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Appraisal

of the Draft Amendments to the Budget Code of Ukraine

on the Creation of the State Fund for Regional Development

The present paper was prepared by the Directorate of Democratic Institutions, Directorate General of Democracy and Political Affairs, in co-operation with Prof. Gérard Marcou, University Paris 1 Panthéon-Sorbonne, Director of GRALE (Research Group on Local Administration in Europe), France.

Introduction

The present appraisal was requested by the Ministry of Finance of Ukraine and a governmental Working Group on Regional Development and Reform of Inter-Budgetary Relations within the framework of the Council of Europe (CoE) Programme to Strengthen Local Democracy in Ukraine (2010-2013, funded by the Swedish International Development Cooperation Agency Sida). A more detailed discussion can be prepared as the next step.

With the proposed amendments of April – July 2011 to the Budget Code on the State Fund for Regional Development, the regional development policy is again on the legislative agenda. The purpose of these amendments is to give to this policy the financial lever that has been missing until now.

The State regional development policy is still based on the 2005 Law n°2850-IV on the Stimulation of the Development of the Regions. This law (Art.12) provided for financial commitments of the State to support the implementation of the regional development policy (0.2% of the total income of the general fund of the State budget), but not of a fund for regional development; this provision was abrogated by the law n°3235-IV of 20 December 2005. In 2008 a reform of the regional development policy was undertaken and a new draft law on principles of the State regional policy was circulated but finally never submitted to the Parliament.[1] Although based on a different concept, the 2008 draft (Art.33) provided for a National Fund of Regional Development to be established by the Cabinet of Ministers, funded by own resources (5% of the profit tax on enterprises, State subsidies and external contributions).

This appraisal will focus on the proposal of 20 July 2011, while taking in consideration the previous stages of the draft amendments. First, the paper will discuss the status and funding of the State Fund, and second, the scope of its commitments.

I. Status and Funding of the State Fund of Regional Development

The State Fund is established by the Budget Code as a part of the special fund of the State budget, according to Article 13 (new paragraph 5). As such it will be the only special fund assignment specifically established by the Budget Code; others have to comply with conditions of Article 13, but are established usually by budget laws. It is embedded in the

[1] Council of Europe Appraisal of the draft Law on the Principles of State Regional Policy of Ukraine, DPA/LEX 8/2008.

budget machinery, and this should help the Fund function, since its funding will depend on the execution of the budget by the Treasury. This is the consequence of the amendments to Article 13, and an ingenious way to move forward.

The State Fund will be funded first by transfers from the general budget, but these transfers will not depend on a specific provision introduced in the budget law; they will be operated by the treasury, just as the rest of resources of the general budget of the closing budget year are transferred to the special fund in order to cover engaged expenditures or to the general budget of the following budget year (Art.57.2). This will be the same for resources assigned to the State Fund for Regional Development as a result of the amendment to paragraph 7 of Article 13, as determined by the new paragraph 7-1 added to Article 13.

The resources left over from the execution of the budget will be included in the resources of the State Fund for the next budget year. According to paragraph 7-1, 10% of the balance will be transferred to the State Fund. Then, at least 2.5% of the total expenditure of the general fund of the State budget is to be transferred to the State Fund for Regional Development, according to the appropriation for precise amount in the law on the budget. Overall, it should be more than 5% of the profit tax, as it was provided for the National Fund by the 2008 law, and much more than the commitment of the 2005 Law on the Stimulation of Regional Development (Art.12) that was to assign yearly a minimum of 0.2% of the total incomes of the general fund of the State budget. This financial commitment was removed before it could be applied.

What is more important, from the implementation viewpoint, is the role of the State Treasury. According to paragraph 7-1, the State Treasury operates the transfers from the general fund to the special fund of the State budget for the State Fund: not before the first day of the new budget year for the balance, and during the budget year for the transfer of 2.5%, or more, of the total planned expenditure in the budget. The Treasury may execute these provisions directly, once they are adopted.

The law does not provide a specific body for the administration of the Fund. Logically, the Minister of Regional Development should be responsible for the Fund. However, according to the current statutes of the ministries, it is the Ministry of Economy which is responsible for regional development policy. Anyway, the application of the law will not depend on the establishment of a complex institutional setting.

These provisions seem therefore to be a good basis for engaging the financing of the regional development policy.

Furthermore, the State fund is expected to collect resources granted by international financial organisations, other financial and credit institutions, and "donor'" contributions (new Article 24-1). Compared to previous solutions, it is quite important for these external contributors to be sure of the commitment of Ukraine regarding regional development. With the thresholds laid down by the law and the implementation conditions fixed by the Budget Code, external contributors should have enough guarantees to direct contributions on regional development. In previous versions of the amendments, the commitment was of 3% of the total expenditure appropriations of the general fund of the budget; this was more appealing than 2.5 plus 10% of the balance of the execution of the previous budget year.

