

**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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Executive Summary

The main focus of the report is on the financial consequences of the territorial reform in the shape similar to this drawn by the former Deputy Prime Minister Roman Bezsmertny. However, several observations and recommendations are valid regardless the territorial reform is introduced or not. The report refers also to pilot research in two oblasts of very different geographical and socio-economic characteristics: Ivano-Frankivsk in Western and Luhansk in Eastern part of the country. Most of empirical calculations are based on data from three rayons in Ivano-Frankivsk oblast (Halytskij, Verkhovinskij and Kosivksij) and two rayons from the Luhansk oblast (Antratseet and Krasnodon).

Territorial Administrative Reform

The most important and the most discussed element of the planned territorial reform is territorial amalgamation on the lowest level and creation of new *hromady*. 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. 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, and if additional functions are not decentralized to the lowest tier, than consolidation would be an unnecessary (and politically costly) 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.

The amalgamation on the lowest level may bring several benefits:

- Territorial consolidation *allows decentralization of more functions*. For example, research conducted in two selected oblasts suggest that transferring of responsibility for secondary education to enlarged *hromady* is feasible;
- Territorial consolidation allows *benefits from economies of scale*. For several services unit costs of delivery may be significantly lower in larger jurisdictions. Research in two selected oblasts suggest that if nothing else apart of territorial organization) changes, the reform would allow to save about 10% of present total expenditures of silsky rady as a consequence of decreased spending on administration.
- 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*.
- Territorial amalgamation may help to *reduce revenue capacity disparities* among territorial units. Our pilot studies confirm this observation. At the same time, we note that disparities

will remain very significant even after territorial reform and they call for a rational equalization system, perhaps including also revenues of the second basket.

The last item brings some more conclusions and recommendations. The possible equalization scheme for basket two revenues should be organized in such a way that it produces no disincentive for effective revenue collection. It should also take into account revenue potential, not actual revenues, which might be affected either by former tax arrears or by consequences of tax relief or rate reductions granted by local governments. Another observation from pilot research is that article 103 of the Budget Code is often not respected. It provides that local governments should be compensated for relief in local taxes granted by national legislation.

Apart of potential benefits there might be also *fears or real negative consequences of amalgamation*, which should be addressed:

- Larger local governments *lengthen the distance between the average resident and the local authority*. 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. 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 may be 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*. 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. 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. The proportional system 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.
- Another fear is that the reform may undermine the *identity of amalgamated villages*. 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. 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.

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

- First, it requires *good information* on territorial units.
- Second, a more formal requirement is the *process of consultation*. The European Charter of Local Self-Government, which has been ratified by Ukraine, requires that any change of territorial boundaries is consulted on with the local community case by case. As far as we are aware, such process of consultation has been so far undertaken in Ukraine only on a pilot basis.

- 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.

Expenditure Responsibilities of the New Administrative-Territorial Units (ATU)

If reform is 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 control over their executive. This 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.

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.

- 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.
- According to our pilot research in the oblasts it is feasible that the enlarged *hromada* manages schools for the 6-15 age group. In fact, there are both relevant school facilities and sufficient contingent of pupils in territories of each of the new *hromada* to be created in the selected rayons.
- *Hromada* should be primarily responsible for sports facilities.
- As regards social welfare services, there are two possible recommendations. One is that *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. The alternative, as in the case of health care, is that social services should be unified. The rayon is of the right size to provide and manage most services, but it should have the flexibility to delegate management of the territorial centres to the larger *hromada* in order to preserve a role for local knowledge and community spirit.

There is a saying “finance follows function”. No matter what decisions are made under territorial administrative reform (TAR) 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.

Revenue Powers

There are two basic problems over revenue. The first and most obvious is *adequacy*. If competences are reassigned appropriate shares of taxes will have to be reassigned as well. The second issue is *accountability*. Local governments currently have little responsibility for setting the rates of the taxes on which they rely, whether assigned (basket 1) or “own” (basket 2).

Three issues in particular need examination.

- **Land tax.** Once the redistribution of competencies has been determined, the appropriate reallocation of revenue shares can be calculated. One possibility is to reallocate Land Tax entirely or predominantly to the *hromada* level. The issue of the variation in revenues from this source has been discussed in the section II of the report.
- **Personal Income Tax.** The assignment of Personal Income Tax (PIT) yields to local budgets by the Budget Code is a major advantage to fiscal decentralization in Ukraine. There are two drawbacks, however. One is the assignment of the tax to the local budget where the employer is registered. This distorts the revenue base of Kyiv and other major cities and necessitates a high degree of horizontal redistribution, with resulting tensions. The change to allocation based on residence is strongly recommended, although the pilot research in two oblasts indicates potential difficulties in precise prediction of its consequences for individual ATUs. The second drawback is that local governments spend the yields of PIT without accountability for the rates imposed on their citizens. Assigning PIT by residence would also make it possible over time to amend the Tax Code to give local government units power to vary the rates of PIT payable by their citizens within legally prescribed limits. These changes (and especially change to residence based allocation) are desirable whether or not territorial reform takes place. However, any substantial shift of competence from the rayon to the *hromada* would need to be accompanied by some revision of the percentages shares of PIT between levels of government.
- **Property Tax.** It might be an important method to strengthen own revenues of local governments. What is suggested is a simplified form of taxation not based on the complex appraisal of market or rental value, but instead rests far more simply on the square meterage of buildings. A single rate per square metre would be adjusted by coefficients for use (residential/commercial/industrial etc) and location. 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. Data collected in selected oblasts suggest that necessary information is almost complete and the tax might be introduced very quickly, once there is political determination. Simulations assuming very low tax rates (0,1 hr per sq m of residential building and 2.9 hr per sq meter of commercial building) suggest that the new tax might add on average at least ¼ to the present revenues from own sources of the lowest level governments. There is a widespread belief that the main beneficiaries of the property tax would be cities, while rural *hromady* will gain very little. It is not quite correct. This belief might be correct in absolute terms (absolute revenues from property tax will be higher in cities). But in relative terms – expressed as a proportion of present revenues from own sources – the gain might be much larger in rural than in urban local governments. It is so, because the present base of local taxation in rural areas is extremely low, so even a very modest taxation of residential properties would make a significant difference.

The Search for a Simpler Formula

Conceptually, Ukraine's equalization formula adheres to established international standards. Equalization transfers to, or from, local governments, oblasts, cities or rayons, are determined by the difference between estimated expenditure needs and estimated revenue means. In practice, however, the application of this concept has proven to be unusually and unduly complex and difficult to follow, even for specialists in this area. With or without territorial administrative reform there is an urgent need to simplify the basis on which transfers are calculated. The expenditure side of the formula is currently buried in a blizzard of separate equations. Because these equations are estimated in absolute terms for each local government it is impossible to

determine whether any local government has either above- or below-average expenditure needs in any of the formula's delegated expenditure areas. This report shows how the expenditure side of the formula can be expressed in relative terms in a single, coherent equation that measures per capita expenditure needs relative to the national average expenditure need.

