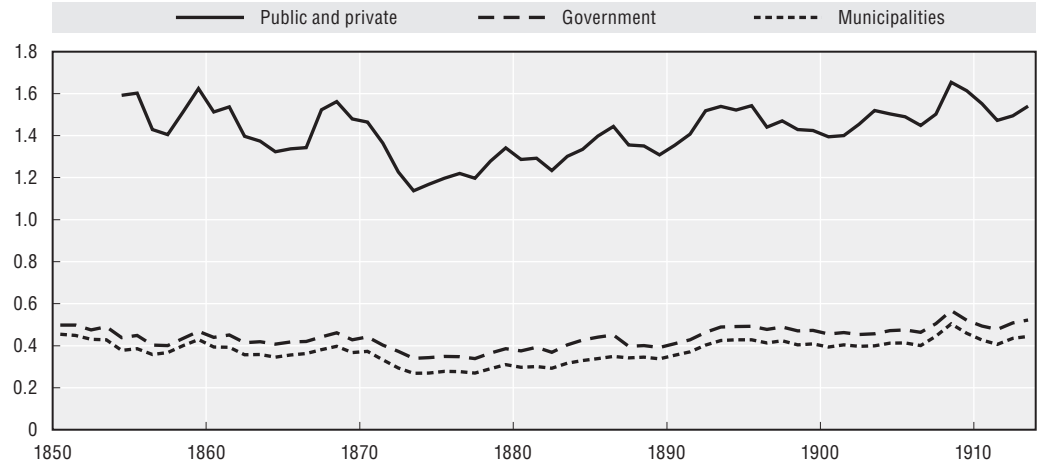
Per cent of GDP



Source: R.H. van der Voort (1994), *Overheidsbeleid en overheidsfinanciën in Nederland, 1850-1913*, NEHA, Amsterdam.

Figure 10. **Expenditure on poor relief by government and private institutions**

Per cent of GDP



Source: R.H. van der Voort (1994), *Overheidsbeleid en overheidsfinanciën in Nederland, 1850-1913*, NEHA, Amsterdam.

income tax rates were very substantial. For example, in 1927, the local tax for an income of 5 000 guilders was 55 guilders in Wassenaar (a village famous in the Netherlands for its rich inhabitants and very impressive houses) and 700 guilders in Steenwijk! These problems were resolved in 1929: the municipal indirect taxes on income were abolished and a municipality fund financed by a national municipality fund income tax was introduced. The purpose was not only to reduce the major differences between municipal income tax rates, but also to ensure the same level of public services in each municipality.

In 1914, in order to facilitate financing the increasing local debt, a special Municipal Bank was created. This bank focused on providing short-term credits for specific investments and did not check whether the financial situation of a municipality allowed such investments with an uncertain return. The Dutch Central Bank therefore intervened. In 1922, the old bank was abolished and replaced by a new Municipal Bank of which half of

the equity stock was owned by the central government and the other half by municipalities, provinces and water boards. The bank stimulated more long-term financing of investments and started to serve as an intermediary for payments between the central government and local governments and between different units of local government.

3.4.2. A centralised welfare state (1929-82)

The transfer by the new municipality fund was based on two indicators: one for income and one for need. If the disposable household income in a municipality was high in comparison to the national average, this increased the transfer. Similarly, if the expenditure on education, police and poor relief was relatively high, this increased the transfer. The economic crisis reduced the revenues from the municipality fund income tax and increased the local expenditure on poor relief. As a consequence, a major part of the municipalities developed serious financial problems. The central government alleviated these problems by providing short-term credits. In 1933, a law was introduced for supplementary support by the central government for highly indebted municipalities. This law also gave the central government the possibility to interfere with municipal autonomy and to impose policy measures – *e.g.* increases in local tax rates to the maximum permitted – or to forbid any new expenditure.

The first national standards for accounting and budgeting by provinces were issued in 1929; two years later, standards for municipalities followed. The standards prescribed cash accounting and the distinction between a current and a capital account. Provinces and local government were obliged to comply with the golden rule of public finance, *i.e.* current expenditure should be financed out of current revenue and investments could be financed by loans. The improvement of local accounting and budgeting was urgent considering the financial problems and the enormous increase in size and diversity of activities during the preceding decades. The impact of local government on national spending and lending could no longer be ignored. Macroeconomic information on the aggregate local government was needed by the central government and central bank for their economic and monetary policy. The new standards made it possible to aggregate the figures of individual municipalities and provinces.

Table 12. **Thorbecke's house 1929-82: A centralised welfare state**

1929: Abolishment of municipal indirect taxes on income and introduction of municipality fund.
1929-31: National standards for accounting and budgeting by municipalities and provinces.
1933: Law for supplementary support to highly indebted municipalities.
The central government assumes more and more responsibilities for social security and health care.
Many new specific transfers by the central government to local governments, non-profit institutions and firms.
Housing improved by minimum standards and subsidies to housing corporations and municipalities.
Refinements in the distribution formulae for transfers by the central government to local governments.
1954: After the disastrous flooding of 1953, creation of water board bank for financing dikes.
1960: Redesign of the transfers from central to local government.
1963: First law to restrict and regulate loans by municipalities and provinces.
1970: Provinces lose their local tax; in 1981, provinces get a surcharge on the national car registration tax.
Since 1958: increasing role for the European Union, *i.e.* part of national policy transferred to European level.
Since 1970: continuing decrease in the number of municipalities, *i.e.* increase in their scale.

The abolishment of the municipal indirect taxes on income did not mean that local taxes became a minor source of finance. For example, in 1932, municipal surcharges on

national taxes on income and wealth were twice as much as the revenue from the municipality fund. In practice, most of the municipal rates were equal to the maximum rate set by the central government. As a consequence, the municipalities did not have much freedom in differentiating the rates of their surcharges and adjusting them to local needs and preferences.

During the period 1929-82, Thorbecke's house became a centralised welfare state. The central government assumed more and more responsibilities for social security and health care. This was reflected by major acts, *e.g.* sickness insurance act in 1929, health care insurance act in 1941, unemployment insurance act in 1952, and old-age pension act in 1956. The Dutch central government tried to direct the development of the Dutch economy and society through many new subsidies, investment grants and other transfers to local government, private firms and non-profit institutions. This was financed by extra taxes, social security contributions, the unexpected revenues from natural gas and – since 1979 – a rapidly rising government deficit and debt.

In the period 1950-82, Dutch public expenditure doubled from less than 30% of GDP to more than 60%. The welfare state with its generous social benefits had an adverse effect on employment, the labour supply and the Dutch economy. Since 1970, employment as a percentage of the potential labour force (*i.e.* the population between 18 and 64 years) decreased by nearly 40%. The stagnating Dutch economy and unsustainable public finance necessitated a drastic change toward a much smaller welfare state with less generous social benefits.

Directly after the Second World War, two-thirds of all municipalities had severe financial problems. Two new earmarked transfers for education and poor relief were introduced, equal to the annual average of the corresponding expenditure by municipalities in the period 1939-41. More and more requests for supplementary support were also granted by the central government. In 1955, two-thirds of the 1 000 municipalities received such support.

In 1960, in order to replace the *ad hoc* and rather subjective system of transfers from central to local government, there was a major revision of this system of transfers. The general purpose was that these transfers should be sufficient to structurally finance the regular activities of municipalities to the extent that they could not be financed out of local taxes or tariffs. In line with the government's budgeting principles for the central government (see Bos, 2008), the level of the general transfer was linked to the trend-based economic growth rate, and increases in wage rates were fully compensated. In this period of rapid economic growth, this implied that the transfer by the central government to municipalities also increased rapidly. The formula for distribution of the general transfer among different municipalities was linked to the number of inhabitants and size of the surface area: bigger municipalities received more per inhabitant. For specific transfers, more specific criteria were also taken into account.

This new and generally more generous system did not resolve the financial problems of all municipalities. In particular, the city of Amsterdam claimed that it was underfunded (see Moor and Slot, 2003). The marriage of the crown princess Beatrix in Amsterdam in 1966 served as a catalyst. The central government wanted to give Amsterdam some money for the extra costs (*e.g.* safety), but Amsterdam showed that this was not at all sufficient. The central government raised its initial bid, but Amsterdam was still not happy. The wedding ceremony was accompanied by major disturbances and uprisings. According to Amsterdam, this reflected that the quality of life in Amsterdam was low due to housing

shortages, chaos on the roads, bad public transport and problems with the young. These problems could not be resolved by Amsterdam due to a fundamental lack of resources. Amsterdam also claimed that it had many specific costs: for example, its academic hospitals were more expensive than normal hospitals, the infrastructure for the harbour urgently needed improvement, and public transport could only to a limited extent be financed through tickets. The central government partly agreed with these claims. However, it also distrusted Amsterdam for not being willing to increase its efficiency, taxes and tariffs, and for the absence of any solid underpinning of its claims. These problems were only resolved when the Alderman for Finance of the City of Amsterdam (Polak) first started to improve Amsterdam's accounting, including analysis of the causes of the various types of expenditure overruns, and then became Secretary of State of Internal Affairs in the central government. In this job, he made the Ministry of Internal Affairs the co-ordinator of the contacts of 16 different ministries with the city of Amsterdam. In 1976, after tough negotiations based on analysis of the various claims, the central government agreed to raise its transfers to Amsterdam by changing the distribution formula of the general transfer more in favour of big cities, by introducing some new specific transfers often relevant for big cities, by granting money via the law for supplementary support for highly indebted municipalities, and by financing the new city hall.

A major problem with judging the requests via the law for supplementary support was the absence of clear criteria. Since mid-1970, various efforts have been undertaken to define in more objective terms the acceptable reasons for financial problems, *i.e.* those reasons that warrant supplementary support by the central government. Distinctions were made between structural reasons (*e.g.* extremely high expenditure on poor relief), distortions in the distribution formulae of general and specific transfers by the central government, and specific reasons. To be accepted as a distortion in the distribution formulae, the reason should be general and be relevant for at least a group of municipalities. Rough quantification of the effects should also be possible. On the basis of a lot of analysis and discussions between central and local government, the distribution formulae of the general and specific transfers were improved and refined on the basis of objective criteria. This drastically reduced the need to ask for funding via the law for supplementary support, and defined much more clearly the responsibilities of individual municipalities to resolve their financial problems.

After the Second World War, the central government started to regulate municipal investments and loans via *ad hoc* interventions, *e.g.* via regulation of the maximum interest allowed on municipal loans. In 1963, this *ad hoc* policy making was replaced by a law. The basic principle was that investment should not be fully financed out of loans but partly by cash, *e.g.* at least 25%. In addition, in periods of economic downturn, a maximum on the aggregate loans by local government could also be introduced directly or indirectly by introducing obligatory financing via the Municipal Bank and restricting this to the resources available.

3.4.3. A smaller and more decentralised welfare state (1983-present)

The transformation into such a smaller welfare state was successful: despite rapidly increasing expenditure on health care, Dutch public expenditure is now about 10% lower than in 1983 (see Table 14). The transformation was inspired by supply-side economics and microeconomic thinking and the philosophy of New Public Management to run the government like a business. This implied privatisation, deregulation and decentralisation and a greater role for incentives and performance management.

Table 13. **Thorbecke's house, 1983-present: A smaller and more decentralised welfare state**

Social assistance and public care services become more the responsibility of municipalities.
An increasing role for public agencies, private firms and incentives.
Privatisation of public corporations and deregulation of housing corporations (1995).
1985: Accrual accounting for municipalities and introduction of local policy management accounting.
Reduction of number of specific transfers to local government, increase of general transfer.
Public schools become more independent from municipalities.
Police regions replace municipal police (1993); 2015: national police replaces police regions.
Continuing decrease in number of municipalities, *i.e.* increase in their scale.
Introduction of city-regions.
Introduction of functional regions for safety and preventive health care.
National fiscal policy becomes embedded in European fiscal policy framework; national monetary policy is transferred to Europe (1993 Treaty of Maastricht).

Table 14. **Dutch public expenditure, 1970-2009**

	1970 level % GDP	1983 % GDP	2009 % GDP	1970-82 change	1983-2009 change
Distributive policy	23.5	36.3	30.1	12.7	-6.1
Social security	11.4	20.0	12.5	8.6	-7.5
Health care	2.8	4.8	9.7	2.1	4.9
Education	6.3	6.3	5.5	0.0	-0.7
Transfers to corporations	3.1	5.2	2.4	2.1	-2.8
Other policy	17.9	18.6	18.6	0.7	0.1
Public administration and safety	10.3	12.0	13.6	1.7	1.6
Defence	2.7	2.9	1.3	0.2	-1.7
Infrastructure	3.0	1.7	1.9	-1.3	0.2
International co-operation	1.9	1.9	1.9	0.1	0.0
Interest	2.9	5.6	2.2	2.7	-3.4
Total public expenditure	**44.3**	**60.4**	**51.0**	**16.1**	**-9.4**

Source: CPB standard tables on Dutch public finance, Netherlands Bureau for Economic Policy Analysis, The Hague.

This also had many implications for the division of tasks between central and local government:

- Privatisation implied selling corporations owned by central and local government, like provincial and municipal banks, water and energy companies, and transport companies.
- Deregulation implied a more independent role for, *e.g.*, public schools and public and private housing corporations. The role of municipalities in public schools has been reduced: many formerly municipal schools for primary and secondary education have been transformed into independent schools receiving their financing directly from the central government. Municipal housing corporations were often transformed into private non-profit organisations. In 1995, the annual subsidies to all Dutch housing corporations were stopped and bought off by a lump sum transfer of 5% of GDP.
- Deregulation and decentralisation also implied abolishment and grouping of many specific subsidies, investment grants and other transfers. Already in 1975, the central government was aware of the problems of having many small and specific transfers to local government. However, only from the mid-1980s did this process of abolishing and grouping specific transfers really start.

- More incentives implied a change in financing Dutch social assistance benefits. In the past, municipalities could claim most of their expenses on social benefits from the central government. However, since 2004, they receive a fixed budget which is insulated from the macroeconomic developments through a calculation by the CPB. As a consequence, municipalities now have an incentive to reduce the number of social assistance benefits. This new policy seemed to be very successful, as the number of social assistance benefits hardly increased in 2004 and 2005 despite a substantial increase in unemployment. However, recent research (Roelofs and van Vuuren, 2011) indicated that municipalities had mainly reduced social assistance benefits by substitution with the nationally financed disability insurance for the young; a decentralisation of (part of) this disability insurance would remove local governments' incentives to divert young people from social assistance to disability insurance.
- More decentralisation and incentives implied that, since 2006, municipalities have taken over various tasks of the national social security arrangements for special care, for example nursing and cleaning services for the elderly and handicapped people.
- Decentralisation implies that child welfare will soon be the responsibility of municipalities and that the role of provinces and central government agencies will be stopped.
- For several decades, local government, some official government commissions and professors in economics advocated that the role of local taxes should be increased in order to better meet local preferences and to stimulate sound financial management. However, in 2006, the opposite happened: part of the local real estate tax was abolished by the national government and replaced by funding via the general transfer to municipalities. Furthermore, for the remainder of local real estate tax, maxima were introduced for the rate and its annual increase. In this way, the right-wing national government wanted to reduce and better control local taxes and to avoid having them used by (left-wing) local government to finance extra expenditure or bad financial management.

In order to increase efficiency, several other major changes in the provision of local services were initiated:

- The number of municipalities was reduced by more than 40%, from 773 in 1983 to 440 in 2009.
- Since 1980, Amsterdam is not only organised as a municipality, but it has also introduced boroughs to govern the various neighbourhoods. Amsterdam started with 16 boroughs, but these have been reduced to six. Rotterdam has followed this example and has introduced 14 boroughs.
- In line with the New Public Management philosophy, the Ministry of Internal Affairs, the Association of Dutch Municipalities and the Association of City Managers started a programme in the mid-1980s to improve financial reporting of municipalities and to start policy management accounting. The City of Tilburg became well-known all over the world for its business-like municipal organisation with an advanced managerial information system linking budgets to measurable policy goals (see Hendriks and Tops, 2003).
- Starting from 1994, several city-regions were introduced; at present, there are eight. These are co-operations of the major cities and their neighbour municipalities. They co-operate in particular with respect to spatial planning, transport, housing, purchases of land, economic affairs, and environmental policy.

- For safety issues like fire, disasters and public order, 25 functional regions have been introduced. These safety regions consist of co-operations between municipalities and government agencies, like fire brigades, police, and medical units. The police regions coincide to a great extent with these safety regions. However, a major difference is that safety regions are financed and organised by local government, while police regions are financed and supervised by the central government. The new central government has decided to introduce a national police. Geographically, the eight city-regions correspond to eight safety and police regions.
- For co-ordinating preventive health care by municipalities, functional regions have also been introduced. This started in 1990 with 63 regions, but it has been scaled up to currently 28 regions; for the major cities, this geographically corresponds well with the city-regions.

In 2002, in order to increase accountability and democracy at the municipal level, a new law was introduced. Before 2002, the council could be regarded as the local government, and the mayor and aldermen were responsible for actually managing the municipality. Due to the new law, the council becomes more like a parliament that should monitor and check local government, *i.e.* the mayor and aldermen. To support the council, courts of auditors have been introduced for all municipalities; these courts of auditors check the legitimacy, effectiveness and efficiency of municipal expenditure and revenue. Furthermore, aldermen are no longer allowed to be simultaneously members of the council. Finally, aldermen can also be recruited without first being members of the council. Efforts to abolish the appointment of mayors by the central government and to choose mayors via local elections failed. However, for some years, councils have had much more influence on the appointment of the mayor, *e.g.* by defining the profile for the new mayor and by introducing a referendum for choosing between the official candidates.

Already since the end of the 1950s, European unification has been a major development. It has added a new European layer of government on top of Thorbecke's house. This new government has introduced new laws, rules and procedures (*e.g.* to ensure fair competition and procurement or to protect the environment), subsidies for poor regions and agriculture, and a common fiscal and monetary policy.

In order to receive European subsidies and to influence European regional policy, Dutch local government has to communicate and compete with other, often much larger, European regions.

The European fiscal policy targets refer to the whole government sector, *i.e.* including not only central but also local government. To the surprise of the Dutch Minister of Finance, in 2003 the Dutch government deficit surpassed the EMU target of 3% of GDP; a major cause was the unexpected and large deficit of Dutch local government. As a consequence, municipalities and provinces now also have to report on their net financial balance[10] and the Dutch Ministry of Finance has allotted a maximum for each municipality and province. The latter becomes relevant when the deficit of the whole Dutch government approaches the EMU norm of 3% of GDP.

4. Tasks and financing of Dutch municipalities and provinces

4.1. *Description*

Table 15 shows expenditure by Dutch municipalities for their different tasks; nine different functions are distinguished. Their total operating expenditure[11] was 10% of GDP, of which a third is spent on social assistance and social services.

Table 15. **Operating expenditure of Dutch municipalities (including joint arrangements) by function in 2009**

	Billion euros	% of total	% of GDP	Thousand euros per inhabitant
Social assistance and social services	19.2	34	3.4	1.2
Spatial planning and social housing	9.5	17	1.7	0.6
Health care and environment	6.3	11	1.1	0.4
Culture and recreation	5.0	9	0.9	0.3
Traffic, transport and water management	5.6	10	1.0	0.3
Education	3.6	6	0.6	0.2
Public administration	4.1	7	0.7	0.2
Safety	2.2	4	0.4	0.1
Economic affairs	1.2	2	0.2	0.1
Total	**56.5**	**100**	**9.9**	**3.4**

Source: Statistics Netherlands statistics on the budget of municipalities.

A similar overview for provinces is provided by Table 16. Their total operating expenditure is 1% of GDP. Traffic and transport is the function with the largest expenditure (32%). Also the welfare expenditure is relatively quite important (26%). However, when the responsibility for child welfare is transferred to municipalities as the current government intends, welfare expenditure will shrink to about a third.

Table 16. **Operating expenditure of Dutch provinces by function in 2009**

	Billion euros	% of total	% of GDP	Thousand euros per inhabitant
Traffic and transport	2.1	32	0.4	0.1
Welfare	1.7	26	0.3	0.1
Recreation and natural environment	0.7	11	0.1	0.0
Environmental protection	0.6	9	0.1	0.0
Economic affairs and agriculture	0.5	8	0.1	0.0
Spatial planning and housing	0.4	6	0.1	0.0
Public administration	0.3	5	0.1	0.0
Water management	0.2	3	0.0	0.0
Total	**6.4**	**100**	**1.1**	**0.4**

Source: Statistics Netherlands statistics on the budget of provinces.

The importance of some provincial tasks is not readily visible when only looking at their expenditure. A major task of provinces is the supervision of municipalities, for example their financial management. Provinces should also take action when municipalities have serious administrative problems or when there is a major political crisis.

Another major task of provinces is spatial planning. Since the 1960s, spatial planning involves all three layers of government. The central government provides the most general philosophy and planning by structural policy papers and schemes, for example a separate fund for infrastructure; the central government is also responsible for translating European rules into national policy. Starting from this national framework, provinces make spatial plans for their region – *i.e.* what are the locations for housing, agriculture, natural environment, company grounds, roads, etc., and what are the changes in the future. Starting from this provincial framework, municipalities make more specific plans and

zoning schemes for future development. The provincial parliament then checks whether these municipal plans are indeed in agreement with the provincial plans.

The largest source of revenue for municipalities is the general transfer by the central government. Since the end of the 1980s, the size of the municipality fund and of the fund for provinces is linked to the change in expenditure by the central government.[12] This implies that municipalities and provinces share proportionally in budget cuts and extra expenditure by the central government. For example, EUR 1 billion extra expenditure on education or defence results in about EUR 200 million extra revenue for the municipalities and provinces. In addition, in particular at the start of a new period of government, the government can decide on extra cuts or extra expenditure for the municipality fund or for the fund for provinces.

Table 17. **Size and composition of the revenue of municipalities in 2009 (including joint arrangements)**

	Billion euros	% of total	% of GDP	Thousand euros per inhabitant
Transfer from municipality fund	17.7	37	3.1	1.1
Specific transfers by central government	12.9	27	2.3	0.8
Social assistance	9.4	20	1.6	0.6
Other	3.5	7	0.6	0.2
Sale of goods and services	11.3	23	2.0	0.7
Taxes	4.4	9	0.8	0.3
Property income	1.9	4	0.3	0.1
Total revenue	**48.1**	**100**	**8.4**	**2.9**

Source: Statistics Netherlands national accounts.

The specific transfers by the central government are the second-largest source of revenue for municipalities. Table 18shows an overview of the specific transfers by ministry; those by the Ministry of Social Affairs and Employment are 62% of the total.

Table 18. **Specific transfers to municipalities, joint arrangements and provinces by ministry, 2009**

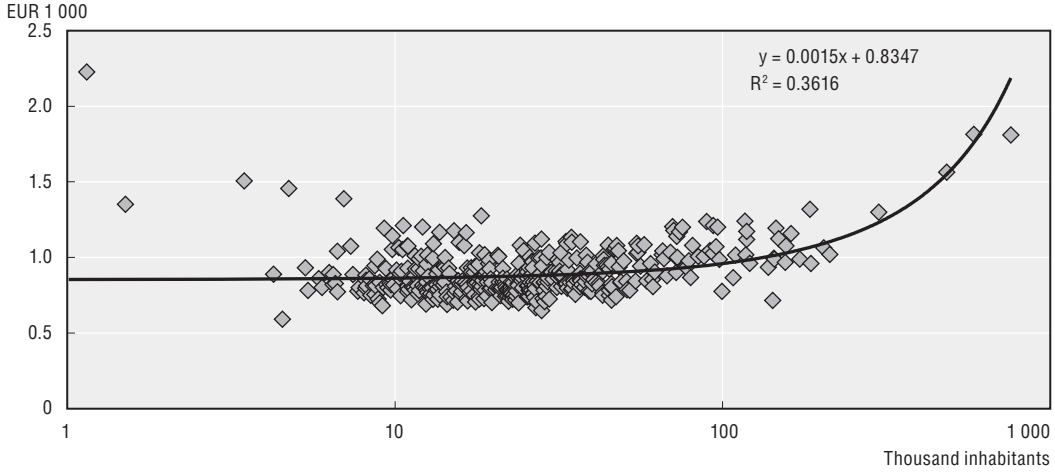
	Billion euros	% of total	% of GDP	Thousand euros per inhabitant
Internal Affairs	0.1	1	0.02	0.0
Economic Affairs	0.1	1	0.02	0.0
Youth and Family	1.3	9	0.23	0.1
Agriculture	0.5	3	0.09	0.0
Education and Culture	0.9	6	0.16	0.1
Social Affairs and Employment	9.5	62	1.66	0.6
Traffic and Water Management	2.1	14	0.37	0.1
Social Housing, Spatial Planning and Environment	0.6	4	0.10	0.0
Health Care	0.1	1	0.02	0.0
Total	**15.3**	**100**	**2.67**	**0.9**
To municipalities	*13.0*	*85*	*2.27*	*0.8*
To provinces	*2.3*	*15*	*0.40*	*0.1*

Source: Dutch central government, *Maintenance Report on Specific Transfers 2010*.

The transfer by the municipality fund is allocated to individual municipalities on the basis of a very complex distribution formula using all kinds of objective indicators. This not only takes account of the number of inhabitants, but also corrects for differences in tax-earning capacity (real estate value of dwellings and business property) and external circumstances, like a regional function or the social and physical structure. The indicators used are the number of households receiving social benefits, the number of people from ethnic minority groups, the number of young or elderly, the density of addresses, and the surface area of the historical centre. However, differences in other revenues, like interest, dividends or the sale of land, are not taken into account. Supplementary to the general distribution formulae, the Frisian Islands and the four major cities receive a fixed amount. For the province fund and the specific transfers, similar complex distribution formulae are used.

Figure 11 shows that the transfer by the municipality fund is on average about EUR 1 000 per inhabitant in 2009. Due to the use of other indicators, for individual municipalities this ranged from EUR 600 to more than EUR 2.5 thousand.

Figure 11. **Transfer of the municipality fund per inhabitant for all Dutch municipalities ranked by number of inhabitants, 2009**

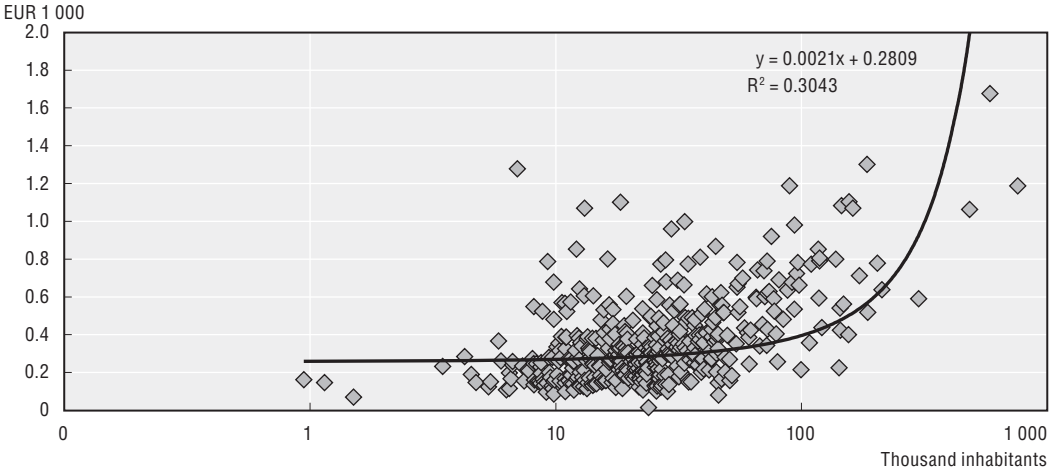


Source: Statistics Netherlands statistics on municipal budgets.

Figure 12 shows that larger municipalities receive more transfers per inhabitant for the function "social assistance and social services". This reflects that cities attract poor people. "Cities have assets that make them appealing to people who start with less and those assets are things to be prized. The fact that poor people are absent from suburbs is a sign that suburbs are not offering them a decent life … We have found that poverty rates rise in areas that gain access to subways. This doesn't mean that subways make people poor, but rather that subways provide access that is valued by people with fewer resources" (Glaeser, 2010, pp. 25-26).

Another major source of revenue for municipalities and joint arrangements is the sale of goods and services (EUR 11 billion). This includes garbage disposal (fees of EUR 2 billion), fees for building permits (EUR 0.5 million), parking fees (EUR 0.5 million), passport levies, sales by social workshops, and the rental of school buildings and sport centres. Figure 13 shows that the fees for building permits differ substantially between municipalities: a building permit for a dwelling of EUR 250 000 costs EUR 12 000 in some municipalities and

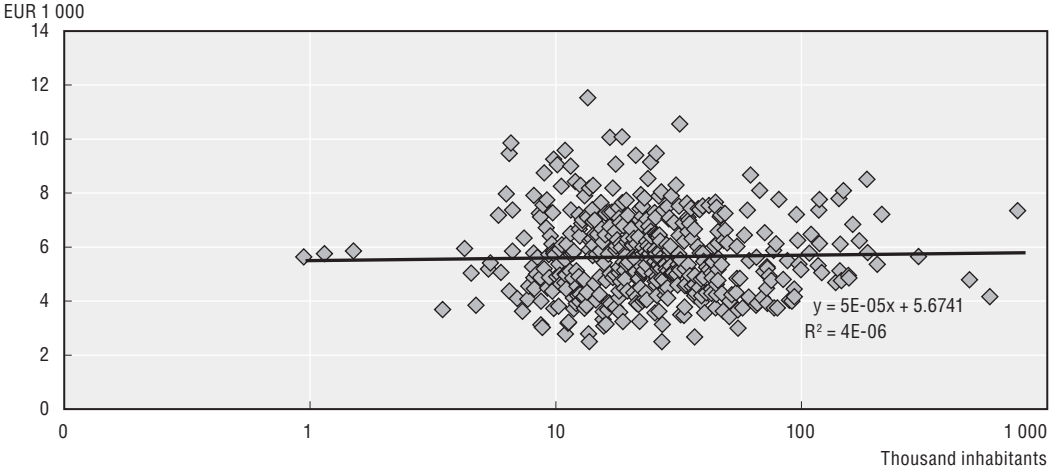
Figure 12. **Transfers by central government to municipalities for the function "social assistance and social services" per inhabitant, 2009**



Source: Statistics Netherlands statistics on municipal budgets.

in others only EUR 2 000. However, the figure also shows that these differences are not correlated to size in terms of the number of inhabitants. So, bigger municipalities do not on average charge more than smaller ones.

Figure 13. **Fees for building permits for a dwelling of EUR 250 000 in municipalities ranked by number of inhabitants, 2009**

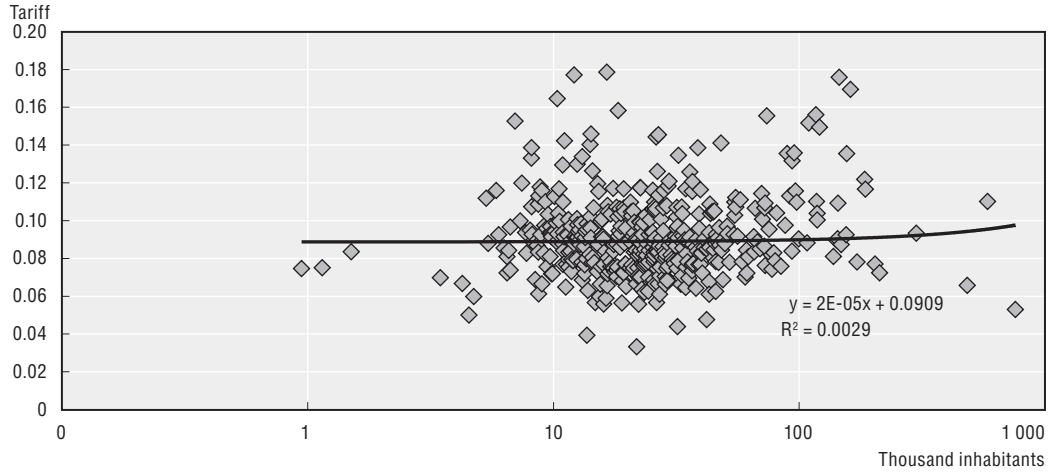


Source: IGG, *Bouwkosten advies* (Advisers in Building Cost Analysis), *www.igg.nl/pages_en/default.aspx* and *www.bouwkostenkompas.nl*.

The municipal taxes amounted to EUR 4.4 billion in 2009. This mainly consisted of real estate tax (EUR 2.9 billion) and a levy for sewerage (EUR 1.2 billion); in addition, also taxes are levied on tourists, dogs and the use of public space by bars, restaurants and shops. The average real estate tax is about 0.09% of the officially estimated real estate value of the dwelling and 0.3% of the value of business property (the aggregate of the charges for owners and users). Figure 14 shows that the tariff of real estate tax is not correlated with the size of a municipality in terms of the number of inhabitants, *e.g.* bigger municipalities do not charge more than small municipalities.

Figure 14. **Tariff of the real estate tax on dwellings by municipalities**

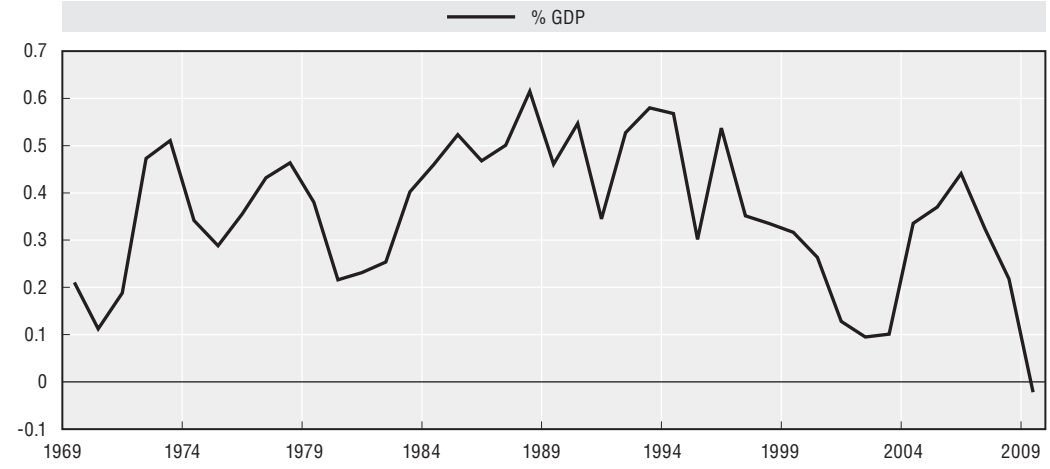
Per cent of officially estimated real estate value, 2009



Source: COELO (Centre for Research on Local Government Economics), University of Groningen.

