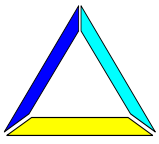
Openness and Transparency of Public Finances in Ukraine: Evaluation and Recommendations

Draft of final report

Kyiv, December 2003



INSTITUTE FOR ECONOMIC RESEARCH AND POLICY CONSULTING

Iryna Akimova, Oleksandra Betliy, Nataliya Leshchenko, Ivan Poltavets, Tatyana Vakhnenko,

Openness and Transparency of Public Finances in Ukraine: Evaluation and Recommendations

Kyiv 2003

Editor: Iryna Akimova

This publication was made possible through support provided by the Poland–America–Ukraine Cooperation Initiative (PAUCI), financed by the U.S. Agency for International Development (USAID), under the terms of Cooperative Agreement No. 121–A–00–00–00822–00.

Abbreviations

AC	Accounting Chamber
bn	billion
CCAA	Chief Control and Auditing Administration of Ukraine
CMU	Cabinet of Ministers of Ukraine
ECLS	European Charter of Local Self–Government
EU	European Union
GDP	gross domestic product
GFS	Government Financial Statistics
IMF	International Monetary Fund
INTOSAI	International Organisation of Supreme Audit Institutions
LGEs	local self-government entities
MST	Ministry of State Treasury
NBP	National Bank of Poland
NBU	National Bank of Ukraine
OECD	Organisation for Economic Cooperation and Development
PIT	personal income tax
SCAS	State Control and Auditing Service of Ukraine
SCC	Supreme Chamber of Control
SNA	Statistics of National Accounts
STA	State Tax Administration
UAH	Ukrainian hryvnia
UN	United Nations
VAT	value-added tax
VR	Verkhovna Rada

Contents

Openness and Transparency of Public Finances in Ukraine: Evaluation and Recommendations

1 Introduction

Openness and transparency of fiscal system constitutes a basis and, at the same time, an important instrument of conducting economic reforms. The comparison of the current openness and transparency of public finance in Ukraine against an earlier report in this field prepared by International Monetary Fund in 1999,[1] allows stating a considerable improvement, especially concerning the existing legal solutions. The Ukraine has a new budget code, the problem of access to information and public tenders has been regulated, first attempts have been made to set in order the procedures of public asset management, a public aid law is under preparation. However, Ukraine still falls below several important standards defining commonly accepted principles of organization and functioning of the public finance sector, and the recommendations issued several years ago by such institutions as the Council of Europe, the IMF, the OECD or the World Bank, are still to implemented. Besides, practical functioning of the sector of public finance deviates significantly from the existing legal norms.

They are several areas within the system of public finance, which need a particular attention of policy-makers and serious reforms. They include the following:

- the distinction between the competences of different public authorities as well as procedures of public finance and asset management, which remain inconsistent and unclear;
- access to information on public finances that continues to be rather limited due to a narrowly defined range of duties of public authorities with respect to fiscal information to be disclosed to general public, as well as a lack of precisely defined field of non-public information;
- financing and functioning of local government, whose strong dependence on state administration prevents efficient execution of public tasks on the local level.

These are the problems of key importance not only for the openness and transparency of public finance but also for the efficacy of functioning of the entire economy.

In our book we have tried to evaluate legal regulations and practices of functioning of Ukrainian public sector in relation to international transparency and openness standards of public finance, and present recommendations of further reforms in this area. Our recommendations concern nine topics, namely organization of general government; budget

[1] Experimental Module on Fiscal Transparency for Ukraine (1999): IMF, http://www.imf.org/ external/np/rosc/ukr/index.htm#I.

planning, passing and execution; recording and reporting of fiscal data; finance of local-self-government; access to fiscal information; public service and anti-corruption procedures; management of public assets; and audit and supervision in general government.

Our recommendations are accompanied by the references to Polish experience, (both positive and negative), which can be exploited during the reforming of Ukrainian fiscal system. Polish experience shows that the longer the process of system transformation, the less willing the society and the politicians are to accept the objectively necessary changes, even in case of improving economic situation. This is an argument for effectuating the necessary reforms as soon as possible.

Our main conclusion is that the best way to create a transparent and effective public finance sector – and at the same time, a well–functioning state – is limiting to a necessary minimum the state interference into functioning of the economy and local communities as well as ensuring a free functioning of all institutions of the civil society.

This book is prepared by the Institute for Economic Research and Policy Consulting (IER) using the materials of the Gdańsk Institute for Market Economics (GIME) within the project financed by the Poland–America–Ukraine Cooperation Initiative (PAUCI). The book comprises the findings presented in the earlier project publications, namely *Fiscal Transparency and Openness in Ukraine: Diagnostic report*[2]*(Kiev, 2003), International Standards of Openness and Transparency of Public Finance in Ukraine's Law and Practice: Assessment Report*[3]*(Warsaw, 2003),* and *Analytical Note: Questionnaire of IMF on Fiscal Transparency (Kiev, 2003),*[4] and unpublished manuscript on recommendations for improving fiscal transparency in Ukraine by GIME (Warsaw, 2003)[5].

The book has four chapters. In chapter 2, we briefly present the assessment criteria, which are based on five most important documents on international standards of fiscal transparency. Chapter 3 describes constitutional grounds of Ukrainian fiscal system. Chapter 4 is devoted to the evaluation of Ukrainian fiscal system and presenting recommendations on its further improvement across nine topics mentioned above. The book ends with the table, where we summarize all our recommendations.

---

2 Authors: I. Akimova, O. Betliy, N. Leshchenko, I. Poltavets, D. Sologoub, and T. Vakhnenko (IER).

3 Authors: M. Mackiewicz, E. Malinowska–Misiąg, W. Misiąg, A. Niedzielski, and M. Tomalak (GIME).

4 Authors: I. Akimova, O. Betliy, N. Leshchenko, I. Poltavets, D. Sologoub, T. Vakhnenko (IER), and M. Mackiewicz, E. Malinowska–Misiąg, W. Misiąg, A. Niedzielski, M. Tomalak (GIME).

5 Authors: M. Mackiewicz, E. Malinowska–Misiąg, W. Misiąg, A. Niedzielski, and M. Tomalak (GIME).

2 Assessment Criteria

The adopted method of assessing openness and transparency of public finance in Ukraine is based on confronting existing legal acts and practice of public sector functioning with standards and recommendation defined in the following five documents:

1) *Revised Code of Good Practices on Fiscal Transparency* worked out by IMF experts;[6]
2) European Charter of Local Self–Government,[7] passed in Strasbourg on the 15th of October 1985, ratified (without exemptions and restrictions) by Ukraine in 1997, in force from the 1st January 1998;
3) *OECD Best Practices for Budget Transparency;*[8]
4) *International Code of Conduct for Public Officials*[9], adopted by the UN General Assembly in 1996;
5) auditing standards, adopted in 1991 by the International Organisation of Supreme Audit Institutions (INTOSAI).[10]

2.1 IMF's Code of Good Practices on Fiscal Transparency

IMF's Code of Good Practices on Fiscal Transparency (called hereinafter: the IMF Code) is a set of recommendations for fiscal sector and organization of budget procedures developed by IMF experts. The recommendations are not binding. However, the IMF evaluates the compliance of the law and practices of the member states to the principles of the Code.

The Code concentrates on the issues related to defining the scope of fiscal sector and determining procedures within it. Separate recommendations relate to free access to fiscal information, transparency of budget procedures and the necessity for independent audit of public funds management.

The most important recommendations of the Code are as follows:

6 http://imf.org/external/np/fad/trans/code.pdf.
7 http://conventions.coe.int/Treaty/EN/cadreprincipal.htm, ETS No. = 122.
8 http://www.oecd.org/dataoecd/33/13/1905258.pdf.
http://www.oecd.org/dataoecd/33/15/1905274.pdf.
9 http://www.un.org/documents/ga/res/51/a51r059.htm.
10 http://www.intosai.org/2_CodEth_AudStand2001_E.pdf.

- general government should be easily distinguished from rest of the economy, and policy and management roles within public sector should be clearly specified;
- there should be a clear legal and administrative framework for management of public sector;
- the public should be provided with full information on the past, current and projected fiscal activity of the government;
- a commitment should be made to the timely publication of fiscal information;
- the budget documentation should specify fiscal policy objectives, the macroeconomic framework, the policy basis for the budget and major fiscal risks;
- budget information should be presented in a way that facilitates policy analysis and promotes accountability;
- procedures of the execution and monitoring of approved expenditure should be clearly specified;
- fiscal information should be subject to independent scrutiny by the national audit body, established by the legislature; timely reports for the legislature and public should be ensured;
- the national statistics agency should be provided with the institutional independence to verify the quality of fiscal data.

2.2 OECD Best Practices for Budget Transparency

OECD Best Practices for Budget Transparency concentrates on public information on budget issues – mainly on the state level. The following three issues are of particular importance:

- to publish information on all stages of budgeting and link budget financial indices to information on aims and tasks to be accomplished through the budget;
- to incorporate into budget information the issues that are relevant for public finance, though not directly detectable in the budget;
- to provide public access to professional and independent assessment of budget data quality.

OECD recommends to publish several types of reports during the budget process, namely:

- budget assumptions, containing – in particular – economic and fiscal policy objectives, government's economic and fiscal policy intentions and economic assumptions;
- reports on budget execution during the fiscal year (monthly and mid–year reports);

- reports on actual (year–end) results of budget execution;
- the general state of government finance directly before the election;
- long–term financial perspective.

OECD also points out that together with budget data there should be information on issues that have a strong impact on public finance, though are not reflected in the budget. For instance, these includes the following data:

- deviations from the forecast of the key economic assumptions underlying the budget;
- tax expenditures and their cost;
- government's financial assets and financial liabilities;
- non–financial assets;
- liabilities related to employee pension obligations;
- contingent liabilities related to the government loan guarantees and legal claims against the state.

OECD points out that principles of data reporting should be made public. It also recommends conducting internal audit of reports and establishing personal responsibility for their accuracy. The report on budget execution should be subject to assessment by Supreme Auditing Institution (SAI), and the Ministry of Finance has to ensure an access of citizens as well as specialized non–governmental organizations to budget data.

2.3 European Charter of Local Self–Government

European Charter of Local Self–Government (ECLS) has been passed by the Council of Europe in 1985. It is a set of political and financial guarantees that the states joining the Charter should grant to their local self–government units. While joining the Charter, the country is not required to adopt all obligations defined in it.[11] When Ukraine had ratified the ECLS, it did not notify any reservations to the provisions of the ECLS. Therefore, based on the Article 9 of the Constitution of Ukraine, the entire ECLS became a *part of the national legal system of Ukraine*.

Most important provisions of the ECLS are as follows:

- the principle of local self–government, denoted as the right and the ability of local authorities to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population, should be recognised in the national legislation, and if possible- in the constitution;

[11] To ratify the ECLSG it is essential to accept at least 20 out of 30 substantial provisions of the ECLSG. It is possible to reserve application of the ECLSG to some types of self–government units exclusively.

- members of self–government councils should be freely elected by secret ballot on the basis of direct, equal, universal suffrage;
- powers given to local authorities should normally be full and exclusive;
- changes in the boundaries of local authority should not be made without a prior consultation with the local communities concerned, possibly by means of a referendum;
- local authorities shall be able to determine their own internal administrative structures;
- any administrative supervision of local authorities is allowed only in cases that are defined in the constitution or laws. Administrative supervision of the activities of the local authorities should focus on ensuring their compliance with the law and constitutional principles;
- local authorities should have the right to own and dispose freely adequate financial resources (commensurated with the responsibilities provided by the constitution and the law). At least, a part of the financial resources of local authorities should derive from local taxes and charges, which rate they can determine within the legal limits;
- the support of local authorities that are financially weak, requires a mechanism of financial equalisation or equivalent measures to correct the effects of the unequal distribution of potential sources of finance;
- transfers to local authorities should not be earmarked for financing specific projects;
- local authorities have the right to recourse to a judicial remedy in order to secure a free exercise of their powers and the principles of local self–government.

2.4 Ethical Standards for Public Officials

International Code of Conduct of Public Officials constitutes an annex to the resolution of UN General Assembly dated December 12, 1996 on fighting corruption. It presents international ethical standards for public officials and describes the issues relevant for fight against corruption.

- **General principles.** Public office should act in the public interest. Public officials should be loyal to public interests of their country expressed in the democratic institutions of the government. Public officials should perform their duties and functions efficiently, effectively and with integrity, in accordance with the laws or administrative policies. Public officials should be attentive, fair and impartial with respect to performing their functions and their relations with the public. Preferential treatment or discrimination of any group or individual by public official is forbidden.
- **Conflict of interests.** The code prohibits public officials to use their official authority for the improper advancement of their own financial interest as well as that of their family. They should not be engaged in

any transaction, acquire any position or function or have any financial or commercial interest that is incompatible with their office, functions and duties. Public officials, to the extent required by their position, shall declare business, commercial and financial interests or activities undertaken for financial gain that may raise a conflict of interests. In case of potential or perceived conflict of interests they should comply with the relevant measures. Public official should not use public money, property, services or information that is acquired while performing their official duties, for the activities that are not related to their official tasks.

- **Disclosure of assets**. Public officials should declare or disclose their personal assets and liabilities in accordance with their position and as permitted or required by law and administrative policies.
- **Acceptance of gifts or other favours**. Public officials should not solicit or receive directly or indirectly any gift or other favour that may influence the exercise of their functions, the performance of their duties or their judgment.
- **Confidential information.** Matters of a confidential nature in the possession of public officials shall be kept confidential also after leaving public service (unless national legislation or the needs of justice strictly require otherwise).
- **Political activity**. Political or other activity of public officials should comply with the legislation and make no harm to the impartial performing of their functions and duties.

OECD defined 12 main principles of ethics in public service, namely:

- ethical standards for public service should be clear;
- ethical standards should be reflected in the legal framework;
- ethical guidance should be available to public servants;
- public servants should know their rights and obligations when wrongdoing are exposed;
- political commitment to ethics should reinforce the ethical conduct of public servants;
- the decision–making process should be transparent and open to the scrutiny;
- there should be clear guidelines for interaction between public and private sectors;
- managers should demonstrate and promote ethical conduct;
- management policies, procedures and practices should promote ethical conduct;
- public service conditions and management of human resources should promote ethical conduct;

- adequate accountability mechanisms should be in place within the public service;
- appropriate procedures and sanctions should exist to deal with misconduct.

For fighting corruption it is vital to provide transparency in hiring public officials, i.e. to publish recruitment principles and information on vacancies, base recruitment on substantial criteria, use clear rules for promoting, and provide employment security.

The World Bank underlines the following key issues for limiting and fighting corruption in public sector:

- a meritoric civil service with adequate monetary payment;
- enhancing transparency and accountability in budget management;
- enhancing transparency and accountability in taxes and customs;
- reforms in provision of public services;
- decentralization combined with accountability.

2.5 INTOSAI Audit Standards

Audit standards, adopted by the International Organization of Supreme Audit Institutions (INTOSAI) in 1991, represent a set of recommendations prepared on the basis of agreement between the Supreme Audit Institutions (SAI's) that join INTOSAI.

INTOSAI audit standards are classified into four groups. The first group contains basic assumptions of the fiscal audit. The second one describes general audit standards. The third group defines field standards, and the fourth one (which we do not refer to later on) specifies requirements related to the form and content of audit reports.

Basic audit assumptions represent the recommendations related to audit environment. Only a part of them is directly addressed to SAI, while the rest refer to conditions facilitating SAI operations, such as promoting accountability by the authorities, unified accounting principles and internal audit. This group also contains the definitions of the basic concepts (performance audit, etc.).

General standards emphasize the importance of four aspects of SAI operations. The first one is independence – understood in the institutional (SAI) as well as professional (auditor) sense. The next issue concerns competencies, i.e. situation in which both SAI and the auditor have appropriate knowledge and experience. The next attribute of SAI operations is so called *due care*, which denotes aiming at maximal reliability in audit. The remaining standards are related mostly to the development policy of SAI and its employees.

Field standards are a set of recommendations related to the organization and conducting audit. Each audit should be carefully planned, the auditor's supervisors should verify the documentation, and gathered proofs should be of an appropriate quality. Audit should check the compliance of certain activities with the existing law.

3 Constitutional Grounds of Ukraine Fiscal System

The Constitution of Ukraine contains numerous legal regulations related to the functioning of fiscal system. None of these regulations contradicts the international standards. At the same time, in some respects, the Constitution does not contain sufficient guarantees for incorporation of these standards in the legal acts of a lower level.

In general, the constitutional division of competencies related to the state budget is compliant to the international standards and practices. The Cabinet of Ministers (government) is responsible for preparing the draft budget, budget execution and reporting on budget execution. The Verkhovna Rada of Ukraine (Parliament) is responsible for adopting the budget and report on budget execution. It is also responsible for adopting possible amendments in the budget. There are three issues that need special attention:

1. The constitution does not contain any limitations in the scope of amendments the Verkhovna Rada of Ukraine can implement to the governmental draft budget. Therefore the government, being responsible for budget execution by Constitution, remains unprotected against any changes in the draft budget that have a political background and may result in disturbances of macro–economical logics of the budget and cause budget unfeasibility. It is even more dangerous, since the Constitution of Ukraine does not impose any constraints on the amount of state debt, and as far as the deficit is concerned, it contains only a generally formulated statement (in the Article No. 95): *the state aims at balancing the budget of Ukraine*.

2. There is no clear statement defining which entities, out of those who have legislative initiative (Article 93) can propose amendments to the budget.

3. There are no regulations concerning the situation, when the budget is not accepted before the budget year starts.

The Constitutions gives the Verkhovna Rada of Ukraine (in the Article 92) exclusive competencies in the matter of setting public subsidies and budget system, formation and payment of the state debt, including issuing state securities. There is no clear statement that the state debt have to be within the range defined by the Verkhovna Rada of Ukraine. A very clear and straightforward ban on deciding on issues related to budget and taxes in the referendum is a very interesting solution.

The regulations referring to the central bank are very general. Article 99 states that providing stability to hryvnia is the basic function of the

National Bank of Ukraine, and Article 100 states that the Council of the National Bank of Ukraine elaborates the basic principles of monetary and credit policy. It is interesting to point out that the legal position of the NBU is to be defined by law (in the Article 100). In our opinion such a solution does not give sufficient guarantees of central bank independency from the executive authority. This independency is violated already by the fact that a half of the members of Council of the NBU are called by the president of Ukraine.

Article 7 of the Constitution recognizes and guarantees *local self–government in Ukraine.* At the same time, the regulations on local self–government included in the Articles 140 – 146 do not define clearly the legal character of the local self–government and constitution–based sovereignty attributes, which would be subject to protection by judiciary as declared in Article 145. In general, some constitutional provisions (e.g. reflected in Articles 13, 14, 140, 146) provide a ground to consider the system of local self–government as being distant from ECLS standards, which have to be binding for Ukraine.

The issue of free access to the information on functioning of public authorities, including public finance, has been emarginated. Article 34 guarantees the citizens the right to collect, store and disseminate information, but there is a lack of regulations that clearly define the obligations of public authorities concerning disclosing and disseminating of such information. The Constitution recommends to publish the report on budget execution (Article 97) is published. At the same time, it does not require publishing the results of audit of budget execution prepared by the Accounting Chamber.

4 Ukrainian Practices: Evaluation and Recommendations

4.1 Organization of the General Government

4.1.1 International standards

IMF Code requires that management rules and policies within the public sector are clearly defined and disclosed to the public. Government sector has to be distinguished from the rest of the public sector as a whole as well as from the rest of the economy. This implies that:

a) the scope of responsibilities of different levels of executive, judicial, and legislative power is explicitly defined;

b) relations between the government, on the one hand, and non-governmental agencies of public sector, on the other hand, are based on clear arrangements. Importantly, independence of the Central Bank – an authority that controls the key aspects of financial activity - is ensured;

c) taxes, duties, fees, and charges have an explicit legal basis. Tax laws and regulations are easily accessible and understandable, and clear criteria guide any administrative discretion in their application;

d) the structure of general government is clearly defined; there are explicit mechanisms to co-ordinate budgetary and extra-budgetary activities.

According to IMF definition, general government covers departments, agencies, funds and financial institutions that are controlled and financed primarily by the state as well as by other organizations that participate in non-commercial activities and are controlled by the society. General government includes:

- all units of central, state, or local government;
- all social security funds (according to the other definition, the funds of social insurance belong to a sub-sector of public finance where these funds operate);
- all non-market, non-profit institutions that are controlled and mainly financed by government units.

4.1.2 Practices and problems in Ukraine

a) Division of responsibilities between the three branches of power

In general, Ukraine meets the requirement concerning clear and explicit division of responsibilities between the three branches of state power.

According to the Constitution, state power is exercised via its legislative, executive and judicial branches (Art. 6). Government is represented by central and local bodies. Local self-government is defined as the right of a territorial community, residents of a village or a voluntary association of residents of several villages into one village community, residents of a settlement, or a city to resolve independently the issues of local character within the limits of the Constitution and the laws of Ukraine (Art. 140).

Constitution of Ukraine (Articles 85 and 116), determines basic responsibilities of the parliament and the government.

The implementation of Budget Code has contributed to the clarification of the role of legislative and executive authorities in the process of preparation, passing and execution of state budget. Budget Code (Sections 5-8) provides a clear framework for the activities of legislative and executive authorities within the budgetary process.

The right of legislative initiative belongs to the President, deputies (i.e. members of the Ukrainian Parliament), Cabinet of Ministers (CMU), and National Bank of Ukraine. However, the Parliament has the highest legislative power.

The highest executive power belongs to the CMU. On the regional level, the executive power is executed by the bodies of local state administration that are controlled by the respective bodies of executive power of a higher level.

The justice is executed exclusively via courts.

b) Independence of Central Bank

The National Bank of Ukraine (NBU) is the central bank of Ukraine, i.e. the special body of central public administration. Ukrainian legislation meets international standards in defining the role of the central bank: its legal status, objectives, functions, responsibilities and basic principles of organization have received a sound legal basis in the Constitution of Ukraine, the Law "On the National Bank of Ukraine" (1999).

The Constitution of Ukraine defines ensuring the stability of national currency as the main function of the NBU. According to the Law on NBU, it should also promote stability of banking sector and price stability in Ukraine. Besides, NBU has several other functions, namely

1. Monopoly right for money emission in Ukraine;
2. Implementation of monetary policy including determining its main instruments;
3. Control and supervision of banking system in Ukraine.

An independence of NBU from legislative and executive branches of power is determined by Article 53 of the Law on NBU, which prohibits any executive and legislative bodies to interfere in the activity of the National Bank, unless it is explicitly determined by the Law on NBU. Article 51 specifies the relationship between NBU, on the one hand, and Verkhovna Rada and President, on the other hand. The President appoints a half of the members of NBU council, and another half is appointed by the Parliament. Moreover, Article 52 obliges NBU to make consultations with the government as for implementation of monetary policy.

Independency of the central bank is an important pre-requisite of the stable and consequent fiscal policy. Permitting the executive authority to interfere in the functioning of the central bank is a threat to the monetary policy as there is no consequent and responsible budget policy without an independent central bank.

Box 4.1
Regulations concerning Central Bank in Poland

As regards the status and organization of the National Bank of Poland (NBP), the Polish Constitution states that:

- NBP is the state central bank and is responsible for the value of Polish currency;
- NBP has an exclusive right to issue money;
- as per the principles defined in acts NBP may issue securities;
- NBP has an exclusive right to set and execute the monetary policy;
- NBP's bodies are: The President of NBP, The Council for Monetary Policy and the Board of NBP;
- President of NBP is elected by the Sejm upon the request of the President of the Republic of Poland for 6 years' term of office;
- President of NBP cannot belong to any political party or to a trade union; neither can he/she be a member of the parliament;
- the Council for Monetary Policy is headed by the President of NBP and the remaining members are elected for 6 years' term of office by Sejm, Senat and the President of the Republic of Poland, each of them selecting one third of members;
- the Council for Monetary Policy defines the assumptions of the monetary policy and presents them as well as the report on the execution of this policy to the Sejm.

Polish Constitution defines clearly an independent position of the NBP and gives the parliament a decisive role in forming the management of the NBP, at the same time protecting the human resources stability at the NBP. Recent experience has shown that these regulations turned out to be efficient in protecting the independency of the central bank. The constitutional range of these regulations prevented the attempts to undermine the position of the NBP. For example, there were attempts to introduce changes in the act on NBP, which might result in at least partial subordination of NBP to the executive authority. Introducing such changes could lead to weakening of the monetary policy, rising in the budget deficit and state debt and, as a result, in worsening of the state financial situation, already being difficult.

Direct NBU credits to the government for financing central budget deficit are prohibited (Art.54, the Law "On NBU" and Art. 15 of the Budget Code). Though a ban on direct NBU financing of central budget deficit is included in Budget Code, it can be, in principle, repealed, especially taking into consideration that Ukrainian law does not forbid modifying other acts in the Budget law.

Besides, there were attempts to involve NBU in quasi-fiscal operations. Specifically, in summer 2002, a long-term refinancing scheme was introduced. According to that scheme, NBU can provide long-term (up to 3 years) refinancing credits to commercial banks aimed at crediting innovative projects for the real sector. Since the refinancing rate of NBU is much lower than the market lending rate, such scheme is expected to reduce interest rates and increase real investment. However, the results

might be quite the opposite. Since this scheme implies significant money creation and implicit involvement of the government in the activity of NBU, it is likely to produce negative expectations of economic agents regarding the exchange rate stability, and, thus, contribute to higher interest rates and lower investment.

Refinancing scheme clearly falls under IMF's definition of quasi-fiscal operations that undermine actual independence of NBU, and does not comply with the international standards of fiscal transparency.

c) Tax system

In general, the tax system of Ukraine has a rather sound legislative basis meeting basic requirements of IMF fiscal transparency code.

The general system and principles of taxation are defined in the Law "On the System of Taxation", which determines the major types of taxes in Ukraine. Verkhovna Rada has an exclusive right to establish and eliminate taxes and duties (obligatory payments) as well as provide privileges for centrally set taxes. This complies with the international standards requiring central taxes to be imposed by the parliament. *In practice, the vast majority of taxes are set by the laws.* **However, currently this principle is infringed with respect to local taxes, whose limits are set by the decree of the Cabinet of Ministers "On Local Taxes and Duties", and personal income tax that is still regulated by the CMU Decree and the Decree of the President.** The situation will improve in January 2004, when the Law "On the Income Tax on Physical Persons" (adopted in May 2003) becomes active.

There are no provisions that limit *the level of central tax rates* directly. However, the Law "On the System of Taxation" defines economic validity as a major criterion for setting the tax rate. According to the legislation, tax rates cannot be changed during the budget year unless extra-ordinary events occur. Moreover, the tax laws should be approved at least half a year before the start of a new budget period.

The Law "On the System of Taxation of Ukraine" and the Law "On the order of tax payments to budgets and state targeted funds" (as well as some other laws on respective taxes) determine administration and payment procedures of central taxes and duties. The rates of local taxes and duties as well as the mechanisms of their administration and payment procedures are set by local councils according to the list and within the limits defined by the Decree of CMU "On Local Taxes and Duties". Local councils also have a right to grant privileges for taxes and duties within the part paid to their budgets.

Control over the execution of tax legislation is conducted by STA. Tasks and responsibilities of STA are clearly defined in related legislation. The documents that regulate taxes and the instructions of STA are open for public access in various legislative databases, and on VR and STA websites. They are also published in numerous official and specific editions. STA provides the taxpayers with necessary explanations.

The instructions of the STA sometimes contradict the legislation. For example, the Law on VAT states that refunding of excessively

paid VAT should be made within 30 days after the tax report has been submitted. At the same time, the order of reimbursement of VAT instruction issued jointly by Treasury and STA prolongs this period till 90 days.

Numerous legislative documents that regulate tax issues and legislative provisions are frequently changed. This issue is complicated by a considerable number of taxes and rates. Presently, there are more than 20 centrally set taxes and duties and 14 local taxes.