On the revenue side of the formula, the Personal Income Tax reform of 2004 has induced a recalculation of the indexes of relative fiscal capacity and these new measurements should be fixed for a three-year period as required by the Budget Code.

I. Introduction

This report draws upon the work conducted and earlier reports prepared by the SUFTAR Project working group during last year. The main focus is on the financial consequences of the territorial reform in the shape similar to this drawn by the former Deputy Prime Minister Roman Bezsmertny. However, several observations and recommendations are valid regardless the territorial reform is introduced or not. They may help to make the inter-governmental finance system in Ukraine more efficient, even if the amalgamation reform is not introduced eventually. In areas indicated by the working group, the SUFTAR project has undertaken pilot research in two oblasts of very different geographical and socio-economic characteristics: Ivano-Frankivsk in Western and Luhansk in Eastern part of the country. Empirical data collected in selected oblasts illustrate and support thesis formulated in the report.

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, and enthusiasm for the reform seems to have evaporated over recent months, it nevertheless remains probable 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 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 offers the 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 the truth of 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 adopted for 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 Self-Government, 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 in Ukraine only on a pilot basis.

- 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. Potential benefits of amalgamation in empirical data from selected oblasts

II. 6.1. Characteristics of the Amalgamation Plans

(a) Ivano-Frankivsk oblast

The selection of oblasts for study (Ivano-Frankivsk and Luhansk) was influenced by the fact that the Institute of Cartography had prepared draft maps for these regions, so it has been possible to use them for simulation purposes. However, for Ivano-Frankivsk it was discovered that maps with the new planned territorial divisions were available for two rayons only, namely Kosivskij and Verhovinskij. Since both of them are located in the mountains, it was decided to include in our empirical investigation one further rayon (Halickij) in order to cover more diversified geographical conditions. In this case simulations are based on a version of the map of Halickij rayon, which has been prepared by the Ivano-Frankivsk oblast state administration and which has tried to follow the general criteria set out in the draft law on territorial reform.

Table 1 below illustrates the possible change in the number of territorial units in our selected areas.

Table 1. Number of local government units in Ivano-Frankivsk oblast – before and after amalgamation

	Old territorial organization	New territorial organization
<i>Rayon tier</i>		
Cities of oblast significance	5	2
Rayon	14	13
<i>Hromada tier (selected rayons)</i>		
Halickij rayon	41 (including 2 towns)	9(*)
Kosivskij rayon	40 (including 1 town)	17
Verchovinskij rayon	22	8
All rayons together	490 (including 10 towns)	no maps prepared for the entire oblast

(*) number based not on official draft prepared in the Institute of Cartography but on own estimations prepared in the oblast, referring to Bezsmertny reform criteria.

Interestingly enough, the present fragmented territorial structure of town and village councils is not a very old one, as it was to some extent produced after 1990. Before that date the number of councils was much lower than nowadays, for example in Verchovinskij there were 15 councils and 28 in Kosivskij rayon. So the pre-1990 number of councils was in the middle between the present very fragmented and the territorially consolidated option suggested by the “Bezsmertny draft”.

(b) Luhansk oblast

Antratseet rayon

In the Antratseet rayon of Luhansk oblast there are two competing visions of how amalgamation might proceed. One of them is referred to as the Bezsmertny, the other is a counter proposal put forward by the rayon administration of Antratseet. Antratseet appears to be the only rayon in Luhansk for which the Rada committee has drawn up an amalgamation plan to date. Here we look at the content of each proposal, comparing their similarities and contrasting their differences.

Under the Bezsmertny plan the rayon of Antratseet would be enlarged to include the large city of Sverdlovsk and its neighbouring rayons. Since the rayon's own amalgamation plan does not envisage any geographic enhancement of the rayon, comparisons of the two alternative plans ignore this feature of the Bezsmertny plan in order to compare like with like. For what it is worth, however, the Bezsmertny plan would create four sub-regions within the enhanced rayon, each having a large rayon city and several *hromady* or amalgamated villages-towns. In the sub-region where the city of Antratseet would become the central rayon city, there would also be three *hromady*. The city of Krasny-Luch would become the rayon city of another sub-region that would have six *hromady*. In the third sub-region, where Rovenky would become the central rayon city, a total of five *hromady* would be established but with two of them drawn from the neighbouring rayon. Finally, the newly added rayon city of Sverdlovsk would have four *hromady* attached to it.

The alternative rayon inspired amalgamation plan has a somewhat different view of how the rayon's villages should be reconfigured. It too envisages the emergence of twelve *hromady* but only seven of these coincide with the designation found in the Bezsmertny plan. The largest of them would have a population of 15,850 and the smallest 3,519.

Krasnodon rayon

In Krasnodon rayon the rayon administration has also recently developed an amalgamation plan for its territory. Under this plan the fifteen villages *radas* that currently exist would be consolidated into seven new *hromadas*. The smallest of these new territorial units would have a population size of 2,550 while all of the others would closely conform to the Bezsmertny criterion of a minimum size of 5,000.

Proposed changes are briefly summarized in the table 2.

Table 2. Proposed schemes of territorial amalgamation in selected rayons of the Luhansk oblast – number of local government units in various variants of the reform

Selected rayons	Current situation	Bezsmertny plan	Alternative plan prepared in the oblast
Antratseet	24 villages <i>radas</i> + 3 towns	12 <i>hromady</i> + 3 towns population of the smallest unit: 4,013	12 <i>hromady</i> + 3 towns population of the smallest unit: 3,519
Krasnodon	15 villages <i>radas</i>	NA	7 <i>hromady</i> population of the smallest unit: 2,550

II. 6.2. Local Reactions to the Amalgamation Proposals

Ivano-Frankivsk Oblast

The impression is that most of financial specialists in the oblast administration were in general sympathetic with the idea of amalgamation on the *hromada* level, although they had a lot of doubts about details and about realism of its quick implementation. Starting from criteria in Bezsmertny report, they even produced their own “prognosis” of maps for some of rayons, which were not covered by the exercise undertaken by Institute of Cartography.

Luhansk Oblast

The response of local budgetary officials to the proposed amalgamation can be described as at best lukewarm. While most officials were not opposed to the idea many were sceptical of its benefits and a number of them felt that it was a misplaced policy priority. Many asked why and why now? A widely held view was that policy concerns should be tied to the issue of local economic development and that territorial administrative reform should be placed on the policy shelf for the next 3-4 years.

