

**AN ANALYSIS OF THE BUDGETARY AND FISCAL  
CONSEQUENCES OF TERRITORIAL-ADMINISTRATIVE  
REFORM IN UKRAINE**

**A Concept Paper Prepared by a Ministry of Finance Working Group on  
Territorial-Administrative Reform**

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## **I. Introduction**

Many villages in Ukraine have a population of less than a thousand people. As such they are widely considered too small to be viable fiscal units capable of effectively delivering local services to local residents. Their small size represents a significant barrier to devolving further expenditure responsibilities in Ukraine. Somewhat paradoxically, small villages require territorial amalgamation and the formation of larger village units before it becomes feasible to contemplate transferring some additional expenditure responsibilities to them.

A draft law on territorial administrative reform has been prepared within the Government during the past year. While the future of its particular proposals is unclear, it remains likely that some form of territorial-administrative reform involving village amalgamation will occur in the future. The first section of this paper touches on what shape this reform might take and on the process of implementing any reform. The paper goes on from there to examine the most important budgetary and fiscal issues that would be expected to arise in the wake of any territorial-administrative reform.

Three key policy concerns springing from any territorial-administrative reform are at the core of this concept paper. First, new and larger administrative-territorial units (ATUs) should be able to develop the technical capacity needed to shoulder more expenditure responsibilities. But which ones does it make sense to ask these new units to perform? Secondly, there should be some realignment of revenue powers to accompany any shift of expenditure functions to the new ATUs. What are the most promising revenue sources for these new units? Finally, fiscal decentralization cannot succeed in any country in the absence of adequate equalization measures. The new ATUs would need to be linked to the State Budget through the current or a revised system of equalization transfers. Is the current formula up to this task and, if not, how might it be modified and simplified to operate more effectively and with a broader scope of application?

## II Territorial Reorganization of Local Governments

### II. 1. *Reforms Under Discussion*

This section sets the background for discussing the financial consequences of territorial-administrative reform in the later sections of the paper. Since there have already been several reports and seminars on the general background and process of the reform prepared by various donors, we stress only briefly the major points and concerns. The section must not be treated as a full discussion of the issues raised.

There are a number of draft laws on local government under discussion. This report examines the financial consequences of three proposals in particular:

- The provision in the present Draft Law on Territorial Structure provides for territorial amalgamation of local governments in Ukraine including creation of city regions, a reduction in the number of cities of *oblast* significance, a reduction in the number of *rayons* and radical consolidation of the lowest tier through creation of new *hromadas* which would be much larger than present village and town councils.
- The assignment to *hromadas* under the Draft Law on Local Self Government of Communities, of responsibility for several competences currently exercised by rayon administrations.
- Under the Draft Law on Self-Government of Rayons, rayon heads will be elected locally instead of being appointed as is now the case, giving the elected rayon councils full control over their executives. Such a change would give the rayon tier will full self-government status.

This paper discusses the implications of these proposals irrespective of their merits or chances of adoption.

### II. 2. *The Rationale for Reform*

The introduction of city-regions (giving the largest cities the rights of an *oblast*) brings a danger that requires careful consideration. Typically, many of their facilities service citizens of the whole oblast (and often more than one oblast) – major hospitals and cultural institutions being good examples. Creating city-regions responsible for these institutions will create a discrepancy between the geographical boundaries of the sub-national unit and the actual catchment area of the services it provides. It has immediate financial implications, requiring either special transfers supporting provision of services by city-regions or complex (and not very practicable) contracts between local governments covering payment for services provided to citizens outside their own jurisdiction. It also produces a democratic deficit, since local authorities would be providing services to many consumers to whom they are not accountable.

However, it is territorial amalgamation of the lowest tier that may have the largest impact on the Ukrainian local government system. Regardless of which criterion for the minimum population size of the *hromada* is finally adopted (5,000 or 3,500 as in newer drafts) the number of basic level local governments would be reduced by more than 50%.

Is such a radical amalgamation necessary? The answer very much depends on the vision of the role the basic tier of local government is going to play in the country. In this respect European experience is very diverse. On the one hand there are countries with many very small local governments. France is the most typical example, with close to 80% of communes having less than 1,000 residents. The Czech Republic, Slovakia, Hungary and Romania provide similar examples. On the other hand several countries have adopted a more consolidated territorial system. United Kingdom provides the most extreme case, but the examples of Sweden, Lithuania, Bulgaria or Poland can also be cited. In none of these countries are there local governments with populations below 1,000, and even jurisdictions with less than 2-3,000 residents are very rare (in UK the smallest local government has over 20,000 citizens).

Both theoretical considerations and empirical examples suggest that if local government is seen mostly as a service delivery unit, then some amount of consolidation is probably required. But if its main function is representing the local community, while basic services are delivered either through upper tier authorities or through cooperative or outsourcing arrangements, then keeping small communities with their own local government may be a good solution.

### **II. 3. *The Potential Benefits of Amalgamation***

European experience suggests that organizing local governments in relatively large territorial units provides several benefits (especially related to capacity for service delivery) and amalgamation may increase the efficiency of the system, although the positive consequences of amalgamation are often over-estimated and/or misinterpreted.

The most important potential benefits may be summarized as follows:

- Territorial consolidation *allows decentralization of more functions*. Indeed, in European countries with larger local governments more functions are usually delivered on the lowest level. According to some research local governments with less than 1,000 residents are incapable of delivering some important local functions. Some argue further that passing more functions to lower tier government also heightens citizens' interest and participation in local democracy, although this last argument is questionable in the light of some recent empirical analysis.
- Territorial consolidation allows *benefits from economies of scale*. For several services unit costs of delivery may be significantly lower in larger jurisdictions. Provision of administrative functions provide most straightforward evidence (per capita spending on administration is negatively correlated with population size), but arguments may be found also in other services such as solid waste management or primary education. It is important to stress that utilizing this potential benefits requires some amount of discretion for local governments to make policy choices (for example to make own decisions on optimal organization of the school network).
- Amalgamating territorial units into larger jurisdictions allows for *more coherent planning* (especially – but not exclusively – land use planning) which may better serve local development purposes.
- Amalgamation may have also an *indirect positive impact on local economic development policies*. Sound economic development policy often requires concentrating resources on a small number of projects of a strategic importance, which would bring benefits for a larger area. Such a concentration is easier in case of territorial consolidation.

- Larger territorial units may also provide opportunity to find *better qualified staff and provide higher standard equipment for the local administration*. However, this positive conclusion should be supplemented by an additional observation – decentralization of additional functions to the lowest tier (from the *rayon* to *hromada* in a Ukrainian context) may bring opposite problems. Although this danger should not be over-estimated, it may prove difficult to find sufficiently qualified staff even in enlarged *hromada*, while officers dealing previously with decentralized services in a *rayon*, might be unwilling or unable to move (or to commute) to smaller towns and villages to perform the same duties for the *hromada* government.

#### II. 4. *Addressing the Possible Negative Consequences of Amalgamation*

There are also significant risks attached to territorial amalgamation which arouse apprehension and opposition on the part of rural communities in particular:

- Larger local governments *lengthen the distance between the average resident and the local authority*. This has both physical and political dimensions - physical in the sense of a longer way from home to the place to which a resident has to go to deal with any administrative issues, political in the sense of a lower residents-per-councillor ratio; in small units contacts between councillors and citizens are much closer and politicians are more accountable to local communities.