This results in the increasing information and administration costs for STA and taxpayers.

Box 4.2
Polish experience in simplification of tax system

Polish experience in simplifying the tax system has its own pros and cons. An introduction of a new structure of taxes based on the standard solutions used in Europe in early 1990s has been a positive step. The CIT, PIT and VAT have been introduced. PIT replaced all existing property taxes. An inclusion of the road tax into the excise tax (excise on petrol) can be also classified as a positive solution.

A reduction in number of tax rates is very difficult due to the protests of some lobbies. Differentiation in VAT rates in Poland led to absurd situations, e.g. fodder mixers being machines for agricultural production are taxed at 0% rate, but if they are used as concrete mixer, the tax rate jumps to 22%. This results in serious interpretation problems and requires a very detailed product classification, which can be a source for ambiguity and creates possibilities for abuse.

The fact that common taxes (PIT) were not consequently introduced was a big mistake made in Poland. The farmers were excluded and paid a lump tax. The same concerns SMEs, which were allowed to use a preferential form of taxing, i.e. tax chart. The basic defect of this system is that in order to pay the tax in the simplified form, the entity cannot exceed a certain employment limit.

The requirement of equal treatment of all taxpayers is not fully observed. For example, Budget Law 2003 forbids non-cash settlements with the budget, and at the same time, includes special provisions for the enterprises of the Ministry of Defense. This contradicts the principle of equal treatment. Numerous privileges for certain social and professional groups, sector or regions also constitute a departure from the equality principle.

Current tax system contains extensive tax privileges that deteriorate the tax base and reduce transparency (see Table 4.1). The principles of granting tax privileges are not clearly and transparently described.

The list of tax deductions and redemptions is very extensive and comprises types of preferences, which are not always clear. This signals about the existence of strong lobbies, which influence the content of law. Privileges could be granted to industries that are "socially sensitive" or important for military defense.

Box 4.3
Elimination of tax privileges in Poland

Cutting down of tax privileges is not an easy task. For example in Poland, a decision to liquidate special economic zones was strongly opposed. The final closure of these zones was forced by the regulations of the EU.

Complete information on tax privileges is not available for public scrutiny. Using submitted tax declarations STA prepares the list of privileges, the estimated amount of losses of budget revenues (as a consequence of granting privileges), and the information on the number of recipients of privileges (form No. 13 ПП). However, the definition of the tax privileges used by STA is not fully compatible with international standards, therefore the estimation of their total amount is not accurate.[12] The estimation can be corrected if more detailed information on revenue forgone across the different types of privileges is available. Unfortunately, such information is not open to the public. Besides, the complete list of entities subject to tax privileges is not publicly available.

More accurate and detailed estimations of total budget revenue forgone due to tax privileges are prepared by International Monetary Fund (see Table 4.1).

Table 4.1
Inventory of Ukrainian tax privileges

	2001 Est	2002 Est	2003 Proj
(in millions of hryvnia)			
Total revenue forgone	**8866**	**9725**	**8554**
Enterprise profit tax I/	**2573**	**1859**	**555**
tax breaks for metallurgy and mining	571	100	0
deductions for investment in fixed assets for metallurgy and mining	194	0	0
deductions for investment in mining, metallurgy, electricity, chemical industries	263	431	0
tax credit for military housing	902	720	0
special economic zones (tax breaks and exemptions)	208	232	256
technoparks (exemption)	7	10	11
heat and power production (EPT-deductible tariff surcharges)	233	0	0
wind electricity (0.75 percent surcharge)	0	95	95
publishing and printing (exemption)	42	92	0
enterprises with disabled employees (exemption/loophole)	32	33	36
free provision of coal to selected population groups	14	14	16
purchase and completion of construction (deduction)	0	10	11

[12] For example, the STA list of VAT privileges includes zero-rating of exported goods (code is 14010115), which according to the definition of tax base, should not be considered as revenues forgone.

Table 4.1 (cont.)
Inventory of Ukrainian tax privileges

exemptions granted by local governments	26	5	5
transfers to non-profit organization in regions	46	50	51
tax break for profile made by non-residents in Ukraine's territory (15 percent rate)	22	25	27
shipbuilding industry	2	16	18
aerospace industry (accelerated depreciation)	1	1	1
reinvested profits from domestic production of baby food	1	1	2
oil exploration (tax. deduction)	0	19	21
other	7	5	5
Personal income tax: occupation-based exemptions	**524**	**605**	**787**
Value- Added Tax 2/	**4288**	**5228**	**5284**
public services paid with fees (exemptions)	23	52	57
sales of baby food (exemption)	2	3	4
Selected goods fur disabled people (exemption)	23	24	27
pharmaceutical products (exemptions and zero-ratings)	861	1123	1238
spa treatments and accommodation for children (exemption)	55	74	81
SERVICES by daycare. centers for children, boarding schools, and shelters (exemption)	5	5	5
Catering for children at high and vocational schools and health institutions	29	*29*	*32*
newly built housing (exemption)	477	533	587
enterprisers with disabled employees (exemptions and zero-ratings/loophole)	*49*	86	95
agriculture:	1401	1565	1724
- catering for workers provided by agricultural producers	5	5	5
- transfer of own products by agricultural producers to individuals	78	0	0
- earmarking of VAT on milk, meat, poultry, wool, dairy products, for producer subsidies	159	201	222
- earmarking of VAT for investment for eligible producers	806	1005	1107
- zero-rating; of milk and meat sales by agricultural producers, to processing enterprises	353	334	390
automobile industry, import exemptions and zero-rulings of their sales	77	I3O	143
aerospace industry, import exemptions and zero-ratings of their sales	15	32	35
shipbuilding industry: import exemptions and zero-ratings of their sales	5	2	2
military equipment industry: partial exemptions and zero-ratings	9	3	4
aircraft industry: exemption on imports, and zero-ratings when financed from budget	0	16	18

Table 4.1 (cont.)
Inventory of Ukrainian tax privileges

periodicals, domestically produced goods, and school books (exemptions)	354	377	415
technoparks (special regime in line with innovation law)	12	22	24
fundamental research, scientific, research-and design services financed from the budget	93	55	61
transportation services with regulated prices (exemptions)	168	172	189
special economic zones	135	155	171
imports used by publishing and printing enterprises (exemption)	158	446	0
limeral service	16	15	17
donations to charities	22	17	19
imports of retail trade enterprises	1	3	3
others	299	290	333
domestic excise taxes	8I	78	86
import duties	350	695	518
printing and publishing	86	225	0
automobile, ship-building, aerospace, aircraft, weapons industries	24	32	36
free economic zones	241	438	482
Land tax	**1028**	**1239**	**1300**
Other	**21**	***22***	**25**
(In percent of GDP)			
Total revenue forgone	4.3	4.4	3.5
Enterprise profit tax I/	1.3	0.8	0.2
Personal income tax	0.3	0.3	0.3
VAT	2.1	2.4	2.2
Import duties	0.2	0.3	02
Land tax	0,5	0.6	0.5
Other	0.1	0.0	0.0

I/ Excludes exemptions allowed by foreign treaties and standard exemptions, such as exemptions for incomes of non-profit organisations.

2/ Excludes exemptions for financial transactions, exemptions stipulated by foreign treaties, exemptions for education and healthcare, and exemptions for government services.

Source: Ministry of Finance, Ministry of Economy, and International Monetary Fund staff estimates in IMF country report No. 03/173 "Ukraine: selected issues", June 2003.

The upcoming tax reform envisages the reduction of tax rates, elimination of the loopholes, and a considerable cut of tax privileges.

d) The structure of general government

The main improvements in clarifying the structure of general government in Ukraine are related to a) incorporation of the majority of extra-

budgetary activities in the special fund of the budget, and b) giving the definition of budgetary entity in the Budget code.

Budget Code defines budget entity as a body/ entity/organization, which is determined by the Constitution of Ukraine, or an establishment/organization, which is formed by a body of state power, a body of power of the Autonomous Republic of Crimea, or a local self-governmental body, and financed entirely from the state or local budget. All budget entities are non-profit units (Non-profitability of budget entities is confirmed by the Order of State Tax Administration No. 355). According to the Budget Code, budget entities are allowed to have their own revenues from certain economic activities. The Cabinet of Ministers defines the list of respective activities. Revenues from these activities are included into a special fund of the budget. Budget units use state funds for fulfilling their tasks in accordance with budget law and normative acts of local councils.

Box 4.4
Definition of general government in Poland

Polish experience as regards definition of organizational forms of general government units can be followed to a limited extent. The advantage of the Polish system is that every unit included in the general government has a clearly defined organizational status and principles for financial management. This results from the regulations relating to the following, which are always accepted by ways of law:

legal status (being a legal entity or not a qualifying criterion for the right to have **own** property and **own** income);
financial competencies of unit bodies;
planning mode;
authorization to dispose funds and property.

The defect of the Polish general government organization system is related to excessive organizational forms and a lack of regulations (apart from the ones relating to accounting and public procurement), which define a unified set of principles for funds and property management in the public sector. Moreover, the existence of numerous institutions operating beyond the state budget disintegrates public finance and makes efficient using and control of public funds difficult.

Presently, the following types of organizational units operate in the state segment of the Polish public funds sector:

- budget entities, i.e. bodies that do not constitute themselves legal entities and are completely financed from the budget, which in Poland encompasses only income and expenditures of budget entities. The character of the Polish budget resembles to some extent the general fund in the Ukrainian state budget;
- state appropriated funds and so called extra–budgetary units, which except for 3 appropriated funds also are not legal entities are connected with the state budget only with the balance of payments to the budget and subsidies from the budget;
- state legal entities operating on the basis of the separate acts (frequently these are acts which form only one specific institution). State legal institutions have own property and financial independency understood as right to plan finance independently and that the profit worked out is untouchable.

However, the present definition of budget entity does not mean that within the general government there exist a unified organizational and legal form of operation applicable to all state and self–government institutions.

Ukrainian state budget encompasses income and expenditures of the institutions of a diversified nature. On the one hand, there are regular state offices that operate on behalf of the state on the basis of appropriated funds and have no income from their own operations. On the other hand, there are institutions that have a large organizational and financial independency, receive their own income and manage their own funds and property. Therefore, it is difficult to state that such diversified units, as for instance parliament administration, tax offices and universities, operate according to a unified scheme, which defines the principles for managing funds and property. The term "budget entity" does not identify the financial system according to which such institutions operate.

The legal status of a budget entity is not properly defined. Ukrainian law does not define special organizational forms, within which different state institutions conduct their operations. Consequently, functioning of the budget entities is actually regulated by non–regulatory instruments, such as State Treasury instructions. This is already a serious infringement of public finance transparency.

Budget entities are included into several registers maintained by the state: One is the STA register of non-profit institutions and organizations, which includes budget entities as a consequence of their non-profit nature. Integrated State register of enterprises and organizations of Ukraine also includes budget entities. In former times, budget units could be distinguished from the other units by a special coding. Presently, it is not possible any more, since the respective coding has been eliminated. A program classification of the budget expenditures, where key spending units are listed, can be also considered as a kind of register of budget entities. However, the program classification covers only state budget leaving local budgets aside. The registers do not provide explicit picture of functions of general government.

Implicitly, basing on the provisions of the Budget Code and the definition of IMF, the following organizations *can be* included into *general government* in Ukraine:

1. Central State government bodies (the legislative and executive bodies, the President of Ukraine, bodies of judicial power, bodies that conduct international activity, i.e. embassies and councils, and local self-governmental bodies).
2. Entities created by central bodies of state and local government including:

- educational state–owned units (e.g. schools, universities, pre-school education establishments of different kinds);
- health-care state-owned units (e.g. out-patients departments, hospitals, sanatorium-and-resort entities);

- state-owned units for culture and art (e.g. libraries, museums, exhibitions, national parks, theatres, national philharmonic societies, netc.);
- R&D units that conduct projects of national importance;
- physical training state-owned units;
- social security units;
- legal entities that are created for fulfilling public tasks and programs.

3. Funds of Compulsory State Social insurance (extra-budgetary funds).

Currently, Ukraine has 4 funds of compulsory state social insurance, namely Pension Fund, Fund of Compulsory State Social Insurance Against Unemployment, The Fund of Compulsory State Social Insurance Against Temporal Working Disability, and the Fund of Compulsory State Social Insurance Against Industrial Accident and Occupational Disease. These funds are non-profit legal entities with their own balances. They implement state policy in the respective areas and manage their financial resources. Currently, extra-budgetary funds play an important role in the economy. In 2003, their revenues account for more than 46% of the revenues of consolidated budget 2003.

However, this implicit picture of general government is not enough. **Budgetary sector of the economy needs an explicit clear definition, which allows its easy distinguishing from the rest of the economy. There is a need for legal provisions that would clearly allocate responsibilities within the general government.**

4.1.3 Recommendations

These are the problems of key importance not only for the openness and transparency of public finance but also for the efficacy in functioning of the entire state. Without having a fully independent central bank there will be no consequent and though budget policy, and a complicated tax system is a serious threat to the dynamic economic growth and to the stability of state income. A clear status of state institutions is a basic condition for efficient management of the state property and public funds. Therefore, these recommendations, next to the recommendations relating to the local self–government and access to public information, are considered to be most important ones out of all our recommendations.

1. The independence of the National Bank of Ukraine (NBU) should be guaranteed in the Constitution.

Constitutional guarantees assuring central bank independency should provide the following:

- the right of the central bank to determine and implement monetary policy independently;
- the decisive role of the parliament in composing central bank bodies (since the composition of NBU's Council should guarantee the independence of the central bank from the President and the Cabinet of Ministers);

- the stability of central bank bodies, i.e the term of office for the members of NBU council being long enough, and a precise definition of cases, when they can be dismissed before the term of office expires.

The ban to finance the state budget deficit by the central bank should be also upgraded to the constitutional level.

In specific conditions in Ukraine, the postulate to extend the constitutional principles regulating the status of the central bank would have to be executed by:

- changing the principles of forming the NBU Council giving the Verkhovna Rada of Ukraine a decisive role in this process;
- transferring some of the clauses of the Law on the National Bank of Ukraine to the Constitution.

2. The attempts of involving NBU in quasi-fiscal operation should be stopped.

3. Tax reform should be continued reducing the number of taxes and tax rates.

The tax reform that has been proceeding slowly during the last years should be continued and result in a decrease of the number of taxes and tax rates. New regulations should constitute grounds for putting the tax system in order, in particular in reference to the exclusive competencies of the Verkhovna Rada of Ukraine to decide on taxes.

After new tax regulations are in place, it is important to ensure the stability of tax system refraining from the frequent changes of legislation.

The simplification of tax system reduces costs both for the state and taxpayers. Simple taxes are easy to collect and control by the state administration, and they provide less room for arbitrary decisions of the officials. The country becomes more attractive to foreign investors.

4. The number of tax exemptions and privileges must be strongly limited and the free economic zones should be abolished.

Simplification of the tax system is enhanced by the reduction of tax deductions and redemptions. Such functions of the state as supporting regions or providing social aid should be executed using non-tax financial and administrative instruments.

5. The legal status of budget entities should be clearly defined by law.

The divergence in the financial schemes used within the general government does not breach any standards and is completely normal. We recommend a formal differentiation (by specifying it in the law) of narrow groups of budget entities that function according to the unified principles.

This recommendation is aimed at showing the differences that occur between the specific groups of budget units, rather than unification of organizational and financial system of public institutions. For instance, it seems evident that public funds management procedures in units, whose

all or almost all expenditures are financed from the state general fund, must differ from the ones applied in such units as state art institutions or universities. Therefore, we propose the following:

- to differentiate several types of institutions currently included in budget entities, defining for each group the specifics of its legal and financial system (e.g. as per the list used in Poland). The minimal requirement is to differentiate a group of institutions that are financed mainly or entirely from the general funds of the state budget from the group of institutions that finance their expenditures mainly or entirely from their own funds included in the special funds of the budget. This differentiation should be reflected in the respective law;
- to define clearly what are the consequences for a budget unit to be a legal entity. This implies identifying the cases, when a certain unit operates individually and independently or operates on behalf and for the state.

4.2 Planning and Passing the State Budget

4.2.1 International standards

Principles and practices related to openness of budget preparation concern budget documentation, setting the deadlines for presentation of pre-budget report and draft budget, and passing the budget. In particular, they require that:

a) budget documentation specifies fiscal policy objectives, fiscal rules, the macroeconomic framework, the policy basis for the budget, and identifiable major fiscal risks; besides budget data is reported on a gross basis distinguishing revenue, expenditure, and financing, with expenditure classified across economic, functional, and administrative categories.

Budget documentation contains detailed information on financial and non-financial performance of all outputs/activities and programs/outcomes in the current year together with comparable information for the previous year; the accounting system has the capacity for accounting and reporting on an accrual basis, as well as for generating cash reports. In other words, budget documentation should include all state revenues and expenditures, and present a wide picture of the financial situation;

b) the division of responsibilities between government branches should be clearly defined including the procedure of budget planning and passing. This also implies that fiscal responsibilities are defined in the legislation (constitutional or administrative law); a high priority is attached to clarifying ambiguity where it arises;

c) the submission deadline of the pre-budget report presentation should be at least one month prior to the tabling of the annual budget. The draft budget should be presented to the legislature no less than three months prior to the start of the fiscal year, and the budget should be approved prior to the start of the fiscal year.

4.2.2 Ukrainian practices and problems

The Budget Code of Ukraine defines budget as a plan of collecting and using of financial funds, which enable state authorities, authorities of Autonomous Republic of Crimea and local self-governmental units to complete their tasks and perform their functions. Consolidated budget is an aggregate of all budgets, and it is used for economic analysis and forecasts. The budget comprises the following items:

- state budget;
- consolidated budget of the Autonomous Republic of Crimea (budget of the Republic and consolidated budgets of regions and cities of republican subordination);
- consolidated budgets of oblasts, and cities of Kyiv and Sevastopol.

Every year, state budget is passed as a special law. The budget consists of general and special funds. Special funds include targeted expenditures,

grants, subsidies for specific purposes, and the residual funds from the previous year. Transfers from general to special funds are allowed only in case they are based on the amendments to the budget act. Extra-budgetary funds can be created only by the Verkhovna Rada of Ukraine.

Box 4.5
Regulations on planning, passing and executing the budget in Poland

In Poland the regulations regarding planning, passing and executing the budget are included in the Law on Public Finance passed in 1998. According to the act, the state budget is an annual plan of income and expenditures and revenues and outlays of:

- state authorities, state control authorities and authorities for defense of rights;
- courts and tribunals;
- central government administration.

In practice, this means that the budget encompasses only budget entities. The construction of the Ukrainian budget, which undermines the inclusion of own revenues of budget entities into special funds, seems to be a better solution than the one adopted in Poland.

a) Budget documentation

Budget documentation is partly compliant with the international standards.

Fiscal rules are also specified in the Budget Resolution and contain, among others, the following:

- the limit of state budget deficit (surplus) as percentage of GDP;
- revenues of consolidated budget as percentage of forecasted GDP;
- the limit of state debt and its structure;
- the total amount of internal transfers;
- weight of capital expenditures in the state budget.

The first draft of the Budget Law is supplemented by the *explanatory note that contains the following information-analytical materials:*

- a detailed description of how budget revenues and expenditures are determined;
- main macroeconomic assumptions for the next fiscal year (projected inflation and exchange rates and the rate of growth of GDP);
- borrowing plan of the government;
- the report on the fulfillment of the Budget Resolution;
- the report on the execution of central and consolidated budget of the preceding year;
- information on the budget resources for the last two years and the next budget year;
- information on the debt service in the long run (30 years);

- detailed information on the stock of the government internal and external debt;
- the list of the current taxes and obligatory payments, accounting for active tax preferences;
- execution of the current budget and the major risks that influence its execution;
- the drafts of the state targeted funds.

Box 4.6
The scope of budget information in Poland (1)

In Poland, the scope of information presented during working on the budget is almost completely compliant to the international standards. Budget assumptions the document prepared by the Ministry of Finance, include among others the following:

- information on state finance and assessment of the economic and social situation;
- economic forecast for the next year;
- proposed changes in acts, which will influence budget income and expenditures;
- budget priorities;
- quantity of budget revenues and expenditures and the deficit.

The budget law contains mainly numerical data, however, the justification is prepared in a descriptive form and is rather voluminous (over 300 pages). The content is regulated by the Law on Public Finance and contains the following:

- assessment of the macroeconomic situation in the budget year and in the following two years;
- plan of revenues and expenditures;
- budget deficit and deficit financing;
- public debt, contingent liabilities due to guarantees and guaranties granted as well as liabilities of the State Treasury;
- directions in privatization of State Treasury property;
- information on current state of general government.

The data on revenues, expenditures, deficit financing is reported on a *cash basis.* The expenditures of the draft budget are presented *across functional and some elements of economic classification***.** Privatization receipts are shown as items of deficit financing. The final release of the Budget Law (available on the web site of the parliament) contains the text of the law and appendices that show revenues, expenditures (across program, functional, and elements of economic classification) and deficit financing items of the central budget, as well as transfers from the central to local budgets. In the year 2003, the draft budget was, for the first time, supplemented by the annexes that show crediting and fixed capital investment programs for 2004.

The evidence shows that explanatory note gives a rather clear picture of the budget draft and, in general, complies with the standards of OECD and IMF.

However, the budget documentation does not allow to see a complete picture of public finance. In particular, **there is no information on**

financial assets and liabilities of the central administration, non-financial assets and remuneration limits. Objectives of the state programs are scarcely indicated and do not provide opportunity for a detailed analysis (e.g. for identifying and tracking expenditures targeted at poverty reduction) decreasing transparency of strategic and operational choices made through government budgets. **A statement of fiscal risks is practically absent**, thus making a forecast of fiscal outcomes and assessment of budget reliability very difficult. **The absence of a proper assessment of various quasi-fiscal activities** leads to the problems in assessing the government's fiscal position and might contribute to poorly *designed fiscal policies.*

To summarize, budget documentation lacks information on the objectives to be achieved by the major budget programs for subsequent years, information on financial and non-financial assets and liabilities of central administration, the assessment of quasi-fiscal activities, and the clarification of the basic fiscal risks to budget execution, which is strongly needed for budget transparency.

Box 4.7
The scope of budget information in Poland (2)

Polish state budget is passed in the form of budget law, which apart from the budget contains the following:

- the list of revenues and expenditures of extra–budgetary economy units (budget establishments, auxiliary units and special units of budget entities);
- plans of revenues and expenditures of state appropriated funds.

Since 2003, it also includes financial plans of other general government institutions - governmental agencies. However, the plans of these institutions are presented in a way that makes impossible their comparison with the remaining part of the sector. The budget law does not include the total amount of financial flows executed in the general government. Some of the institutions (e.g. universities) are only presented in the form of subsidies paid from the budget.

b) Submission deadlines and the role of the government in the process of budget preparation and approval

The Budget Code clearly defines the requirements concerning the process of budget preparation. Most of the requirements are compliant with the international standards.

The Minister of Finance of Ukraine is responsible for the preparation of the budget draft (Article 32 of Budget Code). The Minister defines the main principles related to the organization and methodology of budget planning. On the basis of analysis of the main macro–economy indices for the forthcoming year and budget execution in the current year, the Minister of Finance determines the general level of budget revenues and expenditures and makes an assessment of the amount of budget financing. The latter is used as a basis for preparing proposals for the state budget draft. Budget law has to be passed by Verhovna Rada.

Parliamentary hearings on major guidelines for budget policy for the next budget period should start by June 1st or on the first day of a plenary session of the Verkhovna Rada. The Prime Minister or the Minister of Finance presents a draft of major guidelines approved by CMU to the Parliament (Budget Code, Article 33). This draft should be submitted to the Parliament no later than 4 days before the hearings. While deciding on the budget resolution, the Verkhovna Rada can either approve the Guidelines of the Budget Policy for the next budget period or just take them into consideration. Hence, **fiscal rules set by the government are not binding for Verhovna Rada**. This might result in the situation, when Verhovna Rada proposes the change in expenditures, which does not have a sound economic justification and is not supported by a realistic additional source of revenues.

Box 4.8
Budget process in Poland

According to the Polish Constitution, the Council of Ministers has an exclusive legislative initiative regarding passing and amending the budget law. During its working on the budget draft the Sejm cannot increase budget deficit by either increasing the expenditures or reducing the revenues. The Sejm can increase expenditures only in case when planned budget revenues are also increased. However, it can be easily imagined that budget revenue is increased artificially so that additional expenditures can be entered.

Polish budget law together with the explanatory note is presented in the Sejm by September 30 of the year proceeding the budgetary year.

Article 37 of Budget Code obliges the government to submit the first draft of Budget Law to the Parliament no later than September 15.

The procedure of passing the Budget Law in the parliament is described in details in the Budget Code (Section 7), where the deadlines for passing the law in the first, second and third readings, as well as the responsibilities of the parliament and the government in this process are defined. According to Article 44 of the Budget Code, the Budget Law should be approved by Verkhovna Rada no later than December 1 of the previous year.

However in reality, the deadline for passing the Budget Law has been often violated. For example, Budget Law 2003 was approved on December 26th, the Budget Law 2002 – on December 20th. The reason of the delay was that during the second reading **the Budget Committee of the Verkhovna Rada presented its own budget proposal and got it accepted by the Verkhovna Rada.** Violations of the deadlines and procedures of budget preparation destabilize budget process. An inevitable reduction in time available for the assessment of the draft budget reduces transparency of budget process.

After the Budget Law has been passed, amendments to budget are allowed in case of a serious deviation of budget revenues from the forecasted level, and changes in the structure of expenditures. The amendments to budget should be made only through budget law. Ukrainian legislation does not set limits to the legislative initiative with respect to the amendments in the budget law. The Budget Code (Article 53 and 54) describes special procedures only for the cases, when amendments to the budget result from

the underestimation of revenues or overestimation of expenditures. In reality, the changes in the budget may concern any issues, i.e. revenues, expenditures, structure of the expenditures, transfers to local budgets and government borrowings.

Recent evidence suggests that Budget Laws often introduce a lot of amendments *to other laws* that is not compatible with international standards of fiscal transparency. For example, the Budget Law 2003 (as well as the amendments to the Budget Law 2003) incorporates the changes to tax laws, the law on duty from sale/purchase of currency, the laws that define social privileges, and stops some provisions in another 41 laws. Allowing budget law to make amendments to other laws infringes transparency of budget process. It does not enhance public discussions and leads to the situation, when some amendments are passed by the parliament without a proper consideration. Moreover, a lack of funds could lead to repealing or suspending regulations obliging the state to assign funds to the execution of specific tasks. However, some improvements have been observed during the preparation of Budget Law 2004. In particular, the amendments to tax laws have been incorporated in a separate law that has been approved in the first reading.

The budget year starts on January 1 and ends on December 31. In the exceptional cases, budget can be accepted for a different period of time. Such situations, among others martial law, are mentioned in the Budget Code (Article 3).

In accordance with good practices, Article 46 of Budget Code contains a detailed description of such an arguable situation, when the Budget Law is not passed before the start of the budget year.

In this case, the government has the authority to conduct only those expenditures that were planned for the previous year, and were envisaged in the draft law for the next budget year. Monthly budget expenditures shall not exceed 1/12 of the expenditures proscribed in the Budget Law for the previous year. Also, capital expenditures cannot be made until the Budget Law is passed. The plans for revenue execution are set on the basis of the Budget Law for the previous year.

To summarize, incorporation of amendments to the other laws into the Budget Law, broad possibilities of Verkhovna Rada to amend the budget draft proposed by the government, and violation of the deadlines in preparing and passing the Budget Law constitute a problem for fiscal transparency in the area of budget preparation.