The rejection of the Bezsmertny plan, which galvanized the rayon administration into developing its own amalgamation plan, also seems to clearly indicate the need for extensive local participation in any successful amalgamation effort. The Bezsmertny plan was viewed as a top-down policy measure that failed to properly consider some local peculiarities.

II. 6.3. Variation of Per Capita Revenues

(a) Per Capita Revenue Disparities Before and After Amalgamation

It is usually assumed that amalgamation reform leads to a reduction in disparities in revenues between affluent and poor local governments. Indeed, measures of disparity are usually lower if we consider larger territorial units, but the situation is far from tautological. Much depends on the geographical distribution of affluence and poverty. Merging two units with very low per capita revenues does not lead to the creation of one larger unit with high per capita revenues.

Ivano-Frankivsk Oblast

First, consider the situation in the Ivano-Frankivsk oblast. Assume that nothing else changes except territorial organization. In particular there are the same sources of revenues for the rayon and for the lowest level of local governments. Although in Ivano-Frankivsk oblast the changes on rayon level would not be very big, the change would lead to the decrease of per capita revenues (without transfers) of the general fund in cities of oblast significance (due to their merger with surrounding territories) and a parallel increase in some of the rural rayons. For example per capita revenues of Ivano-Frankivsk city would drop from 470 to 393 hryvna per capita, in Kalush from 414 to 246 and in Yaremcha from 262 to 151 hryvna per capita. At the same time in Kolomyjskij rayon revenues per capita would increase from 76 to 145 hryvna. But for most of the rayons nothing would change, since their boundaries would not change either. Since the least affluent rayons would be affected by amalgamation, the minimal value would also increase from 61 to 86 hryvna per capita. As a result, the ratio of the highest to the lowest value would decrease from 7,7 to 4,55 and the ratio of median to minimum value from 2,28 to 1,62.

Consider next the three selected rayons and the variation in revenues of basic local governments within them. In this case observed disparities are even larger. In Verhovinskij rayon, village councils' per capita revenues without transfers are very low and vary from 24 hryvna (with five more villages in which revenues are below 30 hryvna per capita) to over 100 hryvna in two villages, reaching a peak in Verhovyna (192 hryvna per capita). The median value is 38 hryvna. The territorial reform would change the situation by reducing the level of disparities, but only to a minimal extent. The variation would be from 30 to 192 hryvna with a median value of 44 hryvna. The ratio of maximum to minimum value would decrease from 8 to 6,4. For the majority of local councils in Kosivskij rayon the situation is even more miserable. Per capita revenues without transfer vary from 12 hryvna to 230 hryvna in Kosiv city (with two other councils reaching over 100 hryvna per capita). The median value is 24 hryvna per capita. After the amalgamation the variation would be a bit lower – from 16 to 230 hryvna (and Kosiv would be the only unit with revenues per capita over 100 hryvna), while the median value would increase from 24 to 26 hryvna per capita. Also the variation is even larger than in previously analyzed cases. The ratio of maximum to minimum value would remain very high after amalgamation, though it would fall from 19,17 to 14,38.

Revenue disparities are highest in the Halickij rayon. But the most radical amalgamation suggested for the Halickij rayon brings also the most radical decrease in the level of income disparities. It is not very surprising, since it is easier to undertake radical amalgamation in lowlands rather than in the mountains, where physical accessibility of an area provides a natural barrier for the more radical changes in territorial organization. Although in general the level of affluence in Halickij rayon is higher than in Kosivskij or Verhovinskij, the present level of disparities is also very high. Per capita revenues without transfers vary from 8 hryvna to 183 hryvna in Halich city and 247 hryvna in Burshtyn city. The median value is 23 hryvna per capita. After the amalgamation the level of disparities would reduce significantly. The minimum value would be 15 hryvna per capita, while maximum 185 hryvna, with medium value of 34 hryvna per capita. The ratio of maximum to minimum would reduce from 30,88 at the moment to – still high, but more than twice lower – 12,2 after amalgamation. The results of these calculations are summarized in table 3 and in figures 1 and 2.

Table 3. The potential impact of territorial amalgamation on the level of revenue disparities (per capita revenues of general fund, without transfers)

	Rayons in oblast		Halickij rayon		Kosivskij rayon		Verhovinskij rayon	
	Before amalgam.	After amalgam.	Before amalg.	After amalg.	Before amalg.	After amalg.	Before amalg.	After amalg.
Maximum value	470	391	247	183	230	230	192	192
Median value	139	139	23	34	24	26	38	44
Minimum value	61	86	8	15	12	16	24	30
Maximum/Minimum (%)	770	455	3088	1220	1917	1438	800	640
Median/Minimum (%)	228	162	288	227	200	163	133	147

Fig. 1.

