The governance system at the local level in Ukraine for many years has had built-in conflict as it does not clearly define the responsibilities of elected local authorities and the local administrations, which are a part of the executive branch of power. The local government entities traditionally had little impact on their financing—both in regard to revenue and expenditures. Such a situation failed to create any real incentives for local authorities to be efficient and improve their performance.

The decentralization reform launched in 2014 aims at increasing the financial autonomy of local government entities providing more financing, as well as more powers to the local level. In Ukraine, decentralization in no way means federalization. By now, it basically combined two major pillars.

The first relates to fiscal decentralization, according to which the local authorities received more taxes, but with more responsibilities. The second refers to the administrative issues of decentralization, including the organization of amalgamated territorial communities. The latter, however, is not possible without the former. Through decentralization, local entities receive powers to carry out governance, healthcare, education, regional development, roads maintenance, etc. Overall, the decentralization reform is listed among one of the biggest successes of Ukraine’s reforms in the last four years.

**THE BACKGROUND OF THE REFORM**

Between 1991 and 2014, the Ukrainian government did little towards strengthening the regions. Most decisions were taken at the central level, whereas local governments were fiscally dependent on the central budget.

Moreover, local government entities were (and still are) represented by local self-governance with little powers, while their executive branches (local administrations) are de facto the territorial subdivisions of the central government.

About 60% of local revenues were received in the form of central fiscal transfers, while the share of tax revenues declined from 62% in 2001 to 30% in 2015. Moreover, tax rev...
The Resolution of the Cabinet of Ministry, N°333-p, envisaged the implementation of the broad-based decentralization Action Plan for its implementation.

These documents define the decentralization as one of its top priorities. The decentralization reform was launched with several important decisions taken by the government very fast.

First, in April 2014, the government adopted the Concept of the Reform of Local Self-Government and the Territorial Organization of Power,5 which was followed by the approval of the Action Plan until 2020 (adopted in 2016). The Government Action Plan until 2020 (adopted in 2016) also lists decentralization reform among the priorities. These two strategic documents define the decentralization as the fiscal decentralization. Meanwhile, the Association Agenda between Ukraine and the European Union (EU) focused primarily on the issue of the decentralization of power.

According to the Concept of the Reform of Local Self-Government and the Territorial Organization of Power, the major tasks of the decentralization reform included ensuring:

- the access to quality public services;
- optimal division of powers between local and central executive bodies;
- justification of territorial basis for activity of local self-governance and local administrations to ensure access to quality public services provided by them;
- creation of appropriate material, financial, and organizational conditions to ensure the implementation of own and delegated functions by local self-government bodies.

The decentralization is to be based on the transfer of powers (responsibilities) from the center to the lowest possible local level, the respective shift of financing resources, and the supervision of local government entities by the central government.

According to the Concept of the Reform of Local Self-Government and the Territorial Organization of Power, the decentralization was planned to start with amendments to the Constitution, according to which the reform of powers of local councils and local administrations were to be streamlined. However, since the approval of amendments appeared politically unfeasible6, the reform has started on the basis of the old Constitution. Yet, the Parliament still approved amendments to the Tax Code, which changed the tax distribution between local and central government. Furthermore, all essential legislation was approved for the implementation of the decentralization reform – including the mergers of territories, regional government policies, and provision of administrative services at local level.

The decentralization envisages the creation of administrative service centers at local government entities to enable the provision of most services locally. As of June 2018, 756 Administrative service centers have already been created (452 of them by rayon state administrations), which is a substantial progress in the fulfillment of the task of better access to administrative services for the population. As of June 2018, Administrative service centers have already been created (452 of them by rayon state administrations), which is a substantial progress in the fulfillment of the task of better access to administrative services for the population.

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The amalgamated territorial communities as a cornerstone for fiscal strengthening.