4.2.3 Recommendations

Summing up, our most important recommendations related to the procedure of preparing and passing the state budget are as follows:

1. The scope of budget documentation should be widened.

In particular, it should include information on quasi–fiscal activities, government's financial assets and liabilities, contingent liabilities, non–financial assets and employees' pension obligations. Main possible threats to the budget execution should be identified. Fiscal policy objectives should be clearly specified in the explanatory note to the budget draft.

2. The right of the Parliament to introduce the amendments to the draft budget presented by the Cabinet of Ministers should be limited by Constitution.

In particular, the Constitution should contain current provisions of the Budget Code stating that the Parliament should not have a right to:

- increase state budget deficit proposed by the Cabinet of Ministers in the budget draft;
- increase budget expenditure without setting up the new source of revenue.

3. The Budget law should not contain the amendments to other laws.

The best solution is to include the ban on amending legal acts through the budget law in the Constitution. An inclusion of such a ban in Budget Code or similar legal acts that regulate public finance is not enough. The reason is that legal acts of this type have the same legal power. Therefore, one can imagine passing a new act, which abolishes the regulation containing the ban mentioned above. In case when ban on amending legal acts through the budget is in Constitution, its abolishment becomes much more problematic.

4. The law should guarantee that the Parliament could introduce changes to the budget law only on the motion of the Cabinet of Ministers.

This will reduce the risk of passing the amendments to budget that are rather politically motivated than have a realistic economic justification.

4.3 State Budget Execution

4.3.1 International standards

IMF requirements on transparency of budget execution are focused on specification of the approved expenditures, procurement and employment regulations, and tax administration. In relation to them, the following should be fulfilled:

Comprehensive budget laws and administrative rules that are open to public should govern any commitment or expenditure of public funds. Procurement and employment regulations should be standardized and accessible to all interested parties.

4.3.2 Ukrainian practices and problems

a) Administration of taxes

Although, the tax system of Ukraine is based on a rather strong legislative basis, this does not mean that law provisions are observed.

There are problems with the execution of tax-payers' obligations and rights.

Taxpayers' obligations **concerning submission of the accurate and reliable information to STA as well as full and timely tax payments are not fully executed.** According to the estimates of the Ministry of Economy, shadow economy in Ukraine amounts to 42.3% of GDP. As of 01.01.03, the volume of tax arrears constituted UAH 14.7 bn (i.e. 32% of tax revenues of consolidated budget 2002). STA inspections have discovered unpaid taxes in the amount of UAH 4.9 bn. This is unacceptable because the real tax rates differ from the regulatory ones (which contradicts the law and international standards).

Taxpayers' rights are not fully observed**. The most acute problem is VAT refund arrears** that constituted UAH 7.5 bn as of 01.01.03 (i.e. about 50% of VAT revenues planned for 2003).

Such a practice changes the form of the tax, i.e. instead of the value added tax there is, in fact, a tax on turnover. Such a practice is risky, because there may be unfair sector policy carried out, as some sectors will have the outstanding amounts returned in time, and others will not.

Other consequences of the current situation are as follows:

- depreciation of the prestige and reliability of the state in the eyes of entities operating (or intending to operate) on the market;
- falsification of the picture of public finance – delay in reimbursement inflates the current income, which, in turn, may undermine the budget;
- a lower rate of tax collection – taxpayers try to avoid paying their liabilities to the state, when they feel that the state does not pay its liabilities to taxpayers;

- worsening of financial standing of the companies;
- increase in costs covered by the state if the outstanding amounts are to be returned with interest.

b) Rules concerning public procurement, employment, social benefits, and state aid

Public procurement

The recent improvement of system of public procurement in Ukraine is associated with the implementation of the Law "On public procurement of goods, works and services" that has standardized the regulations of all purchases of goods, works and services, which involve public funds, where the volume of purchases exceeds the specified amounts. The Law sets similar regulations for the purchases financed from the state and local budgets. The Law specifies the cases, when purchases of goods, works and services are to be conducted through a particular form of public procurement, such as open tendering or asking for quotes. "Herald of public procurement" is established for mandatory announcement of tenders. The legislation determines the requirements for the firms that are competing for a contract, and specifies the details of reporting.

In practice, public procurement is dominated by asking for quotes. For example, in the first quarter of 2002, two thirds of all purchases were executed through the mechanism of asking for price quotes. Nevertheless, the amount of funds spent through open tendering is growing.

Box 4.9
Public procurement in Poland

In Poland, there were also attempts to apply non–tender procedures. However, more effective control improved also the application of the act and, presently, several excessively severe regulations are being slowly removed.

The Law includes the provisions concerning protection of national producers. Provided the tender amount does not exceed an established limit, the purchaser can offer a 10%-higher preferential price to domestic producers. Tender conditions can require prospective foreign contractors to use domestic inputs. Some producers (e.g. Association of the blinds) are entitled to the 15%-preferential price increase without any restrictions on the sum of the contract. Public procurement procedure provides exemptions for the contracts related to national defense or purchase of sensitive technologies. The exemptions can be granted by the CMU.

The Decree of CMU "On the Adoption of the Rules of Inter-agency Coordination of Public Procurement" describes the conditions, when centralization of purchases is required. Its provisions are mandatory for central government and are advised for execution to the local governments.

The violations of public procurement regulations are punished in accordance to general provisions for the mismanagement of public funds.

Even though legal regulations seem to be compliant with the international standards, the practice does not ensure full openness

and transparency of public funds management, i.e. the legal provisions are not always observed. The violations include ignoring the requirements of conducting open tenders and their public announcement, as well as providing improper reporting documentation and corruption practices. For example, in the first quarter of 2002, 2,447 enterprises that conducted purchases using public funds were inspected. In 432 cases, the purchase of works, goods and services was conducted without recourse to tendering. There were also violations of the requirements concerning tender documentation and mandatory procedure of the announcement of tenders. During the first quarter of 2002, about one quarter (22 out of 83) of main spenders of public funds did not submit the statistical public procurement form to the State Committee on Statistics.[13]

Though the legislative framework of public procurement seems to be in place, its implementation remains high on the agenda.

Social benefits

Different laws as well as decrees of the Cabinet of Ministers determine types and amounts of social benefits. The compulsory state social insurance is conducted via extra-budgetary funds. Pension benefits,[14] stipends,[15] different privileges and subsidies to the citizens of Ukraine are paid either from the state or local budgets.

Some of the social benefits are not transferred to the citizens who are legally entitled to them, due to scarce budget funds. For example, resolutions of CMU and different ministries set the amount and criteria of eligibility for subsidies for housing and communal services; however, due to insufficient financing some low-income families were not able to use their right and receive state assistance.

Some privileges and subsidies are covered by service providers[16] (e.g. transportation enterprises) at their own expense without appropriate refunding from the budget. In principle, privilege-related losses should be compensated from local budgets on the basis of the reports of service providers. However, in practice, refunding remains a painful question due to a lack of funds in local budgets. This has a negative impact on the financial position of the respective enterprises and pushes them to increase the tariffs for non-privileged groups of consumers. **The insufficient reimbursement of such costs should be classified as quasi-fiscal activities.** Although quasi-fiscal activities itself do not contradict IMF requirements on fiscal transparency, detailed reporting is strongly recommended. **However, there is no such reporting in Ukraine.**

---

13 Letter "On functioning of the system of public tenders in I quarter 2002".

14 The Pension fund receives money from the State budget for paying pension benefits to militaries and additional benefits according to different pension programs.

15 The Resolution of CMU No. 950 establishes the amount of stipends and the procedure of their payment.

16 They include state bodies, bodies of local and regional governance, enterprises, institutions and other organizations.

Some positive development in this respect is associated with the Decree of CMU,[17] which obliges local councils (Radas) to cover travel expenses of their deputies (in line with their right to get free transportation) directly from local budget.

The legislation envisages extensive privileges that are professionally based. Often, these privileges cannot be fully compensated from the budget and turn into a burden for the enterprises.

Ministry of Economy and European Integration of Ukraine estimates the amount of all privileges for the year 2003 of about UAH 17.3 bn, while relevant expenditures in the State Budget 2003 are planned at less than UAH 6 bn.

Existing system of social benefits is not sustainable within the present system of its financing and administration. This situation raises concerns in the distribution of social benefits and reimbursement of costs to enterprises.

State aid

Currently, paragraph 3 of the Article 1 of the Law "On Enterprises" states that enterprises could be provided with subsidies and other privileges, if the state considers it to be socially beneficial.

Ukrainian legislation does not define state aid or determine conditions of its granting. As of today, Ukraine has neither a clear and transparent procedure of providing state aid, nor an institution for its control and monitoring. The lack of legal basis for all public expenditures (e.g. a lack of principles for granting public aid) results in a weakened public scrutiny (throughout the Parliament) over the state expenditures and increases the risk of corruption.

Article 16 of the new Commercial Code, adopted in 2003 (effective since January 1st 2004), entitles the state to grant subsidies and other forms of aid and lists the activities eligible for subsidization (e.g. production of vital medicine, transportation services for socially important freight, etc). The Code stipulates that provision of state aid has to be regulated by additional laws. Being general in its character, Article 16 does not give any details on the amount, timing and procedure of granting, controlling and reporting of state aid. Antimonopoly Committee of Ukraine can consider state aid issues only in case it creates barriers for market entry and increases the danger of monopolization of the market.

Presently, Ukraine has only sector-specific laws on state aid and lacks a general legislation, which is currently being drafted by the Antimonopoly Committee of Ukraine.

[17] Decree of CMU "On rules and conditions of free transportation for the deputies of local councils", No. 1738, 16.11.2002.

Box 4.10
State aid in Poland

In Poland, there is a legal basis for procedures related to executing public procurement, paying remuneration and granting public aid. Moreover, all benefits are paid only in cases defined by law. There is a loophole in case of public investments. The investments should be directly related to public tasks. Investing public funds should be preceded by a professional analysis, which shows how the investment helps to fulfill public tasks and presents a broader context of the investment (economic programs).

Present situation in Ukraine resembles the situation of Poland in the 1980s, when the regulations of the budget law were so general that they allowed subsidizing practically every business entity. Subsidies could be granted in the scope defined by other acts or regulations issued on their basis. In practice, very frequently this act was the budget law for the given year. The definition of the amount for subsidies for a certain group of enterprises in the act was already regarded as constituting legal basis for granting subvention. This led to the situation, in which decisions on granting subsidies were taken arbitrarily.

In 2001, in Poland, an act has come into force, which defines conditions for granting public aid to entrepreneurs. The act introduced relevant limitations in the possibilities of using various financial facilities offered by the state. According to this act, granting public aid is possible only in case it fulfills five conditions at the same time:

1) in case of investing or creating new working places, it complements funds provided by the entrepreneurs;
2) its amount, duration and scope are proportional to the importance of the problem being resolved;
3) the resulting social profits – taking into account the costs of granting the aid – are bigger than those achieved without aid;
4) it supports the projects to the extent, scope and during the timeline indispensable and sufficient to achieve the goals of the aid;
5) it is characterized by transparency, which facilitates its supervision.

Specific laws are passed every time, when state support is provided to any of the sectors or enterprises, which are considered to be of a "special importance" for the economy. These laws are used during the preparation of the state budget. An example of sector specific approach is air-construction industry, where according to the Law "On state support for the air-construction industry in Ukraine", enterprises are entitled to customs and tax privileges during 2002- 2007.

Agriculture, among other types of support, receives tax privileges granted by the Law "On stimulation of the agricultural sector for 2001-2004". In 2001, the volume of tax privileges concerning VAT refund for agricultural sector was about UAH 1,175 bn.

Information on the amount of state aid in the form of direct subsidies can be found in the Law on State Budget. In State Budget 2003, for instance, aid to the agricultural sector foresees financial support of cattle and plant production (Article 2801210), financial support of farmers (Art. 2801230),

financial support of agricultural enterprises in difficult climatic conditions (Art. 2801280), etc. CMU is responsible for distributing financial support to the final recipients via its decrees or orders of the other ministries responsible for a particular sector. State budget as well as treasury reports does not show the distribution of subsidies across the recipients. The amounts of implicit state aid (e.g. state guarantees of loans, tax privileges, etc.) are not disclosed for public scrutiny.

The absence of the clearly defined rules of state aid provision, an independent regulator as well as public reporting contradicts the principle of transparency of public finance.

Remuneration of labor in public sector

Total funds devoted to the remuneration of labor as well as the level of wages in public sector is determined by legislative acts and resolutions of the executive bodies.

The Law "On the Remuneration of Labor" states that remuneration of labor in public sector of Ukraine should be based on the tariff system. According to the Law, wages in budget sector are to be determined on the basis of tariff scale, tariff rate of the first tariff class (which have to be higher than minimum wage), system of basic salaries and description of skills. However, **currently this law is not fully implemented: remuneration of labor in public sector is not based on tariff scale but on basic salaries scale and is regulated by the resolutions of CMU.** Hence the regulation of remuneration of labor in public sector is contradictive.

The resolutions of CMU determine the level of basic salaries and the system of extra payments and bonuses for public employees. Consequently, **the increase in minimum wage initiated in 2002 and 2003 led to a distortion in the inter-qualification wage differentiation**, since it caused an increase in wages of low-paid employees without affecting remuneration of labor in the other groups of public employees.

In order to solve the problem, the system is supposed to be transferred to the required tariff rate. For this purpose the Cabinet of Ministers approved the Resolution "On the remuneration of labor on the basis of unified tariff scale of classes and coefficients for remuneration of labor of employees working in all institutions, organizations of budget sector" (adopted in August 2002), which regulates setting of tariff scales for employees in budget sector. However, **enacting of this Resolution was postponed many times due to scarce budget funds**, thus shifting solving the legislative contradiction to the later.

Every year, State budget law sets the amount of funds dedicated to remuneration of labor, and within these limits, central executive bodies and local administrations determine funds for remuneration of labor for their employees and subordinated budget entities.

However, **planning of remuneration funds for budget entities does not allow the separation of amounts financed via the general funds of state budget from those financed via special funds.**

Besides, t**he system of planning expenditures for remuneration of labor in public sector is not transparent.** For example, in the year

2002, the law that initiated wage increase for 2003 was approved after the adoption of Budget Law, and hence the sources of financing the increase in budget expenditure were not specified. Though, in 2003, the situation has been improved by making amendments to the Budget Code that require the approval of minimum wage level by the Budget Law.

4.3.3 Recommendations

1. Tax payers' rights and obligations should be fully observed.

This, first of all, requires an urgent solution of the problem of paying state budget liabilities.

VAT refund arrears should be eliminated and formation of outstanding payments should be avoided in the future.

The origin of the problem should be identified. The arrears may result from the difficult budget situation, a lack of funds for the up–to–date payments, or they are unfair instruments of running *quasi*–sector policy. If delays are caused by interpretation problems, then the system needs to be simplified or the services should be supported. If the problem lays in difficulties with financing current state budget payments, then the state should pay the outstanding amounts off even if it needs to make a debt and formally increase the state budget deficit.

A compensation for a delay in VAT refunding should be paid. It can be concluded out of the Polish experience that using such techniques by the state as taxes wheedling may have severe financial consequences (incorrectly accrued CIT or VAT is paid immediately to Polish entrepreneurs and the compensations assigned by courts are very high).

2. The law on public procurement should be observed.

Given a rather developed legal basis of public procurement, the focus should be made on ensuring more effective supervision. Also the responsibility for breaching the rules of law must be very clearly defined and implemented.

Implementation of the regulation of public procurement should ensure:

- protection of competition – all entities interested should have a possibility of participating in the tender;
- protection of taxpayers – purchases made by public institutions should minimize costs of taxpayers;
- counteracting corruption – introduction of clear and rigid procedures makes it difficult to conclude contracts by bribing.

In order to achieve these goals, the basic rule of the system should be selection of business counter–party by the way of tender, which everyone can generally take part in. The second important rule should give people or companies that did not win the tender the chance to protest and, in case of any irregularities, demand compensation for profits foregone in the civil trial. There should be also effective control that ensures prevention of

dividing the procurement into parts or lowering the value of the procurement in order to avoid application of the act.

3. A legal basis for all budget expenditure, in particular state aid, should be established.

It would be useful to introduce into Ukrainian law a principle stating that public funds can only be spent for executing public tasks. In order to have this regulation applied, there must exist a clear system of tasks and procedures for executing the expenditure.

The adoption of the special legislation on state aid is very important. The law should comply with the international principles of state aid provision reflected in the legislation of the European Union, namely:

- *Laisser faire:* Any form of state interventions affects market forces limiting competition. Thus, if state support is inevitable its negative impact on competition has to be minimized.
- *Independent institutions:* There should an independent institution that regulates and controls the provision of state aid. Procedures should be transparent and clear.
- *Accountability:* It is crucial to evaluate the need for state aid, the effectiveness of its use, and its effect on competition and economic welfare of the society.
- *Transparency:* Public access to the information on provision and using of state aid should be provided.
- *Limited continuity and scope:* State aid should be limited in its amount, duration, and coverage of support. The limits of using public funds in the entrepreneurial activities should be defined. The availability of aid to a specific recipient should be constrained. Degressive principle of aid provision should be applied: amount of state aid should over time.
- *Sectoral aid:* "Sensitive" sectors or special types of aid should be strictly defined in order to prevent further origination of state aid schemes with a special treatment.

The law on public aid should include the element of *ex ante* assessment so that at the stage of preparing the state budget, each expenditure item for public aid could be consulted with the office supervising public aid.

4. The system of social benefits should be based rather on targeted aid than tax privileges.

5. In the area of remuneration of labour in public sector, the legislative contradictions should be eliminated.

This implies, first of all, an implementation of the tariff scale system, which has been already worked out and supported by the adoption of relevant legislation. Also the system of bonuses in public sector should become clearer and more transparent.

Secondly, the legislation should set a clear procedure for planning the remuneration funds in public sector. A particular attention should be paid to the procedures of defining remuneration funds for entities that are subordinated to spending units. Besides, it is important to specify the procedures of financing the remuneration funds of different budget entities from special or/and general funds of the budget.

4.4 Accountability and Reporting

4.4.1 International standards

Effectiveness of finance sector is largely dependant on the character and type of the control that supervises it. It is important to create such an accounting and reporting system that is able to assess all processes related to managing public finance. Such a system should include the issues related both to the accounting as well as preparing and approving of reports.

Major standards of fiscal accountability and reporting are defined in IMF Revised Code of Good Practices on Fiscal Transparency and OECD Best Practices for Budget Transparency.

In this framework, IMF defines the following principles:

1. Budget information should be presented in a way that facilitates policy analysis and promotes accountability. Thus, public sector balance should be reported, when nongovernment public sector agencies undertake significant quasi-fiscal activities.

2. There should be regular fiscal reporting to the legislature and the public.

- A mid-year report on budget developments should be presented to the legislature. More frequent (at least quarterly) reports should also be published.

- Final accounts should be presented to the legislature within a year after the end of the fiscal year.

- Results achieved relative to the objectives of major budget programs should be presented to the legislature annually.

3. Borrowing or a rundown of liquid assets are deficit financing or "below the line."

4. Budget data should be reported on a gross basis distinguishing revenue, expenditure (that are classified by economic, functional, and administrative categories) and financing. The overall balance of the general government should be a standard summary indicator of the government's fiscal position. It should be supplemented, where appropriate, by other fiscal indicators for the general government (e.g., the operational balance, the structural balance, or the primary balance).

OECD defines terms and content for monthly, mid-year and year-end reports.

4.4.2 Ukrainian practices and problems

a) Fiscal recording

Ukrainian system of fiscal recording has a sound legislative basis.

The Law "On accounting and financial reporting in Ukraine" (as of 1999) establishes accounting rules for all organizational units in the economy. Budget Code defines the overall framework of the accounting system for the units of general government. Article 56 obliges the State Treasury of Ukraine (with the approval of Ministry of Finance) to develop a comprehensive integrated accounting system for all budgetary institutions and extra-budgetary funds. The State Treasury records all operations related to the state budget execution, which reflect all state assets and liabilities. Key spending units have to comply with the rules issued by the State Treasury. Every year in January, the State Treasury issues an order with a detailed description of all the issues related to annual financial reports of budget institutions including the list of all accounting forms to be submitted by budget units and submission procedure.

Unified accounting system of budget units that has been established in 1999-2000 is rather clear, well defined, consistent with the international standards, and operational.

Accounting of organizational units of general government in Ukraine is done on the cash basis – revenues and expenditures are registered only where they are executed. According to the Budget Code (Article 56), the State Treasury of Ukraine comprises all operations of state budget execution in its registry, which reflects all assets and liabilities of the state. Revenues and expenditures are presented on the gross basis.

b) Classification of budget expenditures

Budget Code envisages functional, economic, administrative and program classification of budget expenditures. Functional classification, currently, consists of 10 broad categories (defense, state functions, health, economic activity, social security, public order, culture, communal services, education and environment protection) that are further divided into sub-categories. Budget expenditures are classified by functions, which implementation is connected to expenditures. Economic classification of expenditures is based on economic characteristics of transactions involved. Administrative and program classifications of budget expenditures are closely related to each other: in administrative classification, expenditures are presented across the spending units that are authorized to conduct the expenditures. Program classification presents the list of programs that are financed from budget, and expenditures are shown across the spending units that are responsible for program execution.

The Order of the Ministry of Finance "On Budget Classification and its Adaptation" (2001) constitutes a step forward in improving budget accountability. It puts budget classification in Ukraine in line with the international standards specifying all revenues included into the state budget, and expenditures financed from the state budget. Besides, it classifies deficit financing items, i.e. external and internal borrowings, privatization receipts.

However, the Budget Code does not define privatization receipts as a deficit financing item. Instead, it considers privatization receipts as a source of budget revenues, even though, in reality, it is an item that finances the budget deficit, as it is required by the international standards.

However, from time to time, there are attempts to include privatization into the budget revenues. This could complicate the evaluation of budget deficit.

The Order of the Ministry of Finance "On Budget Classification and its Adaptation" improves management of extra-budgetary funds, which in former times were almost beyond the governmental control. Starting from 2000, the vast majority of revenues and expenditures of extra-budgetary funds has been included into the budget as a special fund. This increases overall fiscal transparency, since both revenues and expenditures of budget units are shown in the budget and transferred through State Treasury account. Such a scheme is in line with IMF standards of fiscal transparency.

Presently, budget classification is in line with the international standards, **though the change in accounting methodology have created some problems for comparing budget data over time.** For example, till 2002 functional classification of the budget expenditures consisted of 25 categories, but starting from 2002 functional classification includes only 10 categories. There is a methodology that allows adjusting fiscal data from the previous period of time to new classification, though technically this procedure is rather complicated.

Box 4.11
The budget methodology in Poland

In Poland, the methodology is precisely regulated and all modifications are described in details. The practice of recent years has shown that there are attempts to introduce modifications, which are aimed solely at changing the accounting result. For example, subsidies to the Social Insurance Fund are included into outlays instead of budget expenditures. This decreases artificially the level of budget expenditures and deficit.

c) Reporting

Ukrainian budget data reporting (both methodology and technical issues) is, to a large extent, consistent with the international standards. On January 10th, 2003, Ukraine became the 52nd country that officially joined the IMF's General Data Dissemination System (GDDS). Ukraine is obliged to pass information on practical usage of standards concerning economic and financial data to the Fund.

Budget data is reported on monthly, quarterly and year-end basis across revenues, expenditures, and financing, with expenditures classified by economic, functional, and administrative categories. Although, the reporting is made on the cash basis, it does not contradict international standards since there are supplementary materials that allow evaluation of the budget outcome basing on the accrual basis. For example, the Treasury collects information on payment and tax arrears and submits it to the Verkhovna Rada, the Cabinet of Ministers, the Accounting Chamber and the Ministry of Finance.

Besides, the Treasury collects information on in-kind revenues of budget entities, however, **in the report all the revenues are provided in monetary terms, and it is impossible to separate in-kind revenues from the rest**. *Both domestic and externally financed transactions are*

included into the accounting system. On the basis of provided information, the Treasury prepares the report on revenues and expenditures of the special fund of the state budget, including information concerning international institutions.

Adoption of the Budget Code has contributed to the transparency of budget reporting by defining the requirements to its content and procedures. This concerns, however, only monthly, quarterly and year-end reports on budget execution, since **mid-year and long-term reports required by the OECD standards are absent in Ukraine**.

Monthly Reports

The State Treasury of Ukraine submits monthly reports on the execution of central budget to Verkhovna Rada, Cabinet of Ministers, Accounting Chamber and Ministry of Finance no later than 15th of the next to reporting month. Besides, no later than 25th of the next month, State Treasury releases information on the execution of protected expenditure items of the budget and the use of the Reserve Fund. Comprehensive monthly reports on budget execution become publicly available around 25-28th of the next to reporting month on the web site of Budget Committee of the Parliament (http://budget.rada.gov.ua).

Monthly Treasury Report is a comparative table that contains information on annual plan, changes to annual plan and executed amount for the reporting period. Information is related to the amount of revenues and expenditures of general fund of central budget planned for the reporting period. This allows calculating the execution rate for different items (actual amount divided by the planned one for respective period). Monthly Treasury report contains the following information:

- execution of revenue items of the central, local and consolidated budgets;
- execution of expenditure items of the central, local and consolidated budgets;
- central budget deficit financing items, classified by the type of borrowing and creditors. Information on borrowing is presented in great details: borrowings are divided into internal (includes privatization receipts) and external ones with a further classification into short, medium and long-term ones.

In general, monthly Treasury Reports on budget execution are in line with OECD best practices as for the terms of their release and the scope of information, specifically, presentation of in-year adjustments to original plan, classification of expenditures and information on borrowing activity. However, they still have some drawbacks.

Firstly, there is no practice to submit any explanatory notes in case of a significant divergence between the planned and actual level of execution of budget items.

Secondly, data is reported in gross terms on a cumulative basis that contradicts OECD standards.

Thirdly, monthly Treasury reports do not contain information on extra-budgetary activities.

Quarterly Reports

In Ukraine, **there are no mid-year reports that show progress in budget execution bi-annually**. Instead, information on 6 months budget execution is shown in monthly Treasury Report that is released no later than the 15th of July. Besides, according to Budget Code (Article 60), the State Treasury submits a quarterly report on budget execution no later than the 35th day after the end of reporting period. The quarterly report has the structure similar to monthly report, but since it is released a few weeks later, it contains more refined data.

Quarterly reports lack some information required by OECD best practices for mid-year reports. **They do not provide: a) an updated forecast of budget outcome for a given year and the following two years; b) a review of assumptions used for preparing the budget; c) information on balance of government's financial and non-financial assets and employee pension obligations.**

Year-end reports

Article 58 of Budget Code and the Decree of Cabinet of Ministers "On the Approval of the Order of Submission of Financial Accounting" obliges all spending units financed from budget to submit their detailed annual reports (including statement of balance, data on execution of revenues and expenditures, and performance data) to the State Treasury and Accounting Chamber no later than the 1st of March of the next to reporting year. Extra-budgetary funds, i.e. Pension Fund, social insurance funds against unemployment, industrial accidents and temporary working disability, submit their year-end reports to Cabinet of Ministers and publish them later in mass media.[18]

Annual budget report has to be submitted to Verkhovna Rada by the Cabinet of Ministers no later than May 1st of the next to reporting year. It is presented in the same form as Budget Law as well as monthly and quarterly Treasury Reports, and contains the following information:

1) a balance sheet of execution of the State Budget of Ukraine;
2) a report on execution of the State Budget of Ukraine;
3) a report on cash flows;
4) information on execution of protected expenditure items of the State Budget of Ukraine;
5) a report on budget arrears;
6) a report on use of resources from the Reserve Fund of the Cabinet of Ministers of Ukraine;
7) information on state debt;
8) a report on loans and other transactions that entail the liabilities guaranteed by the government;
9) consolidated indices of reports on budget execution;

[18] In reality, social insurance funds publish restricted information on their budget execution.

10) information on execution of local budgets; and

11) other explanatory information, which, in the opinion of the Cabinet of Ministers of Ukraine, is appropriate.