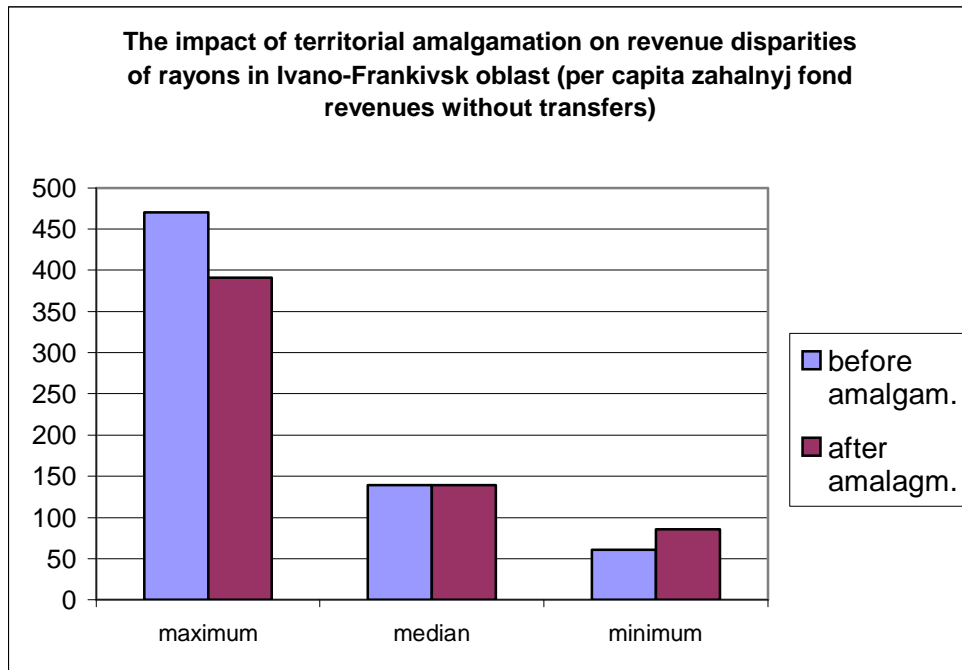
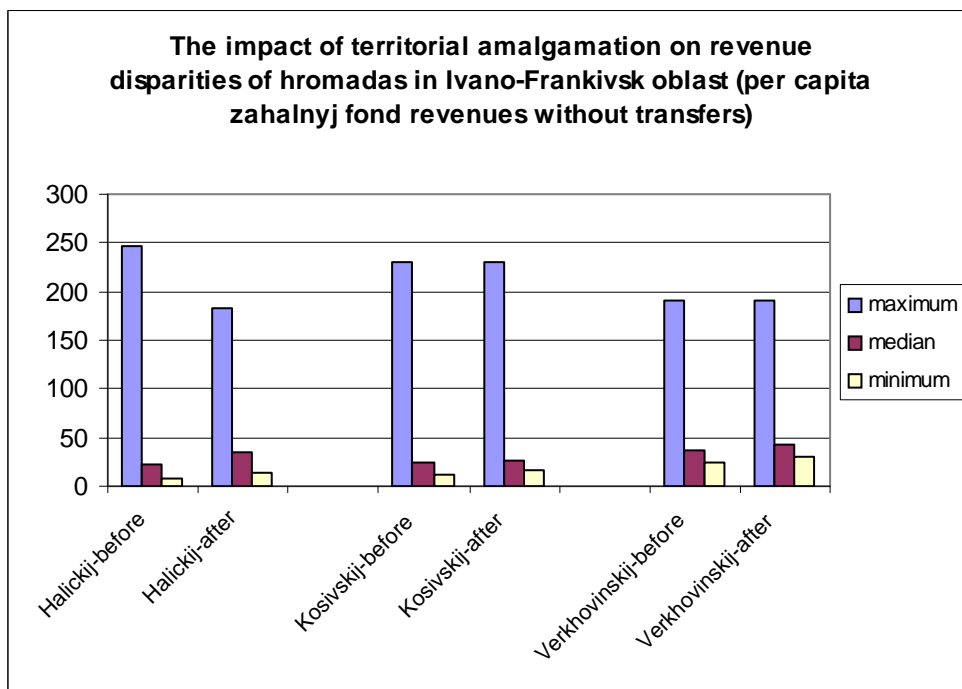


Fig. 2.



Luhansk Oblast

The disparities in per capita general fund revenues between the two cities and also between them and the rayon are relatively insignificant. Per capita revenue disparities are much greater across the array of village budgets. The village with the highest level of per capita revenue enjoys a more than four-fold advantage over the village at the bottom.

As regards the impact of potential amalgamation, a similar picture of diminishing per capita revenue disparities emerges when attention is shifted to Antratsiye rayon in Luhansk. Consider, for example, two of the proposed *hromady*, Nyzhny Nagolchyk and Dyakova that are adjacent to each other in the amalgamation plans. Without amalgamation the observed range of per capita revenue differentials among villages is 73-97 hryvna in Nyzhny Nagolchek and 42-88 in Dyakova. If amalgamation were to take place, per capita revenue in the Nyzhny Nagolchyk *hromada* would become 84.6 hryvna and in the *hromada* of Dyakova it would be 60.3 hryvna. In the absence of amalgamation the ratio of the maximum to the minimum level of per capita revenue is 2.3. With amalgamation this same ratio would drop to 1.4.

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A general conclusion from both field visits is that planned territorial amalgamation might indeed significantly reduce existing disparities in per capita revenue distribution, although they would still remain at a relatively high level. And it would be naive to expect that territorial reform itself would eliminate horizontal imbalance. Consequently, while there might be some relief for the equalization pressure, a strong equalization system would be still needed. It is even more true if new *hromady* are granted an extended scope of functions, for which the horizontal equity principle would require a corresponding system of transfers.

Taking into account the observed disparities in local revenues, one may consider including revenues of the “second basket” (defined in the article 69 of the Budget Code) in the equalization system.

If we discuss potential equalization scheme, it should be constructed in that way that it does not provide a disincentive for local revenue collection. First, the equalization does not need to be full, i.e. it may reduce level of differences, but not liquidate them. Second, the calculations should refer to the tax base rather than to actual collection, which in turn depend (among others) on rates of local fees, exemptions granted by local councils and efficiency in the collection itself. It means such a change would require expanding the database collected on local government finance and could not be introduced immediately.

II. 6.4. Variation in Land and Fixed Agricultural Tax Yields between and within Rayons

Land taxes in most rural local budgets, along with proceeds from another rural land based tax, the Fixed Agricultural Tax, comprise the single largest source of revenue in so-called second basket revenues. Because they belong to the second basket they escape the equalization of revenue sources provided by the formula based transfer system.

The issue of land taxes arises in the context of territorial administrative reform because if additional expenditure responsibilities are given to newly formed *hromady*, additional revenue sources should also be found to avoid increasing transfer dependency (this issue is more extensively discussed in following chapters of the report). Granting *hromady* a larger share of the

land tax is one candidate for an additional revenue source. However, if per capita land tax yields vary a great deal, this particular source of additional revenue would have the unattractive feature of exacerbating per capita expenditure differentials and working in opposition to the transfer formula that provides for equalization of revenue sources.

This part of the report attempts to shed some light on the extent to which there is wide variation in per capita land taxes. Presumably, whatever variation is observed is related to differences in the quantity and quality of land held in different local government jurisdictions or the size of the effective tax base. Some of this variation is also related to differences in local government propensities to grant tax relief. To improve the accuracy of our estimations we also try to relate our observations to revenue capacity, not just actual revenues. In Ivano-Frankivsk, we add to actual collections the consequences of locally decided tax exemptions and tax rate reductions. In both Ivano-Frankivsk and Luhansk the calculations also take into account arrears in payments for both the land tax and the fixed agricultural tax.

This analysis has indicated once more important issue. According to the article 103 of the budget code, the state budget should compensate tax relief granted by national legislation in local government revenues. In practice it seems not to be the case. In Halych rayon of the Ivano-Frankivsk oblasts tax relief granted by state equal to almost one fourth of actual revenues collected from the land tax. In mountainous rayons of Verkhovina and Kosiv it is even more – around half of actual collected amount. This issue calls for closer investigation and perhaps for remedy actions.