One of the key steps within the decentralization reform are the voluntary municipal mergers, which started in 2015. The formation of capable basic level of local self-government was based on the Law on “Voluntary Amalgamation of Territorial Communities”7. It is aimed at the concentration of human capital, infrastructure, and land resource at a local level, which would strengthen communities. The capable community will then be able to provide quality public services (including education and healthcare) to the population.

The amalgamated hromada8 is the unification of several settlements with a single administrative center. Any amalgamated hromada (community) with a city as an administrative center is an urban hromada, any amalgamated hromada with an urban-type settlement as an administrative center is a settlement

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8 Hromada is an amalgamated territorial community.
The Law also introduced the institution of a starosta10 in the amalgamated territorial communities, who is to represent the interests of rural residents in community council11.

According to the Ministry of Regional Development, Construction, Housing, and Communal Services of Ukraine (hereinafter referred to as the Ministry of Regional Development), as of June 11, 2018, 743 amalgamated territorial communities were formed by 3,443 communities with 6.4 mn residents (the number of residents in communities increased by about 5 times to about 8,400 per an amalgamated community)12. If such trends continue, the number of communities is likely to decline from about 11,000 to around 2,400 communities13.

The communities are stimulated to merge through the financial stimulus14. If they do merge, they receive higher revenues: in 2016, total budgets of communities that amalgamated in 2015 increased by 49%15, while in 2017, own revenues of 377 active amalgamated communities more than doubled. Moreover, such amalgamated communities become direct recipients of the central fiscal transfers – including healthcare, education, and infrastructural subventions (earmarked transfers from the central budgets).

Still, the evidence indicates that some communities lack fiscal sustainability. One of the reasons for this is that not all of them were created in accordance with the regional development strategies (in some oblasts such strategies were not approved)16. As a result, some of the amalgamated communities are too small to cope with their new responsibilities17.

The data indicates that the amalgamated territorial communities spent increasing revenues for financing primarily social and other infrastructure. Overall, education, healthcare, administrative services, roads, lighting, water, waste, landscaping, and safety currently belong to the competence of amalgamated territorial communities. The amalgamated territorial communities received more responsibilities in the area of architectural and construction supervision and inspections, which is expected to simplify the construction procedures. The communities also received more powers in the management of land resources. However, the evidence shows that some communities lack managerial competences18 and technical capacities. This is true especially for rural communities.

It was evident that some amalgamated territorial communities are more capable than others in dealing with new challenges and, thus, were expected to be more successful in using additional financing and new powers. To ensure knowledge sharing, the Law on “Cooperation of Territorial Communities”19 defined the mechanism of dealing with common problems faced by communities. According to the Ministry of Regional Development, since the beginning of July 2018, 199 cooperation agreements have already been implemented and 861 communities have taken advantage of this mechanism20. Such activities relate primarily to such issues as waste management and recycling or development of joint infrastructure.

**FISCAL DECENTRALIZATION PATH**

In the end of 2014, the government introduced steps for fiscal decentralization, which were aimed to increase the financing capacity of local government entities. Tax-sharing arrangements were changed, while the list of local taxes was modified (some were abolished, while others were created). Local governments’ taxing power was extended, as they have received bigger freedom in setting tax rates and envisaging exemptions (even though the maximum rates have been capped).

Key taxes that fill local budgets (cities of oblast importance, rayons, and the amalgamated territorial communities) currently amount to:

- 60% of personal income tax, part of the excise tax (important source of revenues in 2015–2017)21;
- 100% of unified tax paid by the taxpayers under the simplified taxation system, and;
- 100% of property tax (property, land)22.

According to the official estimate, in 2018, these four taxes will account for 94.9% of total tax revenues of local budgets. As previously, tax revenues of local budgets are primarily comprised of shared taxes (personal income tax, property tax, unified tax, excise tax).

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10 decentralization.gov.ua is an official web portal devoted to the issues of decentralization reform. It contains the information on the design of the reform, monitoring of its implementation as well as information on the assistance of international donors in the implementation of the reform.