Property income received by municipalities includes interest, dividends and ground rent. Net revenue from buying and selling land is not included in our overview of total revenue of municipalities. The reason is that the annual operating balance of land exploitation from the municipal accounts does not provide a solid estimate of its importance as a source of revenue. Furthermore, in 2009, the operating balance was only some EUR 100 million due to the economic crisis and the drastic reduction of granting land for building houses. The Dutch national accounts provide an alternative measure of the economic importance of buying and selling land for municipalities. It is equal to net explicit sales of land; it ignores any implicit revenue and ignores also the various costs involved, in particular the cost of making land ready for building. According to the Dutch national accounts, during the 1970s the net explicit sale of land was EUR 1 billion, corresponding to between 0.3% and 0.6% of GDP (see Figure 15).

Figure 15. **The net explicit revenue from the sale of land by municipalities, 1970-2009**



Source: Statistics Netherlands national accounts.

Land is in particular a source of net revenue when the municipality is changing its purpose as part of spatial planning: land used for agriculture is cheap, but when it can be used for building housing or business premises its value increases enormously. This revenue can be explicit, but is often also implicit. The latter occurs when the building corporations buying land get a reduction in exchange for an agreement, *e.g.* to construct a road or to build and sell houses for below-market prices. Such implicit and explicit revenue from buying and selling land is concentrated in municipalities where land for agriculture is transformed into land for dwellings and business premises; smart building companies can skim the cream off by buying the land at a very early stage.

Table 19 shows that Dutch provinces have four major sources of revenue: the general transfer by the province fund, specific earmarked transfers, taxes and property income. Unlike municipalities, taxes and property income are an important source of finance. Furthermore, specific transfers by the central government are even more important than the general transfer by the central government. Taxes refer to the provincial surcharge on the national car registration tax. The high property income reflects the richness of several provinces due to equity stock in public corporations, like a big mortgage bank and energy companies.

Table 19. **Size and composition of the revenue of provinces in 2009**

	Billion euros	% of total	% of GDP	Thousand euros per inhabitant
Transfer by province fund	1.3	23	0.2	0.1
Specific transfers by the central government	2.2	38	0.4	0.1
Taxes	1.4	24	0.2	0.1
Property income	0.9	16	0.2	0.1
Total	**5.9**	**100**	**1.0**	**0.4**

Source: Statistics Netherlands national accounts.

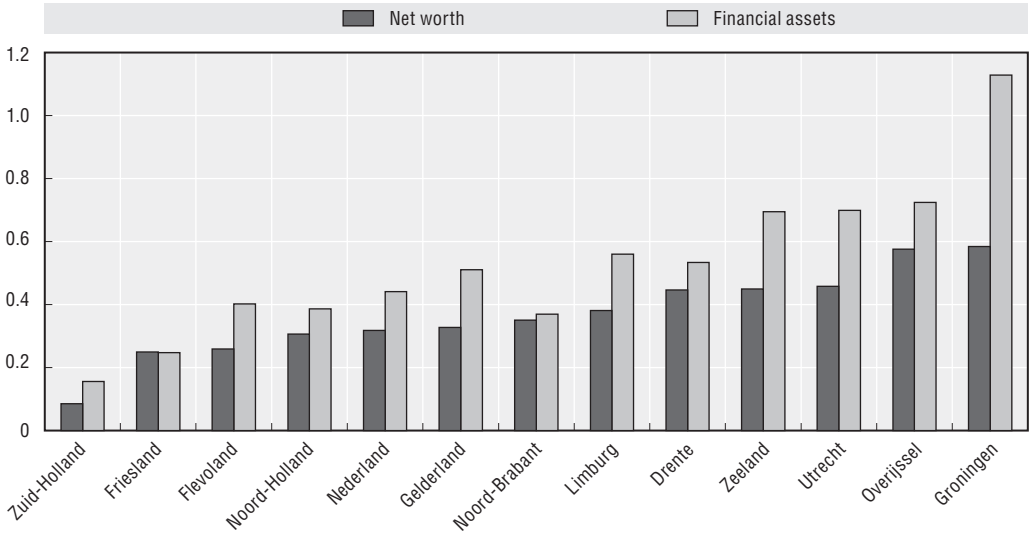
Figure 16 shows that provinces have substantial net worth and financial assets and that some provinces are much richer than others. The amounts could be regarded as conservative estimates, as they have been derived from the provincial accounts in which all assets, including financial assets like loans and equity stock, are valued at historical costs. In particular for equity stock already owned for decades by provinces, this is likely to be an underestimate of their market value.

4.2. Discussion

The tasks and financing of Dutch local government raise many issues (see Section 1 above). This section limits the discussion to seven questions:

- Should municipalities further increase in size?
- Should the eight city-regions be abolished?
- What should be the role of provinces in spatial planning?
- Should municipal taxes as a source of finance be increased?
- Should the role of specific earmarked transfers by central government be reduced?
- How efficient is the current linkage of general transfer to municipalities and provinces to the expenditure by central government?
- Should Dutch provinces be merged and scaled up?

Figure 16. **Net worth and financial assets of Dutch provinces, EUR 1 000 per inhabitant, 2008**



Source: Statistics Netherlands statistics on provincial budgets.

4.2.1. Scale, geographic boundaries and external effects

In order to solve budgetary problems of the Dutch government, a group of civil servants supported by researchers has investigated a wide range of options for efficiency gains and budget cuts. They also proposed to further increase the scale of municipalities. In the moderate alternative, the number of municipalities is reduced from 430 to between 100 and 150. The number of inhabitants then ranges between 40 000 and 750 000. In the more radical alternative, the number of municipalities is reduced to 25-30; their average size will then be about 600 000 inhabitants. Some provinces, like Drente and Zeeland, will then become municipalities. The new Dutch government did not take up this advice; it stressed that scaling up of municipalities should depend on their willingness to merge.

Economic theory provides various arguments for larger municipalities, like more efficient allocation by internalising more external effects, increase in efficiency due to larger scale, a rising minimum scale due to more and more complex tasks, and reducing the vulnerability for local lobbies and personal interest. These arguments have also been used to understand the reduction of the number of Dutch municipalities during the past 160 years (see Section 3 above).

Urban economics and new economic geography (*e.g.* the work by Glaeser and by Fujita and Krugman) are major new areas of economic analysis. These analyses stress the important role of cities and human capital for economic success (see ter Weel *et al.*, 2010). Thousands of years of economic development show that economic activity is concentrated in cities and that human capital and cities are complementary. Cities bring together people who benefit from each other. Most innovation takes place in cities. Interactions between people in cities help them to pick up and develop ideas and to innovate. The easy flow of ideas explains to a great extent how cities survive despite the high rents and potential disamenities like unsafeness, noise and pollution. The attractiveness of a place of business is determined by the attractiveness of cities. Good governance is important for a place of business. The creation of human capital through sound education and the utilisation of

human capital in production are crucial for economic success. There is also a major connection between urban development and human capital formation.

Scenarios can show the implications of the ICT revolution and other major trends for the role of cities and the best governance level. Ter Weel *et al.* (2010) sketch four scenarios: Talent towns, cosmopolitan centres, egalitarian ecologies, and metropolitan markets. In all these scenarios, cities are increasingly important, but the size of the representative city differs, from just over 100 000 in talent towns to many millions in metropolitan markets. The density of these cities depends on both size and specialisation. Large cities drive up the value of land and stimulate high-rise buildings. Specialisation benefits from frequent face-to-face interactions, which are optimised in dense urban areas. Together, size and specialisation suggest that urban density is highest in the large and specialised cosmopolitan centres and lowest in egalitarian ecologies, *i.e.* the scenario with small and non-specialised cities. In all four scenarios, cities are essential for efficient governance (see Table 20). In two scenarios, global institutions should play a major role. The European Union is only important for the scenario "talent towns", while the national government is particularly important in the case of metropolitan markets. In none of the scenarios should provinces play a major role.

Table 20. **Subsidiarity: Which governance level should regulate economic behaviour?**

	Talent towns	Cosmopolitan centres	Egalitarian ecologies	Metropolitan markets
City	X	X	X	X
Province				
Country				X
European Union	X			
Global institutions	X	X		

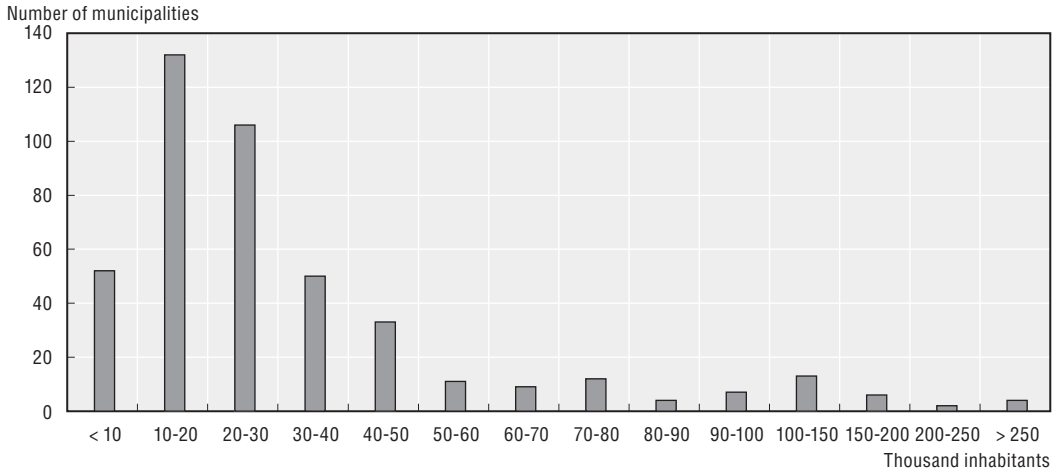
Source: B. ter Weel, A. van der Horst and G. Gelauff (2010), "The Netherlands of 2040", *CPB Special Publication*, No. 88, Netherlands Bureau for Economic Policy Analysis, The Hague, Table 9.4.

These general insights can be supplemented with information on the current size of the Dutch municipalities and the external effects.

At present, the major part of the 430 Dutch municipalities is rather small: 10% have less than 10 000 inhabitants, 25% have between 10 000 and 20 000 inhabitants, and for 20% the number of inhabitants is between 20 000 and 30 000 (see Figure 17). Joint arrangements for co-operation on a voluntary basis can partly remedy the economic drawbacks of such small municipalities. However, such co-operation has high transaction costs, and the voluntary basis can turn out to be insufficient for efficient and effective decision making. The central government policy to allocate more and more complex tasks to municipalities enforces a further scaling up of municipalities.

The number of inhabitants is not the only economic criterion for scaling up. Figure 18 shows that the smallest municipalities are those in the least densely populated regions or in the regions close to the sea or to the border with another country. This is in line with economic logic, as costs of internal communication and transport are higher for such municipalities, local identity is usually stronger, and the external effects of public services are more limited due to distance or being close to the sea or the border.

Figure 17. **The size of Dutch municipalities in terms of number of inhabitants, 2009**



Source: Statistics Netherlands.

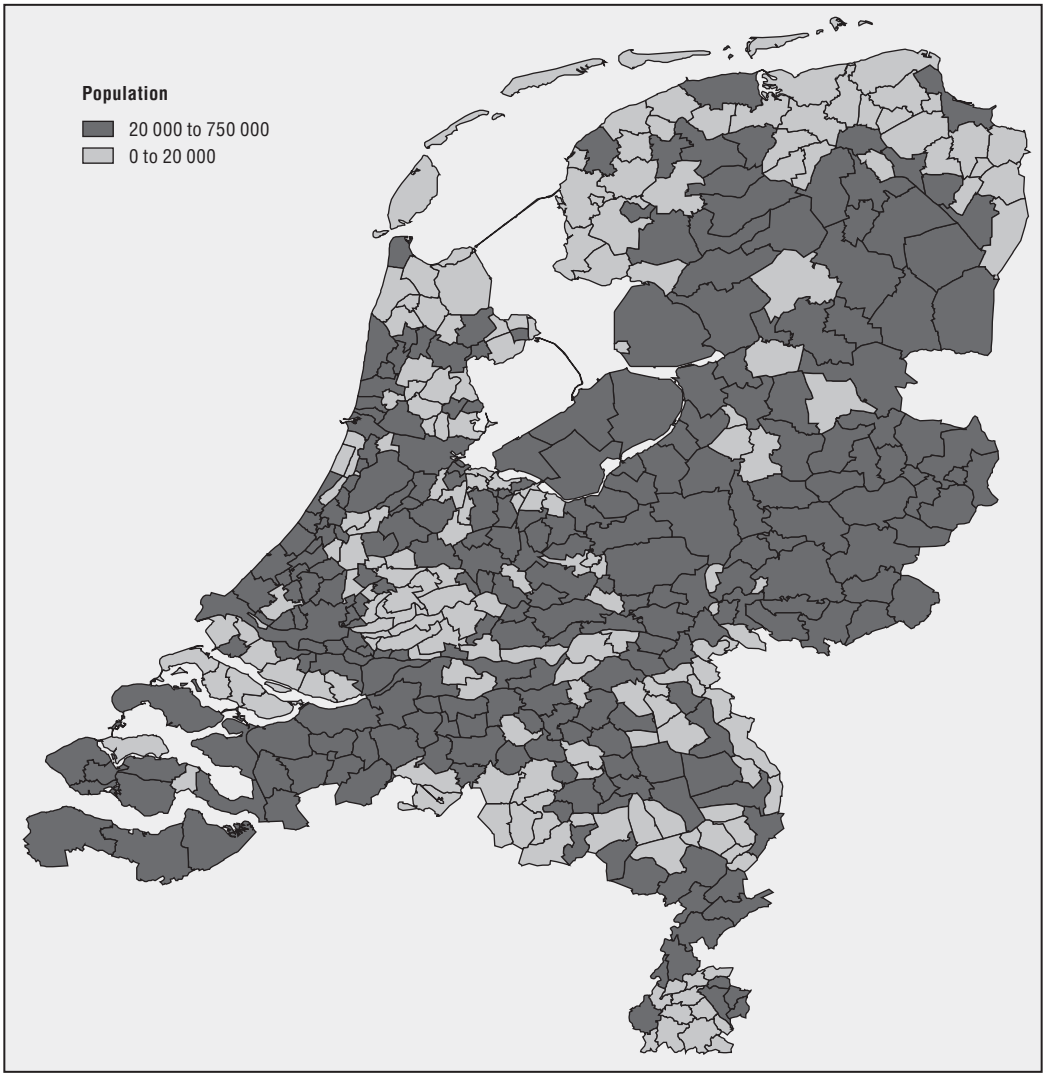
The size of external effects can be measured by analysing the variation in land prices, in particular the difference between the value of agricultural land and the value of land corrected for the value of the buildings (see de Groot *et al.*, 2010, in particular Chapters 5 and 6). For example, what explains that land prices in the centre of Amsterdam are 200 times as high as in the countryside in east Groningen? Table 21 shows that the availability of jobs and of public and private services (*e.g.* railway station, city park, restaurant and theatre) and other circumstances with external effects (*e.g.* distance to the sea and unsafeness) explains half of the variation in Dutch land prices.

Figure 19 shows that more than 60% of the labour force is prepared to travel 20 minutes by car to the place of work, while only 20% of the population is prepared to do that for shopping or visiting a restaurant or theatre. The scope of the positive external effects of a workplace is therefore much larger than that of the external effects of such consumer activities. When travelling by public transport instead of by car, people are even more prepared to travel to the workplace. People are more prepared to travel for attractive natural environment than for urban facilities, but this is still less than for work.

An alternative way to measure external effects is through commuting patterns (see Figure 20). People who live in an urban region travel to the centre of the city in order to work in the central business district or to benefit from the facilities in the centre. Commuting patterns indicate the attractiveness of city centres and the countryside for living, working and consuming during leisure time. The delimitation of local government should preferably internalise such externalities. For example, strong urban regions should not be governed by many different municipalities; this is likely to result in "free rider" behaviour and inefficient decision making for public services with major external effects, *e.g.* public transport, subsidies for cultural activities and city parks. Municipalities should also not be much larger than the scope of the external effects, as this leads to conflicts of interest, hold-up problems and high transaction costs.

Delimiting municipalities on the basis of external effects could result in very large municipalities that are difficult to manage and suffer from control loss (see Section 2 above). From this point of view, urban regions organised in terms of several municipalities co-operating as a city-region can be regarded as an alternative solution. However, the new

Figure 18. **The location of the smallest municipalities in 2009**



Source: Statistics Netherlands.

Dutch government intends to abolish the current eight city-region arrangements and does not want to impose larger municipalities in these urban regions. This is unlikely to lead to more efficient government.

One of the major tasks of Dutch provinces is spatial planning. How do the Dutch provinces with their historical boundaries fit into this modern picture of external effects? Looking at the commuting patterns, the urban region with Amsterdam covers major parts of the provinces North Holland and Flevoland and small pieces of Utrecht and South Holland. This clearly does not fit with the current provinces. Spatial planning in the Netherlands could be improved by delegating tasks of provinces to municipalities and city-regions. Substantially scaled-up provinces could have a role in ensuring co-ordination between municipalities, *e.g.* to avoid disruptive competition in company grounds. The central government should focus on ensuring efficient connections between the various urban regions.

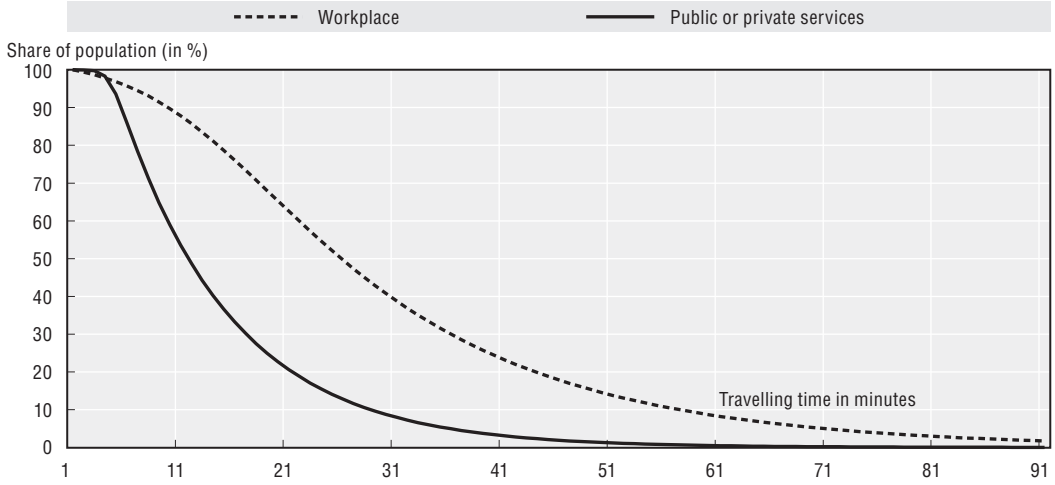
Table 21. **Jobs, facilities and discomfort explain half of the variation in Dutch land prices**

Variable to be explained: Land prices per m^2 on PC-4 level of aggregation

	Average during 1985-2007	Variance explained (without covariance) (per cent)	Variance explained (with covariance) (per cent)
Gross wage per hour (in euros)	6.43	1	1
Accessibility of workplace by car, including correction for traffic jams (thousand jobs)	0.18	13	25
Accessibility of workplace by public transport (thousand jobs)	0.09	3	6
Distance to railway station	67	1	2
Distance to natural environment	0.15	2	4
Distance to city park (surface of the park in the district)	213	1	3
Distance to sea (district is next to the sea)	75	1	3
Historical city centre (number of official monuments per 100 000 dwellings)	1.70	4	8
Inside Amsterdam's ring of canals (0-1 variable)	1 491	0	0
Distance to cultural activities (distance to theatres)	0.16	4	7
Distance of restaurants (distance of high-quality hotels, restaurants and cafés)	6.63	1	2
Distance of shops for fashion and luxury articles (distance to shops for "fun shopping")	0.71	6	11
Poor supply of basic shops (distance to such shops)	-7.73	2	3
Inconvenience, degradation and unsafeness (share of the population reporting these)	-1.14	1	2
Total		**41**	**77**

Source: H. de Groot, G. Marlet, C. Teulings and W. Vermeulen (2010), "Stad en land" (City and Countryside), *CPB Special Publication*, No. 89, Netherlands Bureau for Economic Policy Analysis, The Hague, Table 5.1.

Figure 19. **People are prepared to travel longer for work than for public or private services**

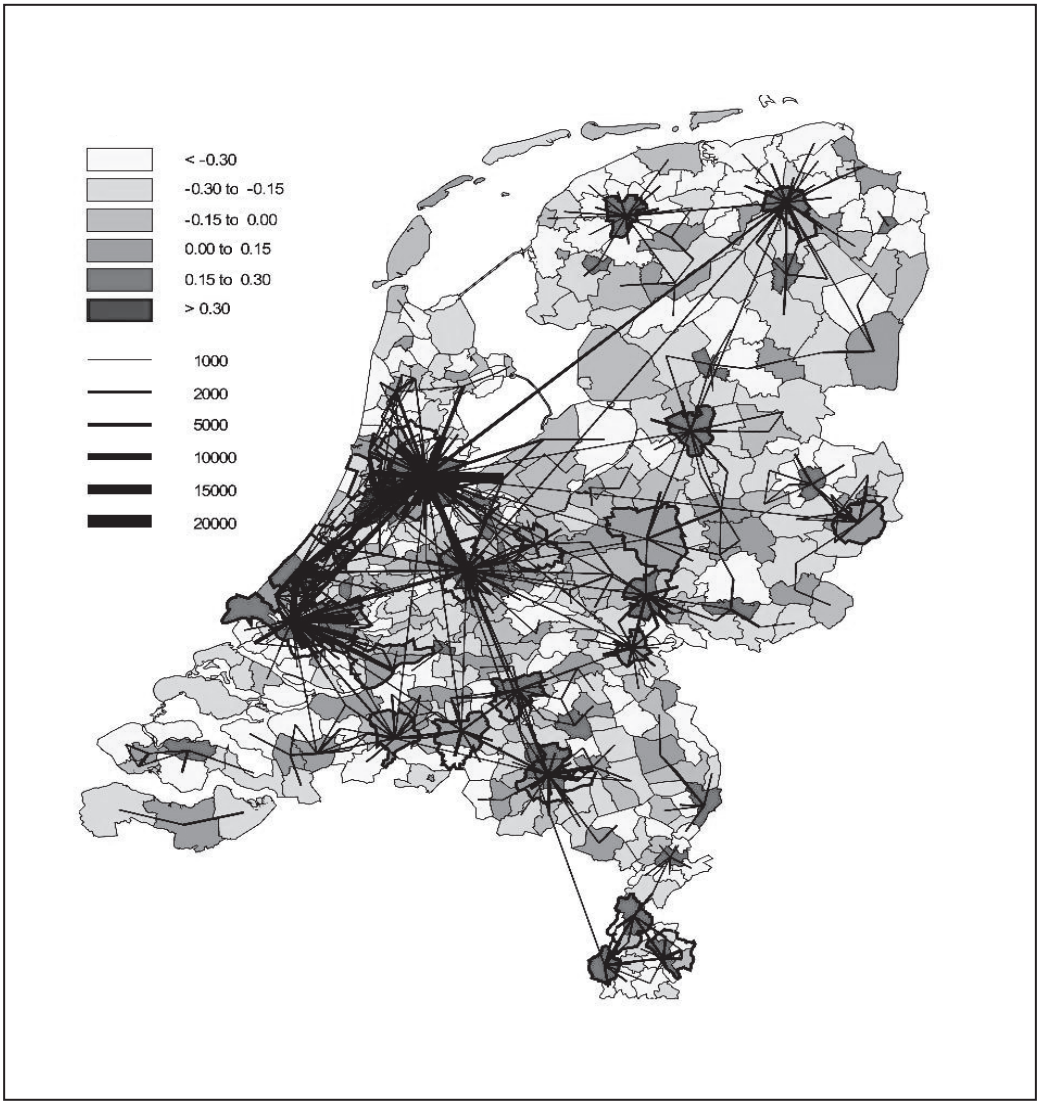


Source: H. de Groot, G. Marlet, C. Teulings and W. Vermeulen (2010), "Stad en land" (City and Countryside), *CPB Special Publication*, No. 89, Netherlands Bureau for Economic Policy Analysis, The Hague, Figure 5.1.

4.2.2. More municipal taxes?

Taxes are only about 10% of total revenue of municipalities. In Dutch policy discussions, it is often argued that enlarging the tax base for municipalities would improve efficiency and local democracy. Is enlarging the municipal tax base a good idea?

Figure 20. **Commuting patterns in the Netherlands**



Source: H. de Groot, G. Marlet, C. Teulings and W. Vermeulen (2010), "Stad en land" (City and Countryside), *CPB Special Publication*, No. 89, Netherlands Bureau for Economic Policy Analysis, The Hague, Figure 2.7.

The incentives of current municipal taxes are already high. The University of Groningen's Centre for Research on Local Government Economics (COELO) compares and analyses the real estate tax rates of Dutch municipalities. The annual report reveals which municipality has the highest rates and the largest increase in rates. Such results are regularly published on the front page of major national and local newspapers and discussed in the local councils. Enlarging the municipal tax base is therefore unlikely to lead to a major increase of these incentives.

Enlarging the tax base for municipalities only makes sense when municipalities can differentiate their tax rates. However, in practice – in particular in small countries that are unitary states – major differences are not allowed. In Dutch history (see Section 3 above), major differences in municipal tariffs resulted in migration and a widening gap between rich and poor municipalities. After the introduction of the municipality fund in 1929,

municipal taxes were still a major source of finance. However, most rates were equal to the maximum set by the central government. In the Scandinavian countries, the local tax base is very high, and local government is governed by elected local and county councils (see Rattso, 2003). Nevertheless, the Scandinavian model is a unitary welfare state and allows little room for local democracy and accountability, as the central government is in control of all public finance. Local tax rates are mostly close to the official maximum, the revenues from municipal income taxes are to a great extent redistributed by the central government, and local and county governments act primarily as agents of the central government.

Table 22. **Dutch taxes on owning, using or buying houses and business premises**

	Billion euros	% of total	% of GDP	Thousand euros per inhabitant
Tax on buying houses (6%)	2.7	36	0.5	0.2
Tax on rental value of owner-occupied dwellings (30% tax rate on 0.55% of official real estate value)	1.9	25	0.3	0.1
Municipal real estate tax (OZB)	2.9	38	0.5	0.2
Total	**7.6**	**100**	**1.3**	**0.5**

Source: Statistics Netherlands national accounts.

Henry George and others have argued that local public services increase the value of land and houses in their neighbourhood. Taxing the value of land to the extent that it exceeds that of uncultivated land or its value for agriculture would therefore be a good source of finance for such local public services, as it gives local government the proper incentives to maximise its tax revenue (see de Groot *et al.*, 2010). In the current Dutch tax system, the central government collects taxes and distributes these via general and specific transfers to local government. Some of the taxes by the central government are related to the value of land and houses, *i.e.* the taxation of the rental value of dwellings and business premises and the tax on buying houses. It would therefore be a no-regret option to transform these into a municipal land tax. This would more than double municipal taxes. Abolishing the tax on buying houses also abolishes the disincentive on moving and therefore improves the mobility on the housing and labour market.

4.2.3. Less earmarked transfers?

Earmarked transfers can be a major tool for the central government to influence local public expenditure. A general transfer by the central government combined with negotiation and consultation is likely to be much less effective. However, ensuring the efficiency and effectiveness of earmarked transfers is not easy:

- Two layers of government, *i.e.* central and local government, have to provide information on the results of these transfers and should justify these results to their managers and politicians. As a consequence, administrative burden and political responsibilities are easily doubled.
- Earmarking transfers leads to partitioned management at the central and local level. However, in reality all kinds of economic and social problems are intertwined. For example, in a backward neighbourhood many problems are interrelated, like unemployment, unsafeness and high drop-out rates at schools. Earmarking transfers (*e.g.* one for fighting unemployment, one for reducing unsafeness and one to improve school attendance) assumes that such problems can be solved in isolation. Earmarked

transfers usually also prescribe the specific type of solution that should be used for solving the policy problem. For example, in order to solve a traffic jam, the earmarked transfer prescribes that roads should be built; this ignores alternatives like improving public transport, adding bicycle lanes or charging higher parking fees. Earmarking transfers can therefore make it very difficult to solve problems efficiently and effectively at a local level. If an efficient and integrated approach is taken, it is an enormous administrative burden to reroute the centrally or locally earmarked transfers. Strict accountants can then also officially declare that the earmarked transfer was used for different purposes or in a different way than intended by the central government.

- Earmarked transfers should preferably be allocated on the basis of objective criteria to individual municipalities and provinces. However, a reliable formula for assessing the needs of individual municipalities and provinces is in practice difficult to find due to all kinds of measurement problems. As a consequence, some will receive too much and others not enough. Earmarking implies that even if you receive too much, you will nevertheless spend it for that purpose. Earmarking reduces by definition the possibility for local government to reallocate the funds for different purposes, for other projects, for other types of policy, or for reducing local debt or taxes. The more small municipalities are involved and the more earmarked transfers are defined in a strict and narrow sense, the larger such inefficiencies.

The number of earmarked transfers should therefore be limited and they should not to be defined too strictly. In order to improve the efficiency and effectiveness of earmarked transfers, their ultimate and general purpose should be defined, and the interactions with other problems and solutions and their financing should be investigated systematically.

4.2.4. Which formulae for the size of general transfers?

The general transfer by the central government to Dutch municipalities and provinces is linked to the major part of the expenditure by the central government, *e.g.* expenditure on defence and education. From a historical perspective, this solution is understandable and clearly an improvement over earlier formula, *e.g.* a surcharge on national taxes. The current formula could be regarded as a monstrous alliance. Local governments are happy because it safeguards them against major budget cuts by the central government; this will only occur when the other expenditure is also cut substantially. It also ensures that local governments benefit when the central government decides to increase their expenditure. For the central government, the formula is regarded as an efficient device in managing public finance: when major budget cuts are necessary, the budget for municipalities and provinces is also automatically cut. At the start of the new period of government, the new government can recalibrate the budget for local governments by deciding on specific additional cuts or extra expenditure.

However, the drawbacks of the formula are easily overlooked:

- It results in all kinds of windfall gains and losses for local government that have nothing to do with their tasks or their financial position.
- It sets a very arbitrary norm on what is a reasonable budget for local government. In the short run, this may not be a problem, but in the longer run it is likely to become an outdated and unbalanced budget (too much or too small) that is hard to change.
- It makes the budgeting mechanism not very transparent and invites spurious political arguments. For example, when some years ago the central government decided to

increase expenditure on health care, police and education by several billion euros, this automatically increased the budget for municipalities and provinces. According to the official statements, the central government and the municipalities and provinces agreed that this extra budget should be spent on the same three policy priorities. However, this is clearly spurious political talk, as municipalities and provinces are hardly responsible for health care, police and education.

It is therefore better to choose a simpler and more neutral formula, *e.g.* a link to the development of GDP with some delay or with an adjustment for wage rates on the basis of the wage rates agreed upon in the market sector.[13] Like with the current formula, at the start of each new period of government, the government can decide to reconsider the size of the transfer by taking into account all kinds of factors like new tasks, efficiency, and the financial health of local government or the prospects of Dutch public finance and the national economy in general.

4.2.5. *How efficient are Dutch provinces?*

From an economic perspective, the current tasks, scale and financing of provinces do not seem efficient:

- One of the major tasks – spatial planning – would work better if transferred to a great extent to municipalities and city-regions (see above).
- The current tax is a surcharge on the national car registration tax and invisible for the inhabitants. As a consequence, voters will not be aware of the trade-off between local taxes, local expenditure and local debt reduction. The link to car registration implies that when you do not drive a car you do not pay taxes to the province. Due to the rapid increase in the number of cars for decades, the provincial tax revenues have gone up rapidly too. This is not in line with the development in the costs and tasks of provinces.
- The democratic process is not very strong. For inhabitants, the tasks of provinces are too general and the effects of provincial policy are too indirect and long term. In order to reduce the distance with voters, provinces have taken up social policy, *i.e.* a task that from an economic point of view should be restricted to the central government and municipalities.
- The increasing size of municipalities implies an increasing internalisation of local external effects and reduces the role for provinces. Also, the co-operation in functional regions for safety and health care reduces the role for provinces. To have clear value added in comparison to municipalities, provinces have to scale up. The reduction in the number of municipalities also reduces the supervisory tasks of provinces.
- Provinces have different roles in different regions; in urban regions with some big cities, their role is much more limited than in regions with many small municipalities. One general funding mechanism for all provinces (taxes plus province fund) cannot do justice to such differences.
- Some provinces are substantially richer than others. This reduces the incentive for efficiency, has not led to any lowering of taxes, and has stimulated spending on social policy and taking over – on an *ad hoc* basis – some of the financing by the central government. For example, in addition to the central government's earmarked transfer for child welfare, provinces decided to also spend part of their own money on child welfare.

- The general transfer is linked to the expenditure by the central government. As a consequence, there is no clear link with the costs and tasks of provinces.
- Voting for provinces serves also to choose the upper house in Parliament. This mixes up voting for local policy issues with voting for national policy issues.

There are therefore serious arguments for reconsidering the role and financing of Dutch provinces. Scaling up to three or four provinces would only partly solve the problems.

Notes

1. Allers and Elhorst (2005) demonstrate that in the Netherlands local tax rates are also influenced to a considerable extent by tax rates in neighbouring jurisdictions: a 10% higher property tax rate in neighbouring municipalities leads to a 3.5% higher tax rate. Such tax mimicking is less pronounced in municipalities governed by coalitions backed by a large majority. This suggests yardstick competition as the most likely source of tax mimicking. Allers and Elhorst also find that Dutch voters seem to be able to penalise incumbents for anticipated tax rate differentials, but not for unanticipated tax rate differentials. This limits the effectiveness of yardstick competition as a mechanism to reduce political rent seeking.
2. See, for example, Buchanan and Tullock (1962) and Niskanen (1971).
3. See also Enikolopov and Zhuravskaya (2007).
4. See, for example, Simon (1957 and 1997) and Kahneman and Tversky (1979).
5. Such knowledge is only available at the national level, *i.e.* at the Ministry of Transport and Infrastructure.
6. Major sources for this section are Israel (1998) and de Vries and van der Woude (1997).
7. For more details, see van Zanden and van Riel (2004).
8. For an overview of the history of Dutch fiscal policy, see Bos (2008).
9. Major sources for this section are van Zanden and van Riel (2004), van Zaalen (2002), van der Voort (1994), van Zanden and Griffiths (1989), Goedhart (1967) and Bos (2006).
10. This national accounts concept of government deficit is fundamentally different from the public sector accounting principles used by Dutch municipalities and provinces. For example, holding gains on equity stock are not relevant for the government deficit according to the national accounts. However, they are included in the public sector accounting notion "net operating balance"; the same applies to all kind of additions and subtractions from earmarked reserves. Another major difference is that the national accounts concept regards all purchases of land or capital assets by the full amount as expenditure and therefore as an increase in deficit.
11. This excludes expenditure on capital formation and includes a charge for capital consumption.
12. This excludes some specific expenditure, for example on social assistance, development aid, infrastructure and the general transfer to municipalities and provinces; it also excludes the expenditure by social security funds. Starting from 2012, this will also exclude the increasing interest payments by the central government.
13. Some other critics have made a similar proposal, *e.g.* van Zaalen (2002).