Ivano-Frankivsk Oblast

In Ivano-Frankivsk oblast, for the rayons analyzed more than half of “second basket” revenues are attributable to the land tax. Revenues from the fixed agricultural tax are considerably smaller. In Halickij rayon they account for only about one-sixth of the revenues provided by the land tax. In the other two rayons (Kosivskij and Verkhovinskij) the tax has no revenue implications as these are mountainous areas where farms are exempt from the tax. According to the collected data, local tax reductions or exemptions are small in the case of the land tax while in the case of the agricultural tax they play a significant role only in Halickij rayon. In Halickij rayon tax reductions almost equal the amounts of tax collected. Territorial variation in potential per capita revenues from these two taxes is very significant as illustrated in figures 3 and 4.

Fig. 3.

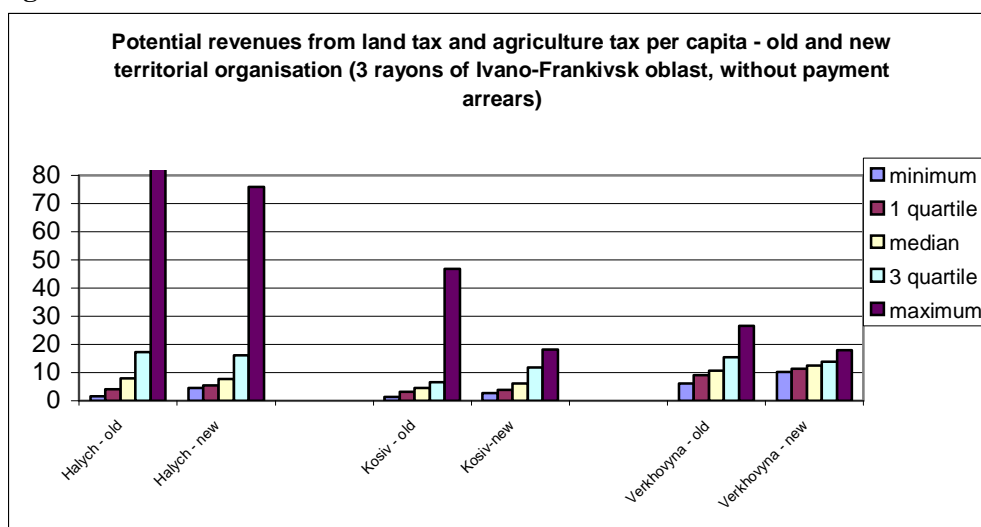
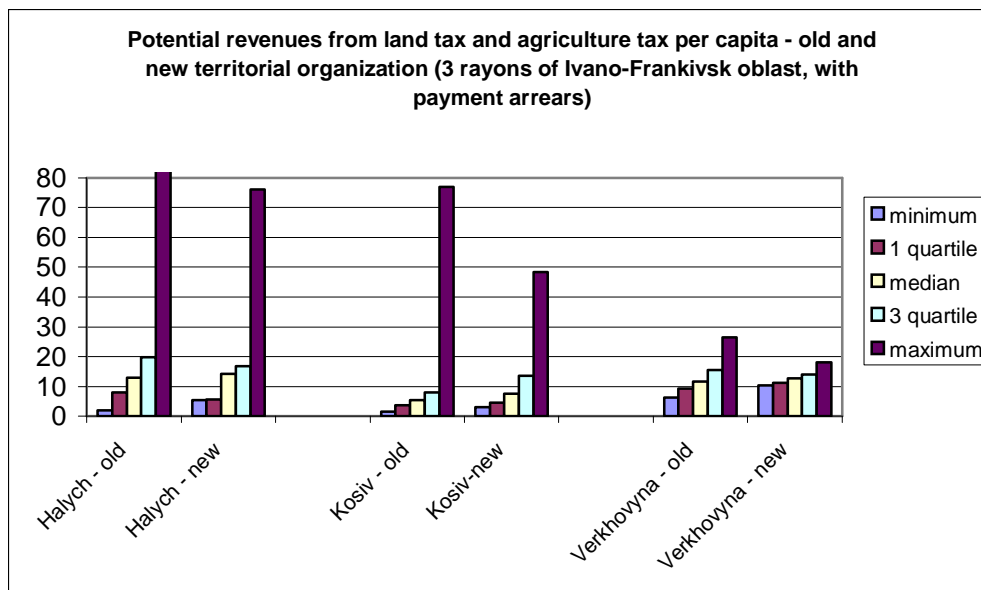


Fig. 4.



In all three selected rayons the potential amalgamation would lead to very considerable reduction of territorial disparities in per capita revenues. However, differences – especially in Kosivskij and Halickij rayons – would remain significant and would justify call for equalization.

Luhansk Oblast

Table 4 below shows calculations of the ratio of the maximum per capita yield to the minimum for cities and rayons in Luhansk oblast and for villages in Antratset rayon. This is for Land Tax only, i.e. it does not include the Fixed Agricultural Tax, and is based on actual tax collected since data on tax reductions and exemptions was not available. The intra-rayon discrepancies in Antratset are particularly notable.

Table 4. Land Tax Variation (maximum/minimum per capita yield)

Budget	Measured Variation
Cities of Luhansk	7,65
Rayons of Luhansk	11,1
Villages in Antratset city	18,8
Villages in Krasny-Luch city	14,4
Villages in Rovenky city	12,5
Villages in Antratset rayon	47

In an attempt to achieve a closer estimate of revenue capacity of - rather than actual revenue - for Luhansk oblast, we compare figures for all land tax (Land Tax and Fixed Agricultural Tax) collected against assessed tax liability. Land taxes are not always paid on time and when tax arrears accumulate over time and are cleared intermittently in subsequent tax years, observed land tax collections may distort the connection between land tax receipts and the underlying size of the land tax base. In other words, current collections of land tax contain a mixture of payments for current tax assessments and for back taxes and penalties. It is arguably the case that the base

of the land tax, i.e. revenue capacity, is more accurately portrayed by the amount of land tax levied annually than by the amount of tax collected.