It is difficult to deny these observations; however two comments can be made in favour of the amalgamation process. First, there is often a choice between having more functions delivered by an enlarged lowest tier of local government or local governments which are closer to citizens but incapable of undertaking significant functions. This choice leads to the conclusion that the ability to re-allocate some functions from the *rayon* to *hromada* level would effectively bring local government closer to people, in spite of the territorial amalgamation.

Second, observations from several countries show that administrative services can be brought closer to people, even if the central town/village is relatively distant. *Hromada* administration may have local branches in individual villages. They do not need to be open on an everyday basis, but perhaps, for example, once a week to serve effectively local citizens. Another solution is progress of e-governance that for example allows people to download and submit forms as well as to find necessary information electronically through the internet. We are aware that at the moment such an option sounds rather exotic for most rural areas in Ukraine, but the technological progress and availability of the internet are developing very fast and adequate solutions maybe feasible within the next few years.

- A frequent fear of amalgamating several settlements in a single local government is *domination by the major town/ village and political marginalization of other villages*. It may be a real danger. What is needed is a political system which secures balanced representation of geographical interests, and protects the interests of small villages. The danger may be reduced through an electoral system, in which the municipality is divided into as many wards as the number of elected councillors (as in United Kingdom or in Polish local governments with less than 20,000 residents). Such a system ensures that no part of the municipality will be unrepresented and that no settlement units can dominate the council and local decision-making.

There is one more argument for such an electoral system. The proportional system suggested for on-coming local elections in Ukraine is more appropriate for larger cities than for small predominantly rural communities. In small communities local politics – and consequently electoral decisions - are based more on direct, personal links and trust rather than on selecting the programmes of the larger groups, whether they are national political parties or local organizations. Needless to say, there are no organized groups to choose among in many small communities.

- Another fear is that the reform may undermine the *identity of amalgamated villages*. Amalgamations are introduced to strengthen local governments and enable them to deliver a wide scope of functions efficiently. But citizens' identification with smaller territorial communities is also a value that is worth protecting. In most of the countries that have undergone amalgamations, smaller villages did not disappear completely as subjects of territorial governments. There is usually a symbolic political representation on the village level. Both in Poland and Bulgaria the legal system keeps traditional names (*solectwo* and *kmetstvo*), village leaders are popularly elected, play an important consultative role in local governance and are recognised as important symbols of local communities. The draft Ukrainian law on *hromada* self-government undertakes this by introducing the position of *vyit* or *soltys*, who would be directly elected in every village (see especially article 30 and 49 of the draft Law).

One more solution that may help to protect the local identity of villages is delegation of some functions of amalgamated *hromada* down to villages. This option is widely used in several countries with consolidated territorial systems. Not all functions require economy of scale, and giving (for example) a small budget for small, local improvement projects (such as improving pavements on a main road) can strengthen "local pride". In the United Kingdom parish councils, although not very powerful, play an important role in local life. In Scandinavian countries experiments with management of some functions by small communities within larger local governments are well advanced. In some Polish local governments, individual villages keep a portion of local taxes and carry out some simple functions.

## **II. 5. The Process of Amalgamation**

An agreed process of amalgamation requires several conditions to be implemented successfully:

- First, it requires *good information (integrating geographical information systems, including topographical, economic, social/demographic, transportation, climatic and other data)* on territorial units. It is necessary first to make good decisions on the shape of new territorial borders. After the new map has been drawn, a feasible system of financing local government operations must be found as well as an equalization system which refers to measures of local spending needs.
- Second, a more formal requirement is the *process of consultation*. The European Charter of Local Governments, which has been ratified by Ukraine, requires that any change of territorial boundaries is consulted on with the local community case by case. It does not mean that results of consultations are binding for central authorities, but they have to be considered. The Charter does not prescribe any particular method of consultation but whichever is chosen, the process requires a considerable amount of time. And starting consultations requires the concrete proposal of a "new map". As far as we are aware, such process of consultation has been so far undertaken on a pilot basis only in Ukraine.



- The third condition of a successful reform is a soundly implemented *information strategy*. It should be implemented parallel to the consultation process and should explain the reasons and benefits from the reform as well as demonstrating how potential negative consequences would be minimized. Although – as already mentioned– support for the reforms through consultation is not a legal condition, implementing the reform with minimal popular support would deprive it of legitimacy and would undermine chances of final success.

## II. 6. *Recommendations*

The conclusion for Ukraine may be formulated in the following way: if there is a plan to pass responsibility for a wider scope of functions to the basic tier of local government then territorial consolidation is highly recommended. But if additional functions are not decentralized to the lowest tier, than consolidation would be an unnecessary (and politically costly) reform.

Amalgamation may have both positive and negative consequences. What is required is a technical *approach which would maximize potential benefits from the reform and minimize risks or potential negative consequences*. Implications include the following points:

- The financial complications and accountability losses arising from the mismatch between jurisdiction boundaries and service catchment areas should be weighed carefully before creating more cities with oblast rights.
- The election of heads of rayon self-governments is part of the “constitutional deal” achieved during the Orange Revolution and desirable; however, much attention needs to be given to distinguishing clearly between self-government and state administration functions at a regional or oblast level. Polish examples prove that even if the intentions of the reform are clear, such clear separation is not very easy in practice
- Amalgamating small settlements in a larger unit needs care in overcoming local fears of domination, neglect and inconvenience. Ward systems of election, a continuing role for village heads, branch office organization, and internet access to local administrative procedures are examples of measures which can help
- A process of consultation over territorial changes is required by the European Charter of Local Self Government and needs to be backed by provision of information carefully prepared both to highlight benefits and assuage fears.

### III. Expenditure Responsibilities of the New Administrative-Territorial Units

#### III. 1. *Some General Principles*

The territorial-administrative reform proposed by the current draft legislation would amalgamate the smaller village and settlement ATUs so that the basic level of elected local government would have a minimum population size capable of undertaking more administrative responsibilities and providing more services than at present. If adopted this would make it possible to consider reassigning to this level some of the competencies currently exercised by the rayon.

However, reforms under discussion also provide for the election of the heads of rayon administrations and would give rayon councils greater, if not complete, control over their executive. This should give rayon administration the proper character of a local self-government and would justify retention of those competencies where it can provide better economies of scale and closer approximation to the optimal catchment areas of service institutions than the town/village level.

Not all rayons are alike, however. Although the rayon stereotype of a collection of villages and settlements is common, in some rayons there are relatively large rayon cities. Their existence raises the possibility that territorial administrative reform should recognize this diversity by allowing an asymmetric distribution of expenditure functions. One option would be to permit large rayon cities to exercise both basic and county level functions for its population while the rayon administration concentrated on delivering county level services to other residents of the rayon.

The specific financial issues raised by territorial-administrative reform relate to the responsibility for delegated competencies. Inter-budgetary relationships established by the Budget Code cover these delegated competencies. Own competencies are not covered by the equalization arrangements. This recognises that in the case of the delegated competencies the State has a duty and interest to ensure a minimum standard and quality of provision. However the act of delegation also recognises that local management adds the value of local accountability and insight. This value can be lost if the state-local relationship relies too much on prescription and command. The maximum value can only be gained from delegation if the relationship is based on empowering local governments to deliver services, setting minimum standards and monitoring performance, but leaving ample room for local discretion about how best to design and manage the services involved.