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Redirecting public finance towards a sustainable path

by
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This article summarises the conclusions of Gerhard Steger, chair of the OECD Working Party of Senior Budget Officials, which he presented at the 2nd International Policy Forum on Budgeting in Seoul in November 2011.

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There is no alternative to fiscal soundness

We have to prevent the past from eating the future. The costs of ageing and debt service represent a high percentage of budget expenditure in many countries. This limits the necessary space for investing in priorities like education, infrastructure, research and development. Therefore, we have to keep and often regain fiscal room for manoeuvre.

There is a decisive message from various experiences these days: trust in fiscal sustainability is key. Either the markets trust a country or that country is in deep trouble. If trust fades away and interest rates race to the top, there is no space left to encourage growth and employment, nor to finance the tasks of the state to the necessary extent. Thus, sound public finances are a prerequisite for growth and proper functioning of the state.

In past decades, interest rates did not always seem to fully reflect the differences in fiscal soundness between countries. Rates used to be quite low even for countries with a relatively modest fiscal record. One could get the impression that the pendulum now swings towards the other extreme. Markets are increasingly nervous and critical. But even if markets exaggerate, as long as they perceive things in a certain way, reality follows their perspective.

To escape the whip of the markets, countries have to build trust and prove day after day, week after week, month after month and year after year that they are determined to secure sustainable public finances.

And as far as sound public finances and necessary budget consolidation are concerned, never forget this: "Either you do it or others will do it for you" – and in a way which you might not agree with. The case of Greece dramatically highlights that a country loses the capability to decide about its own affairs if it lacks a solid basis for public finances. Therefore, it is of the utmost importance that the public's confidence in the soundness of fiscal policies is preserved.

Take care of fiscal minefields

After 14 years as Austrian budget director, this is one of my most important lessons learned: if you have expenditure under control, you most likely have the budget under control. The dynamics of a certain kind of expenditure is widely recognised: the costs of ageing, health care, interest and other items are already perceived as dangerous developments – though not always tackled sufficiently. To redirect public finance towards a sustainable path again, structural reforms have to be undertaken in due time. The longer a country waits, the more pain it will suffer.

But – as the case of Greece shows – it is not just a matter of expenditure: if the tax basis erodes (or never existed to a sufficient extent), this can consequently contribute heavily to budget problems. Therefore, strengthening tax discipline and eliminating tax loopholes are cornerstones of a successful budget strategy.

Another common minefield for sustainable public finances is pro-cyclicality. Here is another experience of a budget director: the most dangerous times for budget discipline are

– good times! The reason is obvious. In good times, governments and parliaments very often cannot resist designing and implementing new expenditure programmes which prove to be unsustainable in bad times. As a result, spending rises in an economic upswing and has to be cut when the cycle turns contrariwise. This pro-cyclical bias in the end frustrates voters and governments because newly invented "goodies" might be subject to cuts during the next downswing, and trust in reliable policy is hampered. But there is even more behind it: pro-cyclicality is poison for the economy; it dampens business further, at a point when pro-cyclicality is most counterproductive – namely, in an economic downswing.

Therefore it is crucial to include counter-cyclical elements in budget rules, which should let automatic stabilisers work and thus contribute to easing economic problems. These days, one should add that it will only work if a country has preserved such sound public finances that financial markets will not punish this country if permission is given for deficit spending in bad times. If a country lacks sufficient fiscal leeway, it will be forced to exert pro-cyclical fiscal consolidation and will rely on "non-Keynesian effects" to stimulate the economy.

Economic imbalances contribute heavily to budget problems. Banks which need to be saved or property bubbles which endanger economies are two well-known examples. Therefore, to successfully safeguard public finances implies taking a close look at economic risks and acting in time. Repercussions of economic imbalances tend to be a major threat for sound public finances. There is no successful budget policy without successful economic risk management.

Finally, never forget the public. Voters are willing to accept even painful consolidation measures to a higher extent than most politicians would think, under (at least) two circumstances. First: they want genuine truth and clarity, and want to be treated honestly. Second: most voters want to see socially balanced sacrifices. Even if the fiscal effect might be limited, the rich (however they may be defined) have to pay a fair share. Thus, communicating good reasons for consolidation and a fair balance of consolidation measures is key. Here's another experience of a budget director: if everyone cries, you've got it right. If some groups are silent, you've missed them. And if everyone cries, the public might get this extremely important message: everyone bleeds, therefore, everyone contributes. This is a very important precondition of successful budget consolidation.

Develop an appropriate general orientation of reform

Institutions matter a lot. This is especially true for good fiscal governance. Thus, enhancing institutional settings is a major component of redirecting public finances towards a sustainable path. The relevant aspects will differ from country to country: it might be necessary to establish an independent economic forecast as a credible basis for prudent budget planning processes; it might also be helpful to implement a fiscal council as an independent watchdog to foster fiscal discipline – and so on and so forth.

The design of institutions often has close links to the implementation of strong fiscal rules. There are several options which should be taken into consideration. Traditional rules focus on the reduction or abolishment of deficits and on reduction of the debt-to-GDP ratio. During the last two decades, another incarnation of a fiscal rule has gained ground: expenditure ceilings, sometimes even in a legally binding form. In this case, fiscal rules can be combined – for instance, an expenditure ceiling and a "debt brake" could very well strengthen each other and speed up fiscal discipline. In any case, fiscal rules always need

to be accompanied by the wielding of a big stick to make sure that they are being complied with. But although sanctions are indispensable, they are not sufficient. A combination of sanctions and incentives for fiscal discipline are crucial. Sticks and carrots should go together: carrots should create incentives for line ministries ("Each minister his/her own finance minister") and administrative units to use taxpayers' money in a responsible way.

Another key issue is transparency. Markets will only trust in fiscal soundness if all relevant facts are on the table. Regular and substantial fiscal reports to parliament and the public are one important aspect; the accounting and budgeting system is another one. Traditionally, budgets are drawn up solely on a cash basis, which is certainly very important but not sufficient. A pure cash perspective lacks important information which is necessary for giving a complete picture of public finances as a transparency requirement. Therefore, an advanced accounting and budgeting system should provide a cash flow, a profit-and-loss statement, plus a balance sheet.

A successful economic and budget policy needs consistency. It's the task of politicians to define priorities and posteriorities, which should be reflected in consolidation efforts. This makes one point very clear: redirecting public finance towards a sustainable path is not just a technocratic exercise. Policy decisions – hopefully coherent – are indispensable and must prove their sustainability in the context of a long-term and medium-term perspective.

A general orientation to redirect public finance towards a sustainable path has to create fiscal space. It is necessary to regain leeway for fiscal policy and to create a financial buffer for rainy days. But it's not only the next downswing of the business cycle which makes fiscal space indispensable. Even more leeway is required by future challenges, such as the costs of ageing, health care, or necessary public investment in education, research and development, infrastructure, and so on.

Finally, cover all levels of government. The experience in various countries gives a clear picture: subnational governments can hamper sound public finances to a considerable extent. Therefore, a focus on central government is necessary but not sufficient. Regional and local government, hived-off agencies, and social security funds all deserve a close look. At the end of the day, it is general government which matters.

Tools of fiscal glory

Derived from examples of best practice, a number of tools can be identified as helpful in the context of fostering sound public finances.

Any budget needs macro-fiscal forecasting. This should be done by an independent institution and not by the finance ministry. The reasons are quite obvious: first, any forecast will be wrong and if the finance ministry forecasts itself, it is responsible for that. Second: forecasts within the administration might be under pressure to be too optimistic. As a macro-fiscal forecast should be conservative to be on the safe side for budget planning and execution, an independent projection will be more credible in that respect.

There is no good fiscal governance without accurate statistics. On the one hand, these statistics are needed as a reliable basis to steer the budget appropriately. On the other hand, accurate statistics are a prerequisite for fiscal transparency. Without such accurate statistics, the whole budget process will be stuck in a fiscal fog, and the credibility of such a budget will be zero.

As budgets are always at risk of being influenced by unforeseen (though not always unforeseeable) factors, solid fiscal risk management is extremely important. Without that, fiscal fog will evolve again. Steering a budget – be it at the stage of planning, implementing or executing – always has to take into account risks both on the expenditure and the revenue side. Good fiscal reports mention those risk components and quantify them.

Planning a budget almost always means allocating scarce resources. This is why top-down budgeting is very helpful. Instead of collecting budget demands from line ministries which can never be fulfilled, the finance ministry restrictively allocates financial resources to them as the basis for budget negotiations. The respective result of the negotiations should refer closely to the finance ministry's original proposal. Such an approach fosters budget discipline and therefore can be considered to be very functional. A prerequisite for top-down budgeting is a clearly defined consolidation strategy. Without a clear specification of who should contribute what amount of resources and why, it will be much more difficult to argue in favour of the demanded sacrifices. Again, this puts politicians in the centre of a budgeting process: their priorities and posteriorities should be the basis for any budget strategy.

A credible medium-term expenditure framework is a cornerstone of each consolidation strategy – first of all, because it deals with expenditure, which has to be restricted; second, because it provides orientation not only on an annual basis but for a longer time frame. This fosters reliable budget planning both within the finance ministry and for line ministries. Credibility is key. Therefore it is of utmost importance that expenditure ceilings are defended as fiercely as possible. In some political cultures, this will require legally binding expenditure ceilings to make sure that any deviation from budget discipline needs the consent of parliament. In other words, it implies a reputational and credibility risk for the respective government which will be recognised by the opposition and the financial markets. As mentioned above, such a medium-term framework should integrate counter-cyclical elements to support a smooth economic development. To make sure that medium-term budget planning is in line with long-term needs, a regular long-term fiscal projection should be undertaken. Such projections should cover some decades in advance.

At the end of the day, fiscal policy is about creating results for citizens: social security, health, education, infrastructure, effective prevention or at least prosecution of crime, etc. Such results cannot be expressed in input figures. Thus, a budget which really steers resources AND results has to deal with performance. This is why performance budgeting is a decisive factor. Experiences from different countries send a clear message: do not do it in a complex way; restrict it to the most important aspects; be lean and focused on top priorities. Limit the number of outcomes and outputs, of indicators, milestones and deliverables. Otherwise performance budgeting might convert into a bureaucratic monster. If this danger is avoided, performance budgeting is a very valuable tool to demonstrate to parliament and citizens how taxpayers' money is used. Thus, the budget transforms into an integral steering instrument of resources and results and, in that way, underlines and even strengthens its role as the central document of any government.

As soon as a budget has been approved by parliament, another important part of budget work starts: (hopefully) rigorous budget execution based on professional controlling. To preserve the credibility of the respective fiscal policy, the budget has to be defended efficiently against all efforts to undermine fiscal discipline. Therefore, expenditure ceilings have to be respected, budget surpluses reached or surpassed, deficits

further reduced if possible. Debt-to-GDP ratios and other central budget indicators have to be met or even overachieved. An accurate accounting system and professional budget controlling (including risk management as mentioned above) are prerequisites for successful budget execution.

When fostering budget discipline, effective watchdogs prove to be helpful. Several incarnations of such watchdogs can be observed. Independent fiscal councils can build up public pressure in favour of fiscal discipline. Courts of audit scrutinise public accounts and advocate effective and efficient use of public money. The opposition in parliament will use each and every opportunity to blame the government for a lack of fiscal discipline. Independent media help to spread information and thus add decisively to the transparency of public finances. Finally and ultimately, financial markets are the most effective watchdogs. Nobody wants to be their victim, and lots of consolidation efforts in many countries happen only if these watchdogs are already hunting or at least threaten to do so. Thus, the most important role of institutional watchdogs is to exert so much pressure in favour of sound public finances that the ultimate watchdogs, the financial markets, do not really see a realistic option for starting a successful hunt.

Foster political will – The role of budget officials

When redirecting public finance towards a sustainable path, politicians need good advice. Budget officials are in charge of providing just that. I will highlight some aspects of how the role of budget officials can successfully contribute to sound fiscal policies.

First of all, communicate clearly. Present accurate facts, prepare options with pros and cons and, on that basis, add suggestions on how to proceed. Give clear messages, and reduce complexity whenever possible. The more you manage to be focused, the bigger the chance that you are at least understood, which is a prerequisite for successful advice. Plus, do not miss the chance to influence things. Communicate immediately whenever it is necessary. A key element of the art of advising is to analyse developments so accurately that helpful warnings and suggestions come on time.

Never try to please political decision makers. They only want to hear good news. Budget officials frequently have to communicate problems, bad news, and the need for difficult decisions. Therefore, budget officials should try to be honest advisers, which often means being the opposite of a nice one. It may be difficult to act in such a way, but in the longer run it pays off. If a budget official tries to communicate only good news, she or he will lose credibility within a very short time. Though the task of budget officials often implies raising difficult issues, budget officials should at the same time always communicate good political reasons to act. This very often implies a choice between two (or sometimes even more) "crocodiles": politicians do not want to do harm to voters; but if fiscal policy is in trouble, politicians have to act quickly and decisively – otherwise negative reactions of the financial markets are very likely, which would provoke very expensive consequences for public finances. Budget officials have to make sure that political decision makers not only look at the "voter crocodile" which may punish them if they act; politicians have to recognise the "financial market crocodile" as well which, in any case, is even more dangerous. If politicians consolidate, they may be punished by the voters, but if they fail to persuade the markets, they will be politically dead for sure. A number of examples tell a brutal story: when ratings go down and interest rates go up, the respective government is finished anyway. Budget officials should convince politicians to fear the

markets more than the electorate. This does not necessarily mean that market regulation and more leeway for politics *vis-à-vis* the economy would be harmful. It just makes clear that, in the world we're living in, markets are stronger than wishful political thinking. And even if politics could manage to gain ground again, this would take a certain period of time. Until then, the "financial market crocodile" will be dominant.

Thus, budget officials should not wait until problems arrive; they should try to anticipate them. The earlier you see a monster rise, the higher the chance to counteract successfully. Experienced budget officials have always prepared elaborate reform proposals either on paper or at least in their minds, and they are always ready to launch them when a window of opportunity opens up. Most of the time, these chances pass quickly. Therefore, it is necessary to act immediately when a chance to influence things emerges.

A proposal is successful only if politicians develop ownership. It is an art to present ideas to politicians as if they were their own. Budget officials should not be vain, but should always be prepared to hand over their "copyright" of good ideas and concepts to political decision makers.

To sum up, budget officials need to identify factors of success in their political system to foster fiscal discipline and to sell budget sustainability to politicians and the public. This is why it is important but not sufficient for budget officials to solely have knowledge in economics. Providing good fiscal advice is about combining economics, political science and psychology.

Finally, the most important task of budget officials is to successfully contribute to preventing a crisis from occurring or spreading further. But if such a crisis has already evolved, here is the suggestion of a long-serving budget director: utilise the crisis to push necessary reforms to strengthen fiscal discipline.

In other words, never let a good crisis go away unused.

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Budgeting in Ukraine

by
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This budget review of Ukraine first discusses some general legal, political and economic characteristics of the country and recent institutional reforms. Section 2 examines the budget formulation process with separate attention for the budget structure and classification, the annual budget preparation cycle, medium-term planning, long-term fiscal sustainability, the organisation of the Ministry of Finance, and the funding of local government. Section 3 addresses the parliamentary budget process with special attention for the Budget Committee, the annual parliamentary budget cycle, and the impact of parliament. Section 4 focuses on budget execution with special attention for the annual executive process, cash management, and budgetary discipline. Section 5 looks at the supply side of the budget process: the ministries and agencies that provide for public administration and service delivery at the level of central government, as well as such provision by local governments. Section 5 also addresses public employment, the civil service, public procurement, and the public enterprise sector. Section 6 looks at accounting and audit, with special attention for financial reporting, internal audit, and external audit.

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Keywords: Budget formulation, budget preparation cycle, budget structure and classification, medium-term planning, long-term fiscal sustainability, parliamentary budget process, parliamentary budget committee, annual budget cycle, budget execution, cash management, budgetary discipline, public administration and service delivery, local government, public procurement, public employment, civil service, public enterprise sector, accounting, audit, financial reporting, internal audit, external audit, Ukraine.

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Preface

This review of the budget process of Ukraine was carried out as part of the work programme of the OECD Working Party of Senior Budget Officials. In 2004, the Working Party established the Network of Senior Budget Officials of Central, Eastern and South-Eastern European (CESEE) countries. Budget reviews serve as a basis for examination of a country's budgetary institutions by the network in its annual meetings and enable participants to discuss the budget procedures of a country in depth.

A team of the OECD Secretariat consisting of Dr. Dirk-Jan Kraan (lead), Ms. Lisa von Trapp, and Ms. Valentina Kostyleva, supported by Mr. Jan van Tuinen (Netherlands Ministry of Finance) and Mr. Matthias Morgner (GIZ, German International Co-operation), undertook a mission to Kiev from 11 to 15 October 2010 to prepare the review. During the mission, the team met with: Mr. Vladimir Lositsky, Head of the Budget Department, Ms. Natalia Tovsta, Deputy Head of the Budget Department, Ms. Liudmilla Litvinenko, Deputy Head of the Department of the Treasury, and other officials of the Ministry of Finance; Ms. Svitlana Danylenko, Director of the Department of Economics and Financing of the Ministry of Education and Science, and other officials of the Ministry of Education and Science; and Ms. Nataliya Shchepotyeva, Director of the Department of Financial Inspection.

The OECD team also met with: Mr. Andriy Vatulev, Head of the Secretariat of the Budget Committee of Parliament, Ms. Svitlana Feshuk, Deputy Head of the Secretariat of the Budget Committee of Parliament, and other officials of the Budget Committee staff; Mr. Oleksandr Yaremenko, Deputy Head of the Accounting Chamber of Ukraine, Mr. Taras Prytula, Director of International Co-operation of the Accounting Chamber, and other officials of the chamber; Mr. Yuri Hanushak, Director of the Association of Cities of Ukraine; and Ms. Klavdia Pavluk of the Institute of Economics and Forecasting. Additional information was provided by Mr. Andriy Bega of the National Agency of Ukraine for the Civil Service, and by the State Statistics Committee and the State Property Fund.

The OECD team is grateful to all these officials and experts for the information they provided and for their willingness to explain the procedures and practices of budgeting in Ukraine. The OECD team appreciated in particular the open and frank discussions with the Ukrainian interlocutors and their continued co-operation in 2011 in further refining some of the information in this report. The draft of the report was completed in March 2012.

The team would like to thank in particular Ms. Valentina Doletska, Deputy Head of the Budget Department, for the excellent organisation of the meetings, her help with the collection of documents, and her extraordinary hospitality during the team's stay in Kiev.

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1. Introduction

1.1. Contents of the review

The main purpose of an OECD budget review is to provide information about the current institutional features of a country's budget process which can serve as a basis of discussion in a meeting of delegates from countries in similar conditions. Such discussions may be useful to other countries in that they can learn from the country under review, and may be useful for the country under review because it can receive suggestions from other countries for overcoming the problems it is facing (peer review). The OECD Secretariat usually adds its own policy suggestions to the reviews, but in general strives for restraint in this respect in order to allow maximal room for exchange of views among peers. In countries of the most eastern part of Europe, restraint seems the more appropriate because these countries are already overloaded with policy advice on budget reform from international organisations and foreign donor countries. In general, this review follows this approach of a focus on description and restraint with recommendations, but with one nuance.

The OECD Secretariat has noticed that the emphasis of the advice from other international organisations and donor countries to eastern European governments often focuses on what is thought to be particularly important for transition countries. However, such advice sometimes does not take into account the features of budgetary institutions actually prevailing in OECD countries. Most OECD budget reviews are of course concerned with OECD countries and serve as peer reviews for member countries of the OECD. However, since 2004 the OECD Secretariat also conducts budget reviews outside the OECD area, particularly in central and eastern Europe and in Asia. The general approach of non-member country reviews is that similar problems should be analysed in a similar way, regardless of whether a country is a member of the OECD or not. Within certain limits, principles of effective and efficient public finance management are equally applicable to OECD and non-OECD countries. A difference in economic context may necessitate different budgetary policies, but generally does not justify a different approach to the reform of budgetary institutions. The current review follows the usual OECD approach, comparing the budgetary institutions of Ukraine with those actually prevailing in OECD countries. In some areas – such as medium-term expenditure frameworks, baseline estimates, governance of state-owned enterprises, steering of executive agencies, internal financial control, and internal audit – this may lead to conclusions that differ from those of other international organisations or donor countries. Since it may be important for Ukraine to be informed about these differences, the current review is less reserved in making recommendations in these areas than in other areas.

Under the before-mentioned proviso, the review follows the usual set-up of an OECD budget review. In the rest of this section, some general legal, political and economic characteristics of Ukraine will be mentioned and recent institutional reforms will be surveyed. Section 2 is devoted to the budget formulation process with separate attention for the budget structure and classification, the annual budget preparation cycle, medium-term planning, long-term fiscal sustainability, the organisation of the Ministry of Finance, and the funding of local government. Section 3 addresses the parliamentary budget process with special attention for the Budget Committee, the annual parliamentary budget cycle and the impact of Parliament. Section 4 focuses on budget execution with special attention for the annual executive process, cash management and budgetary discipline. Section 5 looks at the supply side of the budget process: the ministries and agencies that

provide for public administration and service delivery at the level of central government, as well as local governments that provide for public administration and service delivery at the level of local government. Section 5 also addresses public employment, the civil service, public procurement, and the public enterprise sector. Section 6 looks at accounting and audit, with special attention for financial reporting, internal audit and external audit.

1.2. General characteristics

1.2.1. Legal framework

Ukraine gained independence in 1991. The Constitution of 1996 established Ukraine as an independent republic. The Constitution provides for a unicameral Parliament of 450 members elected for a five-year term, a directly elected President and an independent judiciary. The members of Parliament are elected from party lists on the basis of proportional representation with a threshold of (currently) 3% of the popular vote to gain parliamentary seats. The government is formed by the President and the Cabinet of Ministers. Currently there are 16 ministers, including the Prime Minister. The Prime Minister is nominated by the President with the approval of the Parliament, and resigns upon dismissal by the President (Article 103.9 of the Constitution). The ministers are nominated by the President on the proposal of the Prime Minister (Article 102.10 of the Constitution), and resign if the Prime Minister resigns. The Cabinet needs the confidence of the Parliament and is obliged to resign if it loses confidence (Article 115 of the Constitution). The Cabinet is also responsible to the President. This arrangement characterises the government form of Ukraine as a semi-presidential system. In such a system, it is possible in principle that the President has to work with a Cabinet composed of parties that have not supported his/her own election, as happened in 2006-07 and for a short period after the presidential elections of 2010.

The Constitution enshrines judicial independence (Article 126). There are courts of first instance and appeal courts. The courts of last instance are the Supreme Court and high courts for some forms of administrative jurisdiction. In addition to the regular court system, there is a Constitutional Court that decides on the constitutionality of laws and by-laws. The Constitutional Court is composed of 18 members, six of whom are appointed by the President, six by the Parliament, and six by the congress of judges (Article 148 of the Constitution).

The main laws regulating the budget process are:

- the Constitution of Ukraine (of 1996);
- the Budget Code of Ukraine (of 2010);
- the Law on the Accounting Chamber of Ukraine (of 1996);
- the annual Law on the State Budget of Ukraine.

The revenue side of the budget is further determined by:

- the Tax Code (of 2010).

Other relevant laws are:

- the Law on the Cabinet of Ministers (of 2010);
- the Law on Local Self-Government (of 1997);
- the Law on Local State Administrations (of 1999);
- the Law on the Civil Service (of 1993);

- the Law on Public Procurement (of 2010).

1.2.2. *Geography and demography*[1]

The land area of Ukraine is 603 700 square kilometres, making it the second-largest country in Europe after the Russian Federation.

The population is 45.9 million (January 2010). Ethnic Ukrainians make up 76.5% of the population, the next-largest ethnic group being Russians (13.5%). The population is declining rapidly due to one of the lowest fertility rates in Europe (1.27 births per woman) and substantial emigration (0.3 per thousand in 2008). The population declined from 51.7 million in 1989 to 45.9 million in 2010, a loss of 11.2% in two decades. Life expectancy at birth is low: 68 years (estimation 2008), with a large discrepancy between males (62.2 years) and females (74.2 years). Although estimates vary, approximately two to three million Ukrainian citizens are currently working abroad – most of them illegally – in construction, service, housekeeping and agriculture, with around half of this number in the Russian Federation.

GDP per head is USD 2 569, higher only than Georgia and Moldova among European countries. In 2009, 35% of Ukraine's population could be defined as poor (on the basis of the World Bank's threshold of income less than a dollar per day). Poverty is concentrated in rural areas, particularly in the western and southern parts of the country. Poverty rates are substantially lower in urban areas and in the industrialised east of the country.

1.2.3. *Gross domestic product*[2]

Ukraine experienced a sharp economic contraction in the 1990s following independence. As a result, by 2000 real wages plunged to less than 40% of their 1992 level. Positive economic growth resumed in 2000. During 2001-08, growth of GDP averaged 7.5% year on year, among the highest in Europe. Strong foreign and domestic investment together with improvements in the external terms of trade, due to high steel prices (steel being a main export product of Ukraine), helped maintain double-digit growth in domestic demand. However, with a pre-crisis fixed exchange rate, buoyant international liquidity led to the build-up of foreign commercial debt, causing high inflation (over 30% in 2008) and a widening deficit on the current account (17 percentage points during the period 2004-08).

The global economic and financial crisis hit Ukraine particularly hard. By the fourth quarter of 2008, capital inflows came to an abrupt stop, the terms of trade reversed as steel prices dropped, and export markets shut down. The crisis also accentuated the vulnerabilities of the banking sector, leading to a systemic liquidity and solvency crisis. GDP contracted by 15% in 2009, with investments falling by 46% year on year. Since October 2008, after the abandonment of the fixed exchange rate, the national currency (hryvnia, UAH) has lost about 40% of its value against the United States dollar.

Ukraine's economy resumed growth in 2010 as a result of moderate improvements in external demand. Real GDP grew by 3.7% in 2010. The balance-of-payments pressures have eased, and the current account was almost balanced in 2010 thanks to growing export demand and higher prices of core exports (steel, agricultural products). At the same time, improved rollover rates on external commercial debt supported new inflows on the capital account. Deposits in the banking system have been increasing from the lows of 2009. Consumer price inflation has decelerated to single digits since 2010.

Table 1 summarises the GDP development since 2004 in comparison to the EU, split into the "old" (pre-2004) member states and the "new" (central and eastern European) member states.

Table 1. **Growth of real GDP**

Per cent change on previous year

	2004	2005	2006	2007	2008	2009	2010	2011[1]	2012[1]
EU15 (older)	2.3	1.8	3.0	2.8	0.2	-4.3	1.8	1.6	1.9
EU10/12 (accession)	6.0	5.4	6.2	5.8	4.3	-3.0	1.8	2.9	3.2
Ukraine	12.1	2.7	7.3	7.9	2.1	-15.1	3.7	4.5	4.9

1. Forecasts.

Sources: IMF (2008), "Ukraine: Request for Stand-By Arrangement", International Monetary Fund, Washington, DC; IMF (2011), "Ukraine: First Review under the Stand-By Arrangement", International Monetary Fund, Washington, DC.

1.2.4. Sectoral structure[3]

Ukraine has a major ferrous metal industry, producing cast iron, steel and pipes. Ukraine is one of the largest steel producers in the world. Another important branch is the country's chemical industry which includes the production of mineral fertilisers. Manufactured goods include metallurgical equipment, diesel locomotives, tractors, and automobiles. The country possesses a massive high-tech industrial base, including much of the electronics industry, arms industry and space programme of the former USSR, most of which is owned by the state. Ukraine is a major producer of grain, sugar, meat, and milk products. It is the largest producer of sunflower oil in the world. Because Ukraine possesses 30% of the world's richest black soil, its agricultural industry has a huge potential. However, farmland is for a large part not privatised, hampering access to international investments and best farming technology. The agricultural industry is already highly profitable with 40-60% profits but, according to analysts, its outputs could still rise up to fourfold.

Ukraine encourages foreign trade. The EU is the largest trading partner, with 27.1% of exports and 33.7% of imports in 2008. Trade with the EU has seen double-digit growth in recent years. The Russian Federation is Ukraine's second trading partner, with 21.1% of exports and 28% of imports in 2009. Steel products account for 46% of Ukraine's overall exports. Ukraine is among the top ten arms exporters in the world. The output of Ukrainian defence plants grew annually by more than 50% in recent years, with the largest growth reported by aircraft builders and ship builders.

Ukraine imports 90% of its oil and most of its natural gas. The Russian Federation ranks as Ukraine's principal supplier of oil, and Russian firms now own and/or operate the majority of Ukraine's refining capacity. Natural gas imports come from Russia, which delivers its own gas as well as gas from Turkmenistan. Ukraine transports Russian gas to the EU through its well-developed gas pipeline system, being Europe's vitally important connection to the Russian gas supply.

Ukraine is independent in its electricity supply, moreover exporting it to Russia and other countries in eastern Europe. This is achieved through a wide use of nuclear power and hydro-electricity. The current energy strategy includes a gradual decrease of gas- and oil-based generation in favour of nuclear power, as well as energy-saving measures to reduce industrial gas consumption. Reform of the still opaque energy sector is a major objective of the IMF and World Bank programmes with Ukraine (see below). Ukraine is a

partner country in the EU INOGATE programme (Interstate Oil and Gas Transport to Europe) which has four key objectives: enhancing energy security, convergence of member state energy markets on the basis of EU internal energy market principles, supporting sustainable energy development, and attracting investment for energy projects of common and regional interest.

Table 2 summarises the current sectoral structure of the domestic economy of Ukraine.

Table 2. **Sectoral structure of the Ukrainian domestic economy**

	Contribution to GDP (per cent, 2010)	Employment (per cent of total domestic employment, 2009)
Agriculture	9.8	15.8
Industry	32.3	18.5
Services[1]	57.9	65.7

1. Services include: construction, transport and communication, trade, health and social services, communal and other consumer services, education, culture, art and science, finance and public administration.

Source: CIA (2010), *CIA World Fact Book*, Central Intelligence Agency, Washington, DC.

1.2.5. Political developments

On 1 December 1991, an all-Ukrainian referendum endorsed the independence of Ukraine and the presidential form of government, by 90% of the popular vote. Simultaneously, Leonid Kravchuk was elected as the first President of the new Ukrainian state. He was one of the three participants of the Belovezhski agreements which led to the dissolution of the Soviet Union and the establishment of the Commonwealth of Independent States (CIS). In July 1994, Leonid Kuchma was elected as his successor in pre-term presidential elections. Kuchma was re-elected in 1999 and stayed in office for a total of ten years. During Kuchma's term in office, the new Constitution was adopted. In December 2004, Viktor Yushchenko was elected as President of Ukraine.

The parliamentary elections of March 2006 were based on a new electoral law that introduced a mixed system according to which half of the 450 seats were elected from single-seat constituencies and half from party lists with proportional representation (used in the parliamentary elections of 1998 and 2002). The new electoral law lowered the threshold for parties to be eligible to enter Parliament from 4 to 3%, making it increasingly difficult for any one party to gain a majority of seats. The election of March 2006 produced inconclusive results. None of the three main parties in the new Parliament (Our Ukraine supporting Mr. Yushchenko, the Party of the Regions led by Mr. Yanukovych, and the Yulia Tymoshenko Bloc led by Ms. Tymoshenko) won sufficient seats to govern on its own. Next to the three main parties, only the Socialist Party of Ukraine and the Communist Party of Ukraine secured seats. For months, coalition talks dragged on. By late June 2006, an "orange coalition" was formed between Our Ukraine and the Yulia Tymoshenko Bloc with support of the Socialist Party of Ukraine. However, this coalition unravelled after a few months. In August 2006, Mr. Yanukovych became Prime Minister.

As part of the "orange revolution", the Ukrainian Constitution was changed to shift powers from the presidency to the Parliament. Among other things, as far as the appointment of ministers was concerned, the President retained only the right to appoint the ministers of foreign affairs and defence, with the approval of Parliament. Other ministers are appointed by the Prime Minister. This constitutional revision came into effect in 2006

when Mr. Yanukovych formed the government. As a result, President Yushchenko had to deal with a powerful Prime Minister who had control over many important portfolios.

After more and more parliamentarians defected to the ruling coalition, bringing a two-third majority into sight (which would allow the Parliament to overturn presidential vetoes), Mr. Yushchenko decided to dissolve Parliament. The decree was immediately labelled unconstitutional by the ruling coalition which appealed to the Constitutional Court. Against a backdrop of mutual recriminations and before the court could reach a verdict, negotiations between Mr. Yushchenko, Mr. Yanukovych and Mr. Moroz – leader of the Socialist Party of Ukraine – produced an agreement in May 2007 creating a legal base for an early election in September.

In the new Parliament, five political parties or blocs surpassed the 3% threshold to win a seat. The Party of the Regions emerged as the overall winner with 175 seats in its control, followed by the Yulia Tymoshenko Bloc with 156 seats. The Socialist Party did not reach the electoral threshold, and a new party, the Lytvyn Bloc, led by former parliamentary speaker Mr. Volodymyr Lytvyn, entered the Parliament with 20 seats. The Communist Party of Ukraine obtained 27 seats. However, the formation of a coalition between the Yulia Tymoshenko Bloc and Our Ukraine allowed them to obtain a narrow majority of just one vote, and Yulia Tymoshenko became Prime Minister on 18 December 2007. Ms. Tymoshenko was then ousted as Prime Minister on 3 March 2010 following a parliamentary vote of no confidence and the breaking up of the coalition that had appointed her.

The presidential elections of January/February 2010 were won by Mr. Yanukovych. His major priorities were: the establishment of Ukraine as a democratic state, with respect for the rule of law, the rights of people and freedom of speech; administrative reform, fighting corruption and the shadow economy; building a strong national economy with a high level of employment; increasing salaries and pensions; stability of the price level and the currency exchange rate; introducing European standards of social security, health care, education, housing and quality of life to develop the human potential of Ukraine; reform of the armed forces to build a professional defence force; preserving the principles of openness and good-neighbourly relations in external policy; non-aligned status of Ukraine; European integration of Ukraine; and strategic partnership with Russia, the United States and the EU. After the election of Mr. Yanukovych, the Party of the Regions succeeded in organising a parliamentary majority consisting of the Party of the Regions, the Communist Party, the Lytvyn Bloc, and some others, which voted in a government led by Mr. Mykola Azarov.

The difficult relations between the President and the Cabinet that had complicated the governance of Ukraine almost since independence have now come to an end, thus restoring a certain stability in the political process.

1.2.6. International relations[4]

Ukraine acceded to the World Trade Organisation in 2008 after a long process to enact the required legislation. Although EU membership is at best a distant prospect, a deepening of economic relations with the EU is still expected. Work is under way on a new "enhanced agreement" with the EU, including an extensive free trade deal, to replace the existing Partnership and Co-operation Agreement. Ratification of any enhanced agreement with the EU could take several years, although the free trade deal would come into force sooner.