The annual budget report has a clear structure showing originally planned revenues, expenditures and borrowings, and amendment made during the year. Expenditures are classified across economic and functional categories, and across the spending units. The annual budget report comprises rather detailed information on financial liabilities of the government, i.e. the status of the state debt.

Despite the fact that the scope of the annual budget report is rather extensive, it still does not contain some important data required by OECD standards. **First of all, there is no information on non-financial liabilities of the government**.

Secondly, the balance of general government does not include quasi-fiscal activities of the government, such as subsidized lending, rescue operations etc. At the same time, in the Explanatory note to the report, the CMU provides information concerning expenditures for subsidies and recurrent transfers to enterprises, financial support to agricultural enterprises through mechanisms of interest rates reduction on credits provided by commercial banks, partial compensation of costs for domestically produced agricultural machinery, etc. Besides, together with the annual budget report, the CMU also presents another report on the state guaranteed liabilities. The latter contains information on the enterprises, which have received credits under the state guarantees, and the amount of these credits both in foreign (USD and EUR) and domestic currencies.

However, the information presented in the Explanatory note is rather aggregate and incomplete.

Thirdly, **there is no information on the execution of major budget programs, i.e. the results of the programs or the explanation of the deviations from program's objectives**. Reporting the results of programs is often impossible due to the absence of the clearly defined program targets.

Finally, annual budget reports do not contain information on employment and employee pension obligations, government's financial and non-financial assets.

Pension Fund and social insurance funds submit their annual reports to the Cabinet of Ministers and publish them in press. **However, their reports are not submitted to the Parliament.**

Long-Term Reports

In Ukraine, **there is no practice to develop long-term reports that assess the long-term sustainability of current government policies**. In particular, in terms of budget forecasts there is no research on the impact of demographic changes on government policy in the budgetary sphere. This important issue proscribed in OECD standards, is missing in Ukraine that negatively influences fiscal transparency.

Box 4.12
Budget reporting documentation in Poland

In Poland, the document summing up the budget execution, which is presented in the Sejm, includes the following:
- consolidated information on the budget execution of local self–government units;
- assessment of macroeconomic assumptions and privatization of the State Treasury property.

In the budget report, there is also information on execution of financial plans of all state appropriated funds as well as governmental agencies, and information on the debt, deficit and guaranties of general government. Reporting does not include the entire public sector; it does not contain e.g. information on finances of universities or cultural institutions.

d) Reporting on public borrowing

Currently, Ukrainian legislation does not define public debt. Domestic state debt, according to the definition provided in the Law "On Domestic State Debt", includes liabilities of the Cabinet of Ministers of Ukraine in monetary form. Outstanding debt is equivalent to direct state debt. State debt management is conducted by the Ministry of Finance that performs all operations concerning redemption and servicing the debt, and making new borrowings. The Ministry has to coordinate state debt management activity with the NBU, which is prohibited from direct state budget deficit financing.

According to the Budget Code, the Law "On Domestic State Debt" and the Order of Ministry of Finance "On the Procedure of Accounting of State Debt and Related Operations of the Ministry of Finance", the government should disclose information on state debt in quarterly and annual reports on central budget execution and prepare detailed explanatory notes as for the changes in state debt of Ukraine. In practice, *Ministry of Finance provides extensive information on state debt performance.* It discloses for public access monthly-updated information on dynamics of main state debt indicators including total volume of state debt (both in national currency and U.S. dollars), volumes of external and domestic debt, and volumes of direct and guaranteed debt (both external and domestic), as well as expenditures on state debt servicing and redemption (separately for external and domestic debt). The state debt indicators are also classified by maturity profile and the type of lender. Information on conditional state debt is reported every second month.

During the last several years, due to the adoption of the Budget Code, extensive information on state debt performance was provided. However, some important information of public borrowing is still missing.

Firstly, the liabilities of public entities are neither considered to be a part of state debt, nor reported as a part of public debt due to the absence of the legal definition of the latter.

Box 4.13
Public dept in Poland

In Poland, issues related to the debt and deficits are regulated by the Law on Public Finance. Public debt is defined as a nominal debt of the public sector units settled after eliminating financial flows between the entities belonging to public sector. State Treasury debt denotes nominal debt of the State Treasury. State debt includes the liabilities arising from the following:

- issued securities;
- loans and credits taken;
- required liabilities of budget entities;
- required liabilities resulting, among others, from acts, court decisions as well as guaranties and guarantees.

Secondly, in contrast to international standards, the government does not disclose information on its financial assets, i.e. marketable securities, investments and loans to enterprises and other entities etc.

Thirdly, monthly and annual reports on budget execution show only operations related to the direct debt, i.e. amounts that have been borrowed and repaid during the reporting period, while **there is no detailed information on state guarantees that come into force.** Besides, though the Law on Central Budget regulates issues of state guarantees,[19] **it does not set any explicit limits on the size of guarantees that can be provided in the current year.** This, in fact, could result in a considerable fiscal burden in the future.

According to the Law "On Domestic State Debt", the Ministry of Finance conducts state debt management. Specifically, Ministry of Finance performs all operations concerning redemption and servicing the debt, and making new borrowings. The Ministry has to coordinate state debt management activity with the NBU, which is prohibited from direct state budget deficit financing. However, **from time to time the government tries to involve National Bank in various quasi-fiscal operations**.

Hence, the information that could enhance proper evaluation of the fiscal sustainability is not full due to the absence of the definition of the public debt and a lack of information on quasi-fiscal activities, financial assets, i.e. marketable securities, investments and loans to enterprises and other entities etc. The legislation does not set explicit limits on providing the size of guarantees.

4.4.3 Recommendations

1. Budget reports should present main aggregated data (revenue, expenditure and deficit) in a compatible way with ESA/SNA

[19] Specifically, the Law "On the State Budget 2003" stipulates that state guarantees cannot be provided in the current year, except of guarantees for loans given by international financial institutions in case their redemption has to be made from the central budget.

standards (European System of Accounts/System of National Accounts).

a) This, first of all, concerns the reporting of public debt. The issues related to **public debt should have a sound legal basis**. First of all, public debt should be legally defined, and liabilities of all public sector units should be included into the public debt. The information on quasi-fiscal activities, financial assets, i.e. marketable securities, investments and loans to enterprises and other entities etc, as well as the detailed information on state guarantees that come into force, should be regularly reported.

In the short run, in order to solve this problem, **the Verkhovna Rada should adopt the Law "On the state debt", which is presently discussed in the parliament**. The draft law provides the definition of gross liabilities of state sector, which coincides with the international definition of public debt, and includes state debt, debt of NBU, debt of local self-governance, debt of budget entities, etc. The draft law refines classification of public debt (by adding classification across the type of interest rate) and obliges Ministry of Finance to disclose regular information on main public debt indicators. This is expected to increase transparency of state debt management and reporting in Ukraine.

b) Monthly, quarterly and annual budget reports should contain all data that is required by the international standards:

- this implies that extra-budgetary activities should be reported together with the budget data;
- in addition, monthly reports should present data for each month. In case of a significant divergence between the planned and actual level of budget execution, monthly reports should be complemented with an explanatory note;
- quarterly reports should include an updated forecast of budget outcome (budget revenues and expenditures, borrowings and budget deficit) for the given year and the following two years, review of the assumptions used in preparing the budget, balance of government's financial and non-financial assets;
- data on non-financial liabilities of the government, quasi fiscal activities as well as information on the execution of major budget programs, i.e. the results of the programs or the explanation of the deviations from program's objectives, should be presented in annual budget reports;
- preparation of long term budget reports that assess the long-term sustainability of current government policies should become a part of the process of budget reporting.

2. The Budget Code should define privatization receipts as a deficit financing item.

4.5 Local Governments' Finance

4.5.1 International standards

Principles of functioning of the local self-government are defined in the European Charter of Local Self–Government (ECLS). In 1997, Ukraine ratified this document as a whole and thus committed herself to comply with the principles.

Basic provisions of the European Charter of Local Self-Government focus on the following issues:

a) rights and responsibilities of local self government in regulating and managing public affairs:

- local self-government denotes the right and the ability of local authorities, within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population;
- public responsibilities, in general, are exercised by those authorities, which are closest to the citizens;
- powers given to local authorities should normally be full and exclusive. They may not be undermined or limited by another, central or regional, authority except for that provided by law.

b) financial resources of local self-government entities (LGEs):

- local authorities are entitled (in the framework of the national economic policy) to adequate financial resources of their own, which they may dispose freely within their powers;
- at least a part of the financial resources of local authorities derives from local taxes and charges, which rates, within the legal limits, they can determine themselves.

c) equalization procedures:

The protection of financially weak local authorities calls for an institution of financial equalization procedures or equivalent measures, which are designed to correct the effects of the unequal distribution of the potential sources of finance.

4.5.2 Ukrainian practices and problems

a) Rights and responsibilities of local self government in regulating and managing public affairs

Over the last years, significant improvements have been observed in the constitutional and legal arrangements for the local self-government. Constitution and the Law on Local Self-Governance has granted LGEs an independent political status and defined their rights and responsibilities.

However, up to now some of the fundamental requirements imposed by European Charter are not fulfilled.[20] The main problem lays in the excessive concentration of public tasks and public funds in the hands of state administration and the absence of a clear division of responsibilities between the different levels of local authorities, as well as between LGEs and the state.

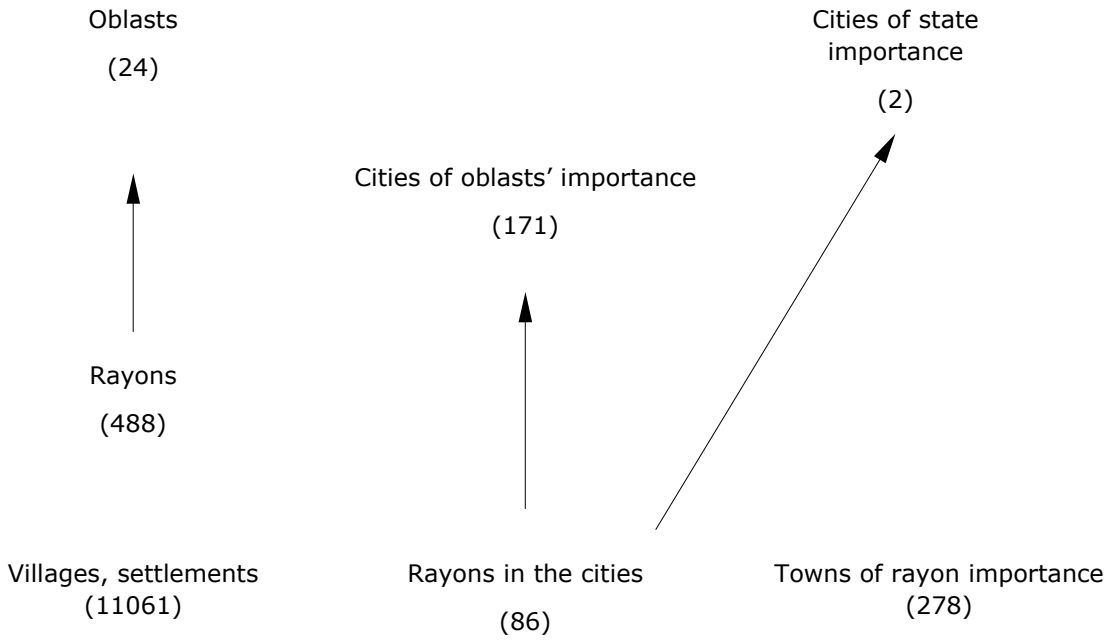
A large quantity of LGEs is a serious obstacle for decentralization of public tasks and financial independence of local self-government.

In Ukraine, local self-government entities are represented by:

- village, settlement, and town (city) councils - elective bodies that represent the interests of territorial communities and decide on their behalf- with their executive boards;
- rayon and oblast councils – elective bodies that represent joint interests of territorial communities of the villages, settlements and towns- which do not have their executive bodies.

The borders of current territorial units of Ukraine have been established in socialist times, when no attention has been paid to the ability of the local governments to provide local public goods. A dispersion of local authorities is especially acute, when it concerns the units that are closest to the citizens (see Graph 4.1).

Graph 4.1
Local Self-Government Entities Ukraine (in brackets: number of entities)



[20] In the Recommendation 102 (2001) dated November 13, 2001 on local and regional democracy in Ukraine issued by the Council of Europe there is a list of incompliance of the Ukrainian law to the content to ECLS.

Administrative arrangement within the given territorial framework is not completely clear. While the number of territorial units in Ukraine is 30,8 thousands, there are only 12,1 thousands LGEs. This is related to the fact that some of the country-side communities elect councils that represent several villages. Only about 11,000 units have their own budgets. As a rule, numerous village councils do not have sufficient financial and administration resources enabling them to execute public tasks. Consequently, some of the tasks, which should be executed by local self-government, are delegated to the rayon level, where they are handled by the state administration.[21] This contradicts Article 3 of the ECLS that defines the local self-government as the right and the ability of local authorities to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population.

The quantity of rayon and oblast LGEs is also too large in the sense that not all of them are able to perform public functions related to the support of regional growth or provision of services beyond the local scope.

Box 4.14
Local self-government in Poland

In Poland, there function almost 2.5 thousand local self–government units – gminas.This still seems to be a large number taking into consideration that some of the village gminas have too little potential to carry out activity aimed at developing its territory. In recent years some gminas have carried no investments.

In 1998, the bigger cities were made poviats, and in the remaining area independent poviats were created. This was one of the biggest mistakes of the reform. Since a large part of extra–local infrastructure, which is exploited by inhabitants of cities having the status of a poviat, is located in the cities, the creation of separate poviats was irrational.

Local self-government in Ukraine has not been empowered with the appropriate authorities. A large part of local tasks is not transferred into own competencies of LGEs.

LGEs have their own and delegated responsibilities. *Own responsibilities of LGEs* include the tasks of local importance that ensure implementation of rights and obligations of local self-governance determined by Ukrainian laws. *Delegated responsibilities* include the tasks that are determined by the state and transferred to the local bodies of self-governance according to subsidiarity principle (Art. 82 of the Budget Code). LGEs are responsible for the provision of certain services in the spheres of education, health care, culture and sports, administration, social protection and social security, transport and roads, environment protection Delegated responsibilities of Ukrainian LGEs contain a lot of tasks (e.g.education services, health care, social protection) which, according to the international standards, should belong to their own responsibilities. Presently, the dominant part of LGEs' tasks is represented by delegated

[21] Kolovitskova O, J. Lukovenko, Ukraine: Enhancing Local Government Revenue Raising Capacity: A Way of Reaching More Accountable Local Government, http://unpan1.un.org/intradoc/groups/public/documents/nispacee/unpan009145.pdf.

responsibilities, whose scope and mechanism of execution is determined in the centre. This implies that LGEs are not independent in choosing the way of executing the delegated tasks. This undermines the autonomy of LGEs in managing public affairs within their localities.

Functioning of LGEs on oblasts /rayon level is infringed, on the one hand, by the absence of their own executive bodies, and on the other hand, by a lack of clear division of competencies between local self-government and local state administration.

Oblast and rayon councils do not have their own executive boards, and this complicates the execution of public tasks by self-governmental bodies. They pass some tasks to oblast and rayon administrations. The latter are accountable to oblast and rayon councils within the tasks " acquired" for execution. In all other respects (i.e. execution of other state tasks) oblast and rayon administrations, which constitute a part of central administration, are accountable to the state administrations of a higher level.[22] Oblast and rayons administrations are subordinated to the state administration of a higher level, which controls execution of the state tasks. The former are not accountable to the local community.

As we have already pointed out above, due to the imperfections in the territorial-administrative system and very limited fiscal capacities, LGEs pass a lot of tasks to oblasts and rayon administrations. Under given circumstances, a clear division of competencies between LGEs and local state administrations is very problematic. According to the Constitution and the Law on Local Self-Governance, LGEs are independent, and central government bodies are prohibited to intervene in the activity of LGEs that concerns the fulfilment of their own responsibilities. **However, in practice, oblast and rayon administrations intervene in the activity of self-governments[23], and a significant part of LGEs' functions is implemented by local state administrations.** The major part of local budget expenditure is executed or directly supervised by the state administrations.[24] Consequently, financial reports do not show the real participation of self-government in public expenditure. This undermines efficiency of local self-government, complicates a division of tasks between self-governmental and governmental sectors, and hampers fiscal transparency.

The problems of local self-government on oblast and rayon level are exacerbated by fiscal arrangements. While competencies of LGEs of the basic level (villages, towns) include preparation, passing and execution of the respective budgets,[25] the situation on the oblast and rayon

---

22 Rayon state administrations are subordinated and accountable to the oblast state administrations, while the latter together with administrations of Kyiv and Sevastopol cities are subordinated and accountable to the central executive organs. Heads of the local state administrations are appointed and dismissed by the President.

23 Recommendation 102 (2001) on local and regional democracy in Ukraine, pkt 12D, Rada Europy, http://www.coe.fr/cplre.

24 Slukhai S., op. cit., p.2.

25 Executive boards of the village's, settlement's and town's councils are empowered to prepare the draft of relevant budget, submit it to the councils

level is completely different. Here, budget planning, execution and reporting is within the competence of state administration. This implies that independency of rayon and oblast self-governments with respect to the budget preparation is reduced to passing the budget bill presented by the local state administration.

The situation, when the executive bodies of oblast and rayon councils are, practically, substituted by the respective state administration, contradicts the principle of autonomy of LGEs in performing public tasks.

The division of functions across the different levels of government is not completely clear, and some functions are overlapping. For example, responsibilities for pre-school and general secondary education are assigned both to towns, villages, and rayons. Primary medical and sanitary aid, out-patient and in-patient aid are defined as functions of towns (villages), rayons and oblasts. Both rayon and oblast LGEs are responsible for the development of physical culture and sports. An unclear division of functions produces conflicts with respect to the distribution of finance across LGEs of different levels.

A similar situation is observed with respect to the division of tasks between central and local government. For example, specialized medical and sanitary aid is assigned both to oblasts and the state.

Ukrainian legislation does not contain a principle of "presumptive competence of local self-government", which would clarify the division of responsibilities between the different levels of the government (i.e. between the state and local self-government as well as between the different levels of self-government). As a result, some of the public activities are not clearly assigned to any specific governmental unit, and nobody is responsible for their execution. This contradicts Article 4 of European Charter, which underlines that powers given to local authorities should normally be full and exclusive.

Box 4.15
Competencies of LGEs in Poland

In Poland, in order to limit competency disputes, a principle of assuming self–government competency was introduced. According to this principle, tasks that are not directly assigned to the state administration are within the competencies of the self–government. In case there are competency disputes between self–government units, the units of basic level have priority in handling this task.

Finally, the division of competencies between the representative and executive bodies of LGEs is also unclear. The representative body– council- may invalidate the decisions of the executive board.[26] In this way, the council overtakes management capacity that results in a loss of a clear functional division between the representative and executive bodies.

for consideration, implement approved budget and report quarterly on budget execution.

[26] Navruzov Y., Local government in Ukraine, In: Local governments in Eastern Europe, in the Caucasus and Central Asia, red. Munteanu I., V. Popa, Budapeszt 2001, p. 127, http://lgi.osi.hu/ publications/ default.asp?id=84.

The legal status of mayor and the scope of his allowable intervention in the activities of the council and executive board are also not clearly defined.[27] In principle, since mayor is elected in general elections, his dismissal requires referendum. In practice, the local council can dismiss the mayor. Recommendation 102 (2001) of the Council of Europe points out that one of the most frequent reasons of the mayor's dismissal is political pressure imposed on the members of the council by the representatives of state administration, which is an evident infringement of transparency in the division of public authority between the state and local self-government.

To summarize, the overwhelming share of delegated responsibilities in the total amount of public tasks performed by LGEs reflects domination of centralized decision-making and undermines the autonomy of local self-government. The absence of the principle of "presumptive competence of territorial self-government" in Ukrainian legislation results in weak responsibilities of governmental bodies and conflicts with respect to expenditure financing.

b) Financial resources of local self-government entities (LGEs)

The major achievements with respect to transparency of LGEs' revenues are related to (1) the adoption of Budget Code (in 2001) that defines strict rules of tax assignments across the levels of the government; (2) an inclusion of all extrabudgetary transactions of LGEs into a special fund of the budget (in 2000); and (3) an introduction of a new budgetary classification in line with GFS standards (in 1998).

However, in the course of intergovernmental finance reform some of the acute problems have not been solved:

- LGEs are not able to affect local budget revenues through setting up the tax rates and defining the tax base;
- major revenue sources have been assigned to delegated responsibilities of the LGEs that limits their fiscal autonomy;
- both own and delegated responsibilities of LGEs are not backed with sufficient revenue sources.

Fiscal activity of the local self-government bodies and subordinated units reflected in the special fund creates problems for transparency of local budgets. Since 2000, LGEs are prohibited to have any extra-budgetary transactions and, instead, are required to include every revenue and expenditure item into the local budget. Revenues and expenditures of LGEs that are not directly related to budget revenues and appropriations must be shown in a "special fund" of local budget. On the one hand, it is an improvement since former extra-budgetary transactions are currently accounted and reported to Treasury. On the other hand, in pure sense, revenues and expenditures related to commercial activity of the budget units do not constitute budgetary operations (such a way of

[27] Recommendation 102 (2001) on local and regional democracy in Ukraine, point 12E Rada Europy, http://www.coe.fr/cplre.

revenue collection and fund allocation is not regulated by fiscal laws or controlled by the government).

Moreover, the present budget division into general and special funds does not help to distinguish between budgetary and former extra-budgetary operations, since special fund combines both pure budgetary and extra-budgetary transactions. Special fund incorporates (1) revenues earmarked to special categories of expenditures; (2) income from commercial activity of the budgetary agencies (e.g. fees for medical services in public hospitals, tuition fees in the universities and so on); (3) charitable contributions of the enterprises that are under the jurisdiction of LGEs (enterprises may donate some money, voluntarily, or as it often happens, in exchange for certain commercial privileges). While the first type of revenues represents budgetary operations, the other two constitute extra-budgetary transactions. As a result, pure budgetary transactions are mixed with extra-budgetary ones and actual volume and composition of the budget is not clear.

Own revenues play a minor role in LGEs' finance. Only in case of cities and settlements own revenues of LGEs exceed 10% of their total budget revenues. This is related to a low average share of local taxes and fees in total budget revenues of LGEs (without transfers from the central budget) which presently is only 3%. The respective indicator for oblast budgets constitutes 0.41%, for budgets of cities of oblast importance - 5.8%, for rayon budgets- 2.4%, and for budgets of villages- 5.9%. Some of local taxes produce such low revenues that maintaining them makes no sense. An insignificant share of local taxes and fees in the revenues of local budgets invalidates the cost-benefit principle of intergovernmental fiscal relations in Ukraine.[28] This also contradicts article 9 of the European Charter.

The rights of LGEs regarding setting local taxes are limited. LGEs can introduce local taxes and fees within the list stipulated by law, and determine the tax rates within the limits prescribed by law. The imposition of certain local taxes (i.e. tax on advertising, communal tax, fee on overseas tourism, hotel fee, market fee, fee for the placement of trade objects) is mandatory. An imposition of other local taxes and fees is subject of free choice of LGEs.

So far, there are no efficient sources of local taxes such as tax on real estate. LGEs revenues from property are also insignificant and constitute only 2.5% of total revenues of local budgets. They mainly consist of privatization receipts. This is a consequence of poor regulation of LGEs' property rights.[29] The status of assets transferred to local self-governments is also unclear.

The major part of local budget revenues is represented by state taxes and transfers from the central budget. Partially, this is a consequence of domination of delegated responsibilities among the tasks of

[28] This principle mean, that taxes paid by local residents play the role of prices for the local public goods.

[29] Recommendation 102 (2001) on local and regional democracy in Ukraine, point 12Cd European Council, http://www.coe.fr/cplre.

local government. State transfers and state taxes[30] assigned to LGEs for the fulfilment of delegated responsibilities cannot be disposed freely. For example, they cannot be used for performing own responsibilities of LGEs.[31] Therefore, financial independency of LGEs, proclaimed by Ukrainian laws, proved to be declarative and efficient fulfillment of the LGEs' tasks is under question.

LGEs are not provided with sufficient funds. On the one hand, budget revenues assigned to LGEs by the central government are scarce. On the other hand, LGEs authority to collect own revenues is limited.

There is evidence about high discrepancies between the actual revenues of LGEs and their legal obligations with respect to performing own and delegated tasks. For example, during the last several years, LGEs' expenditures on communal services (gas, water, and electricity consumption) for subordinated budgetary units covered only 30-40% of their actual costs. Even before a new system of tax assignments by levels has been introduced (when revenues of the local budgets were more significant) LGEs accumulated huge budgetary arrears.

Though Ukrainian legislation obliges the state to transfer to LGEs funds that are sufficient for executing delegated responsibilities,[32] very often the amount of transfers does not allow accomplishment of public tasks. Besides, legislative guarantees of covering the shortage of funds are limited only to the commissioned tasks, while the problems with financing own responsibilities are left out of attention. Self-governments have little possibilities to enforce financial claims in court. Pressed by a lack of financing, LGEs often try to get funds from the non-transparent sources like "voluntary" donations of the companies.

Legal ban on passing local budgets with deficit is a serious infringement of fiscal autonomy of LGEs. Budget Code of Ukraine prohibits passing of oblast, rayon, district (in the cities), settlement and village budgets with the deficit. In case of cities and Crimean AR, the deficit is allowed only with respect to development budget. This prevents LGEs from the efficient implementation of the most urgent investment programs. Legal prohibition to take up liabilities (except for current liabilities) means that local communities do not have access to capital market. This contradicts Article 8 of ECLSG stipulating that for the purpose of borrowing for capital investment local authorities should have an access to the national capital market.

---

30 In order to ensure the fulfillment of delegated tasks, central government assigns to LGEs the following state taxes: Personal income tax, State duty, Fee for the licenses on entrepreneurial activity, Fee for the registration of the business agents, Fee for the trade patent, Unified tax for small businesses, Administrative penalties and sanctions imposed by LGEs.

31 The sources of LGEs' revenues assigned for fulfillment of LGE's own responsibilities include Local taxes and fees, Land fee, Tax on the owners of vehicles, Interests for the budgetary funds deposits, Dividends on the shares owned by municipalities, Fee for the environment pollution, Ratio of the Fixed agricultural tax, Rent fee on municipal property, Profit tax on the enterprises owned by municipalities.

32 Art. 143 of the Constitution.

c) Equalization procedures

The implementation of Budget Code has contributed to the improvement of intergovernmental finance. It has introduced the mechanisms for equalizing fiscal potential of the localities, and a formula-based approach of calculating transfers from the central budget.

However, several important problems remained unsolved:

- LGEs of basic level - small towns and villages – were not involved in the reforming process;
- formula based approach for transfers calculation has not eliminated the possibilities for political bargaining between the centre and the regions;
- methodology for transfers calculation has not accounted for the actual costs of provision of public services and actual tax capacity of the localities;
- control over the execution of delegated responsibilities by LGEs has not been established.

LGEs of the **towns of rayon importance, villages and settlements remained financially subordinated to rayons.** Budget Code regulates the distribution of revenue sources and central budget transfers across the different levels of LGEs only down to the rayons. Rayon councils decide the distribution of funds between LGEs of the lower level. If actual budget revenue of rayon LGE is lower than the planned one, it can cover the deficit (at least partly) by cutting transfers to the municipal units[33]. This model of hierarchical dependency limits financial autonomy of LGEs of the lowest level.

A formula based approach to transfer calculation has not eliminated the possibilities for arbitrary decision-making and political bargaining between the centre and the regions.

Central budget transfers are calculated as a difference between the estimated expenditures on delegated responsibilities (E) and estimated revenues assigned to LGEs for delegated expenditures (R) multiplied by equalization coefficient. Being progressive in general, this formula contains several drawbacks.