The role of intergovernmental finance is to enable local governments to meet their service obligations but it should also leave scope for local choice about how best to do so. The Budget Code made two fundamental changes that are consistent with the best international practice and are worth preserving in any further reforms. First, its norms were based on disaggregating revenue forecasts, distributing the money available by a calculation of relative needs, not absolute costs; this was far more efficient than the previous system which used norms based on ideal costing measures that exceeded available resources, thereby discouraging realistic budgeting and encouraging arrears. The second advantage of the Budget Code was that the relative expenditure needs of individual local governments were calculated by the objective demand for services, and not by the cost of a historic network of institutions.

In this respect the calculation of expenditure needs under the Budget Code formula for intergovernmental transfers to a large extent ignored standards set by some sectoral legislation prescribing a standard network of service institutions. It would not be advisable to reverse this by funding service provision on the basis of administrative structure rather than client need. Stipulating that every ATU should have particular facilities produces, in practice, neither equity

nor efficiency. This is because ATUs will still differ in size whatever criteria are used for reorganising boundaries, and political pressures invariably lead to some difference between the ideal criteria for territorial reorganisation and its implementation. Moreover, stipulating that designation as an ATU entitles a locality to certain facilities is an added incentive to proliferate the number of ATUs, often in contravention of the criteria for amalgamation.

It is far more efficient and equitable to fund ATU services on the basis of the number of potential clients, while recognising exogenous differences in demand and cost, and leave ATUs discretion as to the optimal distribution of institutions providing the service. Reverting to funding based on the stipulation of institutional norms would be a retrograde step.

### **III. 2. *Health Care***

Turning to the individual competencies, the Verkhovna Rada decided earlier this year to keep health care responsibility intact at the rayon level. This should not be altered by TAR. A further subdivision of financial resources for health care creates difficult mismatches between the catchment area of hospitals, clinics etc and administrative boundaries. Contemporary health care management thought also strongly favours integration of primary and secondary health care financing and management to maximize fluidity between types of treatment and care. One does not want a legal division of competencies, for example, to determine whether dialysis is available at a hospital or a clinic. Both Denmark and Sweden, the most decentralized systems in terms of local government responsibility, keep sole charge of health care at the county level.

It should be mentioned that A World Bank review of public expenditure management has recommended integrating funding and management of health care at the level of the Oblast, a proposal also made in 2003 by DFID consultants.

### **III. 3. *Culture***

The Verkhovna Rada decision above also applied to culture and removed all cultural spending to the rayon level. This is more questionable. In international experience responsibility for culture is not normally exclusive to any level of government. It is usually a permissive competence of all tiers with intergovernmental finance providing for equal levels of per capita funding to both upper and lower tiers, but some times weighted in favour of larger population centres because their cultural institutions tend to serve wider catchment areas. Major institutions such as theatres and galleries are frequently funded jointly by upper and lower tiers of self-government. In the case of library services, British experience suggests that operation by the county level in rural areas promotes a flexible mixture of stationary and mobile facilities with access to a larger stock of books and web sites.

### **III. 4. *Education***

The case of education is more complex. Internationally there is no uniform practice in the assignment of responsibility for managing schools. It is frequently divided with the municipal level responsible for up to six years primary education but upper tiers (sometimes including larger cities) running secondary and vocational schools (the pattern in Hungary, Poland and Slovakia, for example). In Poland gmina (the lowest level) run both primary schools (6 to 12 years old) and “gymnasium” (13 to 15 years old), while the county (powiat) is responsible for “lyceum” (16-18 years old) only. In countries with large municipalities such as Bulgaria or Sweden, they may manage all schools except the most specialised. In the UK, on the contrary, all schools operate under the same authority, normally the county or a large city/town.

Legislation often prescribes a maximum class size or a minimum ratio of teachers to pupils. It may also define the curriculum that must be offered to specific age groups. It does not usually govern the distribution of schools which is left to local discretion. In the UK, for example, there are wide differences in the number of age groups combined in a single school.

Systems of intergovernmental finance increasingly base the funding of education on the number of pupils, not on the number of schools, classes or teachers. Most countries, however, recognise the additional costs of rural education and add a differential for population sparsity. Minimum class sizes are not normally prescribed by law, but per pupil funding encourages consolidation of schools and provides a disincentive to keeping very small classes.

The fact that schooling for the 6-15 age-group is regarded as a single level in Ukraine makes allocation of responsibility particularly difficult in rural areas. All *hromada* would probably be justified in running a school for the 6-8 year olds, who do not need much specialised teaching and equipment and cannot be expected to travel far. But these conditions are reversed for the ages from 9 to 15 and the necessary scale economies for this older age group are unlikely to be achievable in the smaller and more rural *hromada*. Assignment of responsibility and resources may have to be asymmetric with different ATUs having different responsibilities. It would be most unfortunate if indiscriminate assignment of responsibilities for basic education to the *hromada* level led to the proliferation of schools for children older than nine.

### **III. 5. Sports and Physical Culture**

In international experience legislation may give local government a power or a duty to provide sporting facilities, but does not normally prescribe any particular type or standard. Intergovernmental finance would assume equal per capita expenditure. Campaigns to improve performance in individual sports might involve matching grants for construction of new facilities such as stadia, running tracks, swimming pools etc, and national sporting associations might offer matching funds for particular types of coaching or competitions. Sporting facilities are normally provided by municipal authorities but their use by people from a wider area may be supported by grants from an upper tier or by per capita funding weighted by population size (the case in the Czech and Slovak republics, for example).

### **III. 6. Social Welfare**

At first sight the obvious solution would be to retain responsibility for residential services at rayon level, but delegate domiciliary services to the amalgamated *hromada* councils. However, a recent survey of public expenditure on the social services has suggested that the present distinctions between the funding of the alternative types of care perpetuates a bias in favour of residential care which may not always be the most efficient or appropriate answer to individual needs.

The survey quoted above concluded that responsibility for social protection and both domiciliary and residential care should be unified at oblast level (see Annex 1). A less radical alternative (perhaps done on a trial basis) might be to assign all funding for non-specialised social care to the *hromada* councils at a per capita level and allow residential care to be provided where necessary. Councils might then fund residential care where appropriate, but this might be managed by the voluntary sector (NGOs), associations of neighbouring *hromada* or rayons on a contracting basis. The option of using associations, however, may be ruled out by current Ukrainian legislation which does not permit single-purpose associations of local governments.

### III. 7. Recommendations

Creation of larger *hromada* would enable them to assume responsibility for some competences currently delegated to the rayon. However, the rayon administration may itself assume the character of a full self government. In such case it would not be advisable to delegate to *hromada* responsibilities which serve wider catchment areas, which might fragment delivery of a service which ought to be coordinated, or where the rayon offers significant economies of scale. In terms of individual services the implications are:

- Health care should remain an integrated service managed and financed at rayon (or even oblast) level.
- All levels of government should have rights to manage and finance cultural activities. Rayons may be best placed to operate library services.
- Assymetrical arrangements may be necessary for education. *Hromada* would normally manage schools for the 6-15 age group, but small *hromada* may cover only the first three to four years of education with cooperative or rayon provision for the older years. Running very small schools at each *hromada* for the post nine year olds would be inefficient.
- *Hromada* should be primarily responsible for sports facilities.
- *Hromada* should be responsible for non-specialised social welfare services, both domiciliary and residential. They should pay for the care of individual citizens placed in residential homes which can be managed by voluntary or cooperative arrangements. However, the alternative of unifying all social welfare and protection responsibility at oblast level should also be considered as recommended by the recent survey on public expenditure.