Relations between Russia and Ukraine have improved markedly. In June 2010, the Ukrainian Parliament passed a law barring the country's membership of military blocks, in effect ruling out NATO membership. In April 2010, the President agreed to extend the lease accorded to the Russian Black Sea Fleet on facilities in Crimea for a further 25 years from 2017, in exchange for a reduction in the price of Russian gas imports. The agreement will ease previous bilateral tensions related to energy supplies.

1.3. Foreign aid[5]

Ukraine's economy grew rapidly from 2000 to 2008 (more than 7% annually). Strong growth was supported by high steel prices (steel exports amounted to 15% of GDP) and lingering Russian subsidies for the gas supply (gas imports amounted to 6% of GDP). Large capital inflows caused the banks and corporations to rely on short-term external borrowing. Household finances and corporate balance sheets were weakened due to increased borrowing from banks in foreign currency encouraged by low interest rates and a rigid monetary policy aimed at stabilising the exchange rate. In 2008, the fiscal position deteriorated sharply. Windfall revenues were spent largely on higher wages and social transfers, propelling gross compensation of employees and social benefits some 220% higher over the period 2004-08. During the first months of 2008, credit growth amounted to 70%, consumer price inflation to 30%, and wage growth to 30-40%. In Ukraine, the global financial crisis set in relatively early, namely in mid-2008. On the export side, the price of steel declined by 65% shortly after July 2008. On the import side, Russia signalled its intention to phase out remaining gas subsidies. In the context of the deepening global financial turmoil, Ukraine was shut out of the international capital markets. Major strains appeared in the banking system, causing among other things the sixth-largest bank to be put under state receivership. After the National Bank of Ukraine had spent USD 4 billion to sustain the exchange rate, it was forced to let the hryvnia float. In this context, the Ukrainian government asked the IMF for a two-year stand-by agreement of USD 16.5 billion in support of its policy plan as laid down in the Memorandum of Economic and Financial Policies (MEFP).

The MEFP envisaged restoring financial and macroeconomic stability. Measures were specified regarding: *i)* appropriate liquidity support and expansion of deposit guarantees; *ii)* a stronger bank resolution framework, including availability of public funds for re-capitalisation; and *iii)* a stronger framework for resolution of household and enterprise sector debts. In addition, the MEFP aimed to facilitate adjustment to potentially large external shocks and to allow gradual reduction of inflation. Measures included: *i)* a flexible exchange rate policy; *ii)* transition to inflation targeting in monetary policy; *iii)* resetting incomes policy in line with targeted inflation; *iv)* maintaining a prudent fiscal policy; and *v)* bringing energy prices more in line with costs. The programme was set up to respond flexibly to economic developments. Recovery of steel prices and resumption of capital inflows would be met with higher reserve accumulation and adjustments to monetary policy (to safeguard inflation targets). Downside risks such as a longer loss of access to capital markets would be cushioned by the flexible exchange rate and additional measures.

In response to the request, the IMF agreed a two-year arrangement under credit tranche terms. IMF financing would contribute to covering Ukraine's balance-of-payments needs. Following initial reserve losses, associated with tactical interventions aimed at facilitating an orderly adjustment of the exchange rate, the financing would be used to build Ukraine's gross international reserves back up to a level that would be sufficient to cover at least 75% of short-term debt obligations.

The new government that took office in March 2010 was confronted with the aftermath of the global financial crisis. It quickly moved to formulate a five-year economic reform plan to tackle long-standing structural weaknesses and, in July 2010, some months before the expiration of the stand-by agreement of 2008, the government requested support from the IMF in the form of a new stand-by agreement spanning the period to the next parliamentary elections scheduled for the fall of 2012, amounting to USD 14.9 billion. The Ukrainian authorities saw a new stand-by agreement as providing a strong signal that sound macroeconomic policies and financing are in place to support adjustment and reforms to ensure that Ukraine will be in a position to deal with risks in the event of worsening external conditions. The new stand-by agreement was expected to catalyse financing from markets and foreign governments to cover Ukraine's still sizeable external financing needs.

The five-year economic reform plan of the new government aims to: *i)* restore confidence and fiscal stability by reducing the general government deficit to 2.5% of GDP in 2012 and setting public debt on a downward path below 35% of GDP by 2015; *ii)* initiate reforms to modernise the gas sector and phase out the deficit of Naftogaz, including through gas tariff increases and a price mechanism that depoliticises price setting of public utilities, making use of the new gas law adopted in July 2010; *iii)* restore and safeguard banks' soundness through completion of recapitalisation plans by end-2010 and strengthened supervision; and *iv)* develop a more robust monetary framework focused on domestic price stability with greater exchange rate flexibility under a more independent National Bank of Ukraine.

As far as fiscal policy is concerned, discussions with the IMF on the new stand-by agreements focused on bringing public finances onto a sustainable path without hampering the nascent economic recovery. It was agreed that the combined general government deficit and the deficit of the state-owned gas company Naftogaz would not exceed 6.5% in 2010. Without policy change, the combined deficit would approach 9% of GDP, reflecting revenue shortfalls, higher wages and pensions, and investment needs for the 2012 UEFA European Football Championship; so the authorities prepared a supplementary budget for 2010 that would bring the lower target within reach. Given the half-year effect of measures and the fragility of the economy, any further effort was not considered feasible in 2010. However, the authorities agreed to reduce the deficit to 3.5% of GDP in 2011 and 2.5% in 2012, while Naftogaz's deficit would be eliminated in 2011. For that purpose, the authorities agreed to adopt the following structural measures: *i)* structural pension reform to be initiated in 2011; *ii)* fiscal reforms, as envisaged in the recently adopted Tax Code and Budget Code, including improved tax collection, a medium-term perspective for budget preparation, and stronger requirements for assessing the impact of new initiatives; *iii)* public administration reforms to be implemented by March 2011, including bringing on budget a larger part of the user fees collected by public enterprises, strengthening the oversight and control of the delivery of administrative services to the public, and improving cost efficiency; and *iv)* additional energy sector reforms, including an additional increase of gas prices by 50% in April 2011, semi-annual price increases thereafter and an automatic price adjustment mechanism to follow import prices, once import parity is reached.

The IMF has agreed the package. The new stand-by agreement includes USD 2 billion for budget support in 2010, which was requested in view of the shallowness of domestic capital markets and the need to enhance confidence in international capital markets.

In the first review under the stand-by agreement of 2010 (February 2011), the IMF concluded that all end-September fiscal performance criteria were fulfilled, although the lifting of the ban on penalties for overdue utility bill payments met with delay. The issuance of bank recapitalisation funds was within programme ceilings. Monetary targets were also achieved, although the agreement on phasing out restrictions on the foreign exchange market met with delay.

The World Bank provides support for Ukraine on the basis of its Country Partnership Strategy (CPS) which covers fiscal years 2008-11 and has the following objectives: *i)* improving competitiveness; *ii)* reforming public finances and the public sector; and *iii)* improving service delivery. In the context of the economic downturn of 2009, the CPS progress review focused its policy priorities on the support of fiscal, business climate and banking sector reforms for the remainder of the CPS. The CPS envisages a lending range of USD 2-6 billion over the four-year CPS period.

The World Bank concluded a series of development policy loans in late 2008 and will initiate a new series focusing on structural reforms. The first of the new series is tentatively sized at USD 500 million. The World Bank will continue with a policy lending series on banking sector reform. A first operation was disbursed in 2009 (USD 400 million) and a second is being prepared (USD 350 million). Both policy lending operations are subject to agreement with the Ukrainian authorities on key structural reforms to be supported.

The World Bank continues to be active in project financing. As of December 2011, among the projects in the public sector are a Public Finance Modernisation Project (USD 50 million), a State Tax Service Modernisation Project (USD 40 million) and a Statistical Modernisation Project (USD 32 million). In addition, the World Bank supports a large number of projects in the spheres of land registration (USD 195 million), energy (USD 366 million), infrastructure and pipelines (USD 104 million), export promotion (USD 304.5 million), social support (USD 99.4 million) and energy efficiency (USD 200 million).

Ukraine joined the European Bank for Reconstruction and Development (EBRD) in 1992, and since then the EBRD has been active in supporting Ukraine's transformation to a market economy. The previous EBRD country strategy for Ukraine, approved in 2007 and effective until recently, outlined four main areas of operational focus: *i)* promoting higher efficiency, competitiveness and corporate governance standards in the local private sector and assisting direct foreign investment; *ii)* promoting the development of the domestic capital markets and providing continued support to micro, small and medium-sized private enterprises through dedicated long-term credit lines with partner banks; *iii)* promoting energy efficiency and security, environmental protection and sustainable use of natural resources throughout all sectors of the economy; and *iv)* improving the efficiency and reliability of key infrastructure, of power generation, transmission and distribution, and of the oil and gas transport systems of Ukraine. A new strategy for Ukraine was approved by the EBRD board on 13 April 2011. It promotes the diversification of production capacities, enhancing the country's competitiveness, the development of local capital markets and energy sector reforms, as well as improving corporate management and transparency.

As of November 2011, the EBRD portfolio in Ukraine accounted for about 296 projects, with the total amount of funding reaching EUR 6.7 billion. The bank's exposure in Ukraine is the second largest after the government of Russia, accounting for one-eighth of the bank's overall portfolio. The financial sector and industry are the two largest sectors of operation in

Ukraine, accounting for four-fifths of the total operating assets. Operations in the infrastructure and energy sectors are also significant. Among other programmes, the EBRD launched a new business advisory services programme aimed at efficiency enhancement of local small business. The programme implies involving local business advisors.

The European Union is another major international donor for Ukraine. For the period from 2007 to 2013, technical and financial assistance is principally provided under the new European Neighbourhood and Partnership Instrument (ENPI). This instrument was established to develop an increasingly close relationship, gradual economic integration and deeper political co-operation, including on foreign and security policy, between the EU and Ukraine. The total budget of the ENPI for the seven-year period (from 2007 to 2013) amounts to EUR 2.7 billion. The main tools to provide technical assistance in the framework of the ENPI are Twinning,[6] TAIEX[7] and SIGMA.[8] Moreover, within the framework of the ENPI, on 2 March 2011 the European Commission and the government of Ukraine signed a Memorandum of Understanding on the National Indicative Programme (NIP) for Ukraine for 2011-13. The overall budget of EU assistance to Ukraine under the NIP is EUR 470 million. The programme focuses on good governance and the rule of law, on the preparations for the entry into force of the agreement on a Deep and Comprehensive Free Trade Area (DCFTA)[9] and on sustainable development, including energy, environment, transport and regional development. Specific programmes of support under these priority areas are at present being developed.

In addition to the IMF, the World Bank, the EBRD and the EU, various country donors are active in Ukraine, particularly Germany (GIZ), the Netherlands, Sweden (SIDA) and the United States (USAID). All of these country donors have programmes in the sphere of financial management. GIZ (German International Co-operation) focuses on assistance in the sphere of budget classification, financial impact assessment of legislation, internal and external audit, and the medium-term expenditure framework. The Netherlands has set up a training facility for financial officials. SIDA (the Swedish International Development Co-operation Agency) focuses on modernisation of the budget process in the Ministry of Finance, line ministries and other central public authorities, and in particular the development of the medium-term expenditure framework and performance-based budgeting. USAID (the United States Agency for International Development) focuses among other things on intergovernmental financial relations. The EU focuses on the development of internal public financial control.

All country donor organisations report a lack of commitment of the Ukrainian authorities and slow progress on separate projects. In view of the substantial overlap of the efforts of international financial institutions and country donors, this situation should not cause surprise. There is a serious problem of donor co-ordination in Ukraine. Two factors are at work in this respect. On the one hand, it is the task of the Ukrainian government to clearly articulate its requests to specific donors for advice. On the other hand, some of the donors are driven by intra-organisational incentives to spend regardless of the needs expressed by the Ukrainian partners. Both factors in combination lead to a considerable waste of efforts and resources that needs to be addressed urgently. It is not enough that donors sit around a table and decide who does what. The urgent requirement is a change of mentality. Aid should only be provided for concrete projects at the explicit request of the Ukrainian authorities, and budgets should only be made available after agreement about such requests has been reached. Intra-organisational incentives to spend predetermined budgets should be removed.

1.4. Fiscal policy[10]

After spending hikes in 2004 related to the presidential election of 2005 leading to a deficit of more than 4% in that year, subsequent Cabinets have succeeded in reducing the deficit to a more sustainable level. However, the global financial crisis has hit Ukraine particularly hard, reducing tax revenues and inducing a general government deficit (exclusive of the Naftogaz deficit and bank recapitalisation costs) of more than 6% of GDP in 2009. In addition, Naftogaz was confronted with large increases in the import price of Russian gas, unilaterally imposed by the Russian Federation. The support for Naftogaz in 2009 amounted to 2.5% of GDP. Bank recapitalisation costs amounted to 2.6% of GDP in 2009.

The budget of 2010 aimed at a deficit of 5.3% exclusive of Naftogaz support and bank recapitalisation costs. When this target slipped, the government proposed and Parliament approved a revision of the 2010 budget in July 2010, lowering the general government deficit to 5.5% and the Naftogaz deficit to 1% of GDP. Measures included: an increase in tax and pension fund revenue (increase in several excise rates, limited loss deduction from 2009, and raised social insurance rates); spending cuts (mostly subsidies, and administrative appropriations for several government bodies); an increase in Naftogaz's revenue and better control over its spending (increased final gas prices for utility companies and households, elimination of gas price privileges for industrial sectors, automated drafting system for utility company payments to improve compliance, measures to save costs and rationalise spending for Naftogaz's operations); mitigation of the impact of rising gas prices and increased taxes on the most vulnerable by extension of existing social assistance programmes; and improvement of the tax administration and spending monitoring.

The revised target was roughly met, mostly due to good revenue performance in the final quarter of 2010 supported by additional non-tax revenue (5.1% of GDP). The Naftogaz deficit was overshot (1.4% instead of 1% of GDP), but the total deficit remained within the 6.5% limit agreed with the IMF.

The stock of value-added tax arrears is nearly phased out. Arrears peaked at UAH 25 billion (2.3% of GDP) in mid-2010 and then declined through issuance of VAT bonds (1.5% of GDP) and cash payments. The end-September 2010 indicative ceiling agreed with the IMF was met. In view of administrative delays in processing claims and budgetary constraints, the Ukrainian authorities have requested a modification of the December 2010 indicative target to allow for a small amount of arrears (0.1% of GDP). They are committed to eliminating all arrears in 2011 and introduced a more systematic process for refunds in 2011.

Fiscal policy in 2011 remained strongly determined by the IMF stand-by agreement. The 2011 general government budget submitted to Parliament targeted a deficit of 3.1% of GDP. As revenues were projected to decline by about 1.7% of GDP, mainly on account of lower non-tax revenue (especially lower profit transfers of the National Bank of Ukraine), the authorities were determined to achieve the adjustment through spending consolidation while protecting capital and social protection outlays. Measures included: *i)* reduction in the public wage bill (freezing real wages, curtailing employment, reducing bonuses); *ii)* reduction in subsidies and discretionary spending on goods and services; and *iii)* consolidation of pension spending by limiting increases and enacting pension reform. The 2011 budget increased capital spending to about 3% of GDP. The authorities considered this necessary to meet project commitments for the 2012 UEFA European Football Championship and for basic infrastructure upgrades which were compressed in recent years. In addition, selected infrastructure projects to be delivered by private companies

and state enterprises were seen as critical, and the authorities planned to facilitate these through state loan guarantees. To control overall public sector indebtedness, state guarantees were limited to UAH 15 billion (1.2%), the same level as in 2010.

On the revenue side, apart from the decline of non-tax revenues, the new Tax Code is broadly revenue neutral (see Box 1) and no other tax policy changes are envisaged in the near term, leading to tax revenues remaining broadly unchanged as a share of GDP. In addition, some specific operations not reflected in the general budget deficit have added to public debt in 2011. The government plans to issue guarantees of 1.2% of GDP. The budget also provides for the recapitalisation of banks, limited to the unused amount carried over from 2010.

Box 1. **The new Tax Code of Ukraine**

The new Tax Code adopted in early December 2010, after considerable public opposition, aims to reform the complex tax legislation, reduce the tax burden over time, and strengthen administration. The Tax Code consolidates most existing legislation, but launches significant changes. The Ukrainian authorities have sought to create incentives for small business owners, thus stimulating growth and job creation. On balance, the code's impact is estimated as revenue neutral in 2011, though with downside risks given potential implementation challenges. The main changes introduced in the code are:

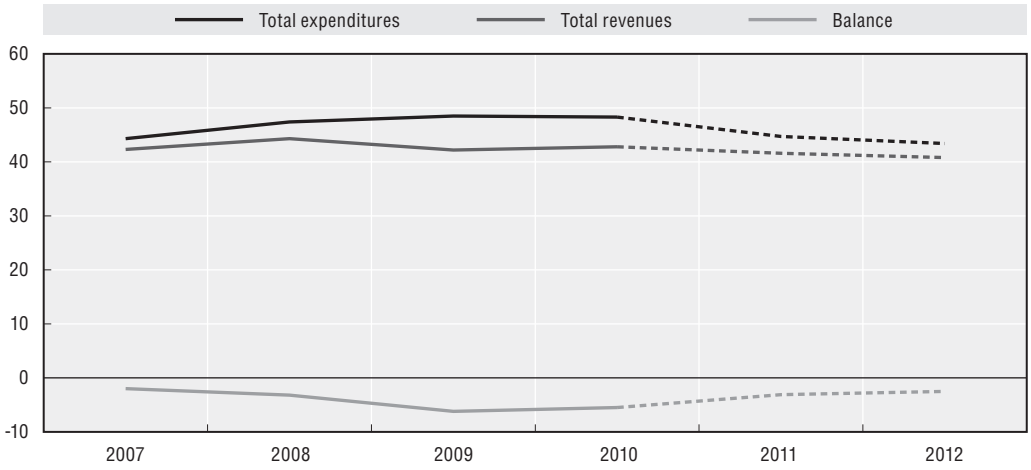
- Elimination of many small taxes (reducing revenue by about 0.2% of GDP in 2011).
- Tax rate cuts. The corporate tax rate will be cut from 25% by two percentage points each year through 2013, to 19%, and then reduced to 16% starting from 2014. The value-added tax rate will be reduced by three percentage points starting from 2014, to 17%. These measures will reduce revenues by about 0.2% of GDP in 2011.
- New taxes and increases in existing rates. The code introduces a property tax for large homes, increases the personal income tax on large incomes from 15 to 17%, and increases a number of excise and other tax rates, generating about 0.4% of GDP in revenues in 2011.
- Tax holidays and exemptions. The code introduces new tax holidays for small enterprises (up to 1 January 2016) and for specific industries (hotels, shipbuilding and aerospace industry, electrical power industry, machine-building industry for agribusiness and light industry, up to 1 January 2021) and a three-year VAT exemption for several sectors that are subject to significant VAT refund fraud. While the overall revenue impact of these measures is likely to be small, they bring distortions, add to existing exemptions and break the VAT chain.
- Changes to the calculation of the corporate profit base and amendments to tax reduction rules. These measures aim at closing a number of loopholes in the existing legislation.

Figure 1 shows the development of expenditures and revenues of general government since 2007 as well as the resulting deficit. The deficit excludes the Naftogaz deficit and bank recapitalisation transfers.

Due to strong growth and low deficits, public debt has been falling rapidly in Ukraine in the period from 2000 to 2008, reaching the bottom level of 12.3% of GDP in 2007. Then a sharp upward turn occurred due to the global financial crisis. Even if GDP growth resumes as currently expected, public debt will not start to fall again before 2013. Given the limited capacity of domestic capital markets, a substantial part of debt (more than half) is held by foreign creditors, which explains the concern to maintain the confidence of international capital markets and the need for IMF support. Figure 2 shows the development of public debt in Ukraine.

Figure 1. **Expenditures, revenues and balance of general government, Ukraine**

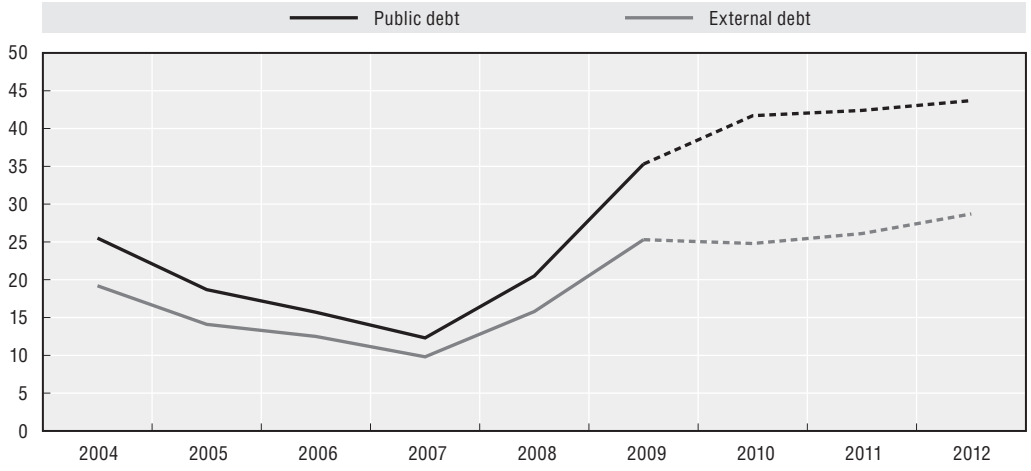
Per cent of GDP



Source: IMF (2008), "Ukraine: Request for Stand-By Arrangement", International Monetary Fund, Washington, DC; IMF (2011), "Ukraine: First Review under the Stand-By Arrangement", International Monetary Fund, Washington, DC.

Figure 2. **General government public debt, Ukraine**

Per cent of GDP



Sources: IMF (2008), "Ukraine: Request for Stand-By Arrangement", International Monetary Fund, Washington, DC; IMF (2011), "Ukraine: First Review under the Stand-By Arrangement", International Monetary Fund, Washington, DC.

1.5. Institutional policy in the recent past

1.5.1. The new Budget Code[11]

In Ukraine, reform of fiscal institutions started around 2000. The Cabinet that took office in 2000 ensured for the first time that enterprises paid their taxes in cash and eliminated a long-standing recourse to mutual offsets. These measures raised receipts significantly and increased transparency. Subsequent Cabinets largely preserved these reforms and introduced others. Methodological changes introduced in 2002 brought revenue planning more in line with IMF standards, by including privatisation as financing rather than revenue. Other reforms included a shift in intergovernmental budget relations: introduced in 2002, this brought greater financial independence to local government by ensuring that transfers go directly to sub-national budgets on the basis of objective criteria, irrespective of the financial situation at the local level.

In 2007, the Cabinet of Ministers adopted a public finance reform strategy which, in its final version, was supported by a major financial contribution of the World Bank (see Section 1.3). Major components of the strategy are:

- introduction of a financial management information system along with the required legislative and organisational adjustments;
- modernisation of accounting, including integration of charts of accounts, and harmonisation with the budget classification;
- further improvements in debt management;
- improvements in monitoring and evaluating institutional reforms;
- improved revenue forecasting;
- introduction of modern internal financial control techniques.

World Bank financing has mostly focused on the financial management information system; World Bank support for other components is relatively limited. Country donors have been asked either to deepen support in other areas or to fund activities that fall outside the boundaries of the existing strategy (see Section 1.3).

In 2007, a Decree on a Concept of Local Finance Reform was signed by the Prime Minister. It set out an ambitious agenda for reform of the funding of local government by the introduction of tax-sharing arrangements and equalisation grants. The reform was intended to proceed in two phases. The revision of the Budget Code was intended as the legal vehicle for the first phase of the reform.

A major revision of the Budget Code was approved by the Parliament in 2009, but subsequently rejected by President Yushchenko in early 2010. After some amendments were made, the Parliament and President Yanukovych[12] approved the new Budget Code later in 2010. Important features of the new Budget Code include:

- Introduction of medium-term budget planning, including:
  - submission of the draft medium-term forecast of the state budget to the Parliament together with the submission of the draft budget law, and approval by the Cabinet of Ministers of an updated forecast within one month after publication of the annual state budget law;
  - a draft medium-term forecast covering two years following the budget year. The forecast is put up under the respective responsibility of the Ministry of Finance (for the state budget) and the local financial authorities (for local budgets).
- Introduction of programme budgeting and of a budget classification according to programmes.
- Improvement of the procedures for the examination and adoption of the state budget of Ukraine.
- Improvement of debt management.
- Improvement of budget management through new procedural rules and adjustment of the budget calendar, allowing more time for budget preparation by line ministries and other central public authorities (CPAs).
- Modernisation of accounting in the public sector.
- Implementation of the European model of public internal financial control.

- Enhancement of the financial autonomy of local government by:
  - expansion of the revenue base of local budgets by reallocation of certain revenue sources from the state budget to local government budgets, and by enlarging the number of local revenue sources which are not taken into account when determining intergovernmental transfers;
  - allocation of responsibilities between the central government and local governments on the basis of the principle of subsidiarity;
  - the promotion of investment areas.

1.5.2. *Innovation projects*

In 2010, the Ministry of Finance of Ukraine launched a programme to modernise public finances, called "Reloading of the system of public finances of Ukraine". This programme aims to provide for more stability in fiscal planning, to shift from micro management to strategic management, to modernise budget regulation based on the updated Budget Code and the Tax Code, to promote and protect investment in infrastructure, and to develop mutually profitable relations with the IMF on the basis of restored credibility of fiscal planning. It is hoped that the implementation of the programme will improve the climate for foreign investment in Ukraine.

The programme encompasses 15 projects that are to be implemented in two stages. In the first stage, among other things, the Budget Code and the Tax Code were implemented, and by-laws and regulations were developed to implement these codes, including regulations concerning the handling of the state debt. In the second stage, projects such as "Virtual University", "Transparent Budget" and the establishment of a "centre for independent assessment and certification of employee competences" were launched. Currently 11 of the 15 projects of the programme "Reloading of the system of public finances of Ukraine" have been implemented.

"Virtual University" is a training facility for civil servants that applies modern technologies of electronic (remote) learning. The training facilitates the acquisition of new knowledge and its practical application alongside professional activity. It is based on the involvement of highly qualified practitioners of the Ukrainian Ministry of Finance and other ministries, agencies and organisations in the training process. It gives trainees access to various sources of information (online libraries, databases, bases of knowledge, etc.).

The major goal of the programme is to provide training at an academic level for civil servants who are working in the areas covered by the Budget Code and the Tax Code. The target group consists of around 20 000 civil servants working in the area of budgeting and 20 000 civil servants working in the area of tax implementation.

The project "Transparent Budget" aims to make available to the public more information about budget preparation and execution. This will allow the public to carry out independent monitoring of the budget process and thus contribute to the fight against corruption. It is expected that this will also increase the sense of responsibility of public authorities for the efficient handling of public resources.

1.5.3. *Privatisation*[13]

After independence, the state privatised on a grand scale. By 1999, more than 80% of all enterprises (accounting for over 60% of GDP) had been privatised but, in many cases, controlling shares of the so-called privatised enterprises remained in government hands,

perpetuating the role of former communist directors and precluding significant productivity gains. Privatisation efforts intensified in 2003-04 in the run up to the presidential elections of 2004. As a result, in 2004 privatisation earnings totalling UAH 9.6 billion (USD 1.8 billion) exceeded the sales recorded cumulatively over the preceding five years. However, this led to a certain debate in subsequent years about the procedures that were followed and to renegotiations of previous contracts.

The appointment in August 2006 of the Cabinet headed by Mr. Yanukovych brought a stop to the reprivatisation debate. Regarding new planned privatisations in the coal sector, the government failed to produce the necessary legislation. After returning to power in late 2007, Ms. Tymoshenko put a renewed focus on privatisation, including reprivatisation. In 2008, her government established a privatisation list including the fixed-line telecommunications monopoly Urktelecom, chemical plants, and six regional power distributors. The Cabinet of Mr. Azarov, after taking office in 2010, appears to push on with privatisation but with a more pragmatic approach. Of the total revenue target of UAH 6.4 billion (USD 820 million), only UAH 1.9 billion (USD 240 million) was realised in 2010. However, the government overshot the 2011 target of UAH 10 billion (USD 1 270 million) after it sold in March 2011 the state's 93% share in Urktelecom to Austrian-based Epic Financial Consulting for UAH 10.6 billion (USD 1 340 million). The revenue from the sale of state enterprises in 2011 comprised UAH 11.01 billion. The forecast amount for the 2012 state budget in terms of revenues from state property privatisation is UAH 10 billion, estimated on the basis of the tasks defined by the Economic Reforms Programme for the years 2010-14 ("rich society, competitive economy, efficient state") which presupposes the optimisation of the public economy sector and completion of privatisation as a broad-scale social and economic project by 2014.

1.5.4. *Pension reform*[14]

Ukraine's pay-as-you-go pension legislation has structural weaknesses. Pension expenditures increased from around 9% of GDP in 2003 to well above 18% in 2009, one of the highest levels in the world. At the same time, the Pension Fund revenues have not increased at the same pace, and more transfers from the central government (having reached 7% of GDP in 2009) are needed to balance the accounts. These developments were the result of an ageing population and a trend increase in the dependency ratio, a low retirement age and minimum contribution periods, generous benefits, favourable treatment of working pensioners, early retirement provisions, extensive special pension regimes, and compliance problems on the revenue side. The government decided to prioritise pension reform, partly in connection with the IMF stand-by agreement.

In December 2010, the government developed a draft law on the pension scheme reform by which, in the medium-term perspective, a series of measures are proposed for balancing the pay-as-you-go pension insurance scheme as well as for setting the parameters for the functioning of the two-level pension system, *i.e.* mandatory defined-contribution pension scheme. The law is expected to improve the pension provision, to mitigate the ageing population effect on the Pension Fund budget, to clarify the conditions for pension contributions, and to help to resolve a number of other social issues.

1.5.5. *Gas sector reform*[15]

Gas sector reform is a high priority under the government's new economic plan (see Section 1.3). Ukraine is one of the least energy-efficient countries in the world and is highly

dependent on imported gas, mainly from Russia. Below-market domestic prices and low payment compliance have weakened the finances of the state-owned Naftogaz company's finances, generating the need for substantial budgetary support. Investment in exploration, extraction and transportation is insufficient, domestic production is well below potential, and gas transit through Ukraine is at risk due to deteriorating pipeline networks.

The reforms undertaken and to be pursued under the new economic plan include:

- Gradually bringing domestic gas prices to import parity. In August 2010, domestic gas price increases of 50% were implemented for households and utility companies. Further gas price increases took place in April 2011 (20%) and July 2011 (20%). Central heating prices were increased by 26% in April and October 2011. Industrial prices are already at market levels, and preferential tariffs for various industries have been eliminated.
- Strengthening social safety nets. To limit the impact of the large gas price increases on the poorest segments of the population, the government has increased transfers (affecting around 5% of households) using established support programmes.
- Strengthening payment discipline, among other things by automatic withholding of utility payments to Naftogaz.
- Liberalisation of the gas sector by a gradual restructuring of Naftogaz, including by adopting separate cost centres for gas imports, gas production and gas transit.
- Modernising the gas transit infrastructure with the help of loans from the World Bank, the EBRD and the European Investment Bank (see Section 1.3).

2. Budget formulation

2.1. National budget

2.1.1. Structure of the national budget

The national budget of Ukraine is composed of the state budget and the local budgets. The state budget is the budget of the central government including all grants and transfers to the local level. Local budgets include the budgets of the Autonomous Republic of Crimea and of the cities of Kiev and Sevastopol, the budgets of *oblasts*, *rayons* and cities, and the budgets of city districts, villages, rural settlements and towns. The national budget can be seen as the consolidated budget of Ukraine. It is used for analysis and forecasts of economic and social development of the country.

The insurance funds are excluded from the national budget. These funds are: the Mandatory Insurance Fund for Unemployment, the Social Insurance Fund for Temporary Disability, the Social Insurance Fund for Occupational Accidents, and the Pension Fund. The insurance funds are managed on a parity basis by the state and by representatives of the trade unions. The budgets of these funds are approved by their boards except for the Pension Fund, which is approved by the Cabinet of Ministers.

A budget reserve fund exists to cover incidental expenditures at each level, *e.g.* related to clean-up operations after natural disasters and the provision of humanitarian aid. The size of the budget reserve fund shall not exceed 1% of the respective budget's general fund expenditures. In 2010, the state budget reserve fund was approved in the amount of UAH 1.5 billion (USD 190 million). The decision on the appropriation of funds from the budget reserve fund is taken respectively by the Cabinet of Ministers of Ukraine, the Council of Ministers of the Autonomous Republic of Crimea, the local state authorities, or the executive authorities of the respective local councils (page 24 of the Budget Code of

Ukraine), with the Cabinet of Ministers of Ukraine (or the Council of Ministers of the Autonomous Republic of Crimea, the local state authorities or the executive authorities of the respective local councils) being accountable on a monthly basis before the Parliament of Ukraine (or the Verkhovna Rada of the Autonomous Republic of Crimea, or the appropriate *rada* of local level) on spending the resources from the funds of the respective budget's reserve fund. The state budget reserve fund refers to the expenditures of the state budget of Ukraine for the respective year approved by the Parliament of Ukraine.

2.1.2. Budget classification of the state budget

The state budget of Ukraine is adopted for one calendar year and consists of two parts: an extensive textual part and annexed budget tables. The textual part, structured by article like any other law, contains a detailed description of the table figures. The text also contains a set of general rules (principles of budgeting, budget reallocation rules, etc.) which are carried over from year to year in the same formulation. The 2010 Budget Code took over most of these provisions, allowing a substantial reduction of the textual part of the 2011 budget (down to 17 pages, whereas the textual part of the 2010 budget amounted to 69 pages). As the textual part refers to the figures in the annexed tables, any changes in these figures lead to changes in the textual part of the law in respective articles.[16]

The appropriations of the state budget are presented in the tables annexed to the budget law. In 2011, there were nine annexes to the state budget law which all have the same legal status and are approved by Parliament as part of the law:

Annex 1: Revenues of the state budget of Ukraine.

Annex 2: Financing of the state budget of Ukraine.

Annex 3: Expenditures of the state budget of Ukraine.

Annex 4: Reimbursement of credits to the state budget and their distribution by programmes.

Annex 5: Distribution of expenditures on health programmes by local governments.

Annex 6: Equalisation grants to local governments.

Annex 7: Subsidies, subventions and other grants from the state budget to local governments.

Annex 8: The list of bodies assigned to control the execution of payments to the budget.

Annex 9: Expenditures on the courts of all jurisdictions.

Annex 3 – the most employed annex, as it contains information on budget expenditures – classifies the appropriations by institution (ministries and other central public authorities), budget holder, and programme (including activities under programmes), with some detail on economic groups (labour costs, utilities and energy services, gross investments) according to the format of Table 3. The columns for labour costs and for utilities and energy services do not necessarily add up to the amount of current expenditures since there may be other current expenditures (subsidies, procurement other than for utilities and energy services, etc.). However, the requirement to specify labour costs and utilities and energy services makes them line items with binding ceilings. Additional spending on these line items is only possible through reallocation.