1. Variable R is considered as "tax capacity indicator" and is calculated as a weighted average of the actual tax collection over the previous 3 years. It reflects different tax-raising efforts undertaken by LGEs in the past and provides no incentives for the future increase in tax collection.

2. Variable E is based on so-called "norms of budget sufficiency" that are calculated as a budgetary fund assigned to a particular expenditure program divided by the number of residents or representatives of target audience. Thus no objective criteria are incorporated in the planning of budget expenditures.

[33] Needs Assessment Report, Ukraine, op. cit., p. 8, Kolovitskova O, J. Lukovenko, op. cit.

3. Since 2003, CMU has introduced special "depressivity coefficients" for R estimation. These coefficients take over 4 values, which are arbitrarily assigned to different LGEs. Thus, the success of the region in intergovernmental fiscal relations depends on its ability to prove "depressivity".

4. CMU approach to estimation of E is based on the numerous "correction coefficients". Both methods of calculation and criteria of their assignment to LGEs are unclear. The success of the region depends on the ability to bargain for a more favourable "correction coefficient".

Though a general approach to calculation of central budget transfers to LGEs of different levels is rather progressive, its transparency is undermined by incorporation of coefficients, which are not based on any objective criteria. In this respect, the principle of equal treatment of LGEs is violated. As a result, transparency of financing delegated tasks is rather low.

Conditional transfers from the central budget are based both on objective criteria and subjective political decisions. LGEs receive conditional transfers for investment and specific social programs from the central budget. Conditional transfers for social programs are calculated as a product of the number of beneficiaries (residents of given territory) and respective norms established by Ukrainian Laws. Such norms do not reflect actual costs of living. The amounts of different social benefits are annually determined on the basis of forecasted level of budget revenues. Conditional investment transfers are distributed according to political preferences: politically strong regions receive more than the weak ones. Thus, the procedure of calculating conditional transfers is also non-transparent.

The share of conditional and equalization transfers in LGEs budget revenues is high: It constituted 44% in 2001, and 45% - in 2002.

Box 4.16
Transfer mechanism in Poland

In Poland the transfer mechanism is very complicated, which is considered to be a large defect of the system. Instead of a simple equalizing mechanism, there are several correction indices. Consequently, the defined revenue source is divided according to unclear criteria. As a result, self–governments cannot calculate how much money they should get from the specific transfers.

The state strictly controls *the direction of spending of transferred funds*: they can be used by LGEs only for executing delegated responsibilities. As long as LGEs are restricted in managing transferred funds, they do not have an incentive to increase efficiency of spending.

At the same time, there is no control over the execution of delegated responsibilities as such. Ukrainian laws envision no regular procedures and mechanisms for control. In relation to this task category, there is only a strict control of the direction of spending financial resources by self-governments. Such a strategy results from the fact that the state transfers insufficient funds for financing of delegated tasks. Consequently, if the extent of execution of delegated tasks were controlled, it would be necessary to close a potential gap by increasing the amount of transfers.

Due to political reasons, it is more convenient to control just the amount and the direction of spending of transferred funds than the result of spending, i.e. the extent and quality of execution of delegated tasks.

The latest innovations in the institutional arrangements for the local budget executions jeopardize fiscal independence of LGEs. Formerly, self-governments selected the banks to carry out their bank accounts themselves. Currently, local budgets are going to be executed through the State Treasury. Although local budgets are considered to be independent, treasury functions will be executed by the local departments of the State Treasury, i. e. coordinated from the center. Bank accounts of self-governments have been replaced by the special accounts in the State Treasury. LGEs do not receive any interest, and the government gains a free source of short-term crediting. Presently, local budget funds, to some extent, are centralized, and LGEs' right of independent management of their own budgets is limited.

4.5.3 Recommendations

The reform of self–government finance system will be a long–lasting process, which can be divided into several stages. First of all, the territorial reform should be introduced including the following:

1) creation of new units at the local level;
2) converting present village and settlement self–government units into auxiliary units;
3) limiting the number of rayons and oblasts.

At the next stage, self–government administration on the level of rayons and oblasts should be established, and all local–self governments should become legal entities. The third stage should concentrate on ordering tasks and competencies and granting self–government authorities a larger competency in executing public tasks. Only these actions can create grounds to build an efficient self–government revenue system and the system of state control over the self–government's operations.

1. New self-government entities should be established as those able to fulfill independently the self–government responsibilities. New units of basic level in rural areas should be created, which encompass the territory of several smaller units, i.e. villages and settlements.

The reform of local self-government should start with forming units being strong in the organizational and financial terms. This would allow performing the majority of public tasks on the local level. The size of the new units should be related to the financial and organizational potential that is necessary for execution of public tasks on the local level. The size should not be too large, so that self–government authorities remain close to the local community. Consequently, we do not recommend transforming rayons into units of basic level, because its primary aim should be executing of regional tasks.

The creation of excessively large units would make it difficult to meet the principle of subsidiary, and therefore, the efficiency of functioning of local

authorities would get worse. This is a problem of big cities, where inhabitants have more difficult access to local authorities.

At the same time, the creation of units that are too small is also undesirable. This creates a risk of permanent dependency on the transfers from the state budget, which undermines the responsibility for executing the tasks. While determining the right size of the basic units, local communities should be consulted, which is, in fact, required by the ECLSG.

The creation of new stronger self–government units in rural areas does not mean that the units operating in villages or settlements are liquidated. These self–governments should be transformed into auxiliary units subordinated to the newly created basic units, and they should execute local tasks delegated by the basic unit. The scope of delegated tasks has to depend on the decisions of the authorities of basic unit. Auxiliary units in villages and settlements, and city rayons could manage some of public property. Auxiliary units would not be legal entities. They would execute only tasks of the basic unit and would act on behalf of the basic unit.

At the same time, newly created basic units should become legal entities, as it is required by ECLSG regulations. This is in the interest of self–government communities, since without having a status of legal entity self–government units could not run independent activity, and the division of competencies between public state authorities is unclear.

Newly created units of the basic level should have a right to possess property, which would enable them to execute public tasks on the local level. The state should equip these units with the required property, i.e. land, buildings and other public infrastructure like roads, bridges, tunnels, water–pipes, sewage infrastructure and sewage treatment plants.

2. The number of rayons should be reduced substantially. A reduction in number of oblasts should also be considered. The size of rayons and oblasts should be functionally adjusted both to the tasks executed with respect to the regional development, and the tasks executed for and on behalf of the regional community.

Creating independent units on the basic level will result in transfer of local tasks from rayons to these units. So, the rayons do not need to remain close to the local communities. Managing extra–local issues, i.e. healthcare system or secondary education, requires the creation of rayons of a bigger organizational and financial potential. Therefore, a reduction in number of rayons seems justified.

It is also important to resolve the issues of the rayons that are situated close to the cities. The areas around the large cities do not have either sufficient infrastructure or financial and organizational potential to be able to complete their tasks. It is better to create rayons including the agglomeration of the city together with the nearby areas.

In the functional division of local community, oblasts are obliged to execute tasks of a regional importance. These are the tasks related to regional development, which require creating strong local units.[34]

[34] In Poland this failed due to political reasons. Originally there were 12 strong regions to be created, but finally 16 voivodships (regions) were created. As a

As in case of rayons, it will not be possible to separate central cities from the oblasts because the oblast cannot execute regional development program without including its center. However, the resistance of regional interest groups may be a serious obstacle in carrying out a successful territorial reform.

3. Self–government executive bodies should be formed on rayon and oblast level. Such administration subordinated to the councils of specific units would replace current local state administration.

Having their own administration enables self–governments to take over responsibility for executing tasks of extra–local and regional character. Local self-government administration will be concentrated on executing rather the priorities of the local communities than those of the state.

The tasks of a nation–wide character delegated to rayons and oblasts will be executed by the state administration that is separated from the regional authorities and organized vertically (subordinated exclusively to appropriate ministries). [35] The operation of these units does not depend on the will of self–governments, therefore this solution is favorable.

Self-government units of oblasts and rayons should have the status of legal entity. This will make governing on the local and regional level more open. Each self–government unit should be equipped with property enabling it to receive revenues that are adequate for execution of the defined tasks.

4. Responsibilities of self–government should be clearly specified. The crucial part of delegated tasks should be transferred to self–governments as their own responsibilities. Self–governments should have a right to distribute funds between the expenditures on executing own and delegated tasks.

The introduction of territorial reform should be accompanied by a clearer division of tasks and competencies between the specific territorial authorities. The state should decide which of the tasks delegated so far to rayons and oblasts should remain within the competencies of state administration, and which ones should be transferred to self–governments as their own tasks. In practice, this means that delegated tasks will be abolished.

The scope of tasks transferred to self–governments should be vast enough so that self–governments can manage a substantial share of public affairs under their own responsibility and in the interests of the local population. ECLSG unanimously states that those authorities, which are the closest to the citizens, shall generally exercise public responsibilities. If the issue is of local or regional character, then it should be handled by the appropriate

result 4 voivodships are relatively small in comparison to the remaining ones and are incapable of fully running regional policy.

35 This solution works well in Poland where police and some of the inspections executing tasks for the sake of the entire society, not solely for local communities, were separated from the territorial administration. They function exclusively vertically as state administration units and are subordinated to appropriate ministries.

self–government unit leaving nation–wide issues to the state administration.

The distribution of competencies between the local self–government units of various levels would result in their mutual independency. Then, certain tasks and revenue should be clearly assigned to the specific self–government units. Neither state administration nor self–government units can decide on the revenue of other self–government units. It will be impossible to define a clear competency system in Ukraine before rayon councils stop handling the distribution of funds for self–government units of the basic level.

The principle of assuming competency works well in case of competency disputes in Poland and should be considered for implementation in Ukrainian law.

5. Responsibilities and legal status of the council and executive board, as well as mayor in the city, should be more precisely specified.

The role of the mayor in regards to a division of competency in the cities should become clearer. Currently, the mayor acts as an executive authority accepting the decisions of the executive board. On the other hand, he/she has the legislative power expressed in signing the decrees of the council. If the major is not subordinated to the council, the latter should not have the right to dismiss him/her. If the mayor is subordinated to the council, then the requirement of his signing the decrees of the council is questionable. We recommend defining more clearly competency division between the municipal authorities.[36]

6. Control over delegated tasks' performance should be established.

The transfer of major part of delegated tasks into own responsibilities of self–government cannot be done over night. For some time, delegated tasks will continue to exist (at least, in a reduced amount). Consequently, the issue of controlling their execution will remain on the agenda. Ukraine can use Polish experience in order to implement ECLSG standards of controlling the execution of delegated tasks. This implies the following:

- the funds transferred from the state budget to self–government become own funds of the latter, which can manage them independently. This provides local self-government an incentive to spend resources rationally;
- in return, self–governments are obliged to execute the delegated tasks on full scale. If they fail to do it, then the part of the funds proportional to the size of unexecuted tasks should be returned back;
- all savings on the delegated tasks can be used for co–financing of own tasks (conditional to full execution of delegated tasks).

[36] Such a need is also specified in the recommendation of the Council of Europe from 2001.

7. Control of self–governments' operations should be limited to issues of their legality. The legality of the self–government's activities should be supervised by the state institution, which has the power to cancel illegal decisions of the self–government bodies. Special courts have to be established to decide on the disputes between the state and local self–government units.

The state should have a right to interfere in the self–government activities only if the law has been breached. The intervention should be limited to restoring the law compliance.

We recommend abolishing the obligation of the local communities to have accounts in the State Treasury. Self-government itself should commission the instruction to withdraw funds from its own account.

All disputes between the self–governments and state administration should be decided in courts instead of being judged the representatives of the field state administration. In order to provide an efficient protection of interests of local community, self–government administration should be created on the extra–local and regional level. The sources of financing for self–governments and the ways of dividing public funds should be clearly defined by law. A full separation of the self–government sector from the state in terms of competencies and finance will help to create a clear system on the level of territorial authority. All disputes between the state and self–government, in particular those related to invalidating decisions of self–governments by the state control institution in case there is a breach of law, should be proceeded in the summary mode. Therefore, we propose to consider a creation of special courts, which would decide on the disputes between the state and local self–government units.

8. Sources of LGE's revenue and the procedure of distribution of public funds between the different levels of self–government entities should be defined by law, instead of being regulated by the decisions of the state or administration officials from LGE of a higher level.

The system of self–government revenue should be stable and predictable. Each community should have a right for mobilization of revenues proportional to the scope of executed tasks. This right should be guaranteed in the Constitution and legal acts. The sources of revenue should be defined in a clear way, and their division should be based on clear criteria, so that each local self–government unit could calculate which share of revenue from a given source it is entitled to.

In Ukraine, local communities that receive their revenue in the amount determined by rayon councils are in the worst situation. Also rayons and oblasts are financially dependent on the decisions of state administration, which defines the principles of distribution of transfers between self–government communities. The assignment of revenue sources to each type of self–government and the procedures of making transfers to self–government units should be regulated by law.

The tasks of the state administration or self–government units of a higher level with respect to financing of local communities should be limited to the execution of transfers. This should be clearly defined by law. Neither state

administration nor other self–government units should be entitled to decide on the amount of revenue assigned to the local community.

9. Transfers from state budget to self–governments' budgets should be based on the precise and objective rules. A unified approach to all LGEs should be applied without any corrections to revenue and expenditure estimates.

A simple and objective mechanism of balancing revenues should be applied, and several complicated coefficients (like correction coefficient and depressivity coefficient) should be skipped.

10. The share of own revenue in LGEs' total revenue should increase. Self–governments should get more power in relation to some state taxes. The list of numerous local taxes and fees should be shortened and quality of their administration improved. Real estate tax might be introduced as an effective revenue source for the local budgets.

Using the potential of own local community in Ukraine in the process of creating the revenues is conditioned by introducing new and effective categories of own revenues. We propose to introduce a tax on real estate, which will feed the revenue of local communities. A certain part of state taxes (e.g. VAT, EPT) can also be transferred to self–governments together with the adequate tax competencies. Then, local communities could estimate the amount of tax collection for the taxes assigned to them. We propose to liquidate local taxes and levies, whose collection is too costly in comparison to the revenues.

Improving the functioning of the tax collection service may increase the share of own revenue in the total revenue of the self–government. Availability of the data on self–government budgets and tax liabilities as well as a possibility to control execution of tasks related to collecting taxes by self–government authorities could have a significant impact on this process.

Observing the system of self–government revenue in Poland we conclude that it is not possible to build identical financing model for municipal and rural communities, since the revenue potential of these two types of communities is based on the different sources.[37] Therefore for Ukraine we recommend to create two separate financing systems of local communities: one for rural communities and another for municipal communities.

11. Each unit of self–government should have an easy access to capital markets limited only by the respective standards ensuring the safety of public finance.

Self–government communities should have access to the national capital market limited solely by the clearly defined precaution standards. As this is one of the ECLSG requirements, it should also be used in Ukraine. This regulation cannot be applied within the existing territorial system, where

[37] The self–government system in Poland was constructed assuming unification of self–governments; therefore the revenue system for cities and rural areas is the same. This solution proved to be inefficient.

rural communities are too weak in financial terms to make debts. There is a significant risk of them being unable to repay the liabilities, which might result in a limited access to basic public services by the inhabitants. This implies that territorial reform should be carried out as soon as possible in order to create strong local communities, so that rural communities can execute the right of financing its operations using the capital market.

The same recommendation applies to financing own tasks by rayons and oblasts. Strong self–governments in rayons and oblasts obliged to execute tasks for the benefit of extra–local and regional community will be able to take financial liabilities and repay them without facing financial risk. This requires, in the first place, the creation of fully independent rayons and oblasts, which have stable and predictable revenue.

To sum up, the creation of effective self–government compliant to the international standards and treaty liabilities of Ukraine is one of the key challenges in making Ukrainian public finance transparent and open.

4.6 Public Availability of Information

4.6.1 International standards

Accessibility of public information depends on its *openness* and *comprehensibility* (transparency) as well as on the existence of the *independent statistical agency*, which verifies quality of the data.

a) Openness of public information

Transparency deals with the guarantees for access to the information. According to the second part of the IMF Code:

- the public should be provided with full information on the past, current, and projected fiscal activity of government (wide scope of information);
- a commitment should be made to the timely publication of fiscal information.

Section 3.4. of *OECD Best practices for budget transparency* stresses that openness of public information includes the availability of all reports free of charge on the Internet.

b) Comprehensibility of public information

Transparency does play its positive role only when information is provided in a clear form and is easy for interpretation. Therefore:

- fiscal data should meet accepted data quality standards;
- budget information should be presented in a way that facilitates policy analysis and promotes accountability.

c) Independent statistical agency

- national statistics agency should be provided with the institutional independence to verify the quality of fiscal data.

4.6.2 Ukrainian practices and problems

a) Openness of fiscal information

Scope: *In general, Ukrainian legislation provides a sound basis for ensuring openness of fiscal information*. Understanding of a high importance of providing access to fiscal information is reflected in placing the issues of budget reporting in the Constitution. Article 95 of the Constitution of Ukraine states that regular reports on revenues and expenditures of the State Budget of Ukraine have to be made public.

This regulation is extended by the Article 28 of the Budget Code, which determines the types of fiscal information to be disclosed by Ministry of Finance to general public. It includes:

1) draft Law on State Budget of Ukraine;
2) Law on State Budget of Ukraine for the appropriate period with annexes as its integral parts;
3) information on execution of the state budget of Ukraine based on quarterly and annual statements;
4) information on the indicators of execution of the consolidated budget of Ukraine;
5) other information on the execution of the state budget of Ukraine.

The scope of aggregated information which is comprised in the Law on state budget and annual reports on budget execution *is coherent with the basic international standards*. Explanatory Note to state budget contains the forecast (in two scenarios: conservative and targeted) of state budget revenues and expenditures across the basic classification categories, and the forecast of demand for credits, and expected revenues from privatization. In the reports on budget execution, there is information on financial flows, debts, liabilities and other financial categories defined in the Articles 59 –61 of the Budget Code.

Indeed, the Ukrainian Budget Code defines the minimal scope of information that should be published. However, the Minister of Finance is free to define a further catalogue of information to be published. Such a solution is undesirable because of two reasons. **Firstly, the scope of information to be published defined by law is too small. For example, public access to information on public debt and tax expenditures, is limited**. Public debt which is considered as a syntetic indicator of the sustainability of public policy is not defined and estimated. Information on some components of public debt, e.g. VAT arrears, is not available for general public**. Information on tax expenditures exists, but is not regularly disclosed to public in a comprehensive way**. State Tax Administration prepares the list of tax privileges and main beneficiaries. Report on tax privileges is a supplementary material to the draft budget and is not open for the public. The aggregated data on tax privileges reported by STA is sometimes misleading, since the STA's definition of tax privileges is very broad, and some items should not be classified as tax expenditures. Moreover, access of the public to the detailed list of major beneficiaries of tax privileges is also limited. This impedes comprehensive analysis and public discussion of the tax expenditures. The obligation to publish information regulated by law also does not include the data on liabilities of public entities and property owned by these entities.

Secondly, such a solution gives **public administration a right to decide on the scope of publishing additional information.** This means that in case of unfavorable phenomena, the Minister of Finance can resign from publishing certain indices or data, which would reveal this problem.

Box 4.17
Regulations on public access to information in Poland (1)

In the Polish legal system there are many regulations that increase the availability of public information. Firstly, the Constitution of the Republic of Poland defines very vast access to the documents on the operations of public authorities to citizens. The reservations are limited only to the cases defined by acts. According to the Constitution the acts may regulate only the mode of disclosing information and not the scope of the information disclosed. The act on access to public information introduces the rule of assuming publicness of public information. The Law on Public Finance defines the timeframe for the publication of some of the information (not only the timeframe for preparing the information).

Therefore, a lack of legal regulations on the mode of disclosing information has two serious consequences. **Firstly, a refusal to disclose information is not an administrative decision, which can be appealed (in the court or to the supervisor). Secondly, timeframes for disclosing the information requested are not defined.** Consequently, most frequent reaction to the request to disclose information will be no reaction at all. This, in fact, is not a refusal, but it makes the request pending. Especially, it concerns disaggregated data or information, which is not subject for mandatory publication. Though Budget Code, the Law "On information" and the Law "On state statistics" provide guarantees of public access to the information of this type, procedures are not clearly defined. Consequently, obtaining of disaggregated fiscal information, which is not subject to mandatory public disclosure, is problematic and limited. **One of the reasons for such a situation is a lack of legal definition of non–public (restricted) information in Ukraine.** This results in the fact that the argument of the information being non–public is overused while turning the request to disclose the information down.

Box 4.18
Regulations on public access to information in Poland (2)

In 2001 in Poland, Public Information Bulletin has been established based on the act on access to public information. The Bulletin publishes information on the activities of public entities in the Internet. Information that cannot be found in the Bulletin should be disclosed upon the request of the applicant in accordance to the mode and timeframe defined in the act. A failure in disclosing the information is subject of sanctions. The access to public information is basically free of charge. In some cases, the public entity may charge a fee calculated at the level of costs of preparing the information.
There is also an act on non–public information that lists the types of information eligible for restricted access. There are 4 degrees (clauses) of restricted access: restricted, confidential, secret and top secret. What is important, assigning an excessively high clause or unjustified restricting of the information is subject to sanctions. Moreover, the act regulates the mode of dealing with the non–public information, which is very burdensome (storing and reading documents in special rooms, etc.) As a result, a special procedure of restricting information as such reduces incentives for overusing the argument of non–publicness as a basis for limiting access to the information.

Timely publication: Ukrainian legislation sets certain requirements concerning timely publication of fiscal information. According to the Article 28 of the Budget Code of Ukraine, the Budget Law should be published in the official journal of the government- Urjadovyj Kurier - within 7 days after its presentation to Verkhovna Rada. Budgetary decisions of local self-governments should be made public no later than 10 days after they have been taken.

Articles 58-61 of the Budget Code specify the deadlines for the State Treasury concerning the presentation of monthly, quarterly and annual reports on the state budget execution to the government, Accounting Chamber and other governmental institutions.

However, the requirement to publish annual and quarterly reports on execution of state budget (Article 28 of the Budget Code) does not contain any specific time limits.

Easy access: *During the last three years, the attention of central authorities to the issues of easy access to fiscal information, in particular via Internet, has been increased.* This is reflected in several decrees issued by the President and Cabinet of Ministers, which focused on the development of access to fiscal information via Internet as well as widening the scope of information on the respective web-sites. Presidential Decree "On additional steps to ensure the transparency of the activity of the bodies of state power" (N 325, from May 17, 2001) outlines the tasks for the state bodies to ensure free access to fiscal information. Two Decrees by the Cabinet of Ministers[38] determine the requirements to the information on the activities of central and local governmental bodies, which should be available on their Internet web sites. For instance, they require local governments to publish information on the execution of local budgets, volume of subsidies and tax collection on their web sites. All bodies of the executive power are obliged to publish information concerning public tenders.

Over the last years, the capacity of the Budget Committee of Verhovna Rada and other institutions responsible for the provision of information to the public has increased, and respective web-sites have become more developed. Presently, up-to-date information on public finance is available on the web-site of VR Budget Committee (http://budget.rada.gov.ua). The information is showing execution of every article of the budget, however it does not provide disaggregated data for local budgets. The web-site of Ministry of Finance (www.minfin.gov.ua) offers general news as well as information on state foreign and domestic bonds, and external state debt.

b) Comprehensibility of information

In general, the quality of Ukrainian statistical data (including fiscal data) is satisfactory, and methods of data compilation are compliant with the

[38] Decree of CMU "On publication of the information on the activities of the executive bodies in Internet" (No. 3, from January 4, 2002) and Decree of the CMU "On further steps on ensuring the transparency in the activities of the executive bodies " (No. 1302, from August 29, 2003).

international standards in this area. Recent IMF evaluation of the quality of Ukrainian statistical data[39] dated August 2003 concludes that *Ukrainian statistics of national accounts, prices, monetary aggregates, public finance and balance of payments, in general, meets international standards*.

Two drawbacks can be mentioned with respect to the quality of statistical data. Firstly, similarly to the other transition countries (e.g. Poland), time series in Ukraine are often corrected due to the continuous adjustment of methodologies to the international standards. These corrections as such do not contradict fiscal transparency standards, if they are followed by a detailed explanation of the procedures of data revision. **This requirement is often not met in Ukraine.** Thus, the IMF Report points out that *„...while revision studies are regularly conducted,* ***insufficient information on the procedures used to revise the data is provided to the public****."*

Secondly, **some data is not backed by any description of the applied methodology. This concerns official estimations of the size of Ukrainian shadow economy**. According to official statistics, the size of Ukrainian shadow economy is above 40% of GDP. Accuracy of such estimations depends on the methodology of calculation, which is not presented to the general public. This prevents improvements in the quality of data on shadow economy and might lead to the substantial errors in the estimation of GDP in Ukraine.

c) Institutions

Existence of an independent statistical agency is an important element of the accessibility to public information. In accordance with the international standards, State Statistical Committee of Ukraine has guarantees of independence proscribed in the Law "On State Statistics". The more general conclusion, supporting this view, was presented by IMF, which pointed out that *„Ukraine's statistical agencies have a legal and institutional framework that supports statistical quality."*[40]

Statistical agency provides free access to statistical data collected within the scope of statistical research plan. The remaining data may be purchased. Administration may even require additional charge but only in case, when it proves that granting information was related to extra costs (copying, etc.).

d) Information on local finance

Quality, scope and public access to the information on local finance is more problematic compared to that on state finance.

State Treasury Reports and web sites of oblast state administrations are the main sources of information on fiscal transactions and financial position LGEs. However, public access to the databases maintained by the Treasury

[39] IMF Report „Ukraine: report on the observance of Standards and Codes – Data Module, p. 4, available at http://www.imf.org/external/pubs/ft/scr/2003/cr03256.pdf.

[40] Available at http://www.imf.org/external/pubs/ft/scr/2003/cr03256.pdf, p. 3.

is limited, and the quality of data presented on the web sites of local state administrations is rather low.

There is no public access to information on LGEs budget debates. The descriptive part of local budget acts is not publicly available. Out of 27 LGEs of the highest level (24 oblasts, 1 Autonomous Republic and 2 cities of state importance) only AR Crimea put some parameters of the draft budget for 2003 on its web site. This makes impossible public discussion during the preparation of local budgets.

Detailed disaggregated information on the expenditures of self-government units is not disclosed. Presently, it is not possible to find out, what kinds of companies are commissioned to execute public tasks. Data on actual employment of LGEs and their administrative expenditures is closed for public. While total administrative costs of LGEs are reflected in the Treasuty reports that are available through the central government agencies, disaggregated data for a particular LGE is unavailable.

Public access to the reports on local budget execution is limited. State Treasury prepares aggregated monthly reports on revenues and expenditures of local budgets, which become available to the public. Quarterly reports with the additional data are not disclosed. Although, some LGEs publish reports on budget execution in the local newspapers, as a rule, is difficult to find disaggregated relevant data on all LGEs. Only 8 oblasts out of 24 report on budget execution on their web sites. The quality of information leaves much to be desired. Actually, public scrutiny of self-governments' activities is limited.

Data on self-government liabilities is not publicly accessible. LGEs report their financial liabilities (including payables) to the Ministry of Finance and the State Treasury, which publishes the aggregated data on liabilities of self-government sector on a quarterly basis. Respective information disaggregated across the different LGEs is not available. Data on LGEs' borrowings and debt is not disclosed to the public. There is no information on contingent liabilities of LGEs.

Information on LGEs' property is not publicly disclosed. Though State Treasury collects the information on municipal assets, it is not disclosed to public (in some cases these reports may be obtained by research institutes via written requests). Data on the fixed assets and working capital, performance and profitability of municipal enterprises is completely unavailable. However, management of municipal assets is an important criterion in assessing the activity of the self-government, therefore it should be open for public scrutiny.