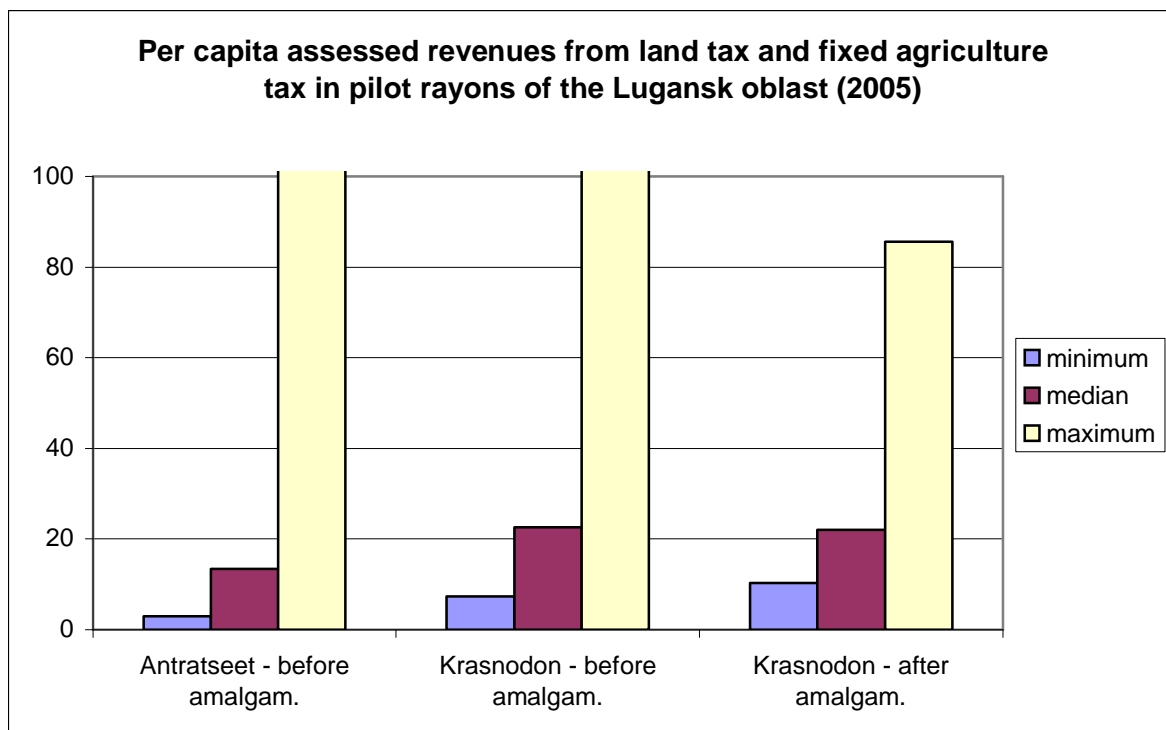
At an aggregate level, in Krasnodon rayon there is a significant imbalance between land taxes that were assessed and those that were collected. In 2005 930,565 hryvna was charged in total but more than twice that amount, 1,924,961 hryvna, was collected. In Antratseet rayon a closer aggregate balance was achieved: 645,044 hryvna was assessed and 641, 933 was collected. However, this aggregate balance masks a great of offsetting imbalance at the village level. As of January 1 2006 total land tax arrears in Antratseet rayon ran to 915,309 hryvna.

The general picture that emerges from a study is that in both rayons there is at least one high yielding village that collects more than it assesses and at least one low yielding village that assesses more than it collects. The result is that the range of per capita collections (4.1 to 547.2 in Krasnodon and 1.1 to 170 in Antratseet) is extended beyond that which is observed for assessments (4.5 to 193.2 in Krasnodon and 1.6 to 155.2 in Antratseet). On this basis it is preferable to rely on assessment rather than collections data as the more reliable indicator of the size of the land tax base.

Analysis of the Fixed Agricultural Tax generates a picture highly similar to that of Land Tax although the amounts involved are much smaller.

That said, however, the conclusion reached in relation to rayons in Ivano-Frankivsk oblast remains unchallenged. Extremely large differences exist in the revenue productivity of the Land Tax and Fixed Agriculture Tax among villages, although – as it is shown on the figure 5, they would be significant decreased by the potential territorial amalgamation.

Fig. 5.



The data from both Ivano-Frankivsk and Luhansk clearly demonstrates that there are wide discrepancies in the revenue productivity of both land and fixed agricultural taxes and that these can be the source of fairly large differences in the level of per capita expenditure among villages.

The intra-rayon differentials in per capita land revenue exceed those measured between rayons and lend support for the position that these revenues should be equalized on a formula basis. However, if this were done, a revised equalization scheme should take into account the nature of the services financed from the second basket and, in particular, that the number of users of communal services may differ from the number of residents as well as that service costs may differ among localities. As in many European countries, the system might be based on weighted population where for towns and cities users of services such as roads for example are normally larger than the number of residents and unit costs of these services are often higher than average.

II. 6.5. Cost Savings from Amalgamation - How Significant?

Spending on administration is usually an area in which scale effects due to the amalgamation process have the most direct impact and can be measured relatively easily. It is especially so in countries like Ukraine, where amount of spending is very strictly regulated by norms governing the number of staff and their salaries. Although our general recommendation is to give more flexibility to local governments in terms of staffing and individual earnings, our theoretical exercise is based on the assumption that the same norms would apply after amalgamation of territorial units. This allows a comparison of actual spending in 2005 with theoretical spending after the reform.

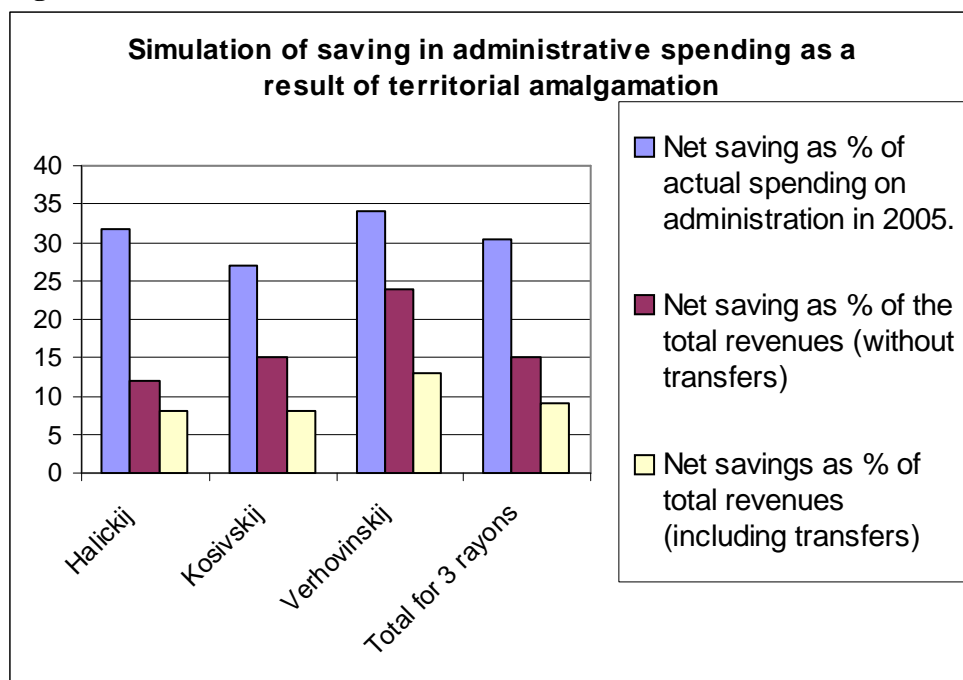
(a) Cost Savings in Ivano-Frankivsk Oblast

In Ivano-Frankivsk the impact on spending at rayon level would be minimal, since only very limited changes in the division of the oblast into rayons are expected. Therefore we concentrate on the basic tier (towns and village councils before and *hromada* after amalgamation). It is assumed for the moment that no other conditions would change, and the only change would be the territorial amalgamation. Expenditure functions for example remain the same. The expected economy of scale is illustrated in table 5 and in figure 6.