There is a saying: 'Finance follows function'. No matter what decisions are made under territorial-administrative reform and regarding the transfer of expenditure functions to new ATUs, the question of how to pay for any transfer will come to the fore in any discussion. Some of the major financial implications of territorial-administrative reform are considered next.

## IV. Realignment of Revenue Powers between the Rayon and the new Hromada

### IV. 1. Key Issues

Re-allocation of functions to *hromada* level would require parallel re-allocation of revenue sources. Moreover territorial-administrative reform can be expected to lead to pressure for increased expenditure on improving the quality of local public services. How could this be financed? Three issues in particular need examination and additional research.

First, if some rayon competencies are reallocated to the *hromada* councils, commensurate shares of personal income tax (PIT) and land tax should also be reassigned to them. Once the redistribution of competencies has been determined, the appropriate reallocation of revenue shares can be calculated. It will also be worth investigating whether the two taxes should be reassigned in the same proportions. An alternative would be to reallocate Land Tax entirely or predominantly to the *hromada* level, and only a smaller part of the rayons' PIT share, given that per capita Land Tax receipts may be more evenly spread across community boundaries than PIT proceeds. The results of the suggested change need to be tested in pilot oblasts.

Secondly, the feasibility should be examined of assigning PIT shares to the place of residence, rather than employment. This practice, common to the vast majority of European countries including Hungary and Poland, should enhance the fiscal capacity of smaller and more rural communities. Initially it would only redistribute the same pool of revenue between local governments. In the longer term, however, it would also provide a basis for permitting local governments to vary the rates of PIT levied on their residents, a long standing practice in Scandinavian countries, for example, but also recently adopted in Croatia and Montenegro. This would significantly shift the burden of fiscal decision making to local government.

A number of qualifications should be added to the previous line of argument. First, the situation in Ukraine is particularly complex. PIT proceeds are presently allocated to the place where an employee's company is registered rather than to the place where the company may operate and the employee work. Secondly, the argument favours limited rate discretion for local governments with rates set perhaps between a narrow range of maximum and minimum rates. Finally, equalization transfers need to be related to differences in the size of the tax base, rather than differences in revenue yields, to avoid penalizing local governments with higher than average/standard rates and compensating local governments that have below average rates. This matter is discussed in greater detail in Section V of this paper when formula concerns are considered.

Thirdly, pressure may be expected to improve the funding of those competencies dependent on "own" (basket 2 revenues). This raises the question whether the basket 2 revenue base could also be increased. One possibility might be to introduce the type of tax on buildings common to neighbouring countries. This is not based on the complex appraisal of market or rental value, as practised in some Western European and North American countries, but instead rests far more simply on the square meterage of buildings. Square meterage would be adjusted with coefficients for use (residential/commercial/industrial etc) and location (based on a rough comparison of relative property values between towns and neighbourhoods within them).

There is a widespread belief that a local property tax based on square meterage cannot be a source of significant resources for local governments. However, the Polish example proves it is not true. In spite of the "per square meter" character of the property tax in Poland, it raises around 1% of GDP or about 15% of total communal revenues annually. The feasibility of

introducing such a tax should be assessed, mainly by investigating the availability of data on the ownership of real estate and the size of buildings. The Law could define only maximum (or maximum and minimum) rates of tax, while local councils would make their own decisions regarding the rate that would apply within this range. (Annex 2 presents the case in greater detail).

#### **IV. 2. Recommendations**

- The reassignment of delegated competences from rayon to *hromada* levels should be financed by reassigning shares of land tax and PIT, with a bias to land tax, together where necessary with shares of deficit transfers from the equalization pool.
- PIT shares should be assigned to local governments according to the taxpayer's place of residence. This should be accompanied, over time, by power for local governments to vary rates of PIT within specified limits.
- *Hromada* finance for basket 2 expenditures should be enhanced by introducing a tax on buildings, calculated per square metre with coefficients for use and location; *hromada* councils would set rates within specified limits.

When territorial-administrative reform has spelled out the expenditure and revenue authorities of the new ATUs, the focus of policy attention will naturally shift to the need for a formula to reconcile differences in fiscal capacity between them. The paper looks next at how the current formula is performing and asks whether it, or some adaptation of it, could serve the purposes of territorial administrative reform.

## V. The Search for a Simpler Formula

### V. 1. *The Purpose of the Formula*

Ukraine made important strides in improving its system of intergovernmental finance when it adopted a formula based transfer program linking the State budget to 686 oblast, city and rayon budgets. The formula serves two vital purposes. First, it ensures that every oblast, city and rayon will have sufficient resources to discharge its delegated expenditure responsibilities. Secondly, it achieves this objective through a network of positive and negative transfers that serve to equalize the revenue capacity of different oblasts, cities and rayons having different sized tax bases but comparable expenditure needs.

In principle, the same formula approach could be applied to the new ATUs under territorial administrative reform. However, as discussed below, both the expenditure and the revenue sides of the current formula require refurbishment before it can be easily extended to a larger population of local governments.

Transfers are calculated as the difference between estimated expenditure needs, based on differences in demographic structure and the exogenous cost of providing public services, and estimated revenue means, based on differences in the forecasted volume of first basket revenues. The formula enables each local government to provide a similar standard of public service at similar costs to local taxpayers.

Territorial administrative reform promises to extend the reach of the formula from 686 local budgets to perhaps as many as four or five thousand budgets resulting from the creation of new administrative territorial units of local government.

Such an enlargement of the scope of the formula presents a number of challenges. First, the current formula will need to be structurally modified to reflect any changes in the expenditure responsibilities of the rayon district and the newly formed administrative-territorial units. Secondly, if local governments are going to be granted some discretion in choosing the tax rates that apply to their revenue base, the revenue side of the formula will need to be adjusted to take into account “potential” rather than “actual” revenues. Otherwise, local governments will have a perverse incentive to keep their rates low and rely more heavily on transfers to finance their budgets. In Poland this problem has been addressed by basing transfer calculations on the revenues a local government would receive if it applied maximum tax rates to its base.

Moreover, the expenditure side of the current formula requires much needed simplification and adjustment to make it more transparent and effective in its operation. In addition, recent changes in the forecasting methodology on the revenue side of the formula have warped the operation of the formula. Both of these problems are discussed in turn.

### V. 2. *The Expenditure Side*

The expenditure side of the current formula suffers from two major defects. One is that the expenditure side of the formula has become buried in a blizzard of equations that seriously detracts from the ability to understand how the formula works. Another is that, by becoming so opaque and complicated, the formula has invited every local government to pressure central government into including special characteristics that might work in its favor.



The formula has encouraged local governments to label institutions as serving purposes having high formula coefficients whether or not they are a local expenditure priority. This has had the effect of reducing flexibility in planning the provision of services to meet changing needs and priorities. It also has been especially criticized by a recent public expenditure review of social service provision that emphasized how the formula discriminates in favor of residential as opposed to community care of the elderly and of the disabled. This unfortunate effect occurs because the expenditure need for social services is tied to residential care and ignores the alternative of possibly less costly community care.