Access to the disaggregated information on local finance is limited by arbitrary decision of government officials. According to the legislation, LGEs may deny the access to information which is legally recognised as a restricted one. In this case LGE is obliged to sent a special notification with a reference to legal provisions. Public access to information which is not considered by law as a restricted one, can not be denied. However, the sanctions against violations of the legislation on public access to information are weak and do not prevent arbitrary decisions of the public officials.

The regulation binds local state administrations to maintain official websites. However, **the scope and the mode of placing information is not proscribed in details.**. Presently, 24 LGEs of the highest level out of 27 have their own websites. However, they present rather scarce information– some statistical indicators or reports on regional economic development and recent legislative acts adopted by oblasts councils and administrations. Only Crimean, Ivano-Frankivsk, Volynsk and Kharkiv oblasts state administrations are the exceptions – the quality and scope of information on their website is rather high. In general, websites continue to play a minor role as a tool for monitoring the activity of the local governments.

Thus, a lot of issues related to openness of LGEs' finance remain unsolved, and elaboration of the comprehensive system for LGEs transparency and accountability is still on the agenda.

e) Freedom of mass media

Freedom of mass media is crucial for improving transparency and openness of public finance. One cannot speak of any transparency if media have a limited access to information and possibility to publish it. Ensuring freedom of mass media and public discussion of fiscal issues is an important condition for transparency of fiscal system.

4.6.3 Recommendations

Prompt improvement in the free access to public information is the necessary condition for increase in fiscal transparency. In order to improve access of the general public to fiscal information in Ukraine, the following measures should be undertaken:

1. The scope of published information should be defined by law, not by administrative decision.

2. A range of published fiscal information should be broaden, including disclosure of the data concerning:

- public debt;
- tax expenditure;
- tax arrears;
- payment arrears***.***

3. The Ministry of Finance should be obliged by law to work out and publish the annual reports containing the data concerning:

- public debt;
- other state assets and liabilities;
- assets and liabilities of local government entities' (in aggregated form).

4. The law should regulate procedures that cover free access to unpublished fiscal information.

It is important to ensure public access to disaggregated unpublished fiscal data that is not legally restricted. A special attention should be paid to the improvement in public access to information on the activities of local self-governments.

5. The scope of restricted (non–public) information should be regulated by law.

6. Collection of all fiscal information should be based on clear methodologies that are disclosed to public.

In case of data revision, sufficient information on the procedures used to revise the data should be provided to the public.

4.7 Public Service[41] and Anticorruption Procedures

4.7.1 International standards

International standards concerning public service are defined in the International Code of Conduct of Public Officials and OECD-PUMA principles for managing ethics in the public sector. These documents set the requirements concerning *the appointment/ recruitment and dismissal of public servants and ethical standards of their behavior*.

a) Status, appointment/ recruitment and dismissal of public servants

Procedures of appointment and dismissal of public servants should be clearly specified and made public. Vacancies in public service should be widely advertised and filled via competitive selection procedures based on sound and transparent selection criteria. Adequate remuneration has to be provided in monetary form. Information on the remuneration system for public servants should be made public.

b) Ethical standards of behavior for public servants and anti-corruption procedures

Ethical standards for public service should be clearly defined within the legal framework. Open to scrutiny decision-making and political commitment to ethics should reinforce ethical conduct of public servants. Adequate accountability mechanisms should be in place within the public service. Appropriate procedures and sanctions should exist to deal with misconduct.

4.7.2 Ukrainian practices and problems

a) Status of public servants and procedures of their recruitment and dismissal

Over the last years, the legal framework of public service has been improved and, presently, in general, complies with the international standards.

The Law of Ukraine "On State Service" (No. 3723-XII from 1993) regulates legal, organizational, economical and social issues of state service. It also determines general issues of activity as well as status of state servants in state structures and apparatus of the latter. With the adoption of the Law "On the local self-governance in Ukraine" (No. 280/97), the regulations of the Law "On state service" were extended to the public servants of local self-governmental bodies. The Law "On Service in Local Self-governmental bodies" (2001) has clarified legal, organizational, economical and social issues of public service in the local self-governmental bodies. This Law and is complementary to the Law "On state service".

[41] In this chapter under 'public' servants we mean state servants and servants of local self-governmental bodies.

Verkhovna Rada determines the state policy concerning the state service, while a special central executive body - *The Chief administration of state service – is responsible for its* implementation and functional management of state service. In 1999, the President of Ukraine approved a Decree that regulates activity of the Chief Administration (No. 1272/99, October, 1999). The Head of the Chief administration of state service is appointed by the President. Regulations do not define a precise time framework for this appointment that creates a risk of its political dependency.

Laws "On state service" and "On service in local self-governmental bodies" proclaim principles of non-discrimination, equality and fairness in recruiting servants, and state that positions in public service can be occupied by any person regardless the origin, wealth, race and nationality, gender, political views, religious believes, and place of living. People cannot be selected or appointed for the position in public service, if they are incapable persons,[42] have convictions that are incompatible with the potential occupation, or might become directly subordinated to their close relatives (i.e. have a conflict of interests). Public servants are required to have an appropriate education and professional training and participate in the competitive selection process, or other procedures foreseen by the Cabinet of Ministers.

There is a limited number of positions, where appointment rules are regulated by the Constitution or special laws. Legal status of the President, the Head of the VR and his deputies, heads of the permanent committees of VR and their deputies, people deputies, Prime-minister, members of the Cabinet of Ministers, Head and members of the Constitutional Court of Ukraine, Head and judges of the Supreme Court, Head and arbiters of Supreme Arbitrage Court, General Public Prosecutor and his deputies is regulated by the Constitution and a special Law of Ukraine. Besides, the President has a right to appoint and dismiss the heads of central executive bodies including ministers and their deputies.

Moreover, according to the Resolution of CMU (No. 676 as of 2003), appointment and dismissal of the heads of the structural subdivisions (department, administration) of central executive bodies needs an approval by the Prime-Minister and/or Vice-Prime-Ministers.

Besides, the President, the Head of the Verkhovna Rada, members of the government, the heads of the local state administrations have a right to appoint members of their patronage service (including assistants, heads of the press-services, advisors and secretaries) in accordance with the staff schedules and corresponding categories.

For the rest of the positions in public service the recruitment rules are set by the Law "On state service" and the Law "On Service in Local Self-governmental bodies".

Recruitment rules

The regulation on recruitment rules for public servants meets the international standards. The information on open vacancies of public servants is to be published and distributed via mass media no later than one month before the competition starts. The recruitment in public service

[42] Incapability is defined by court.

is performed *on the competitive basis* defined by CMU (except of the cases foreseen by Laws of Ukraine).

However, as evidence shows, the implementation of the legislation is far from being perfect: often, requirements of open competition for filling the vacancies in public services are violated, and potential candidates do not necessarily pass compulsory exams.

Dismissal of public servant

The Labor Code determines the background for dismissal of any employee. The Laws "On state service" and "On service in local self-governmental bodies" set additional reasons for dismissal of public servants. The latter include abuse of power; involvement in corruption; retiring age; withholding or providing wrong data concerning their incomes, etc. The change of the leadership in public bodies cannot be the reason for dismissal of public servants, except for those in patronage service. However, **the Laws do not clearly define the complete procedure of dismissal of public servants**.

Remuneration of public servants

The Cabinet of Ministers determines the remuneration system of public servants, including the amount of their basic salary, and the rules for additional payments, bonuses and welfare benefits. Often, basic salary constitutes only 50% of the total amount of remuneration, while the rest is represented by bonuses paid according to the working record, position, extra responsibilities, etc. However, **the level of wages of public servants still remains rather low**, and therefore, it is considered among the major reasons of a high corruption in Ukraine. Besides, there remains a problem of non-monetary benefits. Only aggregate data on wages of state servants is disclosed to the public.

b) Ethics of conduct and anticorruption procedures

Code of ethics and anticorruption legislation

Ukrainian legislation concerning the ethics of conduct for public servants is in accordance with the international standards.

The Law "On State Service" describes the *main ethical norms for public servants*. Public servants have to fulfill their responsibilities conscientiously; treat citizens, supervisors and colleagues with respect; demonstrate high culture of communication; prevent actions that can harm the reputation of public servants. In 2000, the Chief state administration of state service has approved "General ethical standards of behavior of public servants" (Order №783/5004), which summarizes ethical standards, determines the main responsibilities of public servants and provides the definition of conflict of interests. Public servants have wide access to the information on models of behavior, descriptions of required skills and responsibilities in public service.

All specified documents devote a special attention to anti-corruption measures. In addition, the Law "On the fight against corruption" (No.

356/95 as of 1995) provides a legal basis for anti-corruption activities. *This Law defines the activities that are incompatible with public service stressing, among others:*

1) conflict of interests:

- use of the official status of public servant for supporting physical persons and legal entities in their entrepreneurship activity (including receiving subsidies, credits, privileges, etc.) in return for unauthorized material benefits, services, privileges or other benefits;
- performing entrepreneurial activity directly or through intermediary, and combining jobs (except of scientific, teaching, creative activity as well as medical practice);
- being (independently or through intermediary) a member of the Board or other executive bodies of the enterprises, financial intermediaries, economic communities, etc. (except of the cases, when they are involved in management of state-owned shares);

2) refusing providing information, which has to be disclosed according to the active legislation provision, to physical persons and legal entities as well as a deliberate delay or providing invalid or incomplete information.

The legislation also defines the instruments of financial control. Article 6 ("Financial control") of the Law "On the fight against corruption" requires public servants to:

- fill out annual declaration of revenues;
- announce the opening of foreign exchange accounts in foreign banks;
- publish the annual reports on revenues, assets, property and bank deposits.

Accountability mechanisms are also legally defined. Public servants are called to account for the corruptive activity and other violations related to corruption. They are subject of administrative and disciplinary proceedings. The issues of criminal, civil and financial penalties of corruptive activities are solved in compliance with the active legislation. If public servants are found in performing corruptive activities, they are subject of fines. Moreover, they can be fired with canceling the right to occupy positions in public service for the next three years or forever. Public servants can be drawn to the correction works or imprisoned for the abuse of power, falsification, negligence and bribes in large amounts (The Criminal Code of Ukraine, Section XVII).

Summarizing, the Ukrainian legislation meets basic international requirements concerning ethical standards for public servants and anti-corruption activities. **However, there is a significant implementation gap, i.e. legal requirements are not observed and mechanisms of law enforcement are weak.**

For example, there is evidence that **many public servants own businesses either directly or through the relatives and acquaintances. Consequently, they lobby interests of different power groups**. **Public servants often do not provide full information on their property**, since it is formerly registered in the name of their relatives.

Corruption

Adoption of anti-corruption legislation has been followed by the development of numerous government programs, including National program on the fight against corruption (based on the Decree of the President of Ukraine No. 319-97, as of 1997), the Concept of the Fight against Corruption for 1998-2005 (based on the Decree of the President of Ukraine, No. 367/98 as of 1998), and the Plan of Actions Aimed at Strengthening the Fight Against Organized Crime and Corruption in 2003 (the Resolution of the CMU, No. 270-p). These programs offered political (improvement of the legislation), economic (increase of the public servant wage, improvement of tax system, etc.), organizational and administrative (administrative reform) measures. Though, neither of these programs has been fully implemented so far.

As a result, **Ukraine remains on the top of the list of the most corrupted countries in the world**. According to the Global Corruption Report 2003, in 2002,[43] corruption perception index (CPI)[44] for Ukraine constituted 85 (out of maximum equal to 102).[45] C**orruption is common on the local level, when it concerns business registration and licensing**. A high level of corruption is one of the factors that cause a large shadow economy in Ukraine, which is estimated at the level of 42.3% of GDP.

Weak enforcement mechanisms are complimented with a slow pace of reforms of tax, regulatory and administrative system that constitute a necessary basis for the successful anti-corruption efforts. Another important problem is a lack of public control of corruption-related issues. It is related to freedom of mass media that, according to the international evaluations, remains a sensitive topic. According to *the Global survey of media independence* states, publishing and distribution centers remain under state control.[46] The President's administration regularly issues instructions (tiemniks) defining information that is allowed to be presented to the press and television, as well as the way of presentation. Then, these instructions are distributed among the managers of TV stations and publishers.[47]

4.7.3 Recommendations

1. The observation of law provisions concerning activities forbidden for public servants should be controlled and effectively enforced.

---

43 Available at http://www.globalcorruptionreport.org/download.shtml.

44 The CPI is defined as the misuse of public power for private benefits. It used the data collected between 2000 and 2002 and is composed from 15 data sources from nine different institutions.

45 Ukraine shares the same rank with Georgia and Vietnam.

46 Freedom of the press 2003, A Global Survey of Media Independence, Freedom House, New York – Washington, 2003, p. 150.

47 Ukraine: Informal Political Censorship, Human Rights Watch Press Release, available at http://www.hrw.org/press/2003/03/ukraine031703.htm.

The control over observance of law by public employees should be improved, and more serious sanctions for breaching the law should be introduced. It is important to improve control procedures by both internal and external auditors, improve prosecutor's office supervision and ensure a possibility for mass media to inform on all cases of abuse.

2. Appropriate remuneration of labor of public employees is important for fight against corruption.

Besides, measures directed at the improvement of remuneration of labor of public employees should be implemented. In order to prevent corruption–generating situations, the remuneration system should be adjusted to the market situation.[48]

[48] Since a detailed analysis of corruption is beyond the scope of this book, we abstain from more substantial recommendations in this area.

4.8 Management of Public Property in Nonfinancial Sector

4.8.1 International standards

The point of reference for assessing the system of management of public property is one of the basic principles in the IMF Code, according to which:

"The government sector should be distinguished from the rest of the public sector and from the rest of the economy, and policy and management roles within the public sector should be clear and publicly disclosed".

This principle emphasizes the following:

a) the necessity to draw a clear borderline between the regulatory function of the state bodies and the actions undertaken by these bodies in order to execute the role of the state as the owner of enterprises and other assets, which are not directly used in performing public tasks;

b) setting clear and transparent rules of management of public assets;

c) ensuring access to information on the activities and financial standing of public enterprises;

d) setting clear and transparent rules and procedures of public investment, including the rules and procedures of acquisition of shares and equities of enterprises by the state.

Some aspects of management of public property go beyond the strictly conceived idea of public finances. However, the importance of this system for budget issues in Ukraine as well as its significant impact on the perceptions of the state administration activity has motivated us to include these problems in our analysis.

4.8.2 Ukrainian practices and problems

Despite the ongoing privatization process, the public sector remains an important element of Ukrainian economy. State-owned (nonfinancial) enterprises represent a significant share in Ukrainian economy and can be classified into two groups:

1) commercial partnerships with the state share exceeding 50% of authorized capital. This group includes enterprises undergoing privatization;

2) state unitary (100% state owned) enterprises authorized to possess, use and dispose property as well as conduct operational management. This group includes the so-called "fiscal" enterprises (kazenni pidpryemstva).[49]

[49] Ukrainian legislation does not contain explicit definition of fiscal enterprise (kazenne pidpryemstvo). But according to the Law of Ukraine "On Enterprises in Ukraine" (Article 37) state-owned enterprise may be transformed into fiscal one if this enterprise 1) conducts activities which is allowed only to the state-owned enterprises, or 2) the state is the primary consumer of the output (more

These enterprises are authorized to conduct operational management, possess and use the state property, but they are deprived the right to dispose it. Ukrainian legislation allows transforming the state-owned enterprise into a fiscal one following the decision of central governmental body, if this enterprise is not liable for privatization.

As of 01.01.2003, there were 42,484 enterprises in state and 70,231 in communal ownership in Ukraine (both categories constitute about 12% of the total number of enterprises in Ukraine). Besides, the state also manages 2392 blocks of shares[50] belonging to the state. The share of state enterprises in total fixed capital is exceptionally high: as of 01.01.2002 depreciated cost of fixed assets of state and communal enterprises made up 55,4% of fixed assets belonging to the enterprises of all forms of ownership.

The importance of public sector is also related to its industrial structure: The state controls the key sectors such as mining, energy and telecommunication. At the same time, self–government sector plays an important role, since it comprises many trade and service companies on the local level. In relation to the important sectors of the economy, the public authorities play a double role – they own the companies operating in the market, and at the same time, regulate the market.

a) Separation of the regulatory and economic functions of the state

State involvement is particularly strong in the oil and energy sector (gas, electric energy, coal). At the same time, this sector is subject of quite strict state regulations, including price regulations. This leads to a situation, when **the state, as the regulatory body, can (and does) act in the interest of its own enterprises.** It is reflected in the insufficient efforts of the state to ensure efficient performance of the state-owned companies, which are accompanied by "compensating" the losses by means of fiscal instruments, such as tax reductions and tax exemptions as well as direct budget subsidies.[51]

State-owned "natural monopolies" still lack independent regulators. This creates a conflict of interests in the process of tariff-setting and adoption of regulation.

All of the above mentioned practices disorganize the economy and contradict the principles of budget openness. Subsidies, tax reductions and tax exemptions enjoyed by the state–owned oil and energy enterprises constitute implicit subsidies for those energy consumers, who fail to settle their accounts with energy suppliers.

A similar problem exists on the local level as well. According to the data from the National Statistics Committee, in 2002, communal enterprises

---

than 50%), or 3) the enterprise is classified as natural monopoly. Fiscal enterprise is managed by the ministries and central bodies of executive power.

50 Block of shares – certain quantity of shares of the enterprise belonging to one shareholder.

51 cf. Staff Report for the Article IV Consultation with Ukraine, IMF, 2003, p. 31, available at http://www.imf.org/external/pubs/ft/scr/2003/cr03172.pdf.

possessed 23.3% of assets in Ukraine. They produced losses in the amount of UAH 837.6 mln, while their share in total sales was comparatively small. The local governments act on behalf of the population and, at the same time, control public utility enterprises lacking regulatory oversight. **Thus, economic and regulatory activities of local government are not clearly separated, in particular with respect to public utilities.**

Besides, the scope of activity of communal enterprises goes beyond supplying public utility services. Only about 40% of sales by communal enterprises relate to the provision of public utilities. Trade and production occupy a significant part of the activities conducted on behalf of the LGEs.

Thus, on the local level, we deal with two problems: first, the LGEs are involved in many economic activities beyond the scope of public utilities; second, there is a conflict between the interest of the local government as an institution of public authority acting on behalf of and in the interest of the citizens, and its interest of as an owner of commercial units. Combining of these two functions leads to a decrease in the effectiveness and credibility of the local authorities as institutions whose tasks include promoting enterprises.

Box 4.19
Communal economy in Poland

Polish act on communal economy passed in 1996 contains a ban on running business activity beyond public utility, however, allowing for some exceptions. The conditions for such exceptions are defined very generally – e.g. taking up a different activity is possible, when *there are needs of the self–government community that are not met*, and the attempts to limit the unemployment were not successful. It is clear that possible exceptions to the ban (should they be introduced) must be defined in more details.

b) Rules of management of state and communal property

The Law "On Enterprises in Ukraine" defines state enterprises as entities created on the basis of state property. Ukrainian legislation does not provide formal criteria for considering enterprises with mixed ownership as a part of the state sector. This Law will soon be replaced by a newly adopted Commercial Code, which starts acting in 2004. Chapter 2 of the Commercial Code underlines main directions of the participation of the state and local governments in the sphere of economic activity. Article 22 ("Specifics of Commercial Units Management in the State Sector") gives *a more precise definition of the state sector that is compatible with OECD standards*: the enterprise is considered to belong to the state sector, if it is in state property, or the state controls more than 50% of its stocks or has enough votes to have the final say in the decision-making.

Ukraine lacks the legislation on management of state commercial units. Until recently, the central and local governmental bodies have managed the majority of state-owned enterprises. Presently, management of commercial units with government participation is regulated by the Decree of Cabinet of Ministers of Ukraine "On Management of the State Assets". The situation is expected to be improved after the adoption of the

Law "On Management of the Objects in Public Ownership", which now exists as a draft.

Management of state enterprises and state corporate rights is not concentrated in one administrative body; on the contrary, it is dispersed (often on the basis of special minor laws) across different sectoral ministries. This results in miscoordination and a lack of unified approach to management of commercial units. The practice of executing ownership functions in state–owned enterprises by appropriate ministries cannot go in hand with the principle of market economy and, at the same time, does not ensure efficient using of the state property. We perceive such a practice as dangerous not only for the transparency of the government activities, but also for the integrity of the state economic policy. Entrusting management of state enterprises to particular sectoral ministries is bound to lead to a situation, where the "ministry + enterprises" group becomes a unified lobby focused on preserving their already existing privileges, blocking – usually in an effective way – any attempts of a more profound modernization and restructuring, and making their activities nontransparent for the public. Protection provided by the ministries to the state–owned enterprises makes the companies redundant to take any actions aimed at achieving good economic results.

Recently, President of Ukraine issued an Order No. 1-1/72 that requires concentration of state corporate rights in the hands of the State Property Fund of Ukraine, which is, at the same time, responsible for carrying out privatization. This step was intended to introduce a systematic approach to management of corporate rights belonging to the state. State Property Fund is expected to grant the rights to manage state corporate rights to the agents of its choice ensuring public accountability.

The decision to concentrate the responsibility both for privatization and management of state corporate rights in one agency has been backed up by the argument that up–to–date management of the companies and getting them ready for the privatization could be more streamlined. Though, there is a risk that joining of managerial and privatization functions will result in a delay in privatizing the companies that are best prepared for privatization due to their financial condition and stable market position.

Centralization of control over the management of non-corporatized state enterprises is still on the agenda. Presently, management of non-corporatised enterprises is still dispersed among different sectoral ministries and local authorities without any efficient overall control over their activities. There is evidence that some of these enterprises do not conduct proper financial planning, and information on their activities is difficult to get even for the government authorities that deal with the problem (Ministry of Economy and European Integration).

Box 4.20
Management of state property rights in Poland

In Poland, management of state–owned enterprises is executed by one office – Ministry of State Treasury (MST), which is, at the same time, deals with the issues related to privatization. MST operates on the basis of the act that does not give it exclusive rights to represent the state as an owner. Other agencies (on the basis of special acts) are also allowed to execute ownership functions with respect to specific enterprises (and in a wider sense, towards specific components of the state property). This concerns Polish State Railways, Polish Post, companies managing coalmines and resources belonging to state agricultural soil.

At the same time, it is not determined, when the exclusion of the MST competencies can take place. This results in a significant limitation of the MST's competencies.

In some sectors of the economy, granting managerial functions to business ministries leads to a significant slow down in privatization as well as restructuring processes. Also, it is more difficult to run legislative activities aiming at introduction of market competition even in small and niche market segments. At the same time, there are examples of speeding up privatization processes once the MST took over some segments of the economy. E.g. this happened in the banking sector, where withdrawing management of state–owned banks from the competencies of Ministry of Finance revived the privatization process significantly.

c) Access to information on the activities and financial position of the state-owned enterprises

There is a lack of full information concerning the activities and financial position of the state-owned enterprises. State enterprises are not obliged to publish – in a clearly defined and comprehensible form – reports on their activities and financial position; the Government has no similar obligation with respect to the enterprises owned by the Treasury. Therefore, the general public can receive only aggregated information, while data on the financial position of the individual state firm is inaccessible. The situation, when state–owned enterprises do not reveal data on their activity and financial condition, may result in the hidden acquisition of these enterprises by the bodies that manage public property. It is an obvious violation of public finance transparency principle, since all state–owned enterprises have been created on the basis of taxes paid by the citizens. Besides, many of them are a burden to the state budget, since they receive subsidies or tax redemptions and deductions. The absence of public access to the data on functioning of state enterprises makes impossible to assess whether subsidies and tax preferences are justified.

The state-owned joint stock companies are required to publish their financial reports. However, this information is very dispersed. **As a result, full information on the financial position of the state-owned enterprises (including both state firms and joint-stock companies where the state share exceeds 50%) is not available for public scrutiny.**

Box 4.21
Public information on the activity of state sector in Poland

In Poland, all state–owned enterprises and private commercial companies, whose employment and turnover exceed the limits defined in the law, as well as state legal entities operating on *non–profit* principles (e.g. all universities) are obliged to publish once a year the data on their activity, including the balance sheet, P&L, cash flow and opinion of an independent auditor stating the reliability of the data. This obligation stated in the act on accounting is executed by publishing appropriate data in the Official Journal B (Monitor Polski B) – the journal, which presents information that has to be disclosed based on appropriate acts (act on accounting, Commercial Code and laws on public trading of securities). Polish system of information on financial results of state–owned enterprises and institutions has two defects: The information that needs to be published is too formal. There is no sufficient control over the executing of this obligation by the state–owned institutions.

d) Rules and procedures of public investment

There are several types of investment activity with public participation: capital investments from the state and local budgets; public-private investment projects; and investment by the state firms and enterprises with state shares.

The procedure for capital investments with participation of public funds is outlined in the Decree of CMU "On the order of appraisal and tenders for the selection of investment projects foreseeing the participation of funds from the state budget" (No. 2145, 1999).

If capital investments are financed from the state budget, the following three-tier procedure for selecting investment projects is applied. On the first stage, the enterprises that seek participation of public funds in their investment projects may ask sectoral ministries to represent their projects in the fund sharing process. **The ministries choose the projects on the basis of their priorities and economic appraisal, and it is impossible to challenge the decision of the ministry or ask for revision of the application. The procedure does not seem to be entirely transparent as sometimes in the application process it is not an enterprise that approaches the ministry, but rather the ministry itself that selects the enterprises and projects for investment support for political reasons.**

On the second stage, sectoral ministries submit the winning proposals to the Ministry of Economy and European Integration. This Ministry determines which projects to finance from the state budget. Then, it forwards the winning applications to the Ministry of Finance and asks to include these projects into the planning of the state budget for the next year.

On the third stage, 20 days after the State Budget Law of Ukraine is adopted, the Ministry of Economy and European Integration conducts the

final selection of the investment projects taking into account the amount of funds allocated to financing state capital investments. The enterprises that receive capital investments from the state budget are listed in the respective decrees of the Cabinet of Ministers.

The same procedure is applied, if a private party seeks state participation in its projects. However, chances of private parties to get capital investment funds from the government are rather slim, since the major part of capital investment goes into social infrastructure projects.

In Ukraine, investment planning is open to public on case-by-case basis. If the government in addition to public investment seeks private funds, then the plans for such projects are open to public as, for example, in case of concession for construction of the roads (e.g. a consortium was created to build the road Lviv-Krakovets with the government participation). Concession activity of the government is regulated by the laws ("On Concessions", "On concessions for the building and operating automobile roads") and decrees of the Cabinet of Ministers.

Information on the investment projects of state enterprises or joint-stock companies with state shares is not available to the public. Investment decision is taken by the managers of the enterprises and financed from firms' own revenues.

Government involvement in private sector: Currently, government uses a case-by-case approach to decide on its participation in private sector. Sometimes, it buys stocks in the private companies. For instance in 1999, the Cabinet of Ministers of Ukraine approved the proposal of the State Committee on Communications and Informatization to buy out stocks of "UTEL"(telecommunication company) from a private shareholder (Order of CMU, No. 617-p, 1999).

There is a **lack of general rules and procedures regulating an acquisition of shares and equities of private enterprises by the state as well as – in a broader sense – the rules of asset investment by the state.** The absence of such rules may lead to a significant decrease in the effectiveness of privatization processes due to a parallel "tacit renationalization". The possibility of renationalization based on the decisions of the executive authorities that do not need a consent of the Parliament, breaches the clarity of the division of functions between two essential state bodies, and thus interferes with the transparency of public finances.

Box 4.22
Regulations on capital investment in Poland

Polish experience shows that the basic goal of the regulations related to capital investments should be, on the one hand, to provide their transparency (they may be important for the functioning of specific markets), and on the other hand, to eliminate using of capital investments for other purposes, e.g. granting hidden subsidies. In Poland, such operations were executed by the Labor Fund (financing activities related to fighting unemployment and its consequences). The Labor Fund supported the enterprises, which faced economic difficulties, by acquiring their newly issued shares. The loans granted from the budget funds are of a similar nature, since due to a difficult situation of the borrower the probability of returning the loan is low. Summing up, polish experience shows a need for regulations, which forbid using of investment instruments for granting hidden aid from public funds.