Table 5. Possible impact of amalgamation on current administrative spending on the lowest tier of local government (town, village councils versus new *hromada*)

	Actual spending in 2005 (1)	Simulation of spending by new <i>hromada</i> (2)	Net saving (1)-(2)	Net saving as % of actual spending on administration in 2005	Net saving as % of the total revenues (without transfers) of the <i>zahalnyj fond</i>	Net savings as % of total revenues (including transfers)
Halickij	2319,9	1581,7	738,2	31,8	12	8
Kosivskij	2589,1	1886,3	702,8	27,1	15	8
Verhovinskij	1458,3	960,8	497,5	34,1	24	13
Total for 3 rayons	6367,3	4428,8	1938,5	30,4	15	9

Fig. 6.



The expected benefit is quite considerable, with a net saving of around 27% in Kosivskij, and even 34% in Verhovinskij rayon. How important would it be for the overall budget (general fund)? One needs to take into account that administration plays a very significant role in the structure of spending of the lowest tier local governments. In Kosivskij rayon's towns and villages, spending on administration constitutes over 50% of total revenues without transfers, so economy of scale in administrative spending would allow a saving of 15% in revenues without transfer or 8% of the total budget. In Verhovinskij rayon the impact might be even more important. Administrative spending constitutes there over 70% of the general fund revenues (without transfers), so the reduction in spending for administration would allow savings of 24% of revenues without transfers or 13% of the overall budget. The scale of saving would be slightly lower in the Halickij rayon, where administrative spending presently constitutes "only" 38% of revenues without transfers. The amalgamation would allow savings of 12% in revenues without transfers or 8% of total budget revenues.

In some extreme cases (for example Nizhnoberezivska and Serednoberezhivska *hromady* in the Kosivskij rayon) the simulation shows that current administrative spending in new *hromady* would be more than twice lower than in old village councils constituting the new administrative units.

Obviously, the real saving might be lower, since some additional functions might be transferred from the rayon to *hromada* level. These new functions will require some matching administrative spending from *hromada* budget, and in that case we will have a diseconomy rather than economy of scale effect, since new *hromady* are still smaller than currently existing rayons.

The second observation which is necessary in our estimation of possible savings in administrative spending, is that our focus is entirely on current expenditures. It may happen that some capital spending might be necessary in order to provide proper conditions for the work of administration of new, enlarged local governments (*hromady*). This issue would require a separate investigation. However it is possible that proper use of existing buildings (both in the

main settlement and in the smaller villages of *hromady*) may avoid additional investments in office space.

Nevertheless, our calculations show clearly that the economy of scale might be very substantial.

(b) Cost Savings in Luhansk Oblast

The size of savings depends on the size of the villages subject to amalgamation and their number. Villages in the size range of one to two thousand typically devote around three-quarters of their budgets to paying for the costs of administration. Even in a fairly large sized town, such as Petrovska with a population of slightly over 15,000, the costs of administration absorb thirty per cent of total budget resources.

To illustrate the magnitude of the cost savings associated with amalgamation, consider the details of the Bezsmertny plan. According to it, four city councils in Krasny-Luch city would be abolished as a result of the village being assigned to one of the neighbouring *hromady*. One village council in each of the other cities, Antratseet and Rovenky, would also be eliminated. In addition, village councils would no longer exist in the rayon villages of Esaylivka, Malamikolayvska, Bobrekova, Koshari, Mikitovka, Rafaelivka and Rebrekova.

In 2005 the amount spent on administration by the village councils that would disappear under amalgamation totals 1,278,733 hryvna. Whether this amount represents a significant saving depends on what it is compared to. Compared to the 2005 total expenditures of the 14 rayon villages, the saving in administration costs would be 17 per cent. Compared to total village expenditure, excluding those villages retained by the cities of Antratseet and Rovenky, the saving amounts to 10 per cent. But if we compare the size of saving with revenues from own sources (without transfers) the saving is much more significant, so it would help to reduce grant-dependency. Since in Antratseet rayon on average 74% of village revenues comes in form of transfers, it means that saving on administrative cost would be equal to more than one third of current revenues from own sources.

II. 7. 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 precise 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 in 2005 to keep health care responsibility intact at the rayon level. This should not be altered by territorial administrative reform. A further subdivision of financial resources for health care creates difficult mismatches between the catchment area of hospitals, clinics etc and administrative boundaries.

This would run counter to a recent Verkhovna Rada resolution in favour of unifying responsibility for primary and secondary health care. This would imply retaining responsibility at the rayon level or even reassigning the rayon competences to the oblast.

There are at least two strong arguments for this. The first is the practical difficulty already experienced in relations between rayons and oblast cities, that hospitals typically serve patients from outside the jurisdiction of the local government which manages and funds them. The second is the strong professional opposition to separating the management and funding of primary and other health care. Developments in medical technology are continually raising new alternatives for treating particular medical conditions in either primary or secondary facilities. This demands flexibility and innovation which becomes much more difficult if choices are dictated by administrative and financial arrangements rather than technical possibility and clinical judgment. The implication of this Verkhovna Rada resolution is that even if amalgamated *hromady* are created, health care competences should be managed by the rayon local government.

However there is the additional question whether these competences should be reassigned from rayons and oblast cities to the oblast. This could be justified by the facts that medical services in oblast cities often serve the surrounding rayon, and that the specialized services provided by oblast level institutions are often hard to disentangle from general hospital care. In addition oblast medical departments tend to have more experienced health care managers than those available to the rayon.

It is worth to stress that 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 in the LARGIS project.

However, oblast managements would have to show a wider concern for services throughout the region if they were to take over competences already discharged at the level of oblast cities and rayons and might, for example, need some branch organization at rayon capitals. Oblast cities might well resist loss of responsibility for city hospitals.