The state budget of Ukraine is split into general and special funds. The general fund includes all budget revenues that are not earmarked for specific purposes and all

Table 3. **Format of the line-item structure of the state budget of Ukraine**

Code of programme classification	Code of functional classification	Title under the programme classification	General fund					Special fund				
			Total	Current expenditures:	*of which*:		Investment expenditures	Total	Current expenditures	*of which*:		Investment expenditures
					Labour costs	Utilities and energy services				Labour costs	Utilities and energy services	

Source: Ministry of Finance, Ukraine.

expenditures funded from these revenues. The special funds cover budget revenues earmarked for a specific purpose and expenditures for that purpose.

The appropriations for grants to local governments as well as interest on debt are contained in other annexes (6 and 7).

All line items are also classified for informative purposes in functional and economic classifications. The code of the functional classification is applied to the programme level, the code of the economic classification to the line-item level. The economic, institutional and functional classifications are separately adopted by a resolution of the Ministry of Finance. This resolution is annually amended in light of the adopted state budget (and its programme classification). In practice, the economic and functional classifications remain unchanged from year to year, while the institutional classification alters depending on the distribution of budget programmes among line ministries.

An example of the first three columns of the line-item format, as presented in Table 3 for the Ministry of Foreign Affairs, is provided in Table 4.

Table 4. **The programme classification of the Ukrainian Ministry of Foreign Affairs**

Code of programme classification	Code of functional classification	Title under the programme classification expenditure
1400000		Ministry of Foreign Affairs
1401000		Apparatus of the Ministry of Foreign Affairs
1401010	0113	Management of the state policy in the area of foreign affairs.
1401020	0113	Ukraine's contributions to the budgets of United Nations bodies and specialised agencies of the UN and other international organisations.
1401030	0113	Operation of foreign diplomatic missions of Ukraine.
1401040	0113	Ownership for the needs of overseas diplomatic missions of Ukraine.
1401050	0113	Implementation by the Ministry of Foreign Affairs of its authority to conduct foreign policy of Ukraine abroad; organisation of and control over the overseas diplomatic missions of Ukraine.
1401060	0113	Expenditure related to Ukraine's chairmanship of the Committee of Ministers of the Council of Europe.
1401080	0113	Ensuring the stay of foreign delegations coming to Ukraine on official visits.
1401100	0950	Training and development of skills in the area of international relations.
1401110	0113	Financial support for promoting a positive image of Ukraine at the international level.
1401120	0950	Training of diplomatic officers belonging to categories 5-7 of the civil service.
1401130	0113	Production of identity documents for travelling abroad.
1401150	0829	Measures to support relations with Ukrainians residing abroad.

Source: Ministry of Finance, Ukraine.

All budget programmes have codes. The code contains information referring to the responsible ministry or other central public authority (CPA), its budget holder, the programme, and the activities under the programme. The programme code is presented in Table 5.

Table 5. **The Ukrainian budget programme code**

Sample budget programme code (seven digits)			
xxx	x	xx	x
Main line ministry or other central public authority (code of the institutional classification of budget expenditures)	Budget holder of the main line ministry or other central public authority responsible for the budget programme implementation	Budget programmes, implemented by the budget holder	Activities under the budget programme

The programme classification was introduced in Ukraine in 2002. Its implementation was approved in a resolution of the Cabinet of Ministers of 14 September 2002 (No. 538). Until recently, the number of budget programmes[17] in the classification of Annex 3 varied from year to year and amounted to 900-950 programmes (including activities under programmes) per year.[18] Since 2011, the number of budget programmes has been reduced[19] and there are 580 programmes in the draft budget law of Ukraine for the year 2012. Therefore, the number of "line items" is not very large. It is noteworthy that the number of programmes can increase within the budget year (by means of supplementary budget laws).

Each budget programme has its own "passport", a document that defines the objectives and areas of use of programme funds, persons in charge, effective indicators, and other characteristics of the programme. The passport guides the programme implementation during the budget year and contains performance indicators necessary for performance evaluation. The passports are signed by both the responsible line ministry and the Ministry of Finance. As for the state budget, the passports are valid for a one-year period.

The programme passports are compiled by line ministries in co-ordination with the Ministry of Finance immediately after the state budget is approved on the basis of the information provided in the budget requests. Responsible line ministries report on a quarterly basis and at the end of the year on the programme performance results as targeted in the passports.

2.1.3. Budget and priority programmes

Budget programmes in Ukraine are partly based on priority programmes (also called "target programmes" or "earmarked programmes"). The priority programmes are approved by the Cabinet of Ministers for the medium or long term (for 5-10 years) and anchor state priorities. However, they do not authorise expenditures. Priority programmes cover broader areas than budget programmes. Hence, there are fewer priority programmes than budget programmes (for example, in the area of education and science, in 2009 there were 18 priority programmes and 50 budget programmes). Budget programmes develop certain areas of priority programmes and make their financing possible in the upcoming budget year. Therefore, a priority programme which is not sustained by a budget programme does not receive funding and remains on hold. While budget programmes are co-ordinated by the Ministry of Finance, priority programmes are under the responsibility of the Ministry of Economic Development and Trade.

In 2010, there were about 280 priority programmes in Ukraine with varying status (effective, discontinued, on hold, etc.). At present, the government is making efforts to review them in order to eliminate overlapping and discontinued programmes and to analyse the needs.

2.1.4. Programme classification in OECD countries

OECD countries usually have a single budget classification which serves as the basis for budget negotiations within the government and for authorisation by Parliament. Frequently occurring features are:

- a limited number of line items (not more than 500);
- within each line ministry, a single line item for current operational expenditure of the core ministry and for each agency under the ministry (compensation of employment plus procurement);
- breakdown by expenditure groups or programmes (apart from current operational expenditure);
- multi-annual estimates on the basis of current policy provided in the same classification.

A stylised form of such a classification is shown in Table 6.

Table 6. **Stylised budget classification**

	Budget year (b)	(b + 1)	(b + 2)	(b + 3)	(b + 4)
Ministry I					
Current operational expenditure, core ministry					
Current operational expenditure, agency 1					
Current operational expenditure, agency 2					
Etc.					
Programme A					
Sub-programme A1					
Sub-programme A2					
Programme B					
Etc.					
Ministry II					
Current operational expenditure, core ministry					
Current operational expenditure, agency 1					
Current operational expenditure, agency 2					
Etc.					
Programme A					
Sub-programme A1					
Sub-programme A2					
Programme B					
Etc.					
Ministry III					
Etc.					

2.1.5. Cash base of appropriations

Ukraine uses cash-based appropriations. According to the experience of the OECD Secretariat, this is a suitable appropriation standard. Accrual budgeting leads to many practical and technical problems and reduces the transparency and comprehensibility of

the budget, not least for the politicians who have to decide on it. The EU follows an intermediate approach by requiring stabilisation programmes to be on the basis of ESA95 (Eurostat, 1996). This requires that most expenditures be presented on a commitment basis, but with ample room for exceptions in the spheres of revenues and transfers, and with investments on the basis of production rather than consumption.

2.2. The annual budget formulation sequence

2.2.1. Budget calendar

Table 7 summarises the calendar for the annual budget preparation process.

Table 7. **Budget preparation calendar of Ukraine**

By 15 March	The National Bank of Ukraine submits projected monetary indicators for the forthcoming year to the Parliament and the Cabinet of Ministers.
By 20 March	The Ministry of Finance prepares a draft budget declaration for the forthcoming budget year and submits it to the Cabinet of Ministers for consideration.
	Line ministries and other CPAs submit data (estimates) to the Budget Department of the Ministry of Finance on structural changes that have occurred in line ministries and other CPAs (and their budget holders) since the previous year, and make preliminary requests for additional expenditures needed in the upcoming budget year due to new policy/legislation.
By 1 April	The Cabinet of Ministers considers and approves the budget declaration and submits it to the Parliament within a three-day period.
May-August	The Ministry of Finance fixes expenditure ceilings (for current expenditures and capital expenditures included in priority programmes) for the upcoming budget year as well as expenditure benchmarks for two out-years for ministries and other CPAs, and brings them to the attention of line ministries.
	Line ministries and other CPAs submit budget requests (electronically) where they break down expenditures by and within the programmes and, if needed, request and motivate additional resources.
	The Budget Department receives and analyses the budget requests and holds conciliation meetings with the line ministries and other CPAs regarding the parameters of the state budget for the coming budget year.
	The Local Budgets Department of the Ministry of Finance calculates and makes known to the local governments the sub-national revenue forecasts, the amounts of inter-budgetary transfers and the indicators used for defining the transfers.
	The Ministry of Finance prepares a forecast of the consolidated budget of Ukraine on key parameters of revenue, expenditure, financing and debt for a period of three years following the budget year, for the approval of the Cabinet of Ministers (draft resolution).
September	The Ministry of Finance submits the draft budget law to the Cabinet for consideration.
By 15 September	The Cabinet of Ministers approves the budget bill and submits it along with relevant materials to the Parliament and the President of Ukraine.

Source: Budget Code of Ukraine, 2010.

The sequence, deadlines and participants of the budget preparation process are elaborated in details in a document ("action plan") adopted annually by the Ministry of Finance. The plan assigns responsibilities and tasks to the divisions of the Ministry of Finance or to relevant state bodies regarding the draft budget. The action plan is approved by an internal decree of the Ministry of Finance. For example, the action plan for the 2011 state budget and preliminary forecasts for the 2012-14 consolidated budget of Ukraine included the following preparation stages:

- devising goals/objectives for the budget declaration and preparing preliminary indicators for the 2011 budget;
- fixing ceilings, collecting budget requests from line ministries and other CPAs for the 2011 state budget, and preparing parameters for the 2012-14 consolidated budget (for Cabinet's approval and adoption of a Cabinet resolution);
- preparing and submitting the 2011 budget bill to the Parliament of Ukraine.

2.2.2. Budget declaration

The annual budget formulation process starts in January-February with the preparation of a budget declaration for the forthcoming year (see Box 2). The declaration contains the major outlines of budgetary policy for the upcoming budget. The Ministry of Finance drafts and submits the declaration to the Cabinet of Ministers by 20 March. Line ministries can comment the draft declaration and make suggestions. According to the Budget Code, the Cabinet of Ministers approves the budget declaration no later than 1 April and submits it to the Parliament of Ukraine within a three-day period (Article 33.3).[20] Subsequently, the Parliament considers the major outlines of the budgetary policy for the upcoming budget and adopts a resolution on the budget declaration (see Section 3). The draft budget law of Ukraine for the next year must be developed while taking into account the requirements of the Budget Code and the major lines of the budgetary policy for the next budget as adopted or acknowledged in the resolution of the Parliament.

Box 2. **Ukrainian budget declaration for the forthcoming budget year**

The "Budget Goals and Objectives Declaration" (budget declaration) for the upcoming budget year is based on economic and social development projects and programmes, and contains the following provisions:

- basic projections of macro indicators of the economic and social development of Ukraine, including nominal and real GDP, consumer price and producer price indexes, the average official exchange rate of the hryvnia for the year and, by the end of the year, the unemployment rate;
- major objectives of the budgetary policy, in particular with respect to deficit and debt ceilings of the state budget, share of the projected annual GDP distributed via the consolidated budget of Ukraine, the minimum wage, the cost of living, etc.;
- priority tax policy objectives;
- implementation of the priority state programmes;
- interrelationship of the state budget with local budgets, including justification of the share of local budgets in the consolidated budget of Ukraine;
- other issues to be addressed in preparing the budget bill.

2.2.3. Macroeconomic forecasting

In Ukraine, the Ministry of Economic Development and Trade plays a key role in preparing and co-ordinating the macroeconomic forecasts underlying the budget. Forecasting procedures were established in the Decree of the Cabinet of Ministers on Drawing Forecast and Programme Documents of Economic and Social Development of 26 April 2003 (No. 621), which was recently amended in light of the new Budget Code of Ukraine. The amendments introduced strategic plans[21] and modified the terminology and time frames.

The Macroeconomic Forecasting Department[22] of the Ministry of Finance is in charge of medium-term budgetary forecasting, making use of the macroeconomic forecasts of the Ministry of Economic Development and Trade. The department also performs analyses of the impact of macroeconomic developments on the budget and of the impact of fiscal policy on the economy. Finally, the department is responsible for updating its forecasts in

the course of budget formulation and execution, for the preparation of the annual budget execution report, and for disseminating public finance statistics. The co-ordination procedures between both ministries were established by Decree No. 621 mentioned above, but officials of both ministries do not see the division of tasks in entirely the same way, and in practice there may be some overlap.

The Macroeconomic Forecasting Department has a staff of 22 and is organised in five units:

- macroeconomics (5 staff);
- statistics (5 staff);
- modelling (5 staff);
- medium-term forecasting (5 staff);
- budget execution (2 staff).

Macroeconomic forecasting for the forthcoming budget year starts in March. The Ministry of Economic Development and Trade together with the National Bank of Ukraine and other relevant state bodies prepares preliminary macroeconomic forecasts of economic and social developments for the forthcoming budget year[23] (by 1 April 2010 for the 2011 budget). Since 2003, the Ministry of Economic Development and Trade has also prepared preliminary macroeconomic forecasts of economic and social development for the three years following the budget year.

While preparing forecasts, the Ministry of Economic Development and Trade takes into consideration the opinions of independent institutions, for instance the assumptions of the Forecasting Institute of the Academy of Science of Ukraine and those of Consensus Economics.[24] The forecasts of Consensus Economics are posted on the website of the Ministry of Economic Development and Trade.

While the Ministry of Economic Development and Trade prepares its preliminary macroeconomic estimations, the responsible units of the Ministry of Finance submit to the Revenue Department[25] preliminary revenue forecasts for the state and local budgets for the coming budget year and two out-years[26] (by 1 March 2010 for the 2011 budget). The forecasts incorporate expected changes in tax policy. The responsible units also submit an assessment of expected revenue performance in the current year.

The Revenue Department of the Ministry of Finance (25 staff) is organised in four units:

- aggregating unit (7 staff);
- excise taxes and other payments unit;
- income tax and VAT unit;
- natural resources fees and local-level taxes unit.

Each of these units prepares a calculation of tax and fee revenues using the preliminary macroeconomic estimations of the Macroeconomic Forecasting Department[27] of the Ministry of Finance, the prevailing tax legislation, and the data from other relevant ministries or agencies.

The units of the Revenue Department and other responsible divisions of the Ministry of Finance prepare and submit to the Macroeconomic Forecasting Department and the Budget Department of the Ministry of Finance (by 15 April 2010 for the 2011 budget) the following estimations for the upcoming budget year and two out-years:

- revenue forecast of the state and local budgets (in 2010: for 2011 and for 2012-14[28]);
- debt interest payments and repayments from the budget (in 2010: for 2011 and for 2012-14);

- loan reimbursements back to the budget (in 2010: for 2011 and for 2012-14);
- forecasts of deficit financing and interest.

The first calculations are available in April each year and are subject to further adjustments as new macroeconomic forecasts from the Ministry of Economic Development and Trade come in. The Ministry of Economic Development and Trade updates its macroeconomic assumptions up to three times within the period from March to August. By 1 September, the final revenue forecast is submitted to the Budget Department. The calculations are usually quite accurate. Supposing that the economy is stable and that the macroeconomic forecasts are not modified substantially, the calculation error may amount to 5% of total real revenue at most.

If necessary, the Ministry of Economic Development and Trade can further update its macroeconomic estimations for the upcoming budget year and two out-years after submission of the budget to the Parliament. This can occur, for instance, in the period between the first and the second parliamentary readings of the budget bill, as well as during budget execution. If the macroeconomic situation changes substantially during the budget year, the macroeconomic estimations for the budget year are adjusted by a resolution of the Cabinet of Ministers. In practice, such adjustments occur every three months. If there is an impact on the revenues and expenditures, the budget law is subsequently amended (Article 52 of the Budget Code).

2.2.4. Preliminary requests

In March-April each year, the Ministry of Finance asks line ministries to provide data on structural changes and requests for additional expenditures in the upcoming budget year. The data concern in particular:

- changes in budget programmes, inclusion/exclusion of a budget programme, merging or splitting of programmes, transferring a programme to a different budget holder due to legislative changes;
- changes in the parameters that determine programme totals (for instance, increase/decrease in numbers of unemployed, pensioners or other entitlement beneficiaries);
- calculations regarding the need for capital expenditures for the coming budget year;
- sectoral expenditure calculations;
- changes in staff numbers.

2.2.5. Setting ceilings, submitting requests and drafting the state budget

On the basis of the data on structural changes and the preliminary requests of line ministries and other CPAs, the Ministry of Finance fixes expenditure ceilings for current expenditures and for capital expenditures which are covered by priority programmes; these ceilings will further determine the development of the budget formulation process. The ceilings cover the upcoming budget year. In addition, the ministry sets expenditure benchmarks for the two out-years. The ceilings and benchmarks are set in the budget circular which is sent to the line ministries and other CPAs. The budget circular contains various forms to be filled in and guidelines for formulating requests. The Ministry of Finance also establishes a time schedule for further conciliation meetings with the line ministries. And the Ministry of Finance communicates to the line ministries and other CPAs indicative estimates of expenditures and loans issued from the budget, for the two out-years following the budget year (Article 21 of the Budget Code).

Upon receiving the budget circular, the line ministries and other CPAs are given approximately one month to prepare their budget requests.[29] In practice, this means filling in the forms annexed to the budget circular. In one form, requests for additional expenditures can be made and motivated. The requests should contain reliable and comprehensive information and be submitted to the Ministry of Finance on time (see Box 3). According to Article 35 of the Budget Code, the budget requests should take into account the reports on the implementation of budget programmes as envisaged in the passports of the previous year. The line ministries and other CPAs should also provide information about the contribution of the requested resources to the stage-by-stage implementation of priority programmes. Finally, line ministries and other CPAs should prepare activity plans for the budget year and the following two years which provide information about the policies to be funded by the requested resources.

Box 3. **Budget formulation process in a line ministry (or other CPAs) in Ukraine**

Line ministries (or other central public authorities) are requested to submit information on structural changes and make preliminary requests for additional expenditures in March-April of the year preceding the budget year.

Following these preliminary requests, line ministries receive from the Ministry of Finance a circular fixing the expenditure ceilings and providing guidelines for preparing budget requests. Line ministries issue similar circulars for their budget holders prescribing expenditure ceilings and providing instructions for request preparation. The budget holders are required to provide their budget requests to the financial directorate of their line ministry. Upon receipt of these requests, the financial directorate draws up a single budget request for the Ministry of Finance.

According to the representatives of the Ministry of Education, the real expenditure needs usually surpass the expenditure ceilings of the Ministry of Finance by approximately 30% and therefore the budget request exceeds the expenditure ceilings. The Ministry of Education sees the ceilings as not binding and has learned over time that they can be increased through negotiation.

When the budget bill is being scrutinised in the Parliament, line ministers have another opportunity to explain the potential use of additional resources, but cannot plead for changes since they have to respect the budget bill as submitted by the Cabinet of Ministers. Upon the approval of the state budget law, line ministries are allowed 45 days to draw up programme passports in co-ordination with the Ministry of Finance on the basis of the information provided in the budget requests. The line ministries also report on a half-yearly basis and at the end of the year on the programme performance results as targeted in the passports.

The budget requests are sent electronically to the Ministry of Finance. The ministry checks the conformity of the requests with the expenditure ceilings and assesses the effectiveness and efficiency of the proposed policies (Article 36 of the Budget Code). The budget requests are subsequently discussed and agreed between the line ministries and the Ministry of Finance according to the schedule of conciliation meetings. If the Ministry of Finance fails to reach an agreement with a line ministry (or other CPA), the Ministry of Finance will note the lack of agreement when it submits the budget bill to the Cabinet.

Following the budget request assessments and the conciliation meetings, the Ministry of Finance develops a budget bill for the forthcoming budget year which is then submitted

to the Cabinet of Ministers along with the relevant materials. The Cabinet delivers the budget bill to the Parliament and the President of Ukraine by 15 September each year.

2.3. Medium-term planning

2.3.1. Medium-term budgetary framework

The new Budget Code of Ukraine (2010) introduced a forecast of the state budget for the two years following the upcoming budget year. The forecast is developed by the Ministry of Finance jointly with the Ministry of Economic Development and Trade and the National Bank of Ukraine, together with other relevant ministries and CPAs, and includes the following indicative forecasts (Article 21 of the Budget Code):

- major macro indicators of economic and social development (nominal and real GDP, consumer and producer price indexes, annual average and end-of-year exchange rate of the hryvnia, enterprises' profits and payroll costs, the unemployment level, exports and imports of goods and services, and other indicators used in the development of a draft budget);
- the consolidated budget of Ukraine by major types of revenues, financing, expenditures, and borrowing;
- the state budget by major types of revenues, financing, expenditures, and lending;
- expenditures for budget programmes ensuring implementation of priority programmes, including those financed by loans (borrowings) obtained by the government from foreign countries, banks, and international financial institutions;
- the grants to local governments.

The state budget indicative forecast for two out-years is submitted to the Parliament with the budget bill. The forecast is adjusted to comply with the adopted version of the state budget, and then approved by the Cabinet of Ministers within one month after the Law on the State Budget is published.

The indicative forecast for the state budget of Ukraine for the two out-years is seen by the Ukrainian authorities as a target indicator for the line ministries for the medium term.

The newly introduced forecast for the state budget for two out-years resembles to some extent a medium-term budgetary framework[30] (MTBF) as defined by the European Union. However, the framework, according to the EU, includes medium-term budgetary objectives or ceilings, not just forecasts. The role of an MTBF consists in helping to ensure fiscal discipline. Furthermore, the existence of an MTBF may facilitate monitoring by providing benchmarks against which budgetary developments can be assessed over time. The strengthening of the MTBF usually serves as a complement to the introduction of other institutional reforms such as an expenditure rule or top-down budgeting. As of 2008, almost all EU countries (except Cyprus,[31] Greece, Hungary, Luxembourg and Portugal) have budgetary frameworks covering from two to five out-years.

Medium-term budgetary planning has a very important role in OECD countries. Objectives or ceilings focus on the expenditure side of the budget and take the form of medium-term expenditure frameworks (MTEFs). The level of commitment with regard to MTEFs in these countries is generally high, which promotes better fiscal discipline and improves budgetary outcomes (a low deficit, or a surplus, and low debts). As of 2008, 20 OECD countries[32] have been working with expenditure frameworks that establish ceilings or targets for periods covering from three to five years (see Box 4).

Box 4. **Medium-term expenditure frameworks in OECD countries**

An expenditure framework is a normative instrument capturing policy objectives of the government and imposing limits on spending over the medium term. The design of expenditure frameworks differs across countries. The frameworks can be either flexible (updated each year in the light of the previous year's outcomes, new estimates of the consequences of current policies, and new political priorities) or fixed (when the figures remain unaltered from year to year once they have been set).

The major advantage of a flexible framework in comparison to no framework is that, at the time of budget formulation, the multi-annual consequences of all policy changes have to be traded off against each other and against the adjustment of medium-term targets. This guarantees that the consequences of new spending initiatives in future years (which may be larger than in the first year, so-called "camel noses") are accounted for. Similarly, it ensures due consideration of savings measures which phase in slowly – which is the case with most major measures since they require changes of the law or reorganisation of administrative units.

A few countries (notably Austria, the Netherlands, Sweden and the United Kingdom) have fixed expenditure frameworks. The major advantage of a fixed expenditure framework over a flexible framework is that it is (more) effective in realising multi-year expenditure targets. Precisely because the overall ceiling cannot be changed from year to year, the target is automatically realised as long as the framework is maintained. Although only a few OECD countries work with a fixed expenditure framework, many others seek to keep their expenditure framework as stable as possible from year to year (without formally committing to a fixed framework).

An expenditure framework can be rolling like in Austria and Sweden, or it can be periodical like in France and the United Kingdom. In a rolling framework, an additional year is added at the end of the framework period when the first year (or budget year) expires. In a periodical framework, a new sequence of ceilings is drawn up at periodic intervals, for instance at the beginning of every new cabinet period.

Expenditure frameworks can be distinguished along several other dimensions, notably the number of future budget years covered, the number of ceilings they establish, and their comprehensiveness (how much of government spending is subject to the framework). In terms of future budget years covered, many frameworks cover a three-year period (France, Sweden) or four-year period (Finland, the Netherlands). The United Kingdom moved from a three-year to a five-year forward framework with the 2010 "Comprehensive Spending Review". In terms of the number of sub-ceilings, some frameworks establish only a single aggregate ceiling on expenditures (Sweden), while others contain a number of binding sub-ceilings at the ministerial level (the Netherlands, the United Kingdom) or the policy area level (France). In terms of comprehensiveness, some governments argue that particularly volatile items or items determined by entitlements should not be subject to multi-year ceilings (for instance, interest payments or unemployment benefits).

The state budget forecasts for 2013 and 2014 which were developed in accordance with the new Budget Code will serve as a basis for the formulation of the draft state budget for 2013. Yet to get closer to comprehensive medium-term budgetary planning, the Ukrainian government may wish to consider shifting from a forecasting approach to a targeting approach. The best solution could be a flexible framework. While a flexible framework can be annually updated, it provides better fiscal discipline: the multi-annual consequences of all changes have to be traded off against each other and against the adjustment of medium-term

targets for expenditures, revenues or the deficit. The framework should be decided at the start of budget preparation after the preliminary requests of line ministries and other CPAs have been received, and it should be approved by the Cabinet of Ministers and communicated by the Minister of Finance as binding guidelines for the preparation of definitive requests. It is essential (also in a flexible framework approach) that the ceilings not be changed anymore during budget preparation (nor during budget execution). Negotiations may affect allocation within the ceilings but not the ceilings themselves.

2.3.2. Baseline estimates

In order to be credible and realistic, an expenditure framework should rely on multi-annual estimates on the basis of current policy or current law ("baseline estimates"; see Box 5).

The data on structural changes and preliminary request estimates to be submitted by Ukrainian ministries and other CPAs at the start of budget preparation (see Section 2.2.4) are somewhat similar to the baseline estimates in OECD countries. The similarities are that they are provided by line ministries, they capture the cost of current law and/or current policy, and they are used by the Ministry of Finance to establish expenditure ceilings (for the upcoming year). However, the estimates in Ukraine cover only one (budget) year and do not cover out-years. They are not updated further and are not sufficiently comprehensive, as they focus only on changes expected in the budget year, while the concept of baseline estimates implies providing all costs of current law and/or current policy. Therefore, the preliminary request estimates do not fulfil the key purpose of baseline estimates which is to attain consistency between current policy and medium-term fiscal objectives (as provided by an expenditure framework).

Box 5. **Baseline estimates in OECD countries**

OECD countries that work with expenditure frameworks produce and update multi-annual baseline estimates. Each programme has its own particular set of factors that will affect expenditures – for instance, economic variables, demographic developments, price changes, or participation rates. The baseline estimates capture the cost of current law and/or current policy over the medium term and are essential for the allocation of financial resources in the annual budget negotiation. They are essential to ensure the consistency of current law or policy with the multi-annual ceilings. Best practice in OECD countries shows that baseline estimates are frequently updated to reflect any changes in the underlying variables (usually monthly or quarterly) and are prepared at a line-item level (the same level of detail as the annual budget), and that they should be part of the annual budget proposal submitted to Parliament (OECD, 2002). The baseline estimates should also be agreed between the line ministry and the finance ministry. They are an essential tool for budgetary discipline not only during budget formulation, but also during budget execution. During execution, baseline estimates alert at an early stage to overspending, which should immediately trigger corrective measures (not in the next budget).

Establishing the expenditure framework can be seen as a top-down process, and preparing budgetary and multi-annual estimates as a bottom-up process. In fact, the reconciliation of prescriptive targets or ceilings with descriptive line-item estimates is central to a disciplined budget process.

2.4. Fiscal sustainability

Fiscal sustainability – the major objective of fiscal policy – relies primarily on fiscal rules. The 2008 financial crisis has particularly exposed the importance of well-designed fiscal rules (supported by other fiscal institutions reinforcing fiscal discipline, such as medium-term expenditure frameworks and fiscal councils). Therefore, OECD countries consider fiscal rules as one of the most important fiscal institutions, and consistently work on adopting the most efficient design and combination of fiscal rules.

According to the definition of a fiscal rule proposed by Kopits and Symanski (1998), a fiscal rule is "a permanent constraint on fiscal policy, typically defined in terms of an indicator of overall fiscal performance […]. A critical feature of a fiscal rule is that it is intended for application on a permanent basis by successive governments in a given country." Fiscal rules can serve different goals, and their role in promoting budgetary control varies. Fiscal rules can be applied to various fiscal aggregates, such as measures of expenditure, revenue, budget balance or debt.

Ukraine has introduced a debt rule. According to the new Budget Code of 2010, the total amount of public debt and state-guaranteed debt at the end of the budget year should not exceed 60% of annual nominal GDP (Article 18 of the Budget Code). A debt rule of this type is suitable for providing an anchor for fiscal policy in the long run. However, it does not provide sufficient guidance for fiscal policy when debt is well below its ceiling, which is the case in Ukraine (see Section 1).

In addition to the debt fiscal rule, the new Budget Code contains a provision that applies to the revenue side (Article 53 of the Budget Code). It says that if actual revenues of the state budget exceed the revenues approved in the Law on the State Budget, the extra revenues should be spent on top-priority investment programmes (projects) approved under the procedure established by the law and perform actions related to social reforms. This rule is accompanied by the following clause: "the fact of exceeding the targeted state budget revenues is recognised […] based on the results for three quarters in the event the indicators of the state budget revenues […] exceed the target by more than 15%." This rule raises several concerns.

First, this provision promotes pro-cyclical spending.[33] Second, the provision is ambiguous: it states that the extra revenues should be spent "on top-priority investment programmes (projects) approved under the procedure established by the law and perform actions related to social reforms" but the regulation prescribing the procedure for defining top-priority investment programmes has not been established, and it is not clear what are "actions related to social reforms". Such obscure provisions allow spending outside the regular budget process and undermine fiscal discipline.

Together with debt and revenue rules, OECD countries use expenditure and balance rules. Expenditure rules in OECD countries usually set limits on total, primary or current spending in growth rates of GDP, or in per cent of nominal or structural GDP. An expenditure framework is not an expenditure rule (because it is not permanent), but its effect in the medium term is comparable. Expenditure rules and expenditure frameworks must be anchored in a structural balance rule in order to guarantee long-term sustainability (public debt remaining constant as a share of GDP or converging toward a sustainable level, for instance 60% of GDP). Steering on the expenditure side rather than on an annual cyclically adjusted deficit constraint is more transparent and possibly less susceptible to manipulation (Anderson and Minarik, 2005).

Box 6. **Intergovernmental financial relations in Ukraine**

Ukraine is a unitary state with three levels of local government:

- *Oblasts* (24), the Autonomous Republic of Crimea (1), the cities of Kiev and Sevastopol (2);
- *Rayons* (488) and cities in *oblasts* and in the Autonomous Republic of Crimea (177);
- Districts in cities (55), towns (278), settlements (782) and villages (10 279).

Funds can be transferred between the state budget and the local budgets of the first and second levels except the Autonomous Republic of Crimea (691 in total), as well as the local budgets of different levels in accordance with Articles 92 and 93 of the Budget Code.

Decentralisation of public service provision. According to officials of the Ministry of Finance, the division of tasks between the central government and local governments is based on the principle of subsidiarity, which implies that public services are provided by the government that is as close to the citizens as possible while respecting equal rights to basic services and taking into account economies of scale and spill-over effects. The share of local budget expenditures in the expenditures of the consolidated budget of Ukraine is about 44%.

Grants from the central government. Local budgets receive non-earmarked equalisation grants, as well as other grants and subventions from the state budget (an additional service cost related equalisation grant, subventions for social protection programmes, subventions for investment programmes, and other grants and subventions). The share of such transfers in the consolidated budget of Ukraine is 24.8% (in 2011). According to the State Treasury, the transfers from the state budget account for about 52% of the total revenues (local and special fund) of local budgets.

The non-earmarked equalisation grants account for 51.9% of the total amount of transfers from the state budget to local budgets. The remaining grants (48.1%) are earmarked for specific services, such as service cost related equalisation grants, social protection subventions, subventions for the socio-economic development of the regions, etc.

Equalisation grants. Equalisation grants can be provided to all local governments of the first level. The size of equalisation grants is determined in accordance with the Budget Code of Ukraine using the following parameters:

- financial ratios of budget adequacy and their adjustment factors;
- population level and the number of consumers of guaranteed services;
- relative taxation potential index of the relevant budget;
- estimated volume of the revenue basket of local budgets;
- equalisation factor;
- target ratio of the number of employees of local self-government bodies in relation to the population level.

The relative taxation potential index is a factor that expresses the level of potential tax revenue of the local government in comparison with the national average on a per capita basis.