To summarize, the requirement of a clear division between general government and the remaining (commercial) part of the public sector, is not fully observed. The major problems in this field are the following:

- an excessive involvement of the state into economic activity, especially in energy sector, is accompanied by non–compliance with the principles of openness and transparency in management of the enterprises in this sector[52];
- state agencies (ministries) continue to perform both regulatory and economic functions;
- management of state enterprises and state corporate rights is dispersed across various state agencies (ministries);
- there is no full information on economic activities and financial position of state-owned enterprises;
- procedures of taking investment decisions are not completely clear;
- rules and procedures of acquisition of shares of private companies by the state are not defined;
- there is a lack of independent regulators in the sphere of public utilities on the local level.

4.8.3 Recommendations

In the area of management of public enterprises, the reforming measures should be concentrated on separating regulatory and economic functions of the public authorities. This requires creating a transparent structure for managing public property and providing free access to the data on economic results of the public enterprises. This would enhance social assessment of the efficiency of operations of public authorities as entities running commercial activity.

[52] cf. Staff Report for the Article IV Consultation with Ukraine, IMF, 2003, p. 20 (http://www.imf. org/external/pubs/ft/scr/2003/cr03172.pdf).

1. Management of the state–owned companies should be separated from the regulatory functions of the government.

Independent regulators should be created, first of all, in the sectors of natural monopolies. Currently, only the power sector enjoys the presence of the independent regulator, while such industries as telecommunications, railways, public utilities still operate in the environment, where regulatory functions are mixed with economic ones.

2. Management functions of the government should be concentrated in one government agency.

Management rights of state-owned non-corporatised enterprises should be concentrated in one agency basing on the adoption of the relevant legislation.

The risk of postponing privatization of the most efficient state companies that is associated with the concentrating of management and privatization functions in one agency, should not be underestimated. Defining and strictly executing the targets both in terms of the required income of privatization and financial results of companies owned by the state could resolve this issue.

3. State Property Fund as an agency responsible for management of public property should be obliged by law to work out and publish the annual reports containing the data on state property resources and financial standing of the state–owned enterprises.

Preparing and presenting the reports on state property, next to up–to–date management of state–owned enterprises, is an important task of the office responsible for management of public property. Already the working on such reports allows putting some order in managing of state property. Moreover, publication of the reports strengthens control over state resources. Reports on state property should be published on a regular basis within the timeframes defined in advance[53] (correlated with the schedule of budget works), and their scope should include both capital assets of the state property and financial ones, including shares in the commercial companies.

The obligation to prepare such reports should be introduced as soon as possible, even if the first reports are incomplete, and the methodology of carrying accounting of state property components and their pricing is not yet defined. Understanding of the necessity to prepare such a report is the best way for speeding up the creation of a coherent system of property accounting and the methodology for evaluating this property.[54]

---

[53] In Poland this deadline has not been defined, and subsequent reports are created later (e.g. the report for 2001 was published in December 2002).

[54] In Poland, one can observe that the quality of MST reports has improved over years, even though there are some methods used in preparing the report that can be questioned. It is worth mentioning that in local self–governments the obligation to present annual state of property (being an explanatory document to the budget draft) has been binding since 1991.

4. The annual reports of the state–owned enterprises should be open for public.

State–owned enterprises should be obliged to publish data on its property and financial situation on a regular basis. The law should define the following:

- required scope of information being subject of publication;
- standards for preparing the information – it is indispensable to be able to compare information on state enterprises with that on the other entities;
- deadline for disclosing the information.

The agency managing the state property should control the fulfillment of this obligation.

5. Public capital investment (acquisition of assets) should be regulated by Law.

Regulations procedures of making financial investments out of public funds should be defined in the legal acts in the same way as it is done with respect to privatization procedures. This includes investment in buying shares or entire enterprises, regardless of whether public entity becomes a dominant owner of the enterprise (due to investment) or not. The regulations on capital investment should define:

- sectors of the economy, where such investment can be made (or sectors where it is forbidden);
- entities (administration bodies) authorized to make such investment;
- the mode of managing the acquired enterprise;
- the way of presenting the purchase in the budget (it is recommended that such investment concern only the entities that are explicitly mentioned in the budget law).

6. Self–governments' commercial activity that is not related to public services should be prohibited.

Introduction of such a ban is justified by three arguments:

- activity of the local self–government should be concentrated on providing services, which due to various reasons cannot or should not be subject of market trade. When the organizational potential of self–governments is not strong, carrying out different activities may result in negligence of the basic functions that should be fulfilled by the self–government;
- subject to political pressures, business activity of public institutions is mostly not as profitable as the activity of private entities operating in the same market. Consequently, this may result in the pressure on budget to cover the losses of the unprofitable public units, or in an attempt to provide self–government–owned companies with a privileged position (in Poland, it happens that tender is resolved in favor of self–government–owned companies);

- local self–government should support the development of private entrepreneurship.

Local self–government should not be engaged in business activity beyond public utility. Such a ban will be justified, in particular when new principles of functioning of local self–government (that we proposed in chapter 4.5) are implemented.

4.9 Audit and Supervision in the General Government

4.9.1 International standards

International standards concern internal and external audit.

a) External audit

A national audit body or equivalent organization, which is independent of the executive power and appointed by the parliament, should provide timely reports for the legislature and public on the financial integrity of government accounts, including year-end report on budget execution.

According to INTOSAI, the national audit body should meet the following standards:

- *general standards*: individual auditors and the audit body must be independent of the executive authorities, individual entity that are being audited, and any political influence; its establishment should be laid out in the Constitution;
- *field standards*: auditors should a) design regular audit procedures in order to ensure detecting errors, irregularities, and illegal acts affecting financial statements; b) evaluate the reliability of internal control; c) have full access to all necessary records, documents, and personnel;
- *reporting standards*: the chief auditor should be allowed to report directly to the legislature following each audit; audit reports should be independent, objective, fair, and constructive (i.e., they should address future remedial action); reports should be disclosed to public once submitted to the legislature.

Besides, there should be mechanisms that ensure taking of remedial action in response to adverse findings of external audit reports.

b) Internal Audit

According to IMF standards, internal audit covers both audit of an agency by itself (ideally, reporting directly to senior management) and audit of an agency by another agency (e.g., auditing body which is under control of the Ministry of Finance or Prime minister). It should be considered as a separate, specialized system within the governmental organization.

Budget execution should be internally audited, and audit procedures should be open to review.

As defined by INTOSAI, the objectives of internal control systems are to: promote orderly, efficient, and effective operations; prevent a loss of resources due to waste, abuse, mismanagement, errors, and fraud; adhere to laws, regulations, and management directives; develop and maintain reliable financial and management data; and disclose these data in timely reports.

4.9.2 Audit and supervision in the general government in Ukraine

In Ukraine there is no explicit definition of the external and internal audits. According to the Budget Code (Article 26), external control and audit of financial and business activities of budget entities is exercised by the Accounting Chamber (AC) (with respect to supervising the disposal of state budget funds) and the Chief Control and Auditing Administration of Ukraine (CCAA). Consequently, spending units are responsible for organization and accomplishment of internal audit both in their agencies and subordinated budget entities.

However, according to IMF standards, only the AC can be considered as an independent national audit body that exercises external audit, while the CCAA, which is subordinated to executive power, conducts the internal audit.[55] Therefore, in Ukraine, in practice, there are two levels of internal audit: CCAA and internal control/ auditing subdivisions of the central executive bodies.

This multilevel auditor service is bound to result in the confusion of the division of their competences. In fact, the activity of the CCAA duplicates the tasks of the control and auditing subdivisions of the central executive bodies overlapping, at the same time, with the competences of the Accounting Chamber. Often, CCAA and the Accounting Chamber act in a similar way.

Below, we consider Accounting Chamber as an external auditor, while CCAA and subdivisions of central executive bodies are addressed as internal auditors.

a) External Audit

The Accounting Chamber possesses appropriate independence guarantees: According to the Constitution of Ukraine, the AC is independent of the government and controls the execution of state budget expenditures on behalf of Verhovna Rada. The legal basis for the activities of the AC is also provided by the Budget Code and the Law "On the Accounting Chamber" (No. 315 VI from 1996). The Law defines its functions and responsibilities.

The Head of the AC is elected by the absolute majority voting in the Verkhovna Rada for a seven–year term of office. Deputy heads, Secretary and main inspectors are also appointed by the Parliament. Only the Verkhovna Rada of Ukraine may dismiss all of them in strictly defined cases. The remaining members of the Accounting Chamber are employed according to the rules described in the law on public service. Other employees of the AC are hired on the competitive basis and dismissed in compliance with the Law of Ukraine "On Public Service".

The Board of the Accounting Chamber includes the Head of AC, the First deputy head and the deputy head, as well as main inspectors, and the Secretary. The Board deals with the issues of planning and organizing AC's work, designing methodology of control and auditing activity. It takes the

[55] The distinction between external and internal audit is based on their relation to the government administration. The external audit is independent from the latter, whereas the internal audit is part of the administration.

decisions concerning conducting inspections and audits and prepares the reports.

The financial independence of AC is also guaranteed. On the institutional level, the guarantee is based on the direct inclusion of the Accounting Chamber's budget in the State Budget draft presented to the Verkhovna Rada. The basic salaries of the Accounting Chamber's members are about 30% higher than those of other public officials. **However, as evidence shows, there are cases, when budget appropriations to the AC are cut or not fully executed during the year**.[56]

The AC conducts scheduled and unscheduled inspections and audits (The Resolution of the AC's Board, No. 25-14, 03.12.99). The former are conducted on the basis of annual, semi-annual, and quarterly working plans of the Board, departments and other structural subdivisions of AC. Unscheduled inspections and audits are conducted according to the decision of the AC's Board and on the basis of resolutions, protocol decisions and appeals of VR, its committees and deputies, as well as appeals and proposals of the President and the Cabinet of Ministers.

The Accounting Chamber shows due care to making the results of its audits public, which is fully in line with the international standards. Conclusions of the audit are first and foremost presented to the Verkhovna Rada, and then to the public. If the AC discovers violations of law, it approaches the President of Ukraine, Cabinet of Ministers, and other central executive bodies in order to call to account public officials responsible for law violation. In case asset stripping or corruption is discovered, the AC must immediately inform VR and transmit relevant audit documentation to the law-enforcement bodies.

Besides, in compliance with the international standards, the AC audits budget execution and submits a year-end report to the Verkhovna Rada. AC's report is presented to VR within two weeks after the formal submission of the annual report of the Cabinet of Ministers on state budget execution. After receiving conclusions of the AC, VR reviews the report on state budget execution for another two weeks. During the session of Verhovna Rada, presentation of the report of CMU on the state budget execution is followed by the co-report of the Heads of the VR Budget Committee and the AC.

However, presently, external audit covers only the execution of budget expenditures, while control of budget revenues is beyond the responsibilities of AC. Since the AC does not control budget revenues, the parliament can have its own expertise only of the expenditure side of the state budget, which restricts its control over the budget execution.

[56] Annual reports of the AC, available at http://www.ac-rada.gov.ua/main.asp.

Box 4.23
Revenue audit in Poland

In Poland, the Supreme Chamber of Control (SCC) carries out revenue audits of various types on a regular basis. The following issues, among others, are examined during the audit of state budget execution:

- justification of planned revenues (both tax and non–tax ones);
- timely transfer of income gained by budget units to the central account;
- justification of classification of the revenues according to the standards defined by the classification decree.

SCC conducts audits devoted to specific revenue titles. For example in 2003, there is an audit of the income excise tax, which encompasses, among others, the correctness of accruing tax liabilities.

Another example can be quoted out of the German public auditor Bundesrechnungshof, which is engaged in fighting VAT fraud in intra–European Union transactions. The auditors work on the VAT fraud systems and then verify, if the fiscal administration takes effective actions to fight such pathologies.

According to the Law and the resolutions of AC's Board (No. 25-1 as of 1999), the following bodies are subject of inspection and audit by AC:

1) on the central level:

- the administrative department and secretariat of VR;
- the Administration of the President;
- the bodies of Cabinet of Ministers;
- other central executive bodies, state targeted and extra-budgetary funds;
- the National Bank of Ukraine, the Antimonopoly committee, The State property fund of Ukraine, bodies of the State treasury;
- the Constitutional, Supreme and Supreme Arbitrage Courts;
- the Main Public Prosecutor, the Supreme Council of Justice;
- bodies of the national security and defense;
- other judicial, law-enforcement and controlling bodies.

2) on the local level: local state administrations and bodies of local governments;

3) other bodies regardless their ownership type (enterprises, organizations, banks and credit institutions, other financial organizations and their unions, associations, non-state funds and NGOs), but only with respect to the execution of state budget funds.

The main aim of inspections and audits is to check the legality and efficiency of using state budget funds, resources of state targeted funds and extra-budgetary funds, credits and loans received by Ukraine from the foreign countries and international financial organizations, and funds of NBU.

Currently, the AC of Ukraine is a member of INTOSAI (International Organization of Supreme Audit Institutions) and EUROSAI (European Organization of Supreme Audit Institutions) and its activities are, in general, compliant with the international auditing standards. In particular, it concerns the following:

- a wide range of public institutions that are subject of audit (state administration, local administration, as well as private bodies within the scope of public means use) by AC;
- conducting both planned audits (including the annual state budget execution control) and non-scheduled controls, which concentrate on the evaluation of legality and effectiveness of the activities;
- implementing the elements of *ex ante* audit, i.e. issuing opinions on the drafts of legal acts, international agreements, government programs as well as other documents, concerning their potential impact on state finances;
- coordinating its activity with the other body of state control.

However, there are several shortcomings in the present activity of the Accounting Chamber. Firstly, it does not conduct auditing of the internal auditors, in particular the Chief Control and Audit Administration (CCAA) and control and auditing subdivisions of the central executive bodies, in spite of the fact that the possibility of control is guaranteed by law. Such a practice contradicts the requirements of INTOSAI.

At the same time, **the practice of controlling local administrations of how efficiently they manage public funds is somehow contradictory to the stipulations of Art. 8 of ECLSG**. The latter recommends that with respect to the own tasks of LGEs the interference of state authorities should be limited to the cases of illegal activity.

Thirdly, the Accounting Chamber has insufficient organizational background (technical capacity). The AC has no regional branches**,** which certainly makes audit of public bodies in the regions less effective and independent**.**

Box 4.24
Regional branches of the external auditing office in Poland

In Poland the Supreme Chamber of Control has, apart from the head office, 16 field branches with seats in the cities–capitals of voivodships. These branches are equivalent to the departments in the head office structure, i.e. the heads of the branches has the same status as directors of departments in the head office. The branches carry out audits in field institutions, which operate in the territory they supervise. However, they have a right to audit central offices in cooperation with the respective department in the head office.

The branches play a very important role in the functioning of Supreme Chamber of Control. Apart from executing audit tasks mentioned above they assist in planning the auditing process. Having expertise in the field, they help to create control programs revealing the areas of the biggest risk. Moreover, initiating the control they help to provide fast reaction to any ambiguity detected in the public sector.

In its activity, the Accounting Chamber also faces problems typical for external auditors. The heads of budget units do not necessarily follow the post–audit recommendations; during the audit, the authorities of particular units obstruct access to information. These are, however, typical problems faced by external auditors around the world.

b) Internal Audit

The activity of the internal control is compliant with the international standards. This applies both to the State Control and Auditing Service of Ukraine and the auditing units in state offices.

State Control and Auditing Service of Ukraine

The State Control and Auditing Service of Ukraine (SCAS) consists of the Chief Control and Auditing Administration (CCAA), control and auditing administrations of the Republic of Crimea, oblasts, cities of Kyiv and Sevastopil, as well as control and auditing subdivisions in rayons, cities and rayons in cities. In 2002, the Presidential Decree (No. 1265) clarified the status of CCAA as a central executive body coordinated by the Cabinet of Ministers of Ukraine via the Minister of Finance. The President of Ukraine appoints and dismisses the head of the CCAA by a respective decree.

The Control and Auditing Service acts on the basis of the Law of Ukraine "On the State Control and Auditing Service" (No. 2939, January 26, 1993), which defines the status, functions and legislative rules of its activity; and instructions of the Chief Control and Auditing Administration of Ukraine (CCAA), which regulate the mechanisms and procedures of its work. **Besides, the Budget Code defines it as an external audit institution, even though it is internal with respect to the executive power.**

The main tasks of the State Control and Auditing Service include conducting state control over the use of funds and assets, as well as authenticity of accounting and reporting in Ministries, departments, state committees, state funds, budget institutions, and enterprises and organizations, which receive resources from budgets of all levels and state currency funds. State control is conducted in the form of scheduled inspections and audits. However, there are also unscheduled inspections, which can be initiated by corresponding ministries or law enforcement bodies.

According to the Budget Code (Article 113), agencies of the State Control and Auditing Service exercise control over:

- the targeted and efficient use of resources of the state and local budgets;
- the targeted use and timely repayment of loans guaranteed by the Cabinet of Ministers'; and
- accuracy of reporting on the execution of the state and local budgets as well as estimates of revenues and expenditures of budget entities, and compliance of reports with the accounting procedures.

However, such competencies overlap with those of the Accounting Chamber.

The control and auditing service cannot control tax payments of the inspected bodies. Its activity is focused on ensuring budget revenues from non-tax sources (e.g. revenues from renting state property, dividends, repayment of a credits and loans provided at the expense of budget funds or received under state guarantees, etc). Therefore, **like AC, the CCAA have no right to audit tax budget revenues.**

As required by the international standards, the State Control and Auditing Service submits monthly reports on the implementation of the results of its inspections to VR and the Ministry of Finance. The inspection or audit is conducted on the basis of documents signed by the Head of the State Control and Auditing Service, head of the department, their deputies or heads of subdivisions in rayon, city or rayon in city.

The SCAS may conduct an inspection/audit of the organization once a year. However, law-enforcement offices can initiate an inspection/ audit any time. In case of criminal investigation, control and auditing service conducts inspections /audits of the entities of entrepreneurial activity regardless their type of ownership on the basis of the resolution of a state prosecutor.

Though SCAS due to its subordination to the government should be included in the internal control system, **it operates according to the principles of external auditor**. **Its activity does not concentrate on supporting management process in administration**. As in case of the Accounting Chamber, its activity aims at verifying the activities of the administration. **As a result, SCAA's competencies partly overlap with the tasks of internal audit units of the central offices as well as the Accounting Chamber**. The common agreement signed by the AC and the CCAA in 2001 concerning coordination of their audit schedules can solve this problem only partly.

Internal control and auditing subdivisions of central executive bodies

According to the Budget Code (Article 26), spending units are responsible for organization of *internal* financial control and audit both within themselves and in the subordinated budget entities. Internal financial audits must be conducted on every stage of the budget process in order to ensure:

- on-going evaluation of the sufficiency and conformity of the activities of a budget entity with the requirements of internal financial control;
- on-going evaluation of the conformity of these activities with the established tasks and plans.

The head of a budget entity has to be informed about the results of any inspection, evaluation, investigation, research, or audit conducted by an internal auditing unit.

In order to clarify the procedure of internal audit, *the CMU has adopted the Resolution (No. 685 as of 2002) that defines the mechanisms of internal financial control over the activity of enterprises, institutions and organizations, subordinated to corresponding ministries and other central executive bodies.*

According to the Resolution, ministries as well as other central executive bodies and their territorial offices have to create control and auditing subdivisions, which are responsible for internal audit of their own activity and that of the subordinated enterprises, organizations and institutions.[57] In central executive bodies, the heads of such subdivisions are appointed (with the approval of CCAA) and dismissed by the head of a respective central executive body. The candidates for the position of the heads of control and auditing subdivisions in ministries and other central executive bodies have to be approved by the Premier-Minister, the First Vice-Premier-Minister, or Vice-Premier-Ministers according to the division of their responsibilities, and the ministers of CMU. Internal control and auditing subdivisions are accountable to the Chief Control and Auditing Administration (CCAA).

According to the Resolution, internal audit aims at providing ministries and other central executive bodies with the objective information on the use of budget funds and the effectiveness of economic activity. It should prevent inefficient use of budget resources. Therefore*, the activity of internal audit subdivisions support management process in administration and meet the international standards on internal audit.*

Internal control is conducted on the basis of semi-annual plans that should be confirmed by the heads of ministries, other central executive bodies, and their territorial bodies, and approved by CCAA. *In order to eliminate doubling of inspections and audits, the control and auditing subdivisions coordinate their activity with the State control and auditing service.* Unscheduled inspections can be conducted upon the request of the ministers, heads of other executive bodies or their territorial offices, with the notification of CCAA.

As of the January 1, 2003, **only 34 out of 45 ministries and other central executive bodies have created independent control and auditing subdivisions**.[58] Moreover, in many cases **existing subdivisions have insufficient number of employees and, thus, cannot provide the effective financial control of subordinated enterprises, organizations and institutions. The legislative base concerning the activity of these subdivisions is not unified across the ministries and other central executive bodies.** For instance, some regulations on ministries and other central executive bodies do not stipulate audit of the direction and efficiency of using the state budget funds.

4.9.3 Recommendations

1. External and internal audit have to be explicitly defined in Ukrainian legislation.

First of all, the Budget Code should provide explicit definitions of both external and internal audit as well as institutions responsible for each of them. The distribution of functions between these institutions and the rules

[57] In Poland, internal audit service exists in the form of internal audit units in central offices. These services were formed only in 2002.

[58] Report of the Chief control and auditing administration for 2002, available at http://www.dkrs.gov.ua/www/wwwdkrs.nsf.

for their cooperation should be set by special law. Besides, this Law has to foresee a right of external auditor to use results of inspections and audits conducted by internal audit entities while making its reports and recommendations.

2. The scope of audit carried out by the Accounting Chamber (AC) should be spread over the revenue issues.

External audit of the tax collection system and other public liabilities brings more discipline, i.e. it increases the efficiency in operations of the state fiscal services.

Extending the competency of the Accounting Chamber over the revenue side of the budget has an important anticorruption dimension, next to obvious financial profits for the state. Independent (external) institution reinforces the system of incentives, which helps to eliminate abuse of rights by dishonest officials, who have a possibility of interpreting regulations in favor of (or against) the taxpayer – in particular in case of unclear tax regulations that we observe in Ukraine.

Due to a close cooperation with the Parliament, the public external auditor has a better chance to signal about the weak points in the system of public revenues. As a result, the Parliament can react faster and more efficiently by passing legal acts counteracting the waste of public funds.

3. The AC's technical capacity should be improved – especially with respect to establishing regional offices.

Carrying out the effective audit depends largely on availability of appropriate institutional background (technical cap**ability), which provides auditors with organizational back–up. Therefore, territorial subdivisions of the AC should be created**. It will increase the effectiveness of audit in the regions. Besides, regional subdivisions will ensure better expertise of the specifics in operation of field public administration.

4. Internal audit systems should be regularly studied and evaluated by AC.

It implies that the Accounting Chamber of Ukraine should audit the Supreme Control and Audit Administration as one of the institutions of Ukrainian internal audit.

5. The scope of compentencies of the Supreme Control and Auditing Administration's responsibilities should be revised.

Duplicating the competencies and excessive audit leads to a waste of public funds. Since the regulation on the procedures for carrying out internal audit by the internal audit units appeared in Ukraine only in May 2002, there was no much time to solve the problem of duplication of competencies. However, it should not be postponed any more. The functions that are related to the external audit should be removed from the competencies of CCAA.

Since the CCAA is internal to the government, **there is a necessity of amendments to the Budget Code, which will define the CCAA as an**

institution that coordinates activity of all entities conducting internal audit.

The institutions of internal audit should concentrate on supporting management process in administration.

6. Regular audit should be conducted in the local government.

An introduction of modifications in the organizational structure and finances of self–government units suggested in chapter 4.5 should be combined with an **introduction of new principles for external verification of self–government finance**. The verification system should be based on the obligatory audit of self–government budgets execution made by independent and external auditors, who should assess the reliability of the reporting documents and show divergences between the content of the document and the actual state.[59]

Alternative solution is in letting the Accounting Chamber to perform auditing function in regards to key self–government units (oblasts, Autonomous Republic of Crimea, Kyiv and Sevastopol).

[59] In Poland the requirement of audit has not been introduced, yet the act on accounting has been binding since 1994 and it allows the Minister of Finance to put such an obligation on all entities. Reluctance of self–governmental units to introduce such a solution is publicly justified with financial arguments, but there could be also other arguments found.

5 Appendix: Summary of Recommendations

	Area	Problem	Recommendations
1	**Organization of general government**	Actual independence of NBU is undermined by its involvement in quasi-fiscal activities	- The independence of the National Bank of Ukraine (NBU) should be guaranteed in the Constitution. - The composition of NBU's Council should guarantee the independence of the central bank from the President and from the Cabinet of Ministers. - Constitution should prohibit financing the state budget deficit by the central bank. - A long-term refinancing scheme should be abolished as a quasi-fiscal activity that contradicts the law.
		Tax system remains very complicated and not completely transparent	- Tax reform should be continued reducing the number of taxes and tax rates. - The number of tax exemptions and privileges must be strongly limited and free economic zones should be abolished.
		Ukrainian law does not define specific organizational forms, within which state institutions conduct their operations	- The legal status of budget entities should be clearly defined by law. - The law should ensure the differentiation of the institutions that are financed mainly or entirely from the general funds of state budget from those that finance their expenditures mainly or entirely from their own funds included in the special funds of the budget. - The law should identify the cases when a certain unit operates independently and those, when it operates on behalf of the state.

Summary of Recommendations (cont.)

2	**Planning and passing the state budget**	Budget documentation lacks some important fiscal information	- The budget documentation should contain information about quasi–fiscal activities, government's financial assets and liabilities, contingent liabilities, non–financial assets and employees' pension obligations. - Main possible threats to the budget execution should be identified. - Fiscal policy objectives should be specified in the explanatory note to the budget draft.
		Fiscal limits set by the government are not binding during the process of budget passing	- The right of the Parliament to introduce the amendments to the draft budget presented by the Cabinet of Ministers should be limited by law. In particular, Parliament – by constitution regulation – should not have a right to: a) increase state budget deficit proposed by the Cabinet of Ministers in the budget draft; b) increase the budget expenditure without setting up the new source of revenue. - The law should guarantee, that the Parliament can introduce changes to the budget law only on the motion of the Cabinet of Ministers.
		Legislative provisions are frequently changed by Budget Laws	- The Budget law should not contain the amendments to other laws.
3	**State budget execution**	Ukrainian legislation does not define state aid or determine conditions of its granting	- Legal basis for all budget expenditure (in particular for state aid) should be established. - The law on state aid should comply with the international principles of state aid provision, namely principles of laisser faire, independent institution, accountability, transparency and limited continuity and scope. - The law on public aid should include the element of ex ante assessment so that during the preparation of state budget each expenditure item for public aid could be consulted with the office supervising public aid.

Summary of Recommendations (cont.)

		Planning expenditures for remuneration of labor in budget sector remains contradictory and nontransparent	- Tariff scale system envisaged by law should be implemented. - The procedures of defining remuneration funds for entities that are subordinated to spending units should be clarified. - Law should specify the procedures of financing remuneration funds of different budget entities from special or/and general funds of the budget.
		Existing system of social benefits is not sustainable within the present system of its financing and administration	- The system of social benefits should be based rather on targeted aid than tax privileges.
		Implementation of legislative provisions on public procurement is not completely observed	- Observation of the law on public procurement should be controlled. - Those, who did not win the tender, should have a chance to protest and in case of any irregularities, demand compensation for profits foregone in civil trial. - There should be effective control that ensure preventing: a) dividing the procurement into parts; b) lowering the value of the procurement in order to avoid law application.
		Taxpayers rights are not observed	- VAT refund arrears should be eliminated and compensation for a delay should be paid.
4	**Accountability and reporting**	There is no definition of public debt	- Public debt should be legally defined, and liabilities of all public sector units should be included into public debt. - The information on quasi-fiscal activities, financial assets, i.e. marketable securities, investments and loans to enterprises and other entities, as well as the detailed information on state guarantees that come into force should be regularly reported.