Creation of more city-oblasts may add a further complication in divorcing the management of health care facilities from their catchment areas.

III. 3. Culture

The Verkhovna Rada also resolved that competences in the field of culture should be unified.

This would be contrary to general international practice where all levels of government normally have rights to manage and finance cultural services. There are advantages, for example, in managing library services at rayon level, where a flexible mix of stationary and mobile libraries can be managed and larger stocks of books, web site access etc can be accumulated. Village halls, by contrast, should surely benefit from management at community level, whatever size the population.

A distinction needs to be made between the provision of cultural services and the preservation of cultural heritage. There have also been arguments that responsibility for major cultural heritage is beyond the capacity of city budgets and should pass to national government. There should be some inventory of national heritage, which identifies those historical assets like castles for which the State should either take or at least share responsibility. This might involve an earmarked subvention or some other form of partnership. However, the burdens of restoration basically involve capital investment and in so far as the State Budget has sufficient funds these can be made available to cities through capital grants. Moreover city administration is in a better position to mobilize the private sector participation, which plays an important part in restoration in most other countries. The legal obstacles to private and voluntary sector participation in managing and funding cultural facilities clearly need review.

III. 4. 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 stadiums, 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.5. 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 (conducted within the framework of a DFID project) 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. 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 *hromady* 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. 6. 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 draft legislation proposes to assign responsibility for preschool and general secondary education to the *hromada*. If amalgamation results in *hromada* containing over 5,000 population this poses no obvious difficulty and is in line with practice in many European states.

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. The question may be raised however about the feasibility of running education for 9-15 years old, even in the enlarged *hromadas*. This issue is addressed in the next sub-section on the basis of investigation in two selected oblasts.

There is also a question of efficiency. Funding of education is very stretched, but schools complain of lack of freedom to make efficiency savings and also to tailor their curriculum to local needs and demands. Many neighbouring countries fund individual schools on a per-pupil basis (with allowance for unavoidable differences in costs) while leaving school directors and management boards considerable discretion on the allocation of the funds.

If *hromada* are not amalgamated, the alternative of strengthening the role of the rayon would require no change in assignment of competences, but the arguments for devolving more power to school management would remain. In any scenario *hromada* should remain responsible for pre-school education.

III.7. The Feasibility of Transferring Secondary Education to New *Hromady*- Selected oblasts Analysis

(a) Ivano-Frankivsk Oblast

There are two immediate questions that come to mind in determining the feasibility of devolving secondary education to the enlarged *hromada* tier. Is there a sufficient contingent of children of relevant age in every *hromada* to make operating such a school reasonable? Is there sufficient physical infrastructure, namely school buildings available in every *hromada*?

Answering the second question is relatively easy. It involves seeing whether there is at the moment at least one secondary school (*osnovna shkola*) on the territory of the planned *hromada*. The answer is positive, at least as it regards the three rayons taken into detailed scrutiny. In Verhovinskij rayon there are at least 2 such schools in each of the planned *hromady*. In Kosivskij rayon there are two *hromady* in which would be one secondary school, while in the others there are at least two. In Halickij rayon, where the planned amalgamation is the most radical, there is only one *hromada* which would have two secondary schools, while in others there would be at least four.

It is a bit more difficult to assess the quantity of children of relevant school age. There are no village level statistics on numbers population broken down by individual, detailed age groups. Therefore our indirect estimation is based on two indicators:

- (1) number of children of 0-6 years divided by six. It gives a rough estimation of the number of children who might be of relevant age within the next 10 years. But even this information has been difficult to collect. In two rayons we collected it through health care statistics of child-care. In the third rayon (Halickij) we have only data on rural population, but we have failed to collect similar data on urban population.
- (2) number of pupils in 11-15 years age cohorts in schools which are currently operating on each territory.

This indirect investigation suggests a positive answer. The first indicator varies between:

- 23,5 and 93,7 in Halickij rayon (as we mentioned above, data for Halich rayon includes only information on children living in rural areas. The real numbers – including urban residents – would be even higher)
- 37,5 and 163,5 in Kosivskij rayon
- 37,5 and 80 in Verhovinskij rayon

The second indicator suggests that the lowest number of children in the class created on the basis of already existing schools for 11-15 years, might be 15 in one *hromada* in Kosivskij rayon (Sheshorivska *hromada*). In just one more case it would drop below 20. In Verhovinskij rayon the minimal number would be 23 and in Halickij 20. Thus from the point of view of the demand side, such a devolution of function appears justified. There is no single *hromada*, in which children of given age cohort would not fill a class of reasonable size.

(b) Luhansk Oblast

The rayon of Antratseet currently operates nineteen secondary schools that together have a student intake of 3,572 pupils. Most of these schools serve 2-3 population clusters. Of the nineteen secondary schools, thirteen of them offer classes in grades one through to eleven. Four other schools only offer classes up to the ninth grade while two have classes only up to the fourth

grade. Only one of the thirteen full service secondary schools has a small number of students in different grades. All of the others have a student body of between 145 and 424 students. Moreover, within this latter group of secondary schools there is a fairly even distribution of students across the different grades indicating a steady demand for secondary education in the foreseeable future.

The rayon has a limited school bussing program but where it cannot directly provide bussing to students it contracts with private parties to provide school transportation.

In terms of the amalgamation plans every new *hromada* that has been proposed would have a full service secondary school. The only exception would be the *hromada* of Petrovska, which would become a new *hromada* under either of the plans that have been put forward.

In terms of territorial administrative reform there appears to be no serious impediment, on either the demand or the supply side of secondary education, to transferring responsibility for secondary education from the rayon to the new *hromady*.

III. 8. 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 for serving 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.
- According to our pilot research in the oblasts it is feasible that enlarged *hromada* manages schools for the 6-15 age group. In fact, there are both relevant school facilities and sufficient contingent of pupils in territories of each of the new *hromada* to be created in the selected rayons.
- *Hromada* should be primarily responsible for sports facilities.
- As regards social welfare services, there are two possible recommendations. One is that *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. The alternative is that, as in the case of health care, is that social services should be unified. The rayon is of the right size to provide and manage most services, but it should have the flexibility to delegate management of the territorial centres to the larger *hromada* in order to preserve a role for local knowledge and community spirit..

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*

There are two basic problems over revenue. The first and most obvious is *adequacy*. If competences are reassigned appropriate shares of taxes will have to be reassigned as well. Judgments whether funding is “enough” are inevitably relative and subjective, but there seems widespread consensus that health care and education are seriously under-funded. The Budget Code leaves “own” competences dependent upon basket 2 revenues, so that they reflect fully the enormous disparities in local revenue bases.

The second issue is *accountability*. Local governments currently