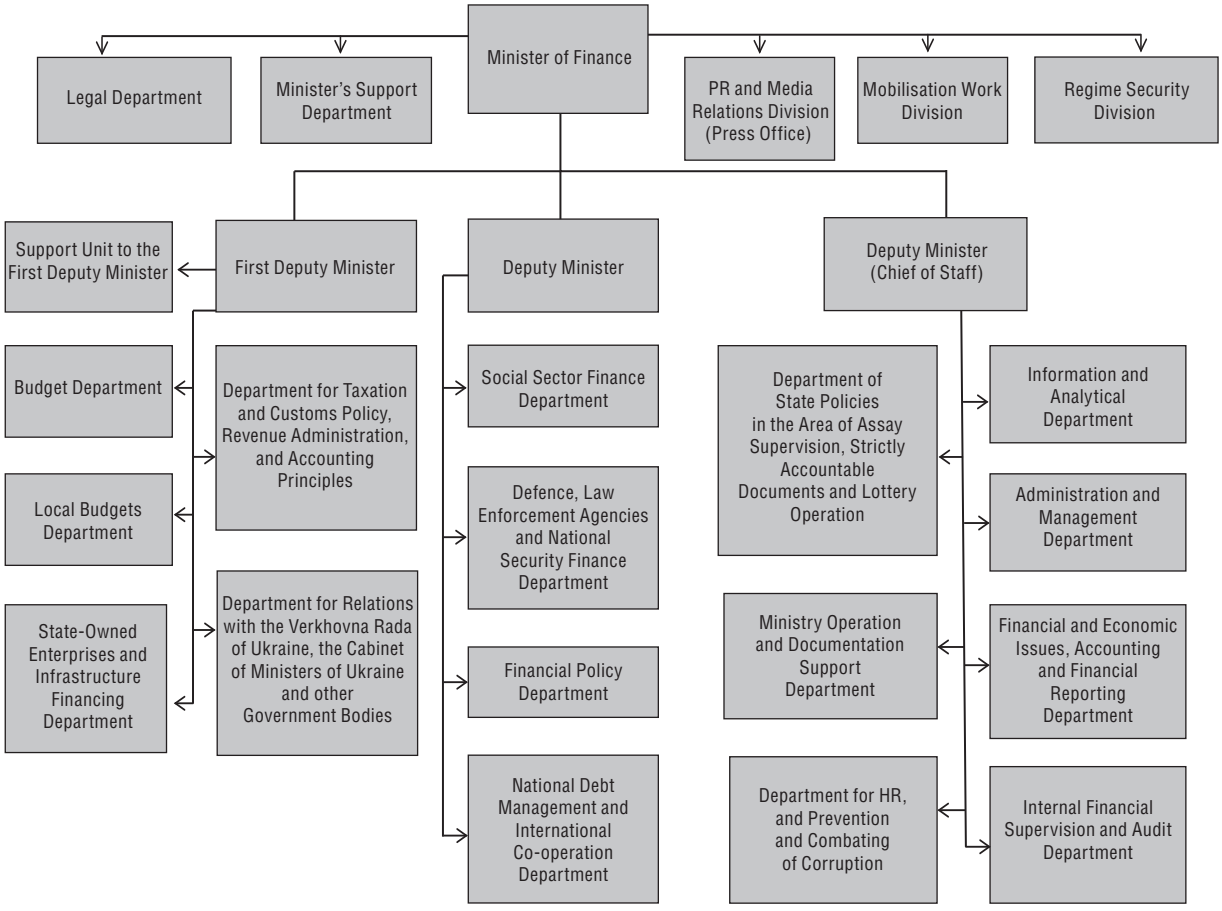
Fiscal rules should also apply to local government (see Box 6 for the funding of local government in Ukraine). According to the Budget Code, local authorities formulate and execute their local budgets independently. However, Article 18.3 of the Budget Code puts constraints on debt and guarantees. In particular, the total amount of local debt and debt guaranteed by the Autonomous Republic of Crimea or an *oblast* as of the end of the budget year should not exceed 100% (400% for the city of Kiev) of the average annual projected volume of revenues in the development budget (net of the amounts of local domestic and foreign

borrowings) defined under the forecast of the corresponding local budget for the next two years following the budget year. Should this threshold be exceeded, then the Parliament of the Autonomous Republic of Crimea and the corresponding *oblast* council can take measures to bring the total amount of debt into compliance with the provisions of the Budget Code.

2.5. Organisation of the Ministry of Finance

The Ministry of Finance of Ukraine is led by the Minister of Finance, the First Deputy Minister and two Deputy Ministers (Figure 3). The First Deputy Minister is in charge of the Budget Department, the Local Budgets Department, and the department responsible for the finances of public enterprises. The Budget Department (with a staff of 60 people) is the core department in the budget preparation process, where contributions of the expenditure divisions are brought together and reconciled in the budget bill. The First Deputy Minister also supervises the Department for Taxation and Customs Policy, Revenue Administration, and Accounting Principles. Of the other two Deputy Ministers, one is in charge of sectoral finances, including the social sector, the state debt and international co-operation. The other Deputy Minister is in charge of the administrative affairs of the ministry.

Figure 3. **Organisation of the Ministry of Finance of Ukraine (as of 2011)**



The total staff of the Ministry of Finance amounts to 900 persons. Overall, the Ministry of Finance plays a central role in the budgetary process of Ukraine. It has considerable power, establishing expenditure ceilings for line ministries and allocating resources within line ministries. The ministry co-ordinates the work of the State Treasury, the customs and tax administrations, and the Financial Inspection (the latter body was formerly known as

the Main Control and Revision Organisation; see Section 6.2 on internal audit). This strong position of the Ministry of Finance is positive for budget discipline, especially during times of fiscal consolidation. However, the power of the Ministry of Finance should not overwhelm the role of line ministries. In OECD countries, there is a common trend to make line ministries more responsible and to give them more discretion over their budget in line with broad strategic expenditure priorities. A strong and independent role of line ministries enables a finance ministry to focus on the larger picture and on strategic issues.

2.6. Conclusion

Since 2002, the state budget of Ukraine has been based on programmes. The number of budget programmes amounts to 900-950 with a decreasing trend in recent years. There are about 580 budget programmes in the state budget of Ukraine for the year 2012. Each programme has a "passport" developed by a line ministry (or other CPA) defining the objectives, the budget holders in charge, indicators of effectiveness, and other programme characteristics. The passport serves to guide the implementation of the programme and to assess its performance.

The introduction of a programme classification is an important step forwards in the modernisation of public finance management in Ukraine. However, there are two remaining concerns. First, the expenditures of the state budget law are presented in a number of independent tables that make it difficult to fully identify the expenditures under each programme. For instance, interest payments and grants to local governments are presented in different tables than operational expenditures. The OECD Secretariat recommends presenting all expenditures by programme in a single table. This will contribute to the transparency of the budget.

The second concern relates to the proliferation of priority programmes. The priority programmes aim to anchor state priorities for the medium and long term. Budget programmes provide funding for priority programmes in the budget year. At present, there are various priority programmes which overlap or are out of date, and there is a lack of co-ordination between them. The need to streamline priority programmes has already been acknowledged by the Ukrainian government. The OECD Secretariat recommends decreasing the number of priority programmes or abolishing them entirely. In OECD countries, sectoral priorities are usually laid down in sectoral medium or long-term plans that are under the responsibility of line ministers and serve to guide budget requests. Sectoral priorities have no special status in the budget process.

Ukraine uses cash-based appropriations. According to the experience of the OECD Secretariat, this is a suitable appropriation standard. The introduction of elements of accrual accounting should be considered carefully and should not hamper the transparency of the budget nor scrutiny by parliamentarians.

Ukraine has made progress with medium-term financial planning but further improvements are possible. The new Budget Code of 2010 requires the Cabinet to adopt a forecast of the consolidated budget by major types of expenditure and revenue for two out-years in the month following the adoption of the budget law. This forecast does not provide a solid medium-term framework and has little impact on fiscal discipline.

To further strengthen medium-term planning, Ukraine needs an effective mechanism which imposes expenditure ceilings on ministries and other CPAs for the medium term (upcoming budget year and two or three out-years). This requires that an expenditure

framework be adopted before the moment when line ministries are asked to submit their budget requests. In view of the volatility of the economic developments in Ukraine, the OECD Secretariat recommends a "flexible framework" approach. This implies expenditure ceilings for the budget year and two or three out-years which are rigorously maintained during budget preparation and execution, but which can be updated annually at the start of a new budget cycle. Moreover, the ceilings should cover both capital and current expenditures.

As well as a medium-term expenditure framework, baseline estimates are an essential component of medium-term planning. Realistic and up-to-date estimates on the basis of current policy or current law are a necessary prerequisite for drawing up a medium-term expenditure framework. In addition, they provide the basis for enforcing budgetary discipline. All overspending, including overspending in out-years, should be compensated immediately when it is observed (which may be at the moment the estimates are updated during budget preparation and execution). The preliminary requests of ministries and other CPAs can be seen as a first step in the direction of developing baseline estimates. However, to provide a sound ground for building up a credible expenditure framework, the preliminary requests need to be frequently updated, cover the medium term and provide all costs of current law and/or current policy. Many OECD countries update baseline items quarterly.

The programme passports compiled by line ministries in co-ordination with the Ministry of Finance after the approval of the state budget provide the basis for performance assessment of budget programmes. Responsible line ministries report on a quarterly basis and at the end of the year on the programme performance results as targeted in the passports. Experience in some OECD countries shows that reporting performance data in the budget (or in the supporting material) can overload the budget documents and impair their transparency. Therefore, the Ukrainian practice of keeping performance assessment apart from the budget process and under the responsibility of line ministers is sensible. However, the frequency of this reporting may be reduced to every half-year rather than quarterly in order to prevent bureaucracy.

Ukraine has introduced a debt rule (the debt should not exceed 60% of annual nominal GDP) and a rule for extra revenues. The provision of the Budget Code regarding the extra revenues could be improved in order to avoid any doubt about spending extra revenues not exceeding the threshold of 15% and to prevent pro-cyclical spending. At the sub-national level, there are constraints on debt and guarantees. The existing set of fiscal rules is useful, but does not sufficiently safeguard fiscal sustainability in the long term.

OECD countries are currently changing their domestic fiscal rules in order to make their fiscal frameworks more solid. Implementation of expenditure rules or an expenditure framework anchored in a structural balance rule[34] is a common tendency in the leading countries. Introducing a structural balance rule seems to be premature for Ukraine at the moment; however, the first steps towards expenditure and balance rules can already be taken. In this regard, Ukraine may wish to consider the introduction of an expenditure framework targeting total or primary spending as a percentage of trend GDP. The expenditure framework should be coupled with a balance rule, which makes the targets of the expenditure framework dependent on the trend revenue.

3. Role of the legislature

3.1. The Ukrainian Parliament – Verkhovna Rada

The Verkhovna Rada (Rada) is the sole body of legislative power in Ukraine. Article 113 of the Constitution establishes the accountability relationship between the Rada and the

executive branch: "The Cabinet of Ministers of Ukraine is responsible to the President of Ukraine and is under the control of and accountable to the Verkhovna Rada of Ukraine within the limits envisaged in Articles 85 and 87 of the Constitution of Ukraine." The authority of the Rada includes "approving the state budget of Ukraine and introducing amendments to it; controlling the implementation of the state budget of Ukraine and adopting decisions in regard to the report on its implementation" (Article 85.4 of the Constitution).[35]

Since 2008, elections and changes in government (and in 2009, the financial crisis) have often disrupted the normal budget cycle in Parliament (see Section 1.2.5).

The Rada's role in the budget process is regulated by the Constitution of Ukraine (Article 85.4 as cited above), by the Budget Code, and by the Rada's Rules of Procedure, specifically Chapter 27 on the "Adoption of the State Budget of Ukraine and Supervision of its Implementation". The Rules of Procedure provide the most detail in terms of Parliament's role in the budget process and, as of February 2010, the Rules of Procedure have the status of a law.

3.2. The Budget Committee

Committees play a vital role in the work of the Rada. In a 2009 survey of 125 deputies, a clear majority reported that committees are the most important place for deliberation on proposed legislation.[36] The Rada determines the composition of committees according to the Constitution (Article 89), the Rada's Rules of Procedure, and the "Resolution on the List, Composition and Competencies of Committees of the Verkhovna Rada of Ukraine". Committee membership and leadership reflect the political composition of the Rada. There are currently 26 standing committees ranging in size from 7 to 34 members, and one *ad hoc* committee with 37 members. The Rada also has the right to establish "temporary special" and "temporary investigative" commissions to consider issues of public interest.

All committees participate in the review of the draft budget, but the main committee charged with budget-related matters is the Budget Committee. The above-mentioned resolution on committees defines the Budget Committee's competencies as: state budget policy and intergovernmental fiscal relations; the state budget of Ukraine (including revenues, expenditures, and budget execution); the budget process; assessment of the budget's compliance with the Budget Code of Ukraine; activities of public financial institutions; and the Accounting Chamber.

Membership on the Budget Committee is highly sought after and, with 34 members, it is the largest standing committee.[37] All political parties and factions represented in the Parliament have the right to delegate at least one representative to the Budget Committee, and the chair and first deputy chairs are normally from different parties. The current Budget Committee leadership comprises a chair, two first deputy chairs and three deputy chairs.[38] Additional members chair the eight Budget Committee sub-committees on:

1. Monitoring the Impact of Draft Laws on Budget Indicators.
2. State Debt and Debt Financing.
3. Revenues.
4. Expenditures.
5. Local Budgets.
6. Social Programmes.
7. Investment Programmes.
8. Activities of the Accounting Chamber and Control of Budget Implementation.

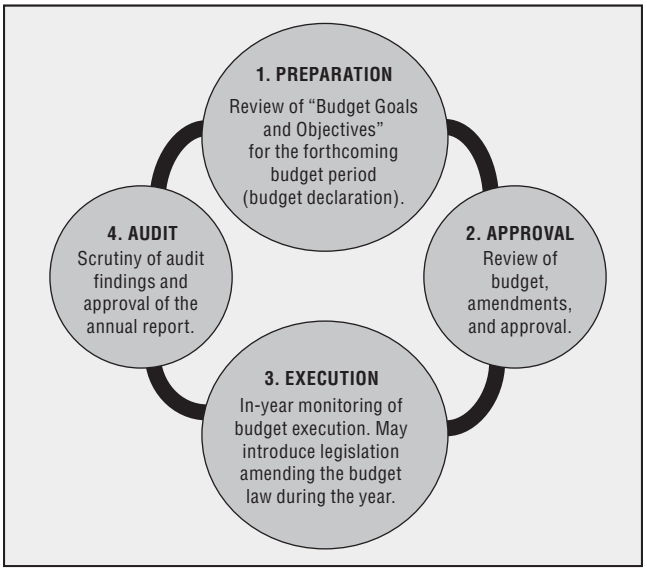
A representative of both the Ministry of Finance and the Accounting Chamber is required to attend meetings of the Budget Committee. The Budget Committee also regularly invites representatives from other government entities and outside experts to participate in its meetings and to provide opinions.

The Budget Committee is supported by a secretariat which comprises around 30 professional staff.[39] All are civil servants (thus largely protected from political shifts in the Parliament) and most have previously worked in the Ministry of Finance. While not formally assigned to cover specific areas of the budget, in practice staff tend to have areas of specialisation. The Budget Committee secretariat reviews the draft budget and prepares relevant analyses. Depending on the issues at hand, it may also call on outside experts and institutions.

3.3. The parliamentary approval process

The fiscal year follows the calendar year except in extraordinary circumstances.[40] The Rada's involvement in the budget cycle can be broken down into four main stages (Figure 4): *i)* examination and adoption of a resolution approving or "taking into account" the executive's budget declaration; *ii)* review, amendment and approval of the executive's draft budget; *iii)* in-year monitoring of budget execution; and *iv)* scrutiny of the Accounting Chamber's audit findings. This section focuses on the first two phases.

Figure 4. **The role of the Verkhovna Rada in the budget cycle of Ukraine**



Article 33 of the newly amended Budget Code stipulates that the Cabinet of Ministers of Ukraine develops and approves the budget declaration no later than 1 April of the year preceding the planned one and, within a three-day period, submits it to the Verkhovna Rada. Previously the Rada received this document at the end of May, which meant limited time for debate. Upon receipt, deputies and committees develop their proposed amendments which are forwarded to the Budget Committee (Article 152.2-4 of the Rules of Procedure). The Budget Committee summarises these proposals and prepares a draft resolution. The government prepares the draft state budget with reference to the Rada's resolution on the budget declaration.

The government has the monopoly of legislative initiative with regard to the budget. Article 116.6 of the Constitution and Articles 32 and 34-37 of the Budget Code establish the roles of the Cabinet of Ministers and of the Ministry of Finance in drafting the budget. Article 96 of the Constitution requires the Cabinet of Ministers to submit the draft budget to Parliament no later than 15 September.[41] The Rada then has approximately two and a half months to review the budget. This is slightly less than the three months recommended by the "OECD Best Practices for Budget Transparency" (OECD, 2002). In addition, the bulk of the work of the standing committees on the budget is undertaken by 1 October (see Table 8).

Table 8. **Parliamentary budget approval timetable in Ukraine**

Within three days of 1 April	The "Budget Goals and Objectives Declaration" (budget declaration) for the forthcoming budget period is submitted to Parliament.
1 May	The government submits the annual report on execution of the budget for the previous year.
1 June	Parliament adopts a resolution on approval or consideration of the budget declaration. Parliament also approves its own budget for the upcoming year at this time.
15 September	The draft Law on the State Budget is submitted to Parliament by the Cabinet of Ministers.
20 September	Presentation of the draft budget law by the Minister of Finance; first plenary debate; referral to the Budget Committee and other relevant committees.
1 October	Deputies and committees submit proposed amendments to the Budget Committee.
15 October	The Budget Committee (in consultation with government representatives) prepares a first opinion.
20 October	First reading; the draft budget with proposals is sent back to the government for revision.
3 November	The government submits a revised draft budget.
20 November	Second reading; after the second reading, no additional proposals can be made.
By 1 December	Bill adopted and sent to the President of Ukraine.

After the submission of the executive's budget proposal, deputies are given roughly five days to acquaint themselves with the budget. Around 20 September, the Minister of Finance presents the draft budget in the plenary followed by a debate in which deputies may ask questions.[42] The draft budget is then referred to the Rada committees.

The standing committees and individual Members of Parliament have until 1 October to submit proposals for amendments to the Budget Committee. Amendments must show sources of funding should they entail additional expenditure. As part of the scrutiny process, committees may conduct public hearings within the scope of their competencies. Government representatives are present at, and participate in, all parliamentary committee meetings.

Authors of amendments come to the Budget Committee to discuss them. A representative of the Cabinet of Ministers is also present during these discussions. The outcomes of these discussions are minuted and used by the Budget Committee staff to create a comparative table of the amendment proposals and the Budget Committee's opinion on whether they should be adopted or rejected. Based on this comparative table, the Budget Committee's opinions and proposals are prepared, debated and voted on in the plenary in the first reading on 20 October. More specifically, a first vote is taken to dismiss all amendments rejected by the Budget Committee. If however, the author of an amendment objects to its rejection, then the amendment is discussed in the plenary. Amendments that are not dismissed are discussed article by article and voted on.[43] Parliament then sends the draft budget with its proposals back to the government for revision. At this stage during revisions, the government may accept or reject Parliament's proposed amendments. The government also has the opportunity to make other changes, including changes to key budget indicators set earlier in the year.[44]

The government submits a revised budget to Parliament by 3 November. The Budget Committee then reviews this revised budget, in particular whether the government has taken Parliament's views into account. At this stage, only the Budget Committee can propose additional changes, although any changes cannot change total amounts but rather would consist of moving allocations from one part of the budget to another. The Budget Committee produces a second opinion recommending that the Rada adopt the revised draft as is, or amend it. If the Parliament cannot agree to the revised draft as a whole, it may vote article by article. The budget must be adopted by 1 December. Typically, the budget is adopted as of the second reading, although there is a procedure in place for a third reading. The approved consolidated budget includes the general parameters of the state budget and the distribution of its indicators under the budget classification (primarily in terms of key spending units and budget programmes) and some additional details in accordance with Article 40 of the Budget Code.

As with any other legislation, once Parliament has adopted the budget law and sent it to the President of Ukraine for signature, he or she has 15 days to sign it (accepting it for execution and officially promulgating it) or to return it to Parliament "with substantiated and formulated proposals for repeat consideration" (Article 94 of the Constitution).[45] The President has only vetoed the budget law once, and typically signs it within three to five days. If the budget law is not in force by the beginning of the new budget year, Article 41 of the Budget Code regulates spending by the Cabinet of Ministers, allowing for monthly expenditure not exceeding one-twelfth of the budget expenditure approved for the previous budget year.

Parliament also plays an oversight role in the execution and audit phases. According to the Budget Code, the State Treasury must report to the Rada on budget execution on a monthly, quarterly, and annual basis.[46] Reports include both financial and budget information (with the latter defined as progress on budget execution in terms of budget classification). During the year, the Rada (as well as the President and the Cabinet of Ministers) may propose, and the Rada may adopt, legislation modifying the state budget law. As demonstrated in Table 9, this happens in practice with a small number of laws adopted each year.

Table 9. **Changes to the state budget law of Ukraine during fiscal years 2006-10**

	2006	2007	2008	2009	2010
Total proposed draft laws modifying the budget law	**11**	**17**	**63**	**43**	**32**
Proposed by the Verkhovna Rada	10	11	51	27	27
Proposed by the President of Ukraine	-	1	4	2	-
Proposed by the Cabinet of Ministers	1	5	8	14	5
Total adopted legislation by the Verkhovna Rada modifying the budget law	**8**	**5**	**9**	**14**	**14**
Proposed by the Verkhovna Rada	7	-	4	7	9
Proposed by the President of Ukraine	-	-	3	1	-
Proposed by the Cabinet of Ministers	1	5	2	6	5

Source: Information obtained from the secretariat of the Budget Committee of the Ukrainian Parliament.

The Budget Code (Article 61) also defines the content of the constitutionally mandated annual report on budget execution submitted to Parliament no later than 1 May of the following year. This report is made public. The Accounting Chamber then has two weeks to submit its own report analysing the government's report (Article 62 of the Budget Code). Article 161.6 of the Rada's Rules of Procedure further states that the Budget Committee

must consider the government's report in conjunction with the Accounting Chamber and prepare its own recommendations within 15 days. The Cabinet of Ministers and representatives of the Accounting Chamber and Budget Committee must all make presentations to the Rada. The Parliament must then "conduct a full discussion and adopt a resolution on approval of a report on implementation of the state budget of Ukraine for the previous year" (Article 162.2 of the Rules of Procedure). The relationship between the Rada and the Accounting Chamber is discussed further in Section 6 on audit.

3.4. The impact of Parliament

The Ukrainian Parliament enjoys wide amendment powers which it uses in practice. There are no limits to the number of amendments that can be proposed, and it is not atypical for upwards of 2 000 amendments to be submitted in the period before the first reading.[47] As noted earlier, the years 2008, 2009 and 2011 were atypical but nevertheless saw proposals for between 500 and 1 000 amendments. Amendments and the vote on the budget are not seen as a confidence vote in the government. The data in Table 10 shows the effects of the amendments submitted and approved by the Parliament on the overall budget revenues and expenditure. According to the Budget Committee secretariat, total changes can range anywhere from 1% to 10%. However, changes to the various parts of the budget may be more substantial. Given that the government has the opportunity to revise its draft budget during the parliamentary review process, it is somewhat difficult to distinguish between the changes initiated by Parliament and the changes initiated by the government. This is particularly true for changes in revenue and expenditure, as the government may dramatically revise macroeconomic indicators between the first and second reading of the draft budget.

3.5. Conclusion

The budget approval process in Ukraine differs from many OECD countries in that it can be characterised as more of a continuous negotiation between the government and Parliament. The draft budget goes back to the government for revision following the first reading in Parliament. And while the government typically takes Parliament's viewpoints and proposals into consideration, the government's revisions may or may not include them. In addition, government representatives are present at, and participate in, all parliamentary committee meetings. This allows committee members to ask questions and engage in an ongoing dialogue.

The Budget Committee in particular and the Parliament more generally benefit from significant non-partisan staff support for budget analyses.

Parliament enjoys wide amendment powers which it uses in practice. Its potential impact on the budget is significant. However, recent years marked by political turmoil, as well as changes in key legislation such as the Budget Code, have restricted parliamentary procedures for debating and amending the draft state budget in the first and second readings. The Parliament would benefit from additional time for debate, in line with OECD best practices for budget transparency (OECD, 2002), in particular extending the period for review by the sectoral committees.

Parliament's relationship with the Accounting Chamber and use of audit findings could also be improved (see the discussion on audit in Section 6).

Table 10. **Dynamics of planned indicators of the state budget of Ukraine, 2006-10 (million UAH)**

Changes from introduction of the draft budget bill to adoption and in-year modifications

2006

	Government draft budget	State budget law adopted by the Parliament	Per cent change	State budget law following modifications during the fiscal year	Per cent change
	15-09-2005	20-12-2005	When approved (%)	Throughout 2006	Throughout 2006 (%)
I. Revenues	**118 706.0**	**124 945.1**	**5.26**	**127 516.6**	**2.06**
II. Financing (deficit)	**9 898.4**	**12 909.0**	**30.42**	**13 245.7**	**2.61**
III. Crediting	**1 160.5**	**772.7**	**-33.42**	**562.9**	**-27.15**
IV. Expenditures, total, *of which*:	**127 443.8**	**137 081.5**	**7.56**	**140 199.4**	**2.27**
1 Transfers to local budgets	23 955.4	32 701.4	36.51	35 057.8	7.21
2 Verkhovna Rada of Ukraine	572.9	606.6	5.87	606.6	0.00
3 Public affairs management	632.7	605.3	-4.33	615.7	1.72
4 Cabinet of Ministers of Ukraine	217.5	233.0	7.13	233.0	0.00
5 Ministry of Finance (including tax and customs services, Main Control and Revision Organisation, State Property Fund)	10 758.6	10 792.0	0.31	9 889.0	-8.37
6 Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences	10 286.7	10 559.6	2.65	10 566.3	0.06
7 Ministry of Healthcare	3 232.7	3 147.2	-2.64	3 154.7	0.24
8 Ministry of Labour and Social Policy and transfers to the Pension Fund	32 681.6	29 714.4	-9.08	30 393.8	2.29
9 Ministry of Defence and Administration of the State Border Guard Service	7 844.6	8 135.9	3.71	8 780.9	7.93
10 Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry	10 733.6	11 075.2	3.18	11 109.8	0.31
11 Judicial authorities	1 507.6	1 628.3	8.00	1 687.9	3.66
12 Ministry of Fuel and Energy and Ministry of Coal Industry	4 329.1	5 184.9	19.77	5 285.6	1.94
13 Ministry of Agrarian Policy	4 224.1	5 657.6	33.93	5 662.1	0.08
14 Ministry of Transport and Communications and State Road Service	5 498.1	5 325.3	-3.14	5 403.6	1.47
	91.39%	91.45%		91.62%	

Source: Information obtained from the secretariat of the Budget Committee of the Ukrainian Parliament.

4. Budget execution

4.1. *Organisation of budget execution*

The Cabinet of Ministers of Ukraine is responsible for budget execution, with the Ministry of Finance providing overall management of budget execution (Article 42 of the Budget Code). The State Treasury, operating as an agency of the Ministry of Finance, has a central role in budget execution. It is responsible for managing payment transactions, for the financial control of commitments, and for accounting.

Ukraine has implemented a single treasury account (STA) held at the National Bank of Ukraine.[48] The STA is the main account used by the state for financial transactions and for management of state and local budget funds. Payments are made through the electronic

Table 10. **Dynamics of planned indicators of the state budget of Ukraine, 2006-10 (million UAH)** *(cont.)*

Changes from introduction of the draft budget bill to adoption and in-year modifications

2007

		Government draft budget	State budget law adopted by the Parliament	Per cent change	The law on the budget considering the introduced amendments	Per cent change
		14-09-2006	19-12-2006	When approved (%)	Throughout 2007	Throughout 2007 (%)
I.	**Revenues**	**140 290.3**	**147 888.1**	**5.42**	**157 287.0**	**6.36**
II.	**Financing** (deficit)	**15 148.4**	**15 715.7**	**3.74**	**19 066.0**	**21.32**
III.	**Crediting**	**1 980.8**	**1 784.9**	**-9.89**	**1 721.5**	**-3.55**
IV.	**Expenditures,** total, *of which*:	**153 457.9**	**161 819.0**	**5.45**	**174 631.5**	**7.92**
1	Transfers to local budgets	38 424.9	42 199.8	9.82	47 315.0	12.12
2	Verkhovna Rada of Ukraine	606.6	696.6	14.84	720.0	3.35
3	Public affairs management	618.3	689.6	11.52	777.6	12.77
4	Cabinet of Ministers of Ukraine	1 879.9	300.7	-84.00	307.1	2.12
5	Ministry of Finance (including tax and customs services, Main Control and Revision Organisation, State Property Fund)	11 541.9	12 636.7	9.49	12 841.6	1.62
6	Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences	12 091.7	12 423.7	2.75	13 219.5	6.41
7	Ministry of Healthcare	3 870.8	4 350.2	12.39	4 534.2	4.23
8	Ministry of Labour and Social Policy and transfers to the Pension Fund	25 981.5	26 010.9	0.11	28 604.2	9.97
9	Ministry of Defence and Administration of the State Border Guard Service	9 482.6	9 901.5	4.42	10 571.6	6.77
10	Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry	13 101.0	13 812.6	5.43	14 994.2	8.55
11	Judicial authorities	1 704.4	1 812.0	6.31	1 896.8	4.68
12	Ministry of Fuel and Energy and Ministry of Coal Industry	5 915.8	8 733.4	47.63	9 132.2	4.57
13	Ministry of Agrarian Policy	7 574.2	6 649.2	-12.21	6 854.0	3.08
14	Ministry of Transport and Communications and State Road Service	6 312.6	6 559.0	3.90	6 802.8	3.72
		90.65%	90.70%		90.80%	

Source: Information obtained from the secretariat of the Budget Committee of the Ukrainian Parliament.

payments system of the National Bank of Ukraine. The State Treasury of Ukraine keeps current accounts in foreign currency opened on its behalf in the National Bank of Ukraine and in the State Export and Import Bank of Ukraine. The State Treasury assures timely and complete recording of all operations, providing users with real-time information about the state of assets and liabilities and budget execution. The State Treasury operates at three levels which approximate the administrative and territorial divisions of Ukraine. The first is the central level, the second is the regional level with 27 departments, and the third is the district level with 633 departments, making a total of 660 local bodies with around 16 000 employees.

Within one month after the budget law is approved by the Parliament, the Ministry of Finance draws up a disbursement schedule of the state budget, the *rozpys*. This document

Table 10. **Dynamics of planned indicators of the state budget of Ukraine, 2006-10 (million UAH)** *(cont.)*

Changes from introduction of the draft budget bill to adoption and in-year modifications

2008

		Draft budget, proposed by the government	Draft budget, proposed by a **new** government	The law on the budget, adopted by the Parliament	Per cent change	The law on the budget considering the introduced amendments	Per cent change
		14-09-2007	26-12-2007	28-12-2007	When approved (%)	Throughout 2008	Throughout 2008 (%)
I.	**Revenues**	**191 125.7**	**215 359.4**	**215 359.4**	**0.00**	**231 932.0**	**7.70**
II.	**Financing** (deficit)	**18 945.0**	**18 500.3**	**18 822.2**	**1.74**	**25 020.2**	**32.93**
III.	**Crediting**	**-1 860.4**	**1 642.6**	**1 809.6**	**10.17**	**3 744.3**	**106.91**
IV.	**Expenditures,** total, *of which*:	**211 931.0**	**232 217.1**	**232 372.0**	**0.07**	**253 207.9**	**8.97**
1	Transfers to local budgets	56 279.7	59 544.2	59 634.2	0.15	62 712.4	5.16
2	Verkhovna Rada of Ukraine	797.4	852.4	860.4	0.94	860.4	0.00
3	Public affairs management	1 015.6	1 236.9	1 236.9	0.00	1 241.3	0.36
4	Cabinet of Ministers of Ukraine	389.1	428.1	428.1	0.00	428.1	0.00
5	Ministry of Finance (including tax and customs services, Main Control and Revision Organisation, State Property Fund)	13 847.8	20 286.4	20 241.4	-0.22	20 767.0	2.60
6	Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences	17 818.5	18 072.3	18 090.2	0.10	18 202.5	0.62
7	Ministry of Healthcare	5 570.6	5 725.8	5 745.8	0.35	5 780.0	0.60
8	Ministry of Labour and Social Policy and transfers to the Pension Fund	29 794.5	38 743.5	38 775.5	0.08	45 241.6	16.68
9	Ministry of Defence and Administration of the State Border Guard Service	11 251.1	11 949.7	11 949.7	0.00	11 976.2	0.22
10	Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry	18 363.8	19 180.7	19 180.7	0.00	19 374.7	1.01
11	Judicial authorities	2 428.4	2 839.6	2 839.6	0.00	2 838.6	-0.03
12	Ministry of Fuel and Energy and Ministry of Coal Industry	9 495.3	12 241.8	12 241.8	0.00	16 004.3	30.74
13	Ministry of Agrarian Policy	11 834.7	9 849.6	9 849.6	0.00	10 994.6	11.62
14	Ministry of Transport and Communications and State Road Service	8 888.9	11 381.2	11 381.2	0.00	12 191.5	7.12
		88.60%	91.44%	91.43%		90.29%	

Source: Information obtained from the secretariat of the Budget Committee of the Ukrainian Parliament.

provides a monthly breakdown of planned expenditure approved by the budget law. In particular, the disbursements to the budget holders by budget programmes are allocated on a monthly basis. The approved *rozpys* is transferred to the State Treasury for execution. The approved *rozpys* can be amended during the year as a result of the following events:

- approval of changes to the state budget law by the Parliament;
- reallocations by the government with the approval of the parliamentary Budget Committee among budget holders or among budget programmes of the budget holder(s).

Changes to the state budget *rozpys* result in the introduction of changes in the monthly cash plans (*koshtorys*) of budget institutions.