The first defect noted above arises from the fact that the current formula measures expenditure needs in an absolute sense for every oblast, city and rayon. This approach makes it virtually impossible for any oblast, city or rayon to calculate whether its expenditure needs are above or below the national average. Formulas, both on their revenue and expenditure sides, are all about deviations from the national average value of revenue and expenditure. On the expenditure side expenditure needs should be measured in a relative sense, in other words in relation to the average national expenditure need for a particular function.

Exactly how expenditure needs could be expressed in relative terms is detailed in Annex 3. Here the reader is spared all the rather complex mathematical detail. To cut through the thick fog of separate calculations in the current formula, this new approach to the formula suggests using a two-stage estimation approach.

In the first stage, the demographic size and the structural characteristics of the population of each local government area would be used to compile the basic determinants of expenditure need for every functional category covered by the formula. The central idea behind this compilation is to obtain an objective measurement of the number of actual or potential consumers of each type of service in the formula, both for the country as a whole and for each local government area.

- In the case of administrative costs, the population would be weighted, as it currently is in the formula, by a set of coefficients that reflect the presence of scale economies in larger cities and rayons. For oblasts, norm based employment levels would be used.
- For health care, the demand for services would also use weighted population variables, where the weights would take into account the relatively higher demands of the very young and the very elderly as well as well as differences in demand between men and women.
- In the area of education, weighted student populations would drive the expenditure need calculation and here, again as is currently done, the weights would mirror observed variation in the costs of educating different types of student in different locations.
- Social service needs would be captured by reference to the number of persons within the major categories of the population for whom the government has a statutory duty of social care, including the elderly, disabled or chronically ill, children requiring social care, the mentally ill, homeless people. Other measures might include levels of unemployment and per capita household income.
- Cultural expenditure needs would also draw on the use of population weights with larger cities having higher weights in recognition of the cultural benefits these larger cities export to non-residents.

In short, the calculations of expenditure need embodied in this first stage would use a great deal of the methodology relied upon in the current formula. The second stage of applying the formula, however, would represent a sharp departure from current formula practice.

Making use of all of the demand related information in the first stage, the second stage would express in a single equation the overall expenditure needs of a local government relative to the national average need. This single equation would also incorporate the expenditure needs of mountainous areas and eliminate the practice of separate calculations for these areas. The exact form this single equation would take appears in Annex 3.

As shown in the Annex, each term in this equation measures the functional expenditure needs of a local government compared to the national average measure of need. In the case of education, for example, if a local government educates more weighted students per capita than the country overall, it has above average expenditure needs in this particular area. And, assuming it is a transfer recipient, it would receive a larger transfer under the formula on account of these above average needs. In each functional spending area the focus is on measuring relative expenditure needs rather than on financing the existing network of public sector facilities.

Presenting the workings of the expenditure side of the formula in this manner makes it easier to understand and interpret and, by doing so, significantly enhances the formula's transparency. Furthermore, the data needed to implement the formula's expenditure side all rest on the verifiable demographic profile of a local government. In that sense the formula is capable of being rolled out to the new administrative territorial units that would emerge from territorial administrative reform. The demographic data of these new units should not be difficult to obtain. Simplifying and clarifying the presentation of the expenditure side of the current formula is an important aspect of developing a simpler formula.

### ***V. 3. The Revenue Side***

The revenue side of the current formula has also recently fallen into a state of dysfunction. Problems on the revenue side began to emerge after the personal income tax reform of 2004. This reform ushered in a flat rate income tax of 13 per cent in lieu of the previous five-rate bracket structure, along with a social privilege that removed low wage earners from the income tax roll.

Forecasting the revenue consequences of this reform for particular local governments represented a difficult challenge for the Ministry of Finance. What was needed in light of the reform was an accurate recalculation of the indexes of relative fiscal capacity, the main forecasting tool used by the Ministry. Unfortunately, the data needed to support these recalculations was unavailable and, as a result, serious forecasting errors were committed in the calculation of equalization transfers in both 2004 and 2005.

Large, relatively high wage, donor cities were among the primary victims of these forecasting errors. Their post-reform personal income tax revenues were significantly overestimated, prompting the Ministry to undertake compensatory actions. In the case of Zaporizhia city, for example, under article 58 of the 2005 State Budget Law, the city was given access to medium term treasury loans to finance its revenue shortfall. A commitment was also made by the Ministry that repayment of these loans would be covered through an adjustment in the city's transfer obligations.

In response to these inadequacies in forecasting, the Ministry of Finance has radically revised its revenue forecasting methodology. In preparing the 2006 State Budget the Ministry forecast local government revenues by extrapolating from the observed revenue trend in 2005 and adding growth and inflation factors to the result. While this procedure may improve the accuracy of revenue forecasts it also has several negative consequences.

It is first of all a direct violation of the Budget Code that requires the use of indexes of relative fiscal capacity. Secondly, by forcing the formula to track the actual revenue performance of local budgets it severely undermines local government incentives to raise revenues, something that the Budget Code fought hard to preserve. Under this forecasting procedure, any local government that increases its revenues at a faster than average rate will see either its equalization transfer drop or its contribution to the State Budget rise.

In other words, elements of State revenue claw-back have been reintroduced to Ukraine's local budget system through the revenue side of the formula producing the precise result that the Budget Code was designed to avoid.

#### ***V. 4. Recommendations***

##### Expenditure

The recommended adjustment to the formula is set out in Annex 3.

##### Revenue

There would seem to be only one sensible solution to the revenue forecasting dilemma and that is to revert to the status quo ante by refining the measurement of the indexes of relative fiscal capacity and flushing out any serious forecasting errors associated with them.

## Annex 1

### ALTERNATIVE PROPOSALS ON SOCIAL SERVICES

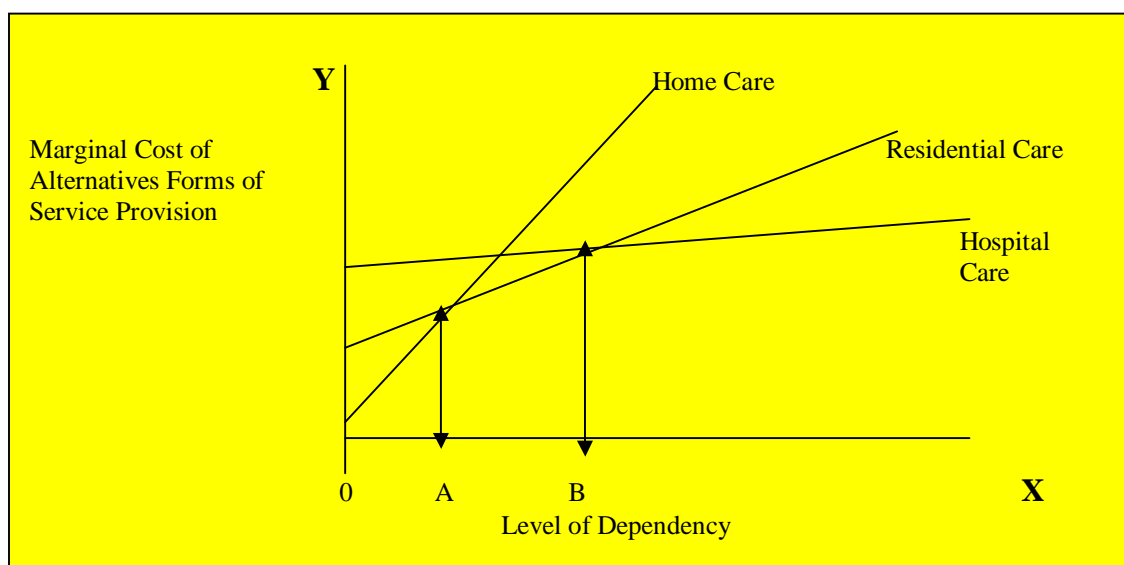
Provision of social services to vulnerable groups of population is an area of significant complexity, arising from the fact that it unites a number of responsibilities currently scattered around a number of line ministries and programmes. Apart from the Ministry of Labour and Social Policy, the line ministries involved in the provision and supervision of social care include the Ministry of Youth and Sports, Ministry of Health, Ministry of Education. Moreover, this area also has to be treated in combination with the expenditures on social protection, currently financed through a completely separate mechanism.