11 Starosta is a local self-government official in villages forming part of an amalgamated territorial community (hromada). A village head is voted during elections and is known as starosta.


13 As of June 11, 2018, 653 starostas have been elected and more than 1,8 thousand individuals are acting starostas.

14 The survey, conducted by the Center of Democratic Initiatives in 2016, showed that heads of local government entities became more interested in merging with other communities after they saw the additional financing received by first amalgamated communities. This also reduced the skepticism about the amalgamation among representatives of civil society.


18 The survey conducted by the Center of Democratic Initiatives in 2016.

19 http://decentralization.gov.ua/laws/show/1508-18

20 https://decentralization.gov.ua/en/about

21 First, since 2015, the local budgets received excise on retail sales with the rate of 2–5%. In 2018, local budgets receive part of the domestic excise tax, excise of fuel, and part of the excise on retail sales.

Local budget own revenues (general fund) gradually increased from 5.1% of GDP in 2014 to 6.7% of GDP in 2017 and are expected to grow further to 7.1% of GDP in 2018. The share of local taxes and fees in local budget own revenues (general fund) increased over the last three years [See Figure 2]. Still, these numbers should be taken with caution while being compared to other countries.

Furthermore, since 2015, the government has changed the policies in relation to transfers provided from central to local budgets. Before 2015, the government covered 100% of the fiscal gap, which did not stimulate local government entities to become more efficient. In turn, the revenues surplus of well performing local entities was withdrawn to the central budget. After the change, the government covers only 80% of possible fiscal gap, while well performing entities transfer to the central budget not the full amount of revenue surplus, but 50% of its size. The financing of healthcare and education was transferred to the rayon level and level of cities of oblast importance and is provided in the form of formula-based direct subventions (earmarked central budget grants). The amalgamated communities are direct recipients of these subventions.

The evidence suggests that in 2015-2016, local budgets spent additional revenues primarily for road construction. This was explained by the delay in the shift of powers to local government entities (which were not amalgamated). However, in 2017, the local government entities received more financing responsibilities. In particular, they became responsible for financing utility services (including heating) of health and educational facilities, as well as payment of wages to non-pedagogical staff of secondary schools. The cities of oblast importance became responsible for financing vocational education schools. The provision of some privileges was also shifted to the local level.

The gap in time between the increased resources and transferred financing responsibilities might be considered as a drawback in the reform path. The local government entities that increased their development budgets in 2015-2016 had to reduce them in 2017 with a risk of underfinancing already started projects.

Still, the evidence indicates that not all local governments can spend received resources effectively. In particular, some local governments keep part of the available financing at the Treasury or on banking deposits instead of using them on the development (since 2015 local governments can keep unspent funds, while prior to that they had to return them to the central budget).

**STATE SUPPORT OF REGIONAL DEVELOPMENT**

- The decentralization and regional development were stimulated by the approved State Strategy of Regional Development of Ukraine until 2020. The Strategy defined three aims of its implementation:
  - increased regional competitiveness;
  - territorial, social and economic integration;
  - effective state management in the area of regional development.

In the framework of the implementation of the Strategy, the Law on the “Fundamentals of State Regional Policy” was introduced. According to the Ministry of Regional Development, it resulted in a sharp increase in state support of regional development [See Figure 1]. Overall, it partially reflects the reduction in the support in the form of equalization transfers in fa-

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**DONORS HELPED THE GOVERNMENT IN THE DRAFTING OF LEGISLATION AS WELL AS IN THE IMPLEMENTATION OF THE CHANGES**

Centers in all oblasts, while another one focuses on the establishment of Administrative Service Centers.

Several large projects were financed, and some are still financed by the U.S. Agency for International Development (USAID). In particular, these are projects DOBRE and PULSE, which were highly evaluated by the Ministry of Regional Development.

Overall, the Ministry of Regional Development is very active in the cooperation with the international donors. The Ministry created the Council of Donors with the aim to ensure strategic coordination between the government and numerous international donors. The coordination is conducted on the basis of a created Matrix of Assistance, which clearly outlines the contributions and tasks of each project in the implementation of specific decentralization reform measures and steps.