II. The Commitments of the State Fund of Regional Development

The provisions on the commitments of the State Fund are less convincing than those on its creation and funding. The problem is the absence of a clear choice on the purpose of the Fund, and hence the risk of dispersion of resources.

The purpose of such fund is not to provide a permanent source of funding for local development budgets, it is rather to make possible for the State to support programmes that are necessary for the development of a region (meaning an area with specific socio-economic features rather than an administrative region), without which the local development capacities would not be sufficient. Interventions should therefore be well targeted and with enough concentration of means in order to achieve a result in a reasonable time. It is a difficult task in all countries, as it is always hampered by competing demands and political bargaining. However, the law should at least show the good direction.

The ambiguity of the concept is reflected in the formulation of paragraph 1 of Article 24: "The State Fund of Regional Development is created for operating expenditures aimed at financing medium and long-term investment programmes (projects), directed at the development of regions and that correspond to the priorities expressed in the State strategy of regional development and the corresponding development strategies of regions, programmes and forecast documents of economic and social development of the State, of the corresponding region, and to State targeted programmes". **The underlined words after "programmes and forecast documents" should be deleted, because they**

open the possibility to misuse the State Fund. In this respect, the best formulation for Article 24-1 is the one of the proposal dated 28 April; the final proposal fails to formulate the policy orientation for which the Fund is created.

For the same reason, the **paragraph 3 of Article 24-1 in the version of 20 July also needs to be revised.** According to this formulation, it belongs to the State Fund of Regional Development to grant to local governments State subsidies for the implementation of investment programmes (projects) as provided by Article 97.1, 5° of the Budget Code, and other capital subsidies provided by the budget law. It is obvious that the State Fund will grant investment subsidies to local governments; however, related to the formulation of paragraph 1 quoted above, it appears that the subsidies mentioned in paragraph 3 are not assigned to regional development, and this again opens the door to the intervention of the State fund for all kinds of non-relevant purposes, and finally as a substitute to an efficient general funding system for local government investments, that is still missing in the Budget Code. **To avoid this problem, paragraph 3 should refer to the priory directions listed in paragraph 5.**

The logic of a permanent investment funding system is also reflected in the version of 7 April, which proposes a general breakdown of the expenditures of the Fund according to fixed percentage according to various types of intervention. This can be done for the calculation of grant with several integrated components corresponding to different situations. But, if the State Fund for Regional Development is deemed to support programmes and projects, the interventions will depend on the schemes submitted to it, and its management should be flexible enough in order to try to support the best. This is incompatible with an *a priori* breakdown determined by the law.

Paragraph 5 of Article 24-1 is better formulated and provides "priory directions" for the use of the State Fund resources. Point 1° refers to the activities developed on the basis of the Law on the Stimulation of the Development of Regions. This Law provides for two main instruments: regional development agreements and deprived territories (with various categories based on socio-economic characteristics). The State Fund could be used to support programmes established on the basis of these instruments. Two other targets listed in paragraph 5 are consistent with the goal to ensure sufficient concentration of the interventions on regional development programmes or projects: supporting inter-regional cooperation (2°); developing cross-border cooperation according to the law on cross-border cooperation (4°). The last point, however, should be specified in order to avoid encouraging the dispersion of interventions. According to 3°, the resources of the Fund could also be used to support investment programmes and projects contributing to solve "specific problems" of administrative territorial units – the draft mentions small cities, settlements in mountainous areas, deprived territories, settlements located in observation areas. All these targets can contribute to regional development and can also be included in regional development agreements and development programmes of deprived territories. But they may also be far from regional development problems. It would be useful to distinguish between programmes or projects of a purely local nature, e.g. those which improve the living environment and the opportunities for the residents of a locality or a small group of localities, and those which have a regional dimension and can impact a wider area.

The recommendation therefore is to **revise point 3°: a) delete "deprived territories", since they are covered by the reference to the Law on the Stimulation of Regional Development in 1°; b) replace the sentence before the brackets by: "implement regional development projects involving specifically certain categories of administrative territorial units" (the following unchanged, subject to a) above).**

Obviously, a rather restrictive approach concerning the use of the State Fund requires establishing a stable and fair system to allocate to local governments the resources they need for their investments. The new Article 103-1 of the Budget Code on subsidies to construction, reconstruction, repair and maintenance of local roads of municipal property is one step in that direction, but there is a need of more global solution to support municipal investments, which represent in most countries a major part of public infrastructure investments.

According to paragraph 6 of Article 24-1, it belongs to the Cabinet of Ministers to determine the criteria for the interventions of the Fund.

Other amendments to the Budget Code are aimed at collecting information on the use of the resources of the State Fund (amendment to Article 59.2) and to report on the interventions of the State Fund (amendment to Article 61.1). **The latter amendment could add the requirement of an evaluation of the impact of the interventions, not only of the consumption of the resources.**