Significant attention to optimisation of financing mechanisms in this area was paid by the recent survey of public expenditures in social services (USIF Preliminary Assessment of Public Expenditure Management in Social Services - PPEM) and the WB CEM. Both of these studies, and especially the USIF PER, identify significant biases the current system creates towards inefficient patterns of service provision. In terms of allocation of expenditure responsibilities, improved provision of social services requires a combination of local knowledge and strategic planning capacities to establish an optimal *balance of service* between residential care and community-based initiatives.

The *Balance of Service* model became a defining characteristic that has underpinned the reform of social services in EU member states. It is called to help governments to focus on identifying different ways of achieving the same level of benefit to clients at least cost to public finances. To achieve this, the governments need to assess the relationship between unit costs, marginal costs, and client need in the context of meeting policy goals.

Diagrams 1 and 2 below provide an **illustration** of how the *Balance of Service* model can be applied to services for the elderly and services for children:

**Diagram 1: Balance of Service Provision – Elderly Services**



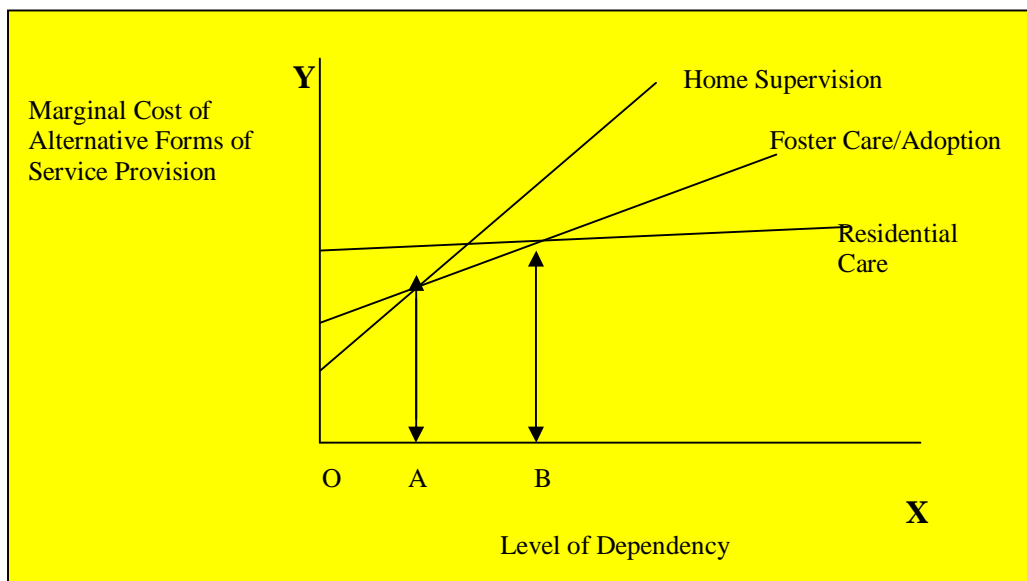
Along the horizontal axis (X) are measured some of the characteristics of elderly people that lead to their being in need of social services, such as their level of dependency: characteristics that lead to an increasing cost of care as they become more severe and are unable to look after themselves. Along the vertical axis (Y) are measured the marginal costs of alternative forms care such as hospital, residential or

home care (domiciliary care). The costs are necessary for the elderly person concerned to achieve a given level of functioning: for instance to perform (or be assisted to perform) the tasks necessary for daily living.

The task of choosing the most efficient form of care for an elderly person is straightforward: the form of care with the lowest marginal cost is picked in each case. Thus in the diagram if the elderly person concerned has a degree of dependency in the range *OA*, then the most cost-effective mode of care is home care; for those in the range of *AB* the most cost-effective mode is residential care; and for the range *B* and beyond it is hospital care.

The *Balance of Service* model is used in EU member states to cover other client groups – e.g. children, people with disability, the chronically ill etc. For example, the modes of service provision for children at risk and in need of protection could be: home under supervision of social services, foster care/adoption, or residential care. Diagram 2 below provides an illustration.

**Diagram 2: Balance of Service Provision – Children’s Services**



The *Balance of Service* model – with its emphasis on achieving improved cost effectiveness, diversifying service provision, and improving client outcomes set the institutional framework for the **Commissioning-Provider** arrangement for social services which splits the financing, commissioning and management of social services from the provision of social services. The objective of this new organisational arrangement was to ensure that the government departments focus on the development of strategic policy directions, defining unit costs of different types of services, assessing marginal costs<sup>1</sup>, the effective management of public finances, and an independent system of inspection quality assurance; while a diverse range of organisations (including government organisations, not for profit non-government organisations, and for-profit enterprises) were contracted - by central and local government agencies - to actually provide a diverse and innovative range of social services that reflected changes in demographic trends, changes in the diverse range of socio-economic problems confronting society, and the need rate. The WB CEM is

<sup>1</sup> Marginal costs are the addition to the total cost of a service needed to take account of each extra client. Thus broadening service provision to encompass a variety of non-residential services may entail hiring new staff to provide the services. This would add a great deal total cost since it would include salary costs, administrative costs, travel costs and even extra office and utility costs. Residential services, on the other hand, tend to have fixed and variable costs that do not alter significantly with the quantity of service produced. Thus the marginal costs for non-residential services may tend to be higher than residential services at a particular level of service output (Byford et. al. 2003).

supportive of this logic and suggests an additional argument which is the need public value by shifting away from the imbalance generated by over reliance on expensive – and often inefficient - residential service provision.

As already mentioned, in order for this model to be implemented, decision makers need to have sufficient information to identify the cost implications of various instruments of service delivery but also sufficient amount of and discretion over resources available to finance the chosen combination of types of services. This model will also require decision makers to create and maintain effective data management systems and databases, which assumes a certain degree of administrative capacity. Finally, the level of government responsible for the balancing task in the area of social services has to be capable of addressing inequalities in poverty and service provision intrinsically present between rural and urban areas in order to handle them in a comprehensive and rational manner. This led the researches to a conclusion that introducing this model will be only possible only by placing responsibility for delivering the balance of service provision at the regional (oblast) level.