As part of the process of budget execution (but also for the purpose of assessment and budget formulation), budget holders are required to submit "passports" for budget programmes

Table 10. **Dynamics of planned indicators of the state budget of Ukraine, 2006-10 (million UAH)** *(cont.)*

Changes from introduction of the draft budget bill to adoption and in-year modifications

2009

		Draft budget, proposed by the government	Revised draft budget, proposed by the government	The law on the budget, adopted by the Parliament	Per cent change	The law on the budget considering the introduced amendments	Per cent change
		15-09-2008	23-12-2008	26-12-2008	When approved (%)	Throughout 2009	Throughout 2009 (%)
I.	**Revenues**	**288 098.1**	**237 547.2**	**238 931.3**	**0.58**	**245 309.4**	**2.67**
II.	**Financing** (deficit)	**17 380.2**	**31 000.0**	**31 105.0**	**0.34**	**31 563.0**	**1.47**
III.	**Crediting**	**3 293.6**	**2 920.1**	**2 715.9**	**-6.99**	**2 715.9**	**0.00**
IV.	**Expenditures,** total, *of which*:	**302 184.7**	**265 627.1**	**267 320.4**	**0.64**	**274 156.4**	**2.56**
1	Transfers to local budgets	68 530.4	59 533.1	60 819.7	2.16	61 483.2	1.09
2	Verkhovna Rada of Ukraine	1 043.7	661.9	740.8	11.93	758.1	2.34
3	Public affairs management	1 624.7	753.2	832.2	10.49	817.4	-1.77
4	Cabinet of Ministers of Ukraine	501.1	281.2	281.2	0.00	281.2	0.00
5	Ministry of Finance (including tax and customs services, Main Control and Revision Organisation, State Property Fund)	31 333.3	23 932.8	23 980.6	0.20	23 193.6	-3.41
6	Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences	21 175.3	20 990.4	21 079.7	0.43	21 079.7	0.00
7	Ministry of Healthcare	7 385.5	5 545.8	5 545.9	0.00	5 904.2	6.46
8	Ministry of Labour and Social Policy and transfers to the Pension Fund	49 228.8	52 593.2	52 593.7	0.00	53 330.9	1.40
9	Ministry of Defence and Administration of the State Border Guard Service	20 152.6	12 864.3	13 566.0	5.45	13 566.0	0.00
10	Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry	27 208.4	19 573.8	20 548.4	4.98	20 548.4	0.00
11	Judicial authorities	3 784.7	2 281.4	2 323.4	1.84	2 447.7	5.35
12	Ministry of Fuel and Energy and Ministry of Coal Industry	17 965.4	5 703.3	5 703.7	0.01	5 719.2	0.27
13	Ministry of Agrarian Policy	11 980.6	5 737.6	5 738.9	0.02	5 738.9	0.00
14	Ministry of Transport and Communications and State Road Service	12 561.6	15 902.8	16 270.3	2.31	12 770.3	-21.51
		90.83%	85.22%	86.05%		83.02%	

Source: Information obtained from the secretariat of the Budget Committee of the Ukrainian Parliament.

to the Ministry of Finance. These documents include planned expenditure as well as other information such as goals, tasks, activities, and expected results (see Section 2.1.2).[49]

The commitments are incurred and the expenditures are accounted for by the budget holders only within the limits of the monthly cash plans (*koshtorys*) of the budget institutions. Payment orders and documents incurring commitments are signed by the heads of the budget institutions and their chief accountants. The State Treasury is responsible for the registration and accounting of commitments and payments of budget holders, and records them in the reports on budget execution. If a commitment is approved, it is registered (the Treasury keeps a register of all commitments). The Treasury bodies reconcile the registration of the budget holders' commitments submitted by each budget holder and the supporting documents in respect of compliance of the data with

Table 10. **Dynamics of planned indicators of the state budget of Ukraine, 2006-10 (million UAH)** *(cont.)*

Changes from introduction of the draft budget bill to adoption and in-year modifications **2010** (as of November 2010)

		Draft budget, proposed by the government	Draft budget, proposed by a **new** government	The law on the budget, adopted by the Parliament	Per cent change	The law on the budget considering the introduced amendments	Per cent change
		16-09-2009	23-04-2010	27-04-2010	When approved (%)	Throughout 2010	Throughout 2010 (%)
I.	**Revenues**	**284 691.9**	**267 452.0**	**267 452.0**	**0.00**	**252 751.2**	**-5.50**
II.	**Financing** (deficit)	**46 748.3**	**57 745.4**	**57 745.4**	**0.00**	**54 095.4**	**-6.32**
III.	**Crediting**	**7 168.2**	**1 641.2**	**1 180.9**	**-28.05**	**1 180.9**	**0.00**
IV.	**Expenditures,** total, *of which*:	**324 272.0**	**323 556.2**	**324 016.5**	**0.14**	**305 665.7**	**-5.66**
1	Transfers to local budgets	83 807.1	77 440.9	77 556.1	0.15	78 014.2	0.59
2	Verkhovna Rada of Ukraine	578.9	839.4	875.7	4.32	822.2	-6.11
3	Public affairs management	984.3	1 051.0	1 051.0	0.00	946.7	-9.92
4	Cabinet of Ministers of Ukraine	331.3	313.9	317.4	1.12	311.8	-1.74
5	Ministry of Finance (including tax and customs services, Main Control and Revision Organisation, State Property Fund)	31 673.7	23 187.0	23 210.0	0.10	22 862.9	-1.50
6	Ministry of Education and Science, National Academy of Sciences and National Academy of Pedagogical Sciences	20 347.5	23 078.4	23 113.9	0.15	22 617.8	-2.15
7	Ministry of Healthcare	6 292.5	6 700.1	6 700.1	0.00	6 135.1	-8.43
8	Ministry of Labour and Social Policy and transfers to the Pension Fund	60 441.7	72 339.0	72 339.0	0.00	69 229.2	-4.30
9	Ministry of Defence and Administration of the State Border Guard Service	15 183.6	15 751.3	15 770.3	0.12	13 584.8	-13.86
10	Security agencies (including the Office of the General Prosecutor, Security Service of Ukraine, Ministry of Internal Affairs, Ministry of Emergency Situations, etc.) and Ministry of Coal Industry	23 069.8	23 163.2	23 163.2	0.00	22 805.2	-1.55
11	Judicial authorities	2 839.3	2 877.0	2 877.0	0.00	2 806.5	-2.45
12	Ministry of Fuel and Energy and Ministry of Coal Industry	9 921.2	7 182.3	7 182.3	0.00	6 278.3	-12.59
13	Ministry of Agrarian Policy	6 008.8	7 242.5	7 144.5	-1.35	5 754.5	-19.46
14	Ministry of Transport and Communications and State Road Service	14 845.2	7 934.9	7 934.9	0.00	9 095.2	14.62
		85.21%	83.17%	83.09%		85.47%	

Source: Information obtained from the secretariat of the Budget Committee of the Ukrainian Parliament.

that included in the register. During the registration and accounting for the budget commitments, an audit is done to check for compliance of the budget fund application with the budget appropriation and the passports of the budget programme (in the event of application of the programme-based method in the budget process). The audited registers of budget commitments are included in the Treasury database. Should the commitments be incurred by the budget holder in violation of legislative requirements, such commitments are not viewed as budgetary commitments and cannot lead to payment from the budget funds. Such commitments are not registered by the Treasury. After eliminating the irregularities, the budget holder re-submits the commitments to the Treasury for registration. The commitments not registered in the Treasury are not subject to payment from the budget funds.

4.2. Cash management

Through the STA, the State Treasury maintains real-time data about the available cash balances. The short-term debt management is the responsibility of a department in the Ministry of Finance, the Department of Public Debt.[50] The State Treasury and the Department of Public Debt communicate on a weekly basis but work from different forecasts, although both use the *rozpys*.

The State Treasury prepares rolling three-month forecasts of cash flows based on the *rozpys*, actual cash-flow data, and historical patterns. These forecasts are circulated to the Ministry of Finance and the National Bank of Ukraine.

A recent "Public Finance Assessment of Ukraine" (SIGMA, 2010) indicates that there have been improvements in debt and cash management, and that the World Bank will continue to support work in this area (see Section 1.3). There is also a project under way with the European Union to explore other countries' experiences as the basis for the development of a regulatory framework for cash management, which is currently lacking in Ukraine (see Box 7).

Box 7. **Models of cash management**

Three basic models of cash management exist in OECD countries, although the majority have adopted a single treasury account.

In the **decentralised** model, all budget holders have their own accounts with commercial banks. These accounts are funded by periodical cash advances supplied by the Treasury on the basis of cash-flow estimates and cash allotment decisions. Budget institutions then make payment orders by drawing on their own accounts.

In the **centralised** model, budget holders are not allowed to have their own accounts with commercial banks. There is only a single account (with sub-accounts), usually kept at the central bank, which belongs to the Treasury. Since the Treasury is not allowed to borrow from the central bank, the Treasury handles short-term borrowing by auctioning securities among the commercial banks. All budget institutions have to send payment orders to the Treasury in order to draw upon their sub-accounts.

In the **hybrid** model, budget holders are allowed to have their own bank accounts with a single commercial bank, but any positive balances on these accounts are daily transferred to the Treasury account with the central bank and all bank accounts are daily supplied with cash advances. The contract with the commercial bank is usually auctioned. Similarly, short-term borrowing is centralised at the Treasury. Budget holders make payments by drawing on their own account with the commercial bank.

Both the centralised and the hybrid model realise efficiency gains through consolidation of balances and centralisation of short-term debt management at the Treasury.

4.3. Budgetary discipline

4.3.1. Overspending and reallocation

Budgetary discipline during budget execution is fairly strict. Pursuant to Article 23 of the Budget Code, no budget obligations or payments can be made without a corresponding budget authorisation in the state budget law (or local budget). If additional resources are needed, the state budget law must be amended. The Cabinet of Ministers, the President or

the Parliament may propose legislation modifying the state budget law. This does happen in practice, with a number of laws adopted each year.

The reallocation regime in Ukraine is also fairly strict. Article 23 of the Budget Code regulates the budget reallocations from one budget holder to another, reallocation between budget programmes within the overall budget of a ministry or other CPA, the increase of development expenditures at the expense of other expenditures, and the reallocation of the state grants among territorial units. Reallocation can be decided by the Cabinet of Ministers of Ukraine with the approval of the parliamentary Budget Committee.

4.3.2. *Carry-overs*

Budgetary control is fairly strict regarding carry-overs. Unused line-item funds cannot be transferred to the next budget year. With the exception of the special fund, the only way to transfer unused funds is by re-appropriation in the upcoming year's budget. For the special fund, any remaining cash balances are kept by the State Treasury to cover the same types of expenses in the next budget period. In the event of no relevant budget allocations for the next budget period, the cash balances of the special fund are transferred to the general fund of the budget (Article 57 of the Budget Code).[51]

4.3.3. *Government Reserve Fund*

The Government Reserve Fund is for extraordinary expenditures, for example responding to natural disasters and for humanitarian aid. The reserve fund should not exceed 1% of the total budget.[52] In 2010, the reserve fund was in the amount of UAH 1.5 billion (USD 190 million). The Cabinet of Ministers decides on the allocation of resources from this fund (Article 24 of the Budget Code). The decision on the allocation of resources from the Government Reserve Fund is taken by the Cabinet of Ministers of Ukraine, the Council of Ministers of the Autonomous Republic of Crimea, the local state administrations, and the executive authorities of the respective councils of local government (Article 24 of the Budget Code). The Cabinet of Ministers (or the Council of Ministers of the Autonomous Republic of Crimea or the executive authorities of local government) report to the Parliament of Ukraine (or the Council of Ministers of the Autonomous Republic of Crimea or the councils of local government) on a monthly basis on the use of the resources (Article 24 of the Budget Code). The reserve fund of the state budget is included in the state budget of Ukraine and accordingly approved by the Parliament of Ukraine.

4.4. *Conclusion*

The organisation of budget execution in Ukraine has improved markedly over recent years and is generally in accordance with practice in OECD countries.

Cash management is still in development. The State Treasury is taking appropriate measures to develop instruments with the aim of improving cash-flow management (supported by a twinning project with the World Bank). It is important that in the co-operation with the World Bank appropriate emphasis is put on the reliability of financial plans.

The Budget Code (Article 23) regulates the procedures for reallocation once the budget is approved by the Parliament. The code stipulates that a government decision on reallocation has to be approved by the parliamentary Budget Committee. On the occasion of the next revision of the Budget Code, the Ukrainian authorities may wish to take into account that many OECD countries allow small reallocations between line items (within

certain thresholds as a percentage of existing appropriations) within a ministry without supplementary budget laws, possibly after notification of the Parliament.

Carry-overs of appropriations can be allowed in Ukraine on an *ad hoc* basis in view of the implementation of the mid-term planning scheme for budget programmes. On the occasion of the next revision of the Budget Code, the Ukrainian authorities may wish to take into account that many OECD countries allow carry-overs within certain margins or with compensation in the next budget year (so that carry-overs cannot accumulate over the years).

5. Public administration and service delivery

5.1. Organisational structure

5.1.1. Central government

In December 2010, the President signed a decree which established a new structure of central government.[53] The number of ministries has been reduced from 21 (including the Prime Minister and one minister without portfolio) to 17 (including the Prime Minister). The Cabinet decides collectively, and all members of the Cabinet have equal voting power. The Prime Minister's vote decides in the case of a draw (Article 52 of the Law on the Cabinet of Ministers).

Prior to the reform, the central government consisted of 20 ministries and 87 other central public authorities (CPAs) and governmental public management bodies. In order to streamline the execution of state policy, the President of Ukraine reorganised the executive branch of government and reduced the number of ministries to 16 and the number of other central public authorities to 58 (74 CPAs in total).

The current 16 line ministries are:

1. Ministry for Economic Development and Trade (the Minister is also the First Deputy Prime Minister).
2. Ministry for Infrastructure (the Minister is also a Deputy Prime Minister).
3. Ministry for Regional Development, Construction and Housing (the Minister is also a Deputy Prime Minister).
4. Ministry for Social Policy (the Minister is also a Deputy Prime Minister).
5. Ministry for Agriculture and Foodstuffs.
6. Ministry for Internal Affairs.
7. Ministry of Culture.
8. Ministry for Emergency Situations.
9. Ministry of Education, Science, Youth and Sports.
10. Ministry of Health.
11. Ministry of Environment and Natural Resources.
12. Ministry of Finance.
13. Ministry of Justice.
14. Ministry of Defence.
15. Ministry of Foreign Affairs.
16. Ministry of Energy and Coal Industry.

There is no clear division of tasks between ministries and other CPAs (state services, agencies, inspections, etc.). Both ministries and other CPAs may perform executive, supervisory and regulatory tasks. One of the key objectives of the administrative reform

was to create a government structure with a clearer division of tasks between ministries on the one hand and various types of other CPAs on the other hand. Another objective was to create more uniformity in the internal structure of CPAs, for instance concerning their financial administration. These objectives have not yet been fully realised.

In some OECD countries, there has been a tendency in the last two decades to move executive agencies out of the core ministries and provide them with a separate financial administration ("arm's-length agencies"). These reforms have contributed to accuracy of information about the costs of policy execution. However, these agencies remain firmly under ministerial responsibility. In the limited number of cases where independence of policy execution is required for appropriate task execution (for example, the electoral committee or the statistical office), the executive agencies still remain under ministerial responsibility as far as operational management is concerned. In addition to government agencies, OECD countries have organised some public agencies in the form of public non-profit institutions with legal personality separate from the state (for instance, cultural institutions and universities). These institutions may receive grants from the state, but their expenditures and revenues are not part of the state budget. In Ukraine, a further clarification of the status and competences of CPAs other than ministries would be useful. Important criteria should include the following:

- Policy development should remain the task of core ministries: no policy development in executive agencies. If policy execution is transferred to an agency, the financial administration of the agency should be completely separated from that of the core ministry (including payment for support services still provided by the core ministry), so that the financial administration of the agency provides accurate insight into the costs of policy execution.
- All agencies should remain under ministerial responsibility except a limited number of agencies for which independence is essential for appropriate task execution; also, for the latter agencies responsibility for operational management should rest with the minister.
- Public non-profit agencies with legal personality should be separated from the state budget.

5.1.2. *Local government*

Ukrainian local government at the level of *oblasts*, *rayons* and cities has representative bodies, the regional councils (*radas*). The councils consist of deputies that are elected by residents on the basis of general, equal and direct suffrage by secret voting for a term of five years. The *oblast* and *rayon* councils and the councils of the cities of Kiev and Sevastopol have no executive bodies. The *rayon* and *oblast* councils delegate executive powers indicated by law to the respective local state administrations. The local government is financed from the local budgets.

The local state administrations serve as executive bodies in *oblasts* and *rayons* and in the cities of Kiev and Sevastopol. The heads of the local state administrations are appointed by the President of Ukraine on the recommendation of the Prime Minister for a term in office equal to that of the President. The heads of the local state administrations are responsible for the organisation and staffing of the local state administrations. The local state administrations are financed from the state budget.

A thorough reform of the structure of local government and the territorial division of the country below the regional (*oblast*) level has been under discussion for more than ten years. Under the auspices of the Ministry for Regional Development, Construction and

Housing, a reform programme has been finalised and adopted by the Cabinet of Ministers. According to this programme, the number of *rayons* will be reduced from the current 488 to around 170; the number of local governments of the first level will be reduced from the current 12 000 to some 1 500. This new structure is expected to meet the requirements of the EU for territorial governance and public administration, as well as the requirements of the EU statistical office EUROSTAT known as *Nomenclature des unités territoriales statistiques* (NUTS). Compliance with the EU requirements and with NUTS is an important precondition to qualify for European structural funds. This reform programme was temporarily put on hold when President Yanukovych took office in the first quarter of 2010.

5.2. *Service delivery*

5.2.1. *Service delivery by central government*

Central government organisations provide collective services in the sectors of defence, public order and safety, environmental protection, penitentiary services, basic research, and transport. For instance, the central government agency in charge of roads (Ukravtodor) maintains about 170 000 kilometres of national roads.

Individual services provided by the central government comprise higher education (universities) and some forms of public health services. For instance, public health facilities which specialise in particular diseases are under the direct command of the Ministry of Health. All other forms of public health services, as well as primary and secondary education, are delivered by local governments. The public health system is fully tax-financed and officially provided free of charge to the population. Old-age and disability pensions and benefits for unemployment, sick leave, work accidents and temporary disability are provided by social security funds which are financed by mandatory payroll contributions.

For the delivery of administrative services such as licenses and permits, the Ukrainian government is currently setting up a web-based database which will help to identify the type of service provided by each central public authority (CPA).[54] Once completed, this inventory shall serve as a basis for the development of an e-government portal which will allow citizens to receive some services on the basis of an online application. Central government services are sometimes provided directly[55] by the CPA in Kiev; however, the majority of services are provided through deconcentrated offices of the CPA at the regional level.

A number of services are provided against payment of a fee. The charging and collection of fees is not always clearly regulated. Fees are not necessarily channelled through the single treasury account. These deficiencies have recently been officially recognised, and the President has instructed the Cabinet of Ministers to develop a draft law to address these issues. The law will prescribe among other things that all non-tax revenue generated by fees for services will be included in the state budget.

5.2.2. *Service delivery by local government*

Local governments provide the majority of services in the sectors of education, public health, housing and public utilities. Table 11 illustrates the distribution of functions between the levels of local government; Table 12 shows expenditures.

In the majority of cases (social protection, education, public health), the service providers are public agencies owned by local government. In some cases (for instance, waste disposal), local governments may contract out service provision to the private sector; in others (for instance, water and wastewater transport and treatment), local governments

Table 11. **Distribution of functions among levels of government in Ukraine**[1]

	Oblasts	Kiev and Sevastopol	Cities in *oblasts* and in the Autonomous Republic of Crimea	*Rayons*	Cities	Villages	Settlements
Education							
Pre-school education		X	X	X	X	X	X
School education	X	X	X	X	X	X	X
Higher education (universities)/ (professional education)	(X)	X					
Primary health care[2]		X	X	X	X	X	X
Secondary health care[2]	X	X	X	X			
Tertiary health care[2]	X	X					
Outpatient, polyclinic and secondary health care		X	X				
Social security	X	X	X	X			
Culture and arts	X	X	X	X	X	X	X
Sports	X		X	X			
Transport	X	X	X	X	X	X	X
Development of housing, utilities and economy	X	X	X	X	X	X	X

1. The distribution of functions is provided in compliance with the Budget Code under circumstances of the year 2011.
2. The terms "primary", "secondary", and "tertiary" health care refer to degrees of complexity of treatment. Primary health care is usually provided by a general practitioner; secondary health care is more specialised treatment usually by a hospital; tertiary health care refers to highly specialised treatment like oncology, etc., by a hospital.

Sources: H. Zimmermann and T. Zhuravel (2009), "Reformuvannya fiskal'noi sistemi v Ukraini yak neobkhidna peredumova reform derzhavnogo upravlinnya" [Reforming the Fiscal System of Ukraine as a Precondition for Administrative Reform], in Cabinet of Ministers of Ukraine: "Administrativna reforma v Ukraini, suchasnyy stan, problemy ta perspektivy" [Administrative Reform in Ukraine, Current State, Problems and Perspectives], Kiev; World Bank (2008), "Ukraine: Improving Intergovernmental Fiscal Relations and Public Health and Education Expenditure Policy: Selected Issues", World Bank, Washington, DC.

may award concessions to the private sector without transferring ownership of the infrastructure.

A large majority of local services is provided through *oblast* and *rayon* administrations on the basis of mandates in state laws (so-called delegated competences). However, there is a considerable problem of unfunded mandates, in that the grants from central governments are not sufficient to provide the services prescribed by law. In particular, local governments have to use a large part of non-earmarked grants and local taxes to fund mandated services, leaving very little room to fund local services not mandated by law.

5.3. *General government employment*

5.3.1. *Size and remuneration*

Employment in general government consists of civil servants and other employees. The status of the first category is regulated by the Law on the Civil Service of 1993, except for certain provisions of the Labour Code which are applicable to all employees including civil servants. The status of other employees is regulated by the Labour Code.

Table 13 provides an overview of employment in general government, including employees on temporary contracts, but this excludes public employment in state-owned enterprises (SOEs). The figure for "public administration" includes the police, the judiciary,

Table 12. **Expenditures of sub-national budgets in Ukraine, by function**

Million UAH, 2006

	Oblasts	Kiev and Sevastopol	*Rayons*	Cities	Villages	Settlements
Education	2 899	8 419	7 863	425	799	400
Health care	5 662	5 271	3 549	19	691	136
Social protection	2 018	3 571	4 440	7	15	7
Public administration	400	1 592	276	141	1 143	200
Economic activity[1]	3 769	3 199	613	184	350	199
Housing	1 662	5 062	256	176	126	121
Culture, media and physical development	1 037	1 026	763	25	271	50
Public order, security, judicial power	1	13	10	1	11	12
Environmental and nuclear safety, emergency services	29	28	37	3	19	3
Subtotal	**17 477**	**28 181**	**17 807**	**981**	**3 425**	**1 128**
Share of total (%)	25.3	40.8	25.8	1.4	5.0	1.6
Share of total (%)		92.0			8.0	

1. Includes construction, agriculture, forestry, fishing and hunting, transport, roads, communication, and other economic activities.

Source: H. Zimmermann and T. Zhuravel (2009), "Reformuvannya fiskal'noi sistemi v Ukraini yak neobkhidna peredumova reform derzhavnogo upravlinnya" [Reforming the Fiscal System of Ukraine as a Precondition for Administrative Reform], in Cabinet of Ministers of Ukraine: "Administrativna reforma v Ukraini, suchasnyy stan, problemy ta perspektivy" [Administrative Reform in Ukraine, Current State, Problems and Perspectives], Kiev.

Table 13. **General government employment in Ukraine**

Thousands of employees

	2000	2005	2007	2008	2009
Public administration	1 198.6	1 028.9	1 036.4	1 067.5	1 078.6
Education	1 609.7	1 668.2	1 693.7	1 702.4	1 698.4
Public health and social security	1 379.6	1 356.6	1 359.0	1 369.9	1 348.1
Public services, culture and sports	0.660	0.817	0.833	0.840	0.784
Total public sector	**4 188.6**	**4 054.5**	**4 089.9**	**4 140.6**	**4 125.9**
Total domestic employment	20 175.0	20 680.0	20 904.7	20 972.3	20 191.5
Public sector in % of total domestic employment	20.76	19.61	19.56	19.74	20.43

Source: OECD estimates based on data obtained from the State Statistics Committee of Ukraine.

and permanent (professional) military personnel. Military personnel serving under conscription are not included. It is acknowledged that data for public employment may not be fully compatible with OECD national accounts data. However, overall figures suggest that the share of public employment in Ukraine is substantially higher than the OECD average (OECD, 2009, p. 67).

When comparing the GDP share of general government compensation of employees, Ukraine does not score particularly high, due to low remuneration levels (OECD, 2009, p. 63). In Ukraine, the share of public sector salaries in per cent of GDP was around 10% in 2007; in 2010, this share was more than 12%. The share of compensation of employees in the central government budget is around 18%. This figure includes civil servants working in the regional administrations (*oblasts* and *rayons*) who belong to the national civil service and are financed by the state budget. The salaries of officials at the regional level who do not have the status of civil servants (and thus are not paid from the state budget), together with the payroll costs of all public employees of first-level local government, are included in the local budgets. The share of compensation of employees in the local budgets is considerably higher, amounting to some 40% (see Table 14).

Table 14. **Public sector pay as a share of central and local government expenditure in Ukraine**

Per cent of total expenditures and of GDP

	2007	2008	2009	2010
Share of public sector pay in central government expenditures	18.7	18.0	18.6	18.1
Share of public sector pay in local government expenditures	38.2	39.1	44.6	49.4
Total public sector pay in % of GDP	10.1	10.3	11.6	12.3

Source: Ministry of Finance annual budget implementation reports, Ukraine.

5.3.2. Civil service

The civil service is regulated by the Law on the Civil Service of 1993. The law was amended as part of the administrative reform of November 2011, with the aim of ensuring necessary conditions for increasing the prestige of the civil service. Among other things, the amendments concerned the definition of the status of civil servant, quality requirements for the services rendered by civil servants, implementation of a transparent mechanism for accession to the civil service, guarantees for the political neutrality of the civil service, implementation of an effective mechanism for prevention of corruption, conditions for transparent administrative procedures, and social and financial protection for civil servants.

The total number of civil servants in Ukraine as of year-end 2009 was almost 300 000. More than one-half of these work in the regional administrations (second-level local government). The number of civil servants has grown by one-third over the period from 2000 to 2009, with the largest share of growth at the regional level.

According to an administrative reform announced by the President in December 2010 (Decree 1085 of 9 December 2010), the number of civil servants working in central government agencies – including their decentralised branches – will be reduced by one-third (Table 15).

Table 15. **Number of Ukrainian civil servants and other employees, 2007-11**

	2007	2008	2009	2010	2011
Total civil servants	276 559	290 765	296 461		
Of which:					
Constitutional authorities[1]	2 620	2 737	12 631	Of 181 051:	Approx. 127 000 will remain.
Ministries, CPAs Kiev[2]	13 076	12 945	13 321		
Ministries, deconcentrated CPAs[3]	145 726	152 045	155 099		
Regional administrations	73 243	75 340	73 438		
Other employees of local government	98 948	100 582	n.a.		

1. Administration of the President, Administration of Parliament, Secretariat of the Cabinet of Ministers.
2. Ministries and other central public authorities based in Kiev.
3. Regional branches of central public authorities.

Source: OECD estimates based on data obtained from the National Agency of Ukraine for the Civil Service.

Entry to the civil service is open to every citizen of Ukraine possessing "appropriate education and professional training" (Article 4 of the Law on the Civil Service). Admission to civil service positions is normally granted following a competitive selection procedure (Article 15 of the Law on the Civil Service); this procedure follows a general regulation approved by the Cabinet of Ministers in 2002. According to this regulation, recruitment is entrusted to the head of each CPA or regional administration who decides to start a competitive selection procedure if there is a vacancy; the CPA or regional administration is obliged to announce a competition in the mass media one month prior to its starting date. Candidates have to pass

an examination in front of a competition commission. The examination includes questions on knowledge of the Constitution, of the Law on the Civil Service and of professional legislation. The competition commission recommends successful candidates to the head of the CPA or regional administration, who takes the ultimate decision.

Article 15 of the Law on the Civil Service states that the President of Ukraine, the chair of the Parliament of Ukraine, members of the Cabinet of Ministers, and the heads of regional administrations have the right to select and appoint their deputies, heads of the press service, consultants and secretaries without the need for these persons to undergo the competitive selection procedure as described above. Once appointed, these people are given the status of a civil servant. This system is called "patronage service" in the law.

Civil servants are classified by categories of positions which depend on the organisational and legal level of the body employing them, the scope and nature of the work to be performed, and the role and place of the positions in the structure of the state body (Articles 25 and 26 of the Law on the Civil Service). Promotion is based on performance and tenure. Every civil servant is required to participate in training courses regularly (at least once every five years). A number of long- and short-term courses are offered by state-run public administration academies (SIGMA, 2006). This education is provided free of charge to civil servants.

Performance appraisal systems are formally in place but need to be developed further. On joining the civil service, an employee is assigned a rank within a category. To obtain the next (more senior) rank within the category, the civil servant needs two years of service and a satisfactory performance appraisal. Each category is divided into a number of seniority ranks. The amount of the rank-related bonus remuneration increases with rank.

Civil servants may be removed from their position only for reasons of severe misconduct (Article 30 of the Law on the Civil Service); dismissals following a change in the Cabinet of Ministers are formally not provided for, except for positions under the "patronage service". In practice, however, changes in the Cabinet regularly result in far-reaching personnel changes in the staffing of CPAs. Staff replacements often reach as far down as the head of department, affecting the third level from the highest civil service level. Civil servants may submit a request for resignation for reasons of health or "principal disagreement" with decisions by superiors (Article 31 of the Law on the Civil Service). After dismissal or resignation from a post, re-entry to the civil service is permitted.

The minister, the first deputy minister and deputy ministers are not civil servants but "political persons". The deputy minister in charge of administrative affairs is formally a civil servant of the second category. However, in the past deputy ministers could be asked to leave office after the appointment of a new minister. Much discussion has evolved around the introduction of the position of "state secretaries" or deputy ministers, who are (better) protected against the "hire and fire" personnel rotation following changes of Cabinet. Thus far, the position of state secretary does not exist in Ukraine. In practice, some deputy ministers remained in their position irrespectively of changes of Cabinet, largely because of their expert knowledge of the subject (this applies, for instance, to the Deputy Minister of Finance in charge of the state budget). As a result of the administrative reform of December 2010, each ministry now has one deputy minister in charge of administrative affairs.

A designated government agency deals with issues related to the management and development of the civil service. This agency, the National Agency of Ukraine for the Civil Service (Natsderzhsluzhba or NAUCS), is not subordinated to any ministry but reports directly to the Cabinet of Ministers. Its tasks comprise the planning and development of

human resources for the public sector, supervision of the "personnel reserve", and integrity and anti-corruption matters (Articles 10 and 11 of the Statute of the NAUCS). The NAUCS is also known as the Main Department for Civil Service and also has an important role in further development of the structure of central government.

The basic salary of a civil servant depends on category and rank. Apart from that, civil servants may be paid additionally for high records of performance, for extremely significant work and for knowledge of foreign languages and their application in their work, and may be provided with additional allowances for a scientific degree and an honourable title. The bonuses are added to the basic salary. The share of pay for tenure (number of years served) ranges between 10% (at least three years) and 40% (at least 25 years) of the sum of the basic salary and the rank-related bonus (Article 33 of the Law on the Civil Service).

Within the limits of the approved payroll, the heads of CPAs and local state administrations are entitled to pay bonuses to employees on the basis of their contribution to the overall performance results, within the limits of the bonus fund. The bonus fund amounts to at least 10% of the payroll fund for basic salaries and may be augmented by savings on the payroll fund. The criteria, procedures and size of the bonus payments are defined in the regulations of the administrations concerned.

The payroll fund allocated to a government organisation is calculated on the basis of the number of staff to be normally employed by the organisation. This normative staff number is endorsed by the Cabinet of Ministers and revised only infrequently. The factual staff numbers are usually below the normative number; the difference can be used to add to the bonus fund.

The ratio of basic pay to bonus pay used to be unbalanced, with up to 80% of the budget of a CPA or local state administration available for bonuses (SIGMA, 2006). This practice was considerably affected during the economic crisis when the bonus budgets were significantly cut. Since 2008-09, the ratio of bonus pay to basic pay tends to be closer to 50%, varying quite significantly across CPAs. The need to bring the pay structure for the civil service into closer alignment with international standards is recognised by the Ukrainian government, and the objective is to increase the role of the basic salary in the salary composition and to improve the system of additional payments and allowances.

Until 2007, salaries in the civil service compared relatively well to the average salaries in other sectors. Depending on the region, civil servants' salaries were between 10 and 70% higher than average wages (Morgner and Wesemann, 2009). In the regions with a less developed economy, especially in rural western Ukraine, employment in the civil service was financially more attractive compared to the private sector than it was in the industrialised regions of eastern Ukraine. In the capital, Kiev, the large number of high-level jobs in the civil service resulted in a financially highly attractive public employment. The situation changed when the generous bonus payments were cut back in reaction to the economic crisis. In addition to stricter limitations for bonus payments, the Ukrainian government refrained since 2008 from pay rises for the civil service (except for pay rises to compensate for inflation) as part of the successive financial assistance packages negotiated with the IMF (see Section 1.3).

5.4. *Public procurement*

Public procurement in Ukraine constituted 11.5% of GDP in 2009 (see Table 16). In 2010, the share was estimated to have risen to 17% of GDP (prognosis by the Economist

Table 16. **Public procurement in Ukraine as a share of GDP, 2008-10**

	2008	2009	2010[1]
GDP (billion UAH)	948.1	914.7	1 008.3
Total procurement (billion UAH)	167.3	105.3	172.1
Total procurement as a share of GDP (%)	17.7	11.5	17.1

1. Prognosis.
Source: Data obtained from the State Statistics Committee of Ukraine.

Intelligence Unit, 2011). These figures are comparable with the lower end of the range found in 19 OECD countries (OECD, 2009, p. 111).

Since July 2010, the legal framework for public procurement in Ukraine has been provided by the Law on Public Procurement. The law was developed in close co-operation with EU and World Bank experts and is regarded to be broadly in compliance with WTO and EU requirements. The current law applies to procurement worth more than UAH 100 000 (around EUR 10 000) for goods and services and UAH 300 000 (around EUR 30 000) for works. Irrespective of the value, procurement in a number of sectors of the economy is not subject to the provisions of the law. Such exemptions apply to cases where state secrets or sovereign rights (like printing bank notes) are affected. Another exemption applies to procurement related to the preparations for the 2012 UEFA European Football Championship, which is less convincingly explained by deadlines for completing the preparations for the event. Since the adoption of the law, a number of ministries have attempted to seek other exemptions for some parts of procurement in their area of responsibility. Such attempts received critical comments by the EU and World Bank experts, as they would undermine the objective of the procurement law to provide for unified and transparent regulation in this sector.

The procurement law provides for equal treatment of domestic and foreign bidders. In contrast to previous regulations, the law now clearly establishes complaint procedures. It provides for a centralised publication of procurement notes and results. Among the shortcomings noticed by the expert community are the excessive requirements for information to be submitted for publication of procurement notices, the lack of provisions for the use of e-procurement, and too ample opportunities for rejecting bidders or cancelling tender procedures.

According to the law, the Ministry of Economic Development and Trade acts as the government authority responsible for appropriate procurement procedures. In case of complaints, the Antimonopoly Committee is the responsible authority. The Ministry of Economic Development and Trade implements the provisions of the law. It provides for uniform procedural standards to be applied in the procurement department of every CPA; it maintains a centralised source of public information for all planned procurements and publishes the results of the procurements.

The procurement procedure as such is carried out by each CPA or local government which thereby becomes the "procuring entity". Each procuring entity establishes a competitive procurement committee and draws up a procurement plan. Each committee consists of at least five members. If an authorised personnel complement of the procurement subject is less than five persons, the number of the procurement committee members shall equal the authorised personnel complement of the procurement subject.

Information about planned procurements is published in printed form and on an Internet portal called "Public Procurement", managed by the Ministry of Economic Development and Trade. The Internet portal also provides information on the results of the single-source procurement. The procuring entities may additionally publish information on procurement plans and results on their own websites. Potential bidders can thus receive information about procurement plans from both the ministry and the procurement entity.

The Law on Public Procurement provides for the following forms of public procurement (see Table 17):

- open bidding;
- restricted bidding;
- two-stage bidding;
- request for price quotations;
- single-source procurement.

Table 17. **Public procurement in Ukraine by type of procedure applied, 2008-10**

	2008			2009			2010		
	Number of tender procedures	Share of number of tenders (%)	Share of funds disbursed (%)	Number of tender procedures	Share of number of tenders (%)	Share of funds disbursed (%)	Number of tender procedures	Share of number of tenders (%)	Share of funds disbursed (%)
Open bidding	73 677	72.7	43.6	62 648	75.2	67.3	75 310	78.9	56.2
Reduction[1]	3 598	3.6	3.0	18	0.02	0.6	1 157	1.2	0.4
Restricted bidding	1 289	1.3	1.1	565	0.7	0.9	388	0.4	0.9
Two-stage bidding	321	0.3	3.1	523	0.6	0.6	367	0.4	0.4
Request for price quotations	13 561	13.4	1.2	17 168	20.6	2.1	15 345	16.1	1.4
Single-source procurement	8 906	8.8	48.0	2 391	2.9	28.5	2 794	2.9	40.7
Total	**101 352**	**100**	**100**	**83 313**	**100**	**100**	**95 361**	**100**	**100**

1. This procedure is no longer applicable since the adoption of the procurement law.
Source: Data obtained from the State Statistics Committee of Ukraine.