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34 For details of the support by international donors see IER (2018) “Priorities of the EU’s Assistance to Ukraine: Beneficial Alignment”, by O. Betliy, Y. Anhel, I. Kosse, V. Krachuk, O. Krivovska, and I. Fedets. Available [online]: http://www.ier.com.ua
KEY CHALLENGES FOR THE FUTURE
The decentralization reform is among the biggest successes of Ukraine’s reform path over recent years. It includes the financial strengthening of local government entities, which become more powerful while making decisions on territorial development. The establishment of amalgamated territorial communities in the framework of the fiscal decentralization reform is among crucial changes recently launched by Ukraine. It results in the creation of capable communities, as well as increased fiscal transparency.

The reform is also supported by the population. In 2017, 42% of the population supported the steps taken in the framework of decentralization reform, while 27% negatively evaluated the measures introduced by the government36. According to the experts’ survey, the decentralization reform is the second most successful reform37.

However, the implementation of the decentralization reform still faces challenges38. One of these relates to the lack of managerial competences of leaders of local government entities (especially of amalgamated territorial communities) to implement fiscal responsibility policies39. In particular, the evidence already shows that the performance of local government entities varies after they have received more financing. Some of them effectively finance infrastructural and social projects, while others have not improved the performance. As a result, the capacities of the leaders of local government entities impact the equity and quality of primary and secondary education and healthcare provision. The communities, especially in rural areas, lack professionals in many sectors — including public health, education, infrastructure, and energy efficiency.

The role of local authorities increases in provision of vocational and educational training (VET) as they are expected to coordinate the state order in VET schools with local employers. This is an essential prerequisite of the adaptation of skills, competences, and vocational qualifications to the needs of the local economy40. Therefore, more capacities are needed at the local level in this area as well.

Another challenge defined in the OECD study relates to ensuring an enabling environment for the reform, which, in particular, relates to the corruption41. The anecdotal evidence suggests that corruption actually became a bigger issue at the local level after decision making was shifted from the central level.

The reform also indicates that the powers of the rayons and amalgamated territorial communities should be streamlined. In particular, this relates to a clear definition of the spending responsibilities between different tiers of administrative units.

The creation of the amalgamated territorial communities again indicated that there is a need for a broad administrative territorial reform. The current number of rayons (districts) is excessive. Moreover, the administrative division of other countries suggests that the oblasts might be also further merged.

This is likely to be a task for the new government, which will have a mandate for the continuation of the decentralization reform after the presidential and the parliamentary elections scheduled for 2019.

In any case, an essential point for the future is the effective communication of the importance of decentralization reform to the public. The government should clearly explain the plan (the sequence of measures) and expected results of the reform to the public to increase the support for the reform. Overall, such a road map of the decentralization reform really needs to consider the fact that it tightly interrelates with the education, healthcare, and tax reforms, which are high in the policy agenda.

THE ESTABLISHMENT OF AMALGAMATED TERRITORIAL COMMUNITIES IN THE FRAMEWORK OF THE FISCAL DECENTRALIZATION REFORM IS AMONG CRUCIAL CHANGES RECENTLY LAUNCHED BY UKRAINE

THE ANECDOTAL EVIDENCE SUGGESTS THAT CORRUPTION ACTUALLY BECAME A BIGGER ISSUE AT THE LOCAL LEVEL AFTER DECISION MAKING WAS SHIFTED FROM THE CENTRAL LEVEL

37 The survey of experts was conducted by the Ilko Kucheriv Democratic Initiatives Foundation on June 8-13, 2018. See https://dif.org.ua/uploads/pdf/994166585708.05753855.pdf
38 Here, only several challenges are listed.
39 The principles of fiscal responsibility in the framework of decentralization include greater transparency, monitoring, and reporting mechanisms at the local level.