For establishing better linkages between social care programmes and the mechanisms to finance social protection, the CEM proposes gradual merger between the current targeted subventions of social protection to provide regional and local governments with more flexibility in spending those funds, including through potential utilisation of these funds on local social care programmes.

## Annex 2

### Taxation of Buildings – Options to Consider

Taxation of buildings has several advantages as a source of local government revenues; consequently it is the most frequent form of local taxation over the world:

- The tax base is relatively evenly distributed, so it may bring significant revenues to almost all local jurisdictions;
- The tax is well defined in geographical space – with a very few exceptions it is easy to define who is going to pay, and which local government will benefit from the tax yield. It is, for example, in sharp contrast with taxes on business activity, where companies registered in one place but having actual business activities in several others, create difficulty in defining which local budgets should benefit from their tax.
- Properties are immovable (limiting the negative consequences of tax competition between local governments)
- Available tax yields can cover a substantial proportion of local government spending needs, at least in respect of communal, physical services.

*Ad valorem* property tax is one of the best and most common forms. On the other hand introducing *ad valorem* property tax in a relatively young and undeveloped property market as in Ukraine raises a lot of difficulties:

- In spite of available simplifying methods and tools, introducing *ad valorem* tax on buildings will require a lot of time and will be relatively expensive since it requires proper data bases and valuation of each individual property.
- In countries with an immature private property market there are also technical difficulties in finding methods of valuation
- The experience of several Central and Eastern European countries shows that introducing such a tax is politically difficult.

Therefore, the imperfect (but more viable) form of per square meter tax is well worth consideration. One of the important advantages of such a solution is that it requires a much simpler data base tax, and can be introduced much faster and cheaper. Currently, sufficient data seems to exist in Ukrainian towns and can be found in the Bureaus of Technical Inventory (BTI). The situation in rural areas is a bit more complicated, but combining information available in BTI's and "economic books" available at every village council, should be a good starting point for assembling the appropriate data base quickly.

Two arguments are frequently raised against such a simplified form of property taxation:

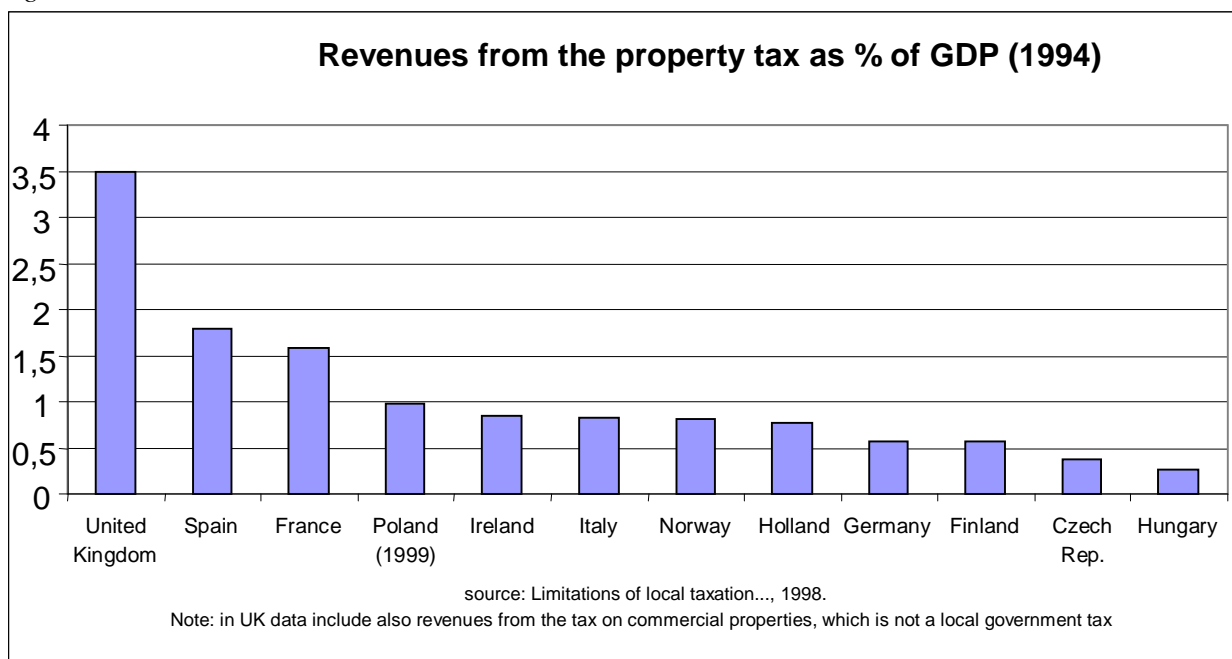
- The tax yields are unfair, since owners (or users) of properties of very different value pay the same amount; such a tax does not reflect "ability to pay" principle";
- There is a wide-spread belief that a meterage base cannot be a source of significant resources for local governments (see also point 6.204 of the World Bank Report 'Improving Inter-Governmental Fiscal Relations in Ukraine')

The former of these negative consequences may be somewhat reduced by introducing coefficients for use (residential/commercial/industrial etc) and location (based on a rough

comparison of relative property values between towns and neighbourhoods within them), as shown in examples described below.

The latter negative consequence (inability to collect significant tax yields from a tax based on meterage) is more a myth than a reality. In Poland the property tax, in spite of its “per square meter” character, raises around 1% of GDP or about 15% of total communal revenues annually. It is illustrated by the figure below:

Fig. 1.



In Poland the property tax is the most important source of own revenues for the lowest level (*gmina*) government. It is raised both on built-up properties and on empty plots of lands (but not when used for forestry or agriculture, which are taxed by separate agriculture tax and forest tax). It brings to local governments over 3 billion of dollars per annum, an amount constituting more than 15% of total *gmina* budget revenues, or 45% of revenues from own sources (without revenues from subventions and tax sharing).

Setting the actual rate of property tax is the role of each local council within maximum rates set by national legislation. In addition the council (in some cases the mayor) is authorized to grant tax reductions or exemptions for some categories of tax payer. The maximal rate is automatically increased every year by the rate of inflation, as announced by the Main Statistical Office.

The rates vary depending on the type of property. For example in 2004 the maximum rate for residential houses was 0.52 zloty (around 0.17 \$) per square meter while the rate for buildings used for commercial activity could reach 17.31 zloty per square meter (around 5.50 \$). The most important rates are illustrated by the table 1. A local council can additionally vary this rate depending on type of commercial activity. As a result of such a structure of maximal rates, over 75% of revenues from property tax come from business. A very big difference between levels of taxation on residential houses and commercial properties may be considered controversial, since it may potentially reduce the accountability of local policy choices by local authorities towards residents-tax-payers.