Summary of Recommendations (cont.)

		The budget reports do not contain all information required by the international standards	- Extra-budgetary activities should be reported together with the budget data. - Monthly reports should present data for each month. In case of a significant divergence between the planned and actual level of budget execution, monthly reports should be complemented with an explanatory note. - Quarterly reports should include an updated forecast of budget outcome (budget revenues and expenditures, borrowings and budget deficit) for the given year and the following two years, review of the assumptions used in preparing the budget, balance of government's financial and non-financial assets. - Data on non-financial liabilities of the government, quasi fiscal activities as well as information on the execution of major budget programs, i.e. the results of the programs or the explanation of the deviations from program's objectives, should be presented in annual budget reports. - Preparation of long-term budget reports that assess the long-term sustainability of current government policies should become a part of the process of budget reporting.
		The privatization receipts are defined as budget revenue source, even though they are used as a deficit financing item	- The Budget Code should define privatization receipts as a deficit-financing item.
5	**Finance of local governments**	An excessive number of LGEs of basic as well as rayon and oblast level is an obstacle for decentralization of public tasks and financial independence of local self-government	- During the reform of territorial system, new units of basic level in rural areas should be created, which encompass the territory of several current units (villages and settlements) and are able to fulfil the self–government responsibilities independently.

Summary of Recommendations (cont.)

	- A reduction in the number of rayons and oblasts should be considered. The size of rayons and oblasts should be functionally adjusted both to the tasks executed with respect to the regional development, and the tasks executed for and on behalf of the regional community.
Self-governments of oblasts and rayon level do not have their own executive bodies	- Self–government executive bodies should be formed on rayon and oblast level and replace current local state administration. - Self-government units of oblasts and rayons should have the status of legal entity.
Delegated responsibilities represent the major part of tasks of local self-government. The division of functions across the different levels of government as well as between the specific bodies of self-governmental is not clear	- Responsibilities of local self–governments should be clearly specified. - The crucial part of delegated tasks should be transferred to self–governments and become their own responsibilities. - Self–governments should have a right to distribute funds between the expenditures on executing own and delegated tasks. - Responsibilities and legal status of council and executive board, as well as mayor in the city, should be more precisely specified.
There is no control over the level of execution of delegated responsibilities	- Control over the execution of delegated tasks should be established. - The control of self–governments' operations should be limited to the issues of their legality. - The legality of the self–government's activities should be supervised by the state institution, which has the power to cancel illegal decisions of the self–government bodies. - Special courts have to be established to decide on the disputes between the state and local self–government.

Summary of Recommendations (cont.)

	The assignment of revenue sources to each type of self–government and the procedures of making transfers to self–government units is regulated rather by administrative decisions than by law	- The sources of LGE's revenue and procedure of distribution public of funds between the different levels of self–government entities should be defined by law. - Each local community should have a legal right to mobilize the revenues proportionately to the scope of executed tasks. - Transfers from state budget to self–governments' budgets should be based on precise and objective rules. A unified approach to all LGEs should be applied without any corrections to revenue and expenditure estimates.
	LGEs' revenues are not sufficient for performing public tasks	- The share of own revenues in total revenues of LGEs should increase. - Self–governments should get more power in relation to some state taxes. - The list of numerous local taxes and fees should be shortened and the quality of their administration improved. - Real estate tax might be introduced as an effective revenue source for the local budgets.
	Legal ban on passing local budgets with deficit reduces fiscal autonomy of LGEs	- Each unit of self–government should have an easy access to capital markets, limited only by respective standards ensuring the safety of public finance.

Summary of Recommendations (cont.)

6	**Public availability of information**	The scope of additional fiscal information open to public is determined by administration	– Law should define the scope of published information. – Law should regulate procedures that cover free access to unpublished fiscal information. – The scope of restricted (non–public) information should be regulated by law.
		The scope of budget information that by law should be disclosed to public, is too small	– A range of published fiscal information should be broaden, including disclosure of the data concerning: - public debt; - tax expenditure; - tax arrears; - payment arrears. – The Ministry of Finance should be obliged by law to work out and publish the annual reports containing the data concerning: - public debt; - other state assets and liabilitieties; - assets and liabilities of local government entities' (in aggregated form).
		Public information on methodologies and procedures used for data revision is insufficient for the analysis of fiscal development over time	– Collection of all fiscal information should be based on clear methodologies that are disclosed to the general public. In case of data revision, sufficient information on the procedures used to revise the data should be provided to the public.

Summary of Recommendations (cont.)

7	**Public service[60] and anticorruption procedures**	Legal requirements on public service are often not observed (in particular with respect to competitive appointment procedure and avoiding conflict of interests)	– The observation of law provisions concerning activities forbidden for public servants should be controlled and effectively enforced. – Control procedures by internal and external auditors, as well as prosecutor's office supervision, should be improved. – Mass media should have a possibility to inform on all cases of law abuse. – Remuneration of labor in public sector should be adjusted to the market situation. This will contribute to fight against corruption.
8	**Management of public property in nonfinancial sector**	State agencies (ministries) and LGEs continue to perform both regulatory and economic functions	– The management of the state–owned companies should be separated from the regulatory functions of the government. – Independent regulators should be introduced in the natural monopoly sectors.
		Management of state enterprises is dispersed across the various state agencies (ministries)	– Management of state-owned non-corporatised enterprises should be concentrated in one government agency.
		There is no full information on economic activities and financial position of state-owned enterprises	– The annual reports of the state–owned enterprises should be open for public. – State Property Fund as an agency responsible for management of public property should be obliged by law to work out and publish the annual reports containing the data on state property resources and financial standing of the state–owned enterprises

[60] In this chapter under 'public' servants we mean state servants and servants of local self-governmental bodies.

Summary of Recommendations (cont.)

		Procedures of taking investment decisions are not completely clear	– Public capital investment and acquisition of assets should be regulated by law.
		The state and LGEs are still too actively involved commercial activities	– Self–governments' commercial activity that is not related to public services should be prohibited.
9	**Audit and supervision in the general government**	External and internal audit is not legally defined	– The Budget Code should provide explicit definitions of both external and internal audit as well as institutions responsible for each of them. – The distribution of functions between the institutions responsible for external and internal audit and the rules for their cooperation should be set by law. – The AC has to audit the Chief Control and Auditing Administration (CCAA) and internal control and auditing subdivisions of the central executive bodies. – The internal audit entities have to report to the AC. – The AC has to have a right to use results of inspections and audits conducted by internal audit entities while making its reports and recommendations.
		The Accounting Chamber does not audit the revenues side of the budget	– The scope of audit carried out by Accounting Chamber should be extended to revenue issues.
		The Accounting Chamber has insufficient organizational background	– The Accounting Chamber has to have regional subdivisions in order to improve auditing on the regional level.

Summary of Recommendations (cont.)

	The functions of Central Control and Auditing Administration overlap with those of internal control and audit subdivisions of central executive bodies and the Accounting Chamber	– The responsibilities and functions of the CCAA have to be reconsidered taking into account the strengthening of the internal control and auditing subdivisions in the central executive bodies. – The CCAA has to play a function of the coordinator of internal audit in Ukraine. All functions, which concern external audit, should be transferred to the Accounting Chamber.
	There is no effective control of local budgets execution	- The verification system should be based on the obligatory audit of self–government budgets execution made by independent and external auditors, who assess the reliability of the reporting documents and show divergences between the content of the document and the actual situation.

Legislative Acts

"Budget Code of Ukraine", No. 2542-III, from 2001.

"Constitution of Ukraine", No. 254k-96BP, from 1996.

State Budget Laws.

1 Organization of the general government

Central Budget The Laws for different years.

Order, instruction (z0113-03) of the State Treasury "On Approving the Instruction on The Order of Compilation in the Year 2003 of Monthly Financial Reporting by Entities and Organizations that Receive Funds from State and/or Local Budgets", No. 17 from 2003.

The Decree of CMU "Concerning Excise Duty", No. 18-92 from 1992.

The Decree of CMU "Concerning State Duty", No. 7-93 from 1993.

The Decree of CMU "On Approving the Limit Number of Employees of Foreign Diplomatic Establishments of Ukraine", № 508-p from 2002.

The Decree of CMU "On Limit Number of Employees of Central Offices of Court of Appellate Jurisdiction, Court of Appeal, and Superior Administrative Court of Justice of Ukraine", No. 572-p from 2002.

The Decree of CMU "On Local Taxes and Duties", No. 56-93 from 1993.

The Decree of CMU "On Personal Income Tax", No. 13-92 from 1992.

The Decree of the President "On Actions for Implementing the Concept of Administrative Reform in Ukraine", No. 810/98 from 1998.

The Decree of the President "On Establishing the State Tax Administration of Ukraine and Local State Tax Administrations", No. 760/96 from 1996.

The Decree of the President "On Increasing Non-Taxable Minimum and Rates of Progressive Taxation of Incomes of Citizens", No. 519/94 from 1994.

The Decree of the President "On Ministry of Education and Science of Ukraine", No. 773 from 2000.

The Decree of the President "On Questions related to State Customs Service of Ukraine", No. 1022/2000 from 2000.

The Decree of the President of Ukraine "On Regulation on Pension Fund of Ukraine", No. 121-2001, from 2001.

The Decree of the President of Ukraine "On System of Central Bodies of Executive Power", No. 1572/99 from 1999.

The Law "Concerning Amendments to The Law of Ukraine "Concerning contributions for Compulsory State Pension Insurance", No. 2452-III from 2001.

The Law "Concerning Rates of Contributions for Certain Types of Compulsory State Social Insurance", No. 2213-III from 2001.

The Law "Concerning Single Customs Tariff", No. 2097-XII from 1992.

The Law "Concerning the Insurance Tariffs for Compulsory State Social Insurance Relating to Industrial Accident", No. 2272-III from 2001.

The Law "On Compulsory State Insurance Against Unemployment", No. 1533-XIV from 2002.

The Law "On Compulsory State Social Insurance Against Occupational Accident and Occupation Disease, that Caused the Loss of Working Ability", No. 1105-XIV from 1999.

The Law "On Compulsory State Social Insurance Related to Temporal Disability and Expenses Associated with Birth or Funeral", No. 2240-III from 2001.

The Law "On Enterprise Profits Tax", No. 334/94 from 1994.

The Law "On Government Procurement of Goods, Works, Services", No. 1490-III from 2000.

The Law "On Labor Protection", No. 196/96-VR from 1996.

The Law "On Land Tax", No. 2535 from 1992.

The Law "On Rates of Excise Duty and Import Duty on Some Goods", No. 313/96-VR from 1996.

The Law "on State Budget of Ukraine for the Year 2003", No. 380-IV from 2002.

The Law "on System of Taxation", No. 1251-XII from 1991.

The Law "On the National Bank of Ukraine", No. 679-XIV from 1999.

The Law "On Value Added Tax", No. 168/97-VR from 1997.

The Order of Ministry of Finance of Ukraine "On Approval of Card of Accounts of Accounting of Budget Establishments and The Order of Use of Card Accounts of Accounting of Budget Establishments", No. 114 from 1999.

The Order of State Tax Administration "On Approval of The Order of Defining the Structure of Feature of Non-profit Establishments (organizations)", No. 355 from 2000.

The Order, instruction (z0019-03) of the State Treasury "On Approval of Instruction on The Order of Reflection of Stocks of Materials and Capital Equipment That Are Supplied Centrally in the Accounting of Budget Entities", No. 232 from 2002.

The Order, instruction (z0497-00) of the State Treasury "On Approval of Instruction on Correspondence of Sub-accounts of Accounting for Reflecting Major Economic Operations of Budget Entities", No. 61 from 2000.

The Order, Instruction (z0787-01) of the State Treasury and Ministry of Economy "On Approval of the Typical Instruction on The Order of Writing off Stocks of Materials and Capital Equipment from the Balance of Budget Entities", No. 142/181 from 2001.

The Resolution of CMU "On Approval for the Year 2003 Limit Wage Bill and Number of Employees, and Limit Expenditures for Maintenance of State Local Administrations of Oblast, Sevastopol City, Rayons and Rayons in City Sevastopol", No. 380 from 2003.

The Resolution of CMU "On Approval Limit Number of Employees of Apparatus of Ministries, Other Central Bodies of Execution Power and Local Bodies that Are Subordinated to them and Establishing Limits of Cars", No. 403 from 2000.

The Resolution of CMU "On Approval of the Budget of the Pension Fund for the Year 2003", No. 249 from 2002.

The Resolution of CMU "On Approval of the List of Own Revenues of Budget Establishments, Requirements for their Creation and Directions of their Use", No. 659 from 2002.

The Resolution of CMU "On Approval of The Order of Composition, Consideration, Approval and Major Requirements for Execution of Budgets (koshtorysv) of Budget Establishments", No. 228 from 2002.

The Resolution of CMU "On Approval of the Resolution on Supervisory Board of the Fund of Social Insurance Against Occupational Accident and Occupation Disease", No. 752 from 2000.

The Resolution of CMU "On Creation of Unified State Register of Enterprisers and Organizations of Ukraine", No. 118 from 1996.

The Resolution of CMU "On Labor Rewarding Basing on Unified Grid of Ranks and Coefficients on Rewarding Labor of Workers of Establishments, Institutions and Organizations of Some Industries of Budget Sphere", No. 1298 from 2002.

The Resolution of CMU "On Limit Amount of Expenditures on Purchase of Cars, Furniture, Other Equipment and Facilities, Mobile-Phones, and Computers by State Bodies, and Entities Establishments and Organizations that are Financed Entirely at the Expense of the State Budget or a Local Budget", No. 332 from 2001.

The Resolution of CMU "On Limit Amounts of Expenditures on Purchase of Cars, Furniture, Other Equipment and Devices, Self-phones, Computers by State Bodies, and Establishments and Organizations That Are Fully Financed from State and Local Budgets", No. 334 from 2001.

The Resolution of CMU "On the Approval of The Order of Submission of Financial Accounting", No. 419 from 2000.

The Resolution of CMU "Question of Ukrainian State Innovation Company", No. 979 from 2000.

The Resolution of the Council of the Fund of Social Insurance Against Occupational Accident and Occupation Disease "On the Budget of the Fund of Social Insurance Against Occupational Accident and Occupation Disease of Ukraine for the Year 2003", No. 15 from 2003.

The Resolution of the Council of the Fund of Social Insurance Against Temporal Disability No. 25 from 2001.

The Resolution of the Verkhovna Rada "On Limit Number of Central Office of Verkhovna Rada of Ukraine", No. 30-IV from 2002.

2 Planning and passing the state budget

The Decree of the Verkhovna Rada of Ukraine "On Main Guidelines of Budget Policy for 2002", No. 2543-III from 2001.

3 State budget execution

Commercial Code No. 4003-XII from 1994.

Letter "On functioning of the system of public tenders in I quarter 2002", No. 19-23/1678-10 from 2002.

The Decree of CMU "On adoption of rules and conditions of free transportation for the deputies of local councils", No. 702 from 1994.

The Decree of CMU "On adoption of the Rules of inter-agency coordination of public procurement", No. 1312 from 2001.

The Decree of CMU "On rules and conditions of free transportation for the deputies of local councils", No. 1738 from 2002.

The Law "On the protection of economic competition", No. 2210-III from 2001.

The Law "On Enterprises", No. 24 from 1991.

The Law "On High Education", No. 2984-III from 2002.

The Law "On protection, unfair competition", No. 236-96-BP from 1996.

The Law "On public procurement of goods, works and services", No. 1490-III from 2000.

The Law "On state support for the air-construction industry in Ukraine", No. 2660-III from 2001.

The Law "On stimulation of the agricultural sector for 2001-2004", No. 2238-III from 2001.

The Law "On the basic conditions of the social protection of the veterans of labor and other senior people in Ukraine", No. 3721-XII from 1993.

The Law "On the indexation of monetary revenues of the people", No. 491-IV from 2003.

The Law "On the Remuneration of Labor", No. 108/95 from 1995.

The Order of CMU "On organizational measures concerning the functionoing of the system of public procurement", No. 1469 from 2000.

The Order of Ministry of Labor and social policy, Ministry of Economics and European Integration, Ministry of Finance, The state committee of construction, architecture and hosing policy, Ministry of Energy of Ukraine, the State stock holding company "Ukrgas", "On the approval of the Methodology for granting the population with subsidies for housing and communal services, purchase of liquefied gas, solid and liquid fuel for stoves", No. 379/2819 (No. 58/45/91/73/51/23/10-538) from 1998.

The Order of the Ministry of Defense "On the regulation of the conditions of the remuneration of labor of employees of the budget military units, institutions and organizations of the Armed forces of Ukraine", No. 216 from 2001.

The Order of the Ministry of Economy and European Integration "On organization of control over the adherence to current legislation on public procurement of works, goods and services", No. 238 from 2002.

The Order of the Ministry of Education and Science "On the regulation of the conditions of the remuneration of labor of employees at some budget scientific organizations of the Ministry of Education and science of Ukraine", No. 453 from 2002.

The Order of the Ministry of Labor and Social Policy "On the regulation of the conditions of the remuneration of labor of employees at structural subdivisions of the state statistics territorial bodies, which are working at the expense of State budget of Ukraine", No. 412 from 2001.

The Order of the Ministry of Labor and Social Policy, the Ministry of health care "On the regulation and establishment of the conditions of the remuneration of labor of employees at the institutions of health protection and the institutions of social protection of population", No. 161/137 from 2001.

The Resolution of CMU "On the approval of the Act on the Fund of the social protection of invalids", No. 1434 from 2002.

The Resolution of CMU "On the approval of the Temporal procedure on the transferring some subventions in 2003 for the execution of expenditures for providing privileges, subsidies and compensations at the expanse of revenues to the general fund of the State budget of transit fees for the transportation of the natural gas and for natural gas extracted in Ukraine", No. 113 from 2003.

The Resolution of CMU "On the basic conditions of the social protection of the veterans of labor and other senior people in Ukraine", No. 94 from 1994.

The Resolution of CMU "On the conditions of the remuneration of labor of employees at budget scientific-research institutions and organizations and other scientific institutions of the National academy of science", No. 74 from 2001.

The Resolution of CMU "On the new size of the costs for the payments for housing and communal services, purchase of liquefied gas, solid and liquid fuel for stoves", No. 1156 from 1998.

The Resolution of CMU "On the Procedure of setting, payment and size of the stipends of pupils, students, cadets, registrars, post-graduate students, persons working for doctor's degree", №950 from 2001.

The Resolution of CMU "On the procedure of the providing privileges, foreseen by The Law of Ukraine On the basic conditions of the social protection of the veterans of labor and other senior people in Ukraine", No. 552 from 1994.

The Resolution of CMU "On the regulation of the conditions of the remuneration of labor of employees at organizations and institutions of some budget sectors", No. 134 from 2001.

The Resolution of CMU "On the regulation of the remuneration of labor of employees of the apparatus of the executive power central authorities, local self-governance bodies and they executive bodies, prosecution bodies and courts, etc.", No. 2288 from 1999.

The Resolution of CMU "On the remuneration of labor on the basis of Unified tariff scale of classes and coefficients of the remuneration of labor of employees working in all institutions, organizations of budget sector, No. 1298 from 2002.

The Resolution of CMU "On the setting for year of 2003 the employment limits, the size of remuneration of labor and maintenance costs of oblasna, Sevastopil city, rayonna state administrations", No. 380 from 2003.

The Resolution of CMU "On the setting of the employment limits of the apparatus of ministries, other executive power central bodies and their subordinated territorial bodies and establishment of the limits of cars that serve them", No. 403 from 2000.

The Resolution of CMU "On the setting of the Procedure of calculations of inter-budget transfers amounts (equalization subsidies, subventions and money transferred to the budget of higher rank) and standards of deductions, state taxes and duties for 2001", No. 1932 from 2000.

4 Accountability and reporting

Act of the Verkhovna Rada "On the Structure of Budget Classification", No. 327/96 from 1996.

The Decree of the President of Ukraine "On Regulation on Pension Fund of Ukraine", No. 121-2001 from 2001.

The Decree of the President of Ukraine "On the State Treasury of Ukraine", No. 335/95 from 1995.

The Law "On Compulsory State Insurance Against Unemployment", No. 1533-XIV from 2002.

The Law "On Compulsory State Social Insurance Against Industrial Accident and Occupation Disease, That Caused the Loss of Working Ability", No. 1105-XIV from 1999.

The Law "On Compulsory State Social Insurance Related to Temporal Disability and Expenses Caused by Birth or Funeral", No. 2240-III from 2001.

The Law "On Domestic State Debt", No. 2604-XII from 1992.

The Law "On Financial Accounting in Ukraine", No. 996-XIV from 2000.

The Law "On the National Bank of Ukraine", No. 679-XIV from 1999.

The of Ministry of Finance "On The Order of Accounting of State Debt and Operations Connected with it by the Ministry of Finance", No. 42 from 2001.

The Order of Ministry of Finance "On Budget Classification and its Adaptation", No. 604 from 2001.

The Order of Ministry of Finance "On Classification of the Revenues and Expenditures of State and Local Budgets", No. 35 from 1992.

The Order of the State Treasury of Ukraine "On the Approval of The Order of Submission of Annual Financial Reports by Budgetary Institutions in 2002", No. 240 from 2000.

The Order, instruction (z0113-03) of the State Treasury "On Approval of Instruction on The Order of Compilation in the Year 2003 of Monthly Financial Reporting by Establishments and Organizations that Receive Funds from State of Local Budgets", No. 17 from 2003.

The Resolution of CMU "On Approval of the Budget of the Pension Fund for the Year 2003", No. 249 from 2002.

The Resolution of CMU "On Approval of The Order of Submission of the Financial Reports", No. 419 from 2000.

The Resolution of CMU "On the Approval of The Order of Submission of Financial Accounting", No. 419-2000 from 2000.

5 Local Government's Finance

The Decree of CMU "On Local Taxes and Fees", No. 56-93 from 1993.

The Decree of the President of Ukraine "On Additional Measures to Ensure Open Activity of the Governmental Bodies", No. 683/2002 from 2002.

The Decree of the President of Ukraine "On Local Taxes and Fees", No. 565/99 from 1999.

The Decree of the President of Ukraine "On the Ministry of Finance of Ukraine", No. 1081/99 from 1999.

The Decree of the President of Ukraine "On the State Treasury of Ukraine", No. 335/95 from 1995.

The Law "On Information", No. 2657-XII from 1992.

The Law "On Local Self-Government in Ukraine", No. 280/97 from 1997.

The Law "On Requests by Citizens", No. 393/96 from 1996.

The Law "On State Statistics", No. 2614-XII from 1992.

The Law "On the Accounting Chamber", No. 18/98 from 1998.

The Law "On the State Control and Auditing Service in Ukraine", No. 2939-XII from 1993.

The Resolution of CMU "On Approval the Formula of the Distribution of Intergovernmental Transfers (Equalization Transfers and Funds Directed Toward State Budget) among State Budget and Local Budgets", No. 1195 from 2001.

The Resolution of CMU "On Approval the Order of the Equalization Transfers and Conditional Transfers from the State Budget to the Local Budgets, Transfers from the Local to state Budget and Intergovernmental Transfers among Local Budgets", No. 490 from 2002.

6 Public Availability of Information

The Decree of the Cabinet of Ministers "On further steps on ensuring the transparency in the activities of the bodies of the executive branch", No. 1302 from 2002.

The Decree of the Cabinet of Ministers "On the order of the publication in the Internet of the information on the activities of the executive bodies", No. 3 from 2002.

The Decree of the President "On additional steps to ensure the transparency in the activity of the state power bodies", No. 325 from 2001.

The Law "On Information", No. 2657-XII from 1992.

The Law "On State Statistics", No. 2614-XII from 1992.

7 Public Service and Anticorruption Procedures

Criminal Code No. 2341-III from 2001.

The Decree of the President "On the Coordination Committee of the Fight against Corruption and organized crime", No. 561-83 from 1993.

The Decree of the President of Ukraine "On improving effectiveness of the activity of the Coordination Committee on the fight against corruption", No. 402 from 2003.

The Decrees of the President concerning the fight against corruption.

The Law "On the Fight against Corruption", No. 356/95 from 1995.

The Law "On the Local Self-governance in Ukraine", No. 280/97 from 1997.

The Law "On the Public Service", No. 3723-XII from 1993.

The Law "On Service in Local Self-governmental bodies", No. 2493-III from 2001.

The Order of Chief Administration of the State Public Service of Ukraine "On the Guide the Typical Occupational Characteristics of the Public Servants Positions", No. 65 from 1999.

The Order of the Chief Administration of Public Service "The General Procedure of Conducting the Exam for the Vacant Places of Public Servants", No. 30/84 from 2002.

The Order of the Chief Administration of the State Public Service of Ukraine "On the Addition to the Guide of the Typical Occupational Characteristics of the Public Servants Positions", No. 94 from 2001.

The Resolution of CMU "On the Administration of the Public Service", No. 209, 2 from 1994.

The Resolution of CMU "On the Centers of Retraining and raising the level of skills of the Employees of Public Bodies, Local Governments Bodies, Heads of State Enterprises, Institutions, and Organizations", No. 224 from 1996.

The Resolution of CMU "On the Procedure of Approval in the Cabinet of Ministers of the Candidates for the Positions of the Heads of Structural Subdivisions of the Central Executive Bodies", No. 676 from 2003.

The Resolution of CMU "On the Procedure of Approval of appointment and dismissal of heads of administrations, departments, other structural subdivisions of local state administrations", No. 1374 from 1999.

The Resolution of CMU "On the Procedure of Conducting the Competition for the Position of Public Servants", No. 169 from 2002.

8 Management of Public Property in Nonfinancial Sector

Commercial Code No. 436-IV from 2003.

The Decree of CMU "On Management of the Property in the State Ownership", No. 7 from 1993.

The Decree of the State Property Fund of Ukraine "On the concept of corporate and dividend policies of the state", No. 1262, from 2000.

The Order of CMU "On proposals of Purchase of shares of closed corporation 'UTEL' by state-owned telecommunications enterprise 'Ukrtelekom'", No. 617-p from 1999.

The Decree of CMU "On The Order of appraisal and tenders for the selection of investment projects foreseeing the participation of funds, the state budget", No. 2145, 1999.

The Laws "On Concessions", No. 209-IV from 2002.

The Law "On concessions for the building and operation of automobile roads", No. 1286-XIV from 1999.

The Law of Ukraine "On Enterprises in Ukraine", No. 887-XII from 1991.

The Decree of Cabinet of Ministers of Ukraine "On Management of the State Assets", No. 8-92 from 1992.

The Decision of the President of Ukraine No. 1-1/72 from 2003.

9 Audit and Supervision in the General Government

The Decree of the President "On the Chief control and auditing administration", No. 65/2000 from 2000.

The Instructions and Orders of the Chief Control and Auditing Administration.

The Law "On the Accounting Chamber", No. 18/98 from 1998.

The Law "On the State control and auditing service in Ukraine", No. 2939-XII from 1993.

The Laws On the Appointment of the members of the Accounting chamber of Ukraine.

The Report of the Chief control and auditing administration "On the activity of the state control and auditing administrations in 2002".

The Resolution of CMU "On the Conduction of the internal audit by ministries and other central executive bodies", No. 685 from 2002.

The Resolution of CMU "On the regulation of the remuneration of labor of employees of the apparatus of the executive power central authorities, local self-governance bodies and they executive bodies, prosecution bodies and courts, etc.", No. 2288 from 1999.

The Resolution of the ACU "On the consideration of the Instruction of the procedure of conducting inspections and audits of the ACU", No. 25-1 from 1999.