The law further defines criteria for selecting the appropriate procedure. Open bidding is the main procurement procedure. A two-stage bidding procedure may be applied if the procuring entity is unable to determine in advance the required specifications of goods or works and if it is necessary to hold preliminary negotiations with participants in order to make an optimal procurement decision. Price quotations may be requested in cases of procurement of goods and services for which a permanently active market exists, provided the procurement value does not exceed UAH 200 000. The single-source procurement procedure is a procedure according to which a procuring entity enters into agreement with a single bidder following negotiations with one or several bidders and acceptance of the successful bidder's proposal. The responsibility for selecting the appropriate procedure rests with the procurement committee created within the procuring entity.

The number of public procurement tenders carried out annually usually exceeds 100 000 tenders per year (but in 2009 when the Ukrainian economy was hit hard by the economic crisis, the number was lower). The majority of tenders apply the open bidding procedure. Public enterprises are responsible for the largest part of public procurement as shown in Table 18.

Table 18. **Public procurement in Ukraine by client, 2008-10**

Million UAH and share of total procurement

Origin of funding	2008		2009		2010	
	Million UAH	Share of total (%)	Million UAH	Share of total (%)	Million UAH	Share of total (%)
State budget of Ukraine	28 149	16.8	23 993	22.8	23 058	13.4
Budget of the Autonomous Republic of Crimea	2 386	1.4	204	0.2	364	0.2
Local budgets	22 558	13.5	13 635	13.0	13 394	7.8
Funds of public enterprises	18 719	11.2	31 359	29.8	58 952	34.3
Funds of joint stock companies with public ownership greater than 50%	90 918	54.4	35 206	33.5	73 757	42.9
Other (including social security funds, the National Bank of Ukraine)	4 565	2.7	868	0.8	2 595	1.5
Total	**167 295**	**100**	**105 265**	**100**	**172 120**	**100**

Source: Data obtained from the State Statistics Committee of Ukraine.

5.5. *Public enterprise sector*

The public enterprise sector can be divided into two main parts: public enterprises which are owned and controlled by the state or by local government on the one hand; and joint stock companies in which the state or local government owns a part of the shares, on the other hand. According to the statistics maintained by the State Property Fund of Ukraine, there are 4 148 public enterprises owned and controlled by the state (state-owned enterprises, SOEs). They are active in many sectors of the economy (see Table 19).

Table 19. **State-owned enterprises in Ukraine by sector of economic activity**

Sector	Number
Electricity generation	30
Metallurgy	18
Chemistry	60
Engineering and metal processing	273
Timber processing and paper production	124
Construction materials	49
Light industry	38
Food production and processing	196
Transport	238
Construction	219
Agriculture	780
Other (for instance, real estate)	2 100
Not specified	23
Total	**4 148**

Source: Data obtained from the State Property Fund of Ukraine.

Apart from the above-mentioned SOEs, the state holds shares in a further 664 joint stock companies. In 290 of the latter, the public share exceeds 50%. Ownership rights are executed by the State Property Fund and other bodies of government.

The state portfolio of public enterprises (including joint stock companies with more than 50% state shares) has reported losses over the past years (see Table 20).

Table 20. **Aggregated financial results of SOEs and of joint stock companies with state shareholding greater than 50%**

Million UAH

	Public enterprises	Joint stock companies with state shareholdings greater than 50%
2006	-784.8	-40.1
2007	-734.6	-553.1
2008	-836.0	-692.2
2009	-1 764.7	-1 250.5

Source: Estimates of the Ukrainian Ministry for Economic Development and Trade.

Among the SOEs are natural monopolies like Ukrenergo (power generation and distribution), Naftogaz of Ukraine and Ukrtransgaz (natural gas transport), and Ukrposhta (postal services). Their profitability can usually be secured by regulated prices for their services. However, in the past two crisis-affected years, this was not always possible, as shown by the example of Naftogaz which was subsidised with UAH 24.4 billion in 2009. About one-quarter of the SOEs (1 789 SOEs, or 26.3% of all SOEs) operate in the real estate sector, mostly leasing premises in public buildings under market conditions or acting as intermediaries for the provision of public services.

In accordance with the Commercial Code of Ukraine, SOEs have to draft annual financial plans. In the case of the natural monopolies, or if the financial plans show planned profits exceeding UAH 50 million, these financial plans have to be approved by the Cabinet of Ministers. In all other cases, the plans are subject to approval by the relevant ministry. The financial plans set a figure for the expected payments to the state budget.

In cases where SOEs incur losses, the government takes an ambiguous position. As of April 2010, some 440 SOEs were believed to be bankrupt. However, bankruptcy laws do not apply to SOEs and joint stock companies with more than 25% of public shares. Officially, a "no bailout" policy applies, but Naftogaz alone in 2009 received financial support of UAH 24.4 billion (which equalled 2.7% of GDP in that year). Moreover, entire sectors of the economy benefit from quasi-permanent subsidies. Coal mining, where officially no privatisation has yet taken place, receives funds each year from the state budget for investment in equipment and infrastructure. Subsidised or regulated tariffs (at below-market rates) for electricity or natural gas are beneficial for both public and private enterprises in the chemical and metallurgic industries. In more fragmented sectors like agriculture, regulated tariffs more frequently create market imbalances when applied preferentially to public agricultural businesses.

The joint stock companies were expected to contribute UAH 297.8 million from dividends to the 2009 state budget (up from UAH 263.8 million in 2007 and 273.8 million in 2008). This target for 2009 was actually overshot, and a total of UAH 435 million was transferred to the budget. Apart from the revenue from dividends, the state budget receives income from taxes paid by the joint stock companies (UAH 855 million in 2008, UAH 470 million in 2009, according to the annual reports of the State Property Fund).

In Ukraine, there are still a number of enterprises which are regarded as attractive assets for privatisation. The question whether to start the privatisation process for several of these assets has been debated for quite some years and is influenced by political considerations about the "strategic importance" of such enterprises, by lobbying of

domestic business groups and by the state of the economy, which has caused some planned privatisations to be postponed in view of market conditions. Under the current government, privatisation activity has increased again (see Section 1.5.3).

5.6. Conclusion

The government of Ukraine has embarked on an ambitious programme to modernise its public administration and arrangements for service delivery. In 2010, new legislative frameworks for administrative reform and for public procurement were adopted. New legislation regulating the civil service, the delivery of public services and the organisational structure of local government has been prepared but has thus far not been implemented. After years of slow progress in these areas, it is important that these reforms are pursued energetically.

The reduction of the number of ministries from 21 to 16 brings the structure of the government of Ukraine closer in line with that of comparable OECD countries such as the Czech Republic, France, Poland, the Slovak Republic and Spain, which all have between 15 and 17 ministries (OECD, 2009, p. 37).

Recently, progress has been made with the clarification of the status and competences of CPAs other than ministries. A "Scheme of the CPAs Organisation and Interaction" was approved by a decree of the President of Ukraine in December 2010 (Decree 1085 of 9 December 2010). The organisation, competences and activities of ministries and other CPAs (state services, agencies and inspections) are governed by the Law on the CPAs (Law 3166-VI of 17 March 2011).

Local governments have an extensive mandate to provide public services. However, local governments often lack sufficient resources to fund their mandates. The government should review these mandates in the light of available resources and make sure that all mandates can be funded by earmarked and non-earmarked grants.

Local government finances are administered by the central tax service (revenue) and the State Treasury (expenditure), thus providing for effective enforcement of the existing rules of financial administration.

The share of public employment in Ukraine is larger than in most OECD countries. The share of total public employment has remained at around 20% of total domestic employment over the last ten years. The number of civil servants as a part of public employment grew by almost 50% between 2000 and 2009. Currently the government has embarked upon a 30% reduction of the number of civil servants.

In spite of recent adjustments, public sector pay still consists for a large part of bonuses and other allowances not included in basic salaries. In OECD countries, bonuses and other incentive payments – if they exist at all – generally comprise a small share of the basic salary. The Ukrainian authorities may wish to consider reducing the bonus part of the salary with a simultaneous increase of the basic salary.

In per cent of GDP, the public procurement sector is comparable with the OECD average. Unified legislation has been adopted in Ukraine to regulate the sector following a period of insufficient oversight. Given the vulnerability of public procurement for corruption, the enforcement of the current legislation should be pursued.

Ukraine has a very large public enterprise sector that is characteristic for a number of eastern European countries. The sector is fragmented and there is no consistency in the

status of companies. Subsidies and tariff regulations can lead to market distortions. It is important that the government pursue its policies aimed at the reduction or abolition of both subsidies and price or tariff regulations.

Since late 2010, the government has increased privatisation after a period of limited activity, but privatisation policies are not always transparent. It is important that privatisation be resumed with vigour now that the market circumstances are improving again. Transparency of the procedures should be a primary concern in this effort.

6. Accounting and auditing

6.1. Accounting

The accounting methodology is regulated by the Ukrainian Ministry of Finance which co-ordinates the activities of the State Treasury.

The accounts of the state budget and the local budgets of Ukraine are kept at the State Treasury. The accounts reflect all expenditures and revenues of the state and local budgets as well as the assets and liabilities of the state and the local governments.

The State Treasury has a single treasury account at the National Bank of Ukraine for executing financial transactions and for an effective management of the resources of the state and local budgets through the electronic payment system of the National Bank. To carry out transactions in foreign currency related to the execution of the state budget, the State Treasury keeps current accounts in foreign currency opened on its behalf in the National Bank of Ukraine and in the State Export and Import Bank of Ukraine.

State debt, liabilities of budget holders, and revenue and expenditure transactions are accounted for at the moment the payments are made (cash basis), while the transactions related to budget funding are accounted for at the moment the funds are credited to an account. Certain agencies and funds apply the accrual method in their accounts, according to which the transactions and events are recognised at the moment they arise irrespective of the date of payments.

In the period 2007-15, a thorough reform of government accounting methods is being pursued. Pursuant to the strategy of the accounting system modernisation in the state sector for the years 2007 to 2015 (approved by Decree 34 of the Cabinet of Ministers of 16 January 2007), the national accounting standards are to be applied in the state sector starting from 2013. The strategic goal of this reform is the strengthening of the public sector accounting system with consideration of the requirements of international standards. The State Treasury and the Accounting Chamber have agreed a common format for the financial reports on budget execution. Starting from 2013, the ministries and other CPAs are expected to compile the financial reports according to the national accounting standards.

The chief accountant of the ministry or other CPA assures that the financial statements and budgetary reports are compiled and submitted in compliance with the set requirements. The forms of financial reporting and the order in which they are filled in are set by the Ministry of Finance. The State Treasury is responsible for the composition, consolidation and presentation of the reports on budget execution.

There are monthly, quarterly and annual financial reports. A monthly report is presented to the Parliament, the Cabinet of Ministers, the Accounting Chamber and the Ministry of Finance no later than 15 days after the end of the reporting month. Summary indicators of state budget execution, information about the use of particular budget

articles and information on the use of the reserve fund are presented no later than 25 days after the end of the reporting month. A report on the development of public debt is presented no later than the first day of the second month after the end of the reporting month. A quarterly report is presented no later than 15 days after the end of the reporting quarter; it contains sections such as summary indicators of monetary developments, the development of state debt, summary indicators of state budget execution, and state guarantees. An annual report on the execution of the state budget is presented no later than the first of May of the year following the reporting year; it contains similar sections as the quarterly reports and, in addition, summary indicators on the execution of local budgets and explanatory information requested by the Cabinet of Ministers. The Ministry of Finance takes care of the publication of all financial reports.

The annual financial report is reviewed in Parliament. The Minister of Finance presents the report and makes a speech. The chair of the Accounting Chamber and the chair of the Budget Committee present their own reports. The review is completed by a parliamentary resolution acknowledging the government report. Parliament does not approve the report.

6.2. Internal audit

The establishment of internal audit units in accordance with international best practice is a relatively new development in Ukraine. This initiative is governed by the concept of public internal financial control for the period until 2017 (hereinafter referred to as the Concept)[56] and the action plan on its implementation (hereinafter referred to as the Action Plan).

According to the Concept and the Action Plan, in the first stage (2008 to 2011) the legal framework for public internal financial control (PIFC) was adjusted to the EU requirements. In addition, measures were taken concerning the training of personnel and information supply.

Starting from 2012, the next stage of implementation of the Concept and the Action Plan is being launched, namely the establishment of internal audit units in the ministries and other CPAs.

The budgetary legislation of Ukraine (Constitution, Budget Code, decrees of the Cabinet of Ministers) clearly identifies the obligations of the budget holders including those for internal financial control and internal audit (see in particular Articles 26 and 111 of the Budget Code). Ukraine is developing internal financial control and internal audit in accordance with European standards.[57]

In addition, a government decree regarding internal audit subdivisions and the conduct of internal audit in the ministries and other CPAs, as well as internal audit standards and a Code of Ethics for Internal Auditors, were adopted in September 2011.

Traditionally, some of the functions of internal control were fulfilled in Ukraine by the Main Control and Revision Organisation (MCRO) and by decentralised subdivisions inspecting the ministries and other CPAs.

At the end of 2010, the actual number of employees in the MCRO was 7 818, while there were 1 446 employees in the decentralised subdivisions inspecting the ministries and other CPAs. The administrative reform of December 2010 (see Section 5.3.2) will lead to a 20% reduction of the number of employees of the MCRO (which was recently renamed "Financial Inspection") and its local bodies.

The internal audit units in the ministries and other CPAs that are being established starting from 1 January 2012 will be based on the currently acting decentralised inspecting subdivisions for ministries and other CPAs of the MCRO and will perform the function of internal audit in the Ukrainian system of public internal financial control (PIFC).

As long as the internal audit units in the ministries and other CPAs as part of the PIFC arrangement are not yet developed to the extent necessary to assure an adequate level of internal control, the Ukrainian authorities consider it necessary to maintain external fiscal inspection by the MCRO on behalf of the government.

Pursuant to the Concept, the MCRO is defined as the body in charge of implementation of reforms in the PIFC system in Ukraine, and the Ministry of Finance is defined as the co-ordinator of reforms in the area of public finance.

Since 2007, a separate structural subdivision of the MCRO fulfils the tasks of co-ordination, methodology development and supervision of the acting decentralised inspecting subdivisions at the ministries and other CPAs. This subdivision, the Administration for PIFC Harmonisation (with a staff of 11 persons) currently performs the function of the central harmonisation unit in the European sense.

In OECD countries, internal financial control is entirely left to budget holders (the Anglo-Saxon/Nordic model), or to budget holders and relatively small units of controllers reporting to the finance minister but often located in the line ministries and agencies (the southern European model). However, this refers to preventive control, not to *ex post* assessment which, in OECD countries, is the exclusive domain of internal and external audit institutions.

In the view of the OECD Secretariat, Ukraine is progressing steadily towards a comprehensive arrangement of internal control and audit. In due course, this arrangement will encompass three elements:

- Preventive internal control by budget holders through effective administrative procedures.
- Preventive control by the State Treasury on commitments and payment (see Section 4.1).
- *Ex post* control by internal audit units in the ministries and other CPAs, building on the current decentralised internal control subdivisions for the ministries and other CPAs.

If this arrangement is fully developed in a few years' time, there will no longer be a need for decentralised subdivisions inspecting the ministries and other CPAs or for *ex ante* inspectors as exist in southern European countries. This implies that the role of the MCRO should be reconsidered in the medium term, making sure that the best possible use is made of its valuable expertise – either in the new internal audit units or in the financial directorates of the ministries, or elsewhere – in a way that further contributes to the quality of financial management in Ukraine.

In OECD countries, internal audit units (as opposed to the central steering and co-ordination unit) are placed within the ministries and agencies and report to ministers and agency heads. This is an important requirement for the effective execution of their primary tasks, which are to identify financial risk and to give advice to budget holders on risk reduction. A relation of confidence with budget holders is an essential prerequisite for the fulfilment of these tasks. In this respect, the current intentions of the government of Ukraine are fully consistent with OECD country practice.

6.3. External audit

6.3.1. Legal basis and budget

In 1996, the Accounting Chamber of Ukraine (ACU) received constitutional status. The organisation and activities of the ACU are regulated by the Constitution, the Law on the Accounting Chamber of Ukraine, the Budget Code, and other legislative acts (secondary legislation).

According to the Law on the ACU, the Chamber is subordinated and accountable to the Parliament. The ACU operates independently of any other state authority.

The appropriation for the ACU in the 2009 state budget amounted to UAH 54 million (about EUR 5 million) which is relatively little *vis-à-vis* comparable OECD countries.

During budget preparation, the ACU has to submit its budget request to the Ministry of Finance. This is felt by the ACU as a violation of its independence, as the Chamber has to control the Ministry of Finance. However, the submission of budget requests to a ministry (not always the finance ministry) is common practice in OECD countries, as usually some ministry has to take care of the budget law for the high colleges of state. It is important, though, that the supreme audit institution can bring its views on its own budget to the attention of Parliament.

6.3.2. Competences and tasks

The ACU is the supreme audit institution of Ukraine. It audits the expenditures of the state budget and reports its findings in public reports. It also provides public advice on the budget law submitted by the government to Parliament and issues reports on budget execution (Article 243 of the Law on the ACU). In addition, the ACU audits the preservation and use of state property. The ACU also audits classified (secret) expenditures concerning national security and defence.

A constitutional amendment of December 2004 stipulated that the remit of the ACU would be extended to include the audit of state revenues. Before that amendment, the ACU had no right to control the revenue side of the budget. However, recently the Constitutional Court declared the 2004 constitutional amendments invalid. As a consequence, the ACU has lost the right to audit state revenues. On the other hand, the ACU has expert knowledge on revenues and can issue analytical reports on the revenue side of the budget. In addition, the ACU can issue opinions on the completeness and timely collection of revenues as part of its reports on budget execution. In this context, the ACU can also identify deviations from the approved revenue estimates in the budget, observe and analyse violations, and make proposals regarding their rectification (Article 22 of the Law on the ACU).

The ACU has no right to audit the expenditures of local budgets. It can, however, audit the state grants to local governments which make up more than 90% of the revenues of local budgets.

The ACU produces both financial audits and performance audits. Financial audits assess the accuracy and reliability of the financial reports and the compliance with prevailing legislation. Performance audits assess the effectiveness and efficiency of expenditures. All audit reports contain recommendations for correcting errors and deficiencies as well as for measures to increase effectiveness and efficiency of the use of public resources.

The audit reports are sent by the Accounting Chamber to the Parliament and to the heads of the relevant ministries, other CPAs, enterprises and other institutions subject to audit. The

detected violations of law and inflicted damage to the state are communicated by the Accounting Chamber to the Parliament. In the event of violations entailing administrative or criminal responsibility, the board of the ACU can decide to pass the materials concerned to the law enforcement agencies (Article 26 of the Law on the ACU). The board of the Accounting Chamber can decide, if necessary, to send advice to the President of Ukraine, the Cabinet of Ministers, the Ministry of Finance and other CPAs about the audit findings.

The ACU issues quarterly reports on budget execution. In addition, the ACU reviews jointly with the Budget Committee of Parliament the annual report on budget execution that is submitted to Parliament by the Cabinet of Ministers by 1 May following each budget year. To prepare the review, the ACU issues a report on the disbursement of public funds within 15 days after submission of the report to Parliament. The ACU has no formal right to approve the annual report on budget execution. Parliament and government can just "draw lessons" from the opinion of the ACU on how to improve budget execution in the future.

One-third of the membership of the Parliament can order the ACU to perform an audit on a specific subject.

The ACU is of the opinion that performance auditing should be an exclusive task of the internal audit units and the ACU. In its view, the Financial Inspection should not perform performance audits. The ACU is also of the opinion that the Financial Inspection should be placed in the Ministry of Finance if it is to be reshaped as a steering and co-ordination unit for internal audit.

6.3.3. Organisation and working methods

The board of the ACU consists of the chair, two deputy chairs, the secretary, and nine chief controllers. The members of the board are appointed by Parliament by means of a secret ballot for a term of seven years.

The ACU has ten departments, each headed by a chief controller. The ACU includes regional offices covering the whole country and directs some of its tasks to the regional offices. The regional offices conduct their own audits under the direction of the central management of the ACU (taking into consideration the annual audit working plan).

As of December 2009, the total staff of the ACU amounted to 479 employees. The central office had 362 employees and the regional offices had 117 employees.

The ACU is a member of the EUROSAI Governing Board. Currently, the project for "Implementation of Twinning Fiche Terms of Reference" is being developed in co-operation with the Swedish National Audit Office. Furthermore, the Accounting Chamber of Ukraine has been selected as the external auditor for the Organisation for Security and Co-operation in Europe (OSCE).

The college of the Accounting Chamber formulates the work plan of the chamber on the basis of proposals from the department directors. The college takes into account the suggestions of the Parliament and its committees. The college ensures that the work plan includes the obligatory consideration of addresses and proposals from the President of Ukraine and from the Cabinet of Ministers.

6.3.4. Results

In 2009, the ACU issued 130 reports, of which 20 concerned state priority programmes (see Section 2.1.3). In addition, 610 letters and notifications were sent to public authorities

with requests to react to detected violations and deficiencies and to take action to recover public funds.

In 2009, 25 reports were forwarded to the General Prosecutor's Office (14 by decision of the ACU board, 11 on the request of the General Prosecutor). The ACU never lost a single case in court when a prosecution took place.

By 1 December every year, the ACU submits an annual report to Parliament on its activities and the costs of these activities. The report also contains summary information on the audit reports and the frequency of detected infringements. In addition, information bulletins are published regularly and made available on the website of the ACU. Communication about results is also promoted by press conferences and briefings, interviews, public speeches and articles in electronic and printed mass media.

6.3.5. *Follow-up of the reports*

Ministries and other CPAs are supposed to react to the findings and recommendations of the ACU but their reactions are not always complete and adequate.

The Cabinet of Ministers reviews the completed audit reports and informs the ACU of the actions taken. The ACU maintains a database on recommendations and actions taken.

Regularly, but at least twice a year, committees of the Parliament scrutinise ACU reports and notifications. This may lead to proposals for the amendment of the budget law or substantive laws.

The parliamentary resolution on the review of the annual report on budget execution (see Section 6.2) generally includes a range of proposals to eliminate ineffective or inefficient policies, to be taken into account during the preparation of the upcoming budget.

6.3.6. *Revision of the Law on the Accounting Chamber*

The ACU has drafted a revision of the Law on the Accounting Chamber. This draft clarifies the role and competencies of the ACU in many respects. The draft was prepared with the help of foreign experts. The draft pre-supposes the adjustment of Article 98 of the Constitution (reinstatement of the amendment of December 2004 allowing the audit of state revenues; see Section 6.3.2).

6.4. Conclusion

In recent years, a thorough reform of the accounting methods in the government has been pursued. The strategic goals of this reform are the strengthening of the accounting methodology and the creation of a single methodological basis of accounting and reporting in accordance with international standards. Important progress has been made, but the reforms have not yet been completed and should be pursued.

The budgetary legislation of Ukraine (Constitution, Budget Code, decrees of the Cabinet of Ministers) clearly identifies the obligations of the budget holders including those for internal financial control and internal audit (see in particular Articles 26 and 111 of the Budget Code). Ukraine is developing internal financial control and internal audit in accordance with European standards. For that purpose, it will adopt legislative acts (secondary legislation, including a decree by the Cabinet of Ministers) required for the establishment of internal audit units in the ministries and other CPAs.

Ukraine is progressing steadily towards a comprehensive arrangement of internal control and audit. If this arrangement is fully developed in a few years' time, there will no

longer be a need for decentralised subdivisions inspecting the ministries and other CPAs or for *ex ante* inspectors as exist in southern European countries. This implies that the role of the MCRO should be reconsidered in the medium term, making sure that the best possible use is made of its valuable expertise.

In OECD countries, internal audit units (as opposed to the central steering and co-ordination unit) are usually placed within the ministries and agencies and report to ministers and agency heads. This is an important requirement for the effective execution of their primary tasks, which are to identify financial risk and to give advice to budget holders on risk reduction. A relation of confidence with budget holders is an essential prerequisite for the fulfilment of these tasks. In this light, it is recommended to the authorities of Ukraine that audit units are not centralised but rather placed inside ministries and other CPAs.

The Accounting Chamber of Ukraine has developed into an effective and well-organised supreme audit institution. Its production of audit reports (both financial and performance audits) is impressive, and its contribution to the quality of financial reporting and the effectiveness and efficiency of the use of public funds is generally acknowledged.

In some OECD countries, the supreme audit institution can audit state revenue and the budgets of local governments. The Ukrainian authorities may wish to consider a similar extension of the remit of their supreme audit institution.

Notes

1. *Sources:* Economist Intelligence Unit (2010b) and State Statistics Committee of Ukraine (2001) (*http://en.wikipedia.org/wiki/Demographics_of_Ukraine*).
2. *Sources:* Economist Intelligence Unit (2008, 2010a, 2010b, 2011), World Bank (2010), IMF (2008, 2010, 2011).
3. *Sources:* Economist Intelligence Unit (2008, 2011).
4. This section is largely based on Economist Intelligence Unit (2008, 2011).
5. *Sources:* IMF (2008, 2010, 2011).
6. Twinning is a technical assistance tool which implies that state institutions of European Union countries deliver technical assistance to Ukrainian public institutions in order to share best practices and to help adopt and implement reforms and legislation consistent with EU policy.
7. TAIEX (Technical Assistance and Information Exchange) is an instrument of the European Commission's Directorate-General for Enlargement. TAIEX helps countries with regard to the adoption, application and enforcement of EU legislation.
8. SIGMA, a joint initiative of the EU and the OECD, supports Ukraine in its efforts to improve governance and management by: assessing reform progress and identifying priorities for reform against baselines set by good European practice and existing EU legislation; supporting institution building, and setting up legal frameworks and procedures to meet European standards and good practice; and facilitating assistance from the EU and other donors by helping to design the preconditions for projects and to implement action plans.
9. The DCFTA is designed to deepen Ukraine's access to the European market and to encourage further European investment in Ukraine.
10. *Sources:* Economist Intelligence Unit (2008, 2010a, 2010b, 2011), IMF (2008, 2010, 2011).
11. *Sources:* Economist Intelligence Unit (2010a), SIGMA (2010).
12. Mr. Yanukovych succeeded Mr. Yushchenko in February 2010; see Section 1.2.5.
13. *Source:* Economist Intelligence Unit (2008).
14. *Sources:* Economist Intelligence Unit (2010a, 2011); IMF (2011).

15. *Source:* IMF (2011).

16. That is the reason why the Parliament amends articles together with the lines in the budget tables.

17. A budget programme is a systematised list of activities aimed at achieving a general goal and tasks, implementation of which is proposed and fulfilled by a spending unit in accordance with its responsibilities (Article 2 of the Budget Code).

18. The number of budget programmes has been increasing since 2002 and reached a thousand by 2007. Starting from 2007, the government made efforts to decrease the number, and in the 2008 budget there were 923 programmes, in the 2009 budget 991 and in the 2010 budget 919. These numbers do not take into account appropriations for interest and grants to local governments that are appropriated in other annexes of the state budget.

19. See the "Strategy for optimisation of the budget programmes' number" adopted by Government Resolution No. 292-p dated 6 April 2011.

20. Prior to the 2010 amendments to the Budget Code, the budget declaration had been adopted too late in the budget formulation schedule, so it could not be taken into account during budget preparation. From 2010, the declaration has to be approved early enough to provide guidelines on policy priorities.

21. Strategic plans include the "Development Strategy for Ukraine" for ten years, the "State Strategy for Regional Development" and state strategies for specific regions.

22. The Macroeconomic Forecasting Department has recently been integrated into the Budget Department of the Ministry of Finance.

23. In practice, it is a one-page document listing key parameters.

24. Established in London in 1989, Consensus Economics prepares monthly compilations of country economic forecasts and topical analyses (see *www.consensuseconomics.com/about.htm*).

25. The Revenue Department has recently become a unit of the Department for Taxation and Customs Policy, Revenue Administration and Accounting Principles.

26. The forecasts for two out-years are the current requirement of the new Budget Code; the 2001 Budget Code required three out-years.

27. It is interesting to mention that, within the Ministry of Finance, the Revenue Department receives macroeconomic forecasts from the Macroeconomic Forecasting Department. The Revenue Department may comment or make suggestions on these macroeconomic forecasts, if needed, and accept the forecasts to be used in calculations. If the Revenue Department disagrees with the macroeconomic estimations, it has to address the Macroeconomic Forecasting Department, which in its turn addresses the Ministry of Economic Development and Trade with a reasoned request to reconsider and change the macroeconomic forecasts. This fact supports the argument that the Ministry of Economic Development and Trade is essentially the only producer of macroeconomic estimations in Ukraine.

28. In the 2010 budget formulation, the old rule was applied. Therefore the forecast covered three out-years and not two.

29. According to Article 2 of the Budget Code, a budget request is a document developed by a key spending unit containing duly substantiated proposals on the amounts of budget funds required to conduct its activities in the future budget periods.

30. In the EU Domestic Fiscal Governance Database, the medium-term budgetary frameworks (MTBFs) are defined as those fiscal arrangements that allow government to extend the horizon for fiscal policy making beyond the annual budgetary calendar (see *http://ec.europa.eu/economy_finance/db_indicators/fiscal_governance/framework/index_en.htm*).

31. *Note by Turkey*: The information in this document with reference to "Cyprus" relates to the southern part of the Island. There is no single authority representing both Turkish and Greek Cypriot people on the Island. Turkey recognises the Turkish Republic of Northern Cyprus (TRNC). Until a lasting and equitable solution is found within the context of the United Nations, Turkey shall preserve its position concerning the "Cyprus issue".

    Note by all the European Union Member States of the OECD and the European Union: The Republic of Cyprus is recognised by all members of the United Nations with the exception of Turkey. The information in this document relates to the area under the effective control of the Government of the Republic of Cyprus.

32. *Source:* OECD *Budget Practices and Procedures Database*, *www.oecd.org/gov/budget/database*.

33. It may be argued perhaps that the 15% margin serves to identify "structural revenue gains" as opposed to cyclical windfalls, but even in this interpretation it would be safer to maintain the separation between expenditures and revenues and reserve the structural revenue gains for tax relief. Revenue rules of this type exist in several OECD countries (the Netherlands, the United States).

34. The structural fiscal balance is obtained by removing the cyclical component from the headline fiscal balance. The cyclical component depends on two factors: the size of the output gap; and the output elasticity of the tax yield, which indicates the extent to which the tax yield reacts to fluctuations in GDP. The determination of the output gap is not always an easy exercise for OECD countries, and there are ongoing political discussions about the calculation procedures.

35. Article 85 of the Constitution stipulates that the Verkhovna Rada has to give its consent to the appointment of the Prime Minister by the President. Article 87 of the Constitution refers to the power of the Verkhovna Rada to undertake a vote of no confidence in the Cabinet of Ministers.

36. This response was given by 68.8% of the 125 deputies who participated in the survey in February-April 2009 by the Parliamentary Development Project for Ukraine II (PDP II). This survey was the sixth since 1998, and it tracked attitudes and opinions of deputies on a variety of issues.

37. The second-largest standing committee has 27 members. It should be noted that the Budget Committee is a focal point for lobbying from the business community, and that many parliamentarians come from business backgrounds and maintain strong links to the business community.

38. The current chair is from the People's Party (Lytvyn Bloc) and the deputy chairs are from the All-Ukrainian United Fatherland (BYuT Bloc) and the Party of the Regions.

39. One head of secretariat, three deputy heads, 15 general counsel, six senior consultants, three consultants, and one specialist. Consultants are permanent staff. Deputies may also seek assistance from their faction's secretariat or their personal staff on budgetary matters, but this is not common practice.

40. Such extraordinary circumstances include martial law or a state of emergency (Article 3 of the Budget Code).

41. The draft budget is also published in the government *Courrier* seven days after submission to Parliament (Article 28.2 of the Budget Code).

42. The Verkhovna Rada is allowed to return the draft budget if it is missing documents or is not in line with the Budget Code or the "Budget Goals and Objectives Declaration" for the forthcoming budget period. In this case, the government is obliged to revise the draft budget and resubmit it within seven days. In practice this is rare, although it did happen once in the late 1990s.

43. If the budget is not balanced at this point, it can be submitted for a second first reading.

44. In 2009, these changes were quite significant due to the financial crisis.

45. Article 94 of the Constitution continues:

    In the event that the President of Ukraine has not returned a law for repeat consideration within the established term, the law is deemed to be approved by the President of Ukraine and shall be signed and officially promulgated.

    If a law, during its repeat consideration, is again adopted by the Verkhovna Rada of Ukraine by no less than two-thirds of its constitutional composition, the President of Ukraine is obliged to sign and to officially promulgate it within ten days.

    A law enters into force in ten days from the day of its official promulgation, unless otherwise envisaged by the law itself, but not prior to the day of its publication.

46. Monthly reports are issued within 15 days (state budget) and 25 days (consolidated and local budgets) of the close of the reporting period. Quarterly reports are issued within 35 days of the close of the quarterly reporting period.

47. In 2006, 2 233 amendments were submitted and 1 900 were recommended for consideration by the government following the first reading. In 2007, the numbers were 2 330 and 1 800 respectively.

48. The single treasury account (STA) is divided into 27 technical accounts.

49. According to Article 20.8 of the Budget Code: "The key spending unit (budget holder) together with the Ministry of Finance of Ukraine shall develop and approve the budget programme passport within 45 days following the date when the Law on the State Budget of Ukraine comes into effect."

50. The Department of Public Debt has recently become the National Debt Management and International Co-operation Department.

51. Balances of the state budget funds of Ukrainian institutions operating abroad also remain on the accounts opened abroad in order to make expenditures in the next budget period in accordance with their cost estimates.

52. However, an exceptional case was noted in 2008 when, following summer floods, the Parliament voted to increase the reserve fund and reduce expenditure elsewhere.

53. Constitutional amendments in 2004 had shifted the competency to create ministries and other CPAs from the President to the Cabinet of Ministers. In October 2010, these amendments were rescinded by the Constitutional Court (see Section 1.2.5).

54. Register of government services (*http://reestr.center.gov.ua/*).

55. Examples comprise the issuing of registered seals for doctors and a number of licenses and permits in the field of environmental protection which are issued exclusively in the capital Kiev.

56. Approved by Government Decree No. 158-p dated 24 May 2005 (revised No. 1347-p dated 22 October 2008 and No. 1601-p dated 23 December 2009).

57. In the last decade, international financial organisations have started to put much emphasis on the notion of "public internal financial control", but in many OECD countries this notion did not exist as a separate set of requirements for financial management. However, these countries do have regulations in place that define the duties and responsibilities of budget holders which can retrospectively be interpreted as "public internal financial control".

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