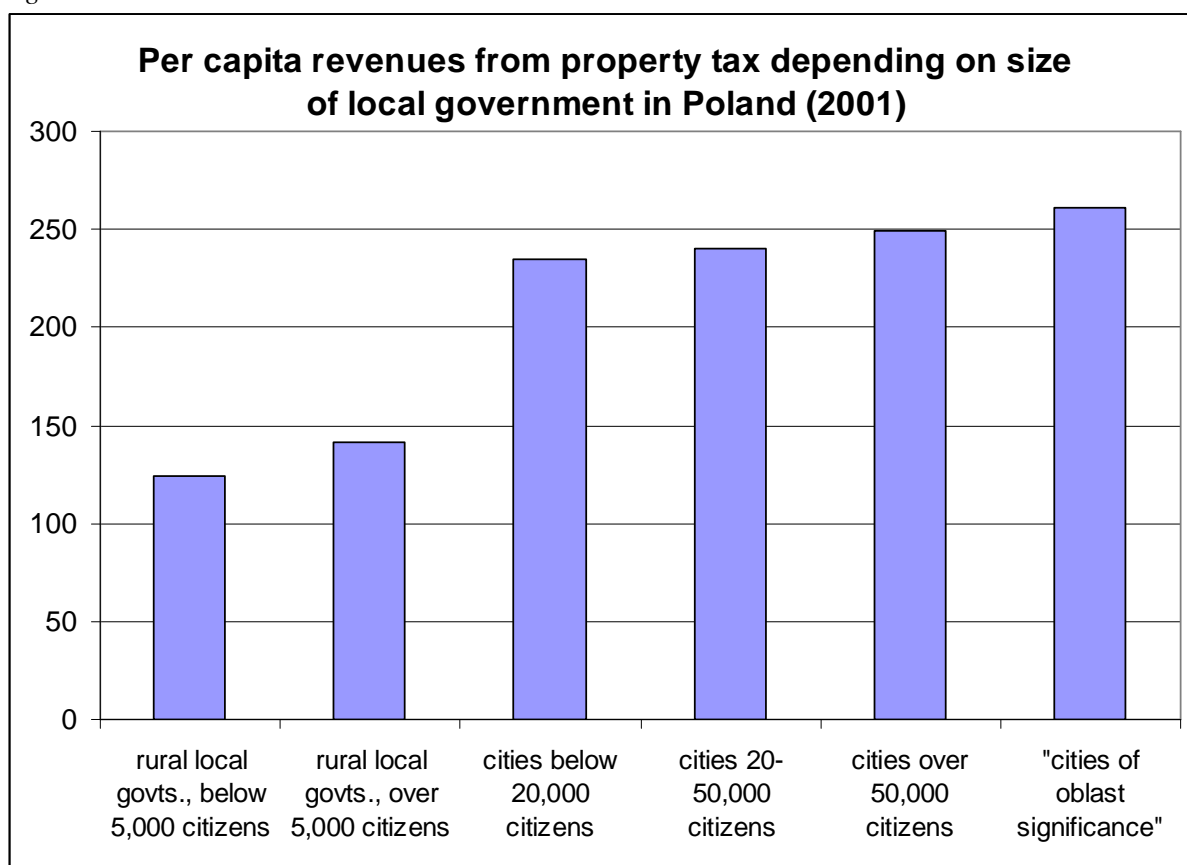


Table 1. The most important maximal rates of local taxes in Poland

	2001	2002	2003	2004
- residential houses	0.46 PLN/sq.m.	0.49 PLN/sq.m	0.51 PLN/sq.m.	0.52 PLN sq.m.
- commercially used buildings	15.86 PLN/sq.m	16.83 PLN/sq.m	17.31 PLN/sq.m	17.42 PLN/sq.m
- commercially used empty plots of land	0.56 PLN/sq.m	0.60 PLN/sq.m	0.62 PLN/sq.m	0.63 PLN/sq.m
- other building structures such as airports, antenna masts, waste disposal plants etc.	2% of the value used for depreciation purposes			

Note: 1 dollar is approx. 3.4 PLN

Fig. 2.



Note: figures in Polish zloty per capita; 1 US dollar is approximately 3.3 PLN.

Figure 2 shows that such a construction of the tax generates significant revenues both in large and small local authorities. Although revenues per capita in the largest cities (cities of *powiat* status – close equivalent of Ukrainian cities of oblast significance) are more than twice larger than in small rural communities, the revenues to rural local governments are still substantial and usually provide more than 10% of local budget incomes.

Czech Republic and Slovakia<sup>1</sup> provide interesting examples of additional variation of maximal rates depending on type of location. Because typically the value of properties is much larger in big cities than in smaller, peripheral communities, the maximal rates reflect the size of settlement

<sup>1</sup> The regulation is not valid for Slovakia any more, since 2005 local governments enjoy an unlimited freedom to set rates of local taxation.

unit. Until 2005, in Slovakia the rates were adjusted by the following coefficient depending on the size of town/village:

- 1 in villages <1,000
- 1.4 in villages 1-6,000
- 1.6 in towns 6-10,000
- 2 in towns 10-25,000
- 2.5 in cities over 25,000
- 3.5 in district capitals or in spa resorts
- 4 in regional capitals
- 4.5 in Bratislava, the capital city.

In addition local government may vary the rate according to the location in particular districts of the city.

A combination of Polish and Slovak experience in this respect may be an interesting option for Ukraine to consider.

## Annex 3

### The Search for a Simpler Transfer Formula

It has been argued above that the over-complex presentation of the expenditure side of the current formula used by the Ministry of Finance impedes a clear understanding of how the formula works. A large part of this problem stems from the emphasis given to estimating absolute expenditure needs rather than relative expenditure needs. A clearer grasp of the formula can be obtained by expressing measured expenditure needs in each functional expenditure category relative to the national average need.

A single equation that captures the aggregate expenditure needs of each local government relative to the national average would have the following mathematical structure:

$$(1) V_j / P_j = V / P_U \{ \phi_A \phi_j^A K_A + \phi_H \phi_j^H (\lambda P_j^* / P_j / \sum \lambda P_j^* / P_U) + \phi_E * (S_j / P_j) / (S_U / P_U) + \phi_{SC} \phi_j^{SC} ((1 + \alpha_j) P_j / \sum (1 + \alpha_j) P_j) + \phi_S (R_j / P_j) / (R_U / P_U) \}$$

The variables appearing in this expenditure formula have the following interpretation:

V = the volume of total local government spending in the State budget;

V<sub>j</sub> = the volume of estimated expenditure needs in the j'th local government; the subscript "j" refers to the oblast level administration, and cities and rayons within an oblast; the treatment of mountainous areas is dealt with in the appendix;

P<sub>j</sub> = population of the j'th oblast or the j'th city or rayon within the oblast;

P<sub>u</sub> = population of Ukraine;

P<sub>j</sub><sup>\*</sup> = age and sex weighted population of the j'th local government;

P<sub>u</sub><sup>\*</sup> = age and sex weighted population of Ukraine;

S<sub>i</sub> = the weighted number of students in the j'th local government;

S<sub>u</sub> = the weighted number of students in Ukraine;

R<sub>j</sub> = the number of weighted social service recipients in the j'th local government;

R<sub>u</sub> = the number of weighted social service recipients in Ukraine.

φ<sub>k</sub> = the share of total expenditure, V, allocated to the k'th expenditure function in the State budget;

φ<sub>j</sub> = the share of total oblast expenditure allocated either to the oblast administration or to all cities and rayons in the oblast for the functional expenditure categories labeled as either A(administration), H(health care), or CS(culture and sports); in health care for example, this share is defined as .65 for cities and rayons.

K<sub>A</sub> = adjustment coefficient for scale economies in public administration;

λ = a scalar reflecting the supply of health services by State funded institutions to a local government area;

α<sub>j</sub> = weight given to population size in the supply of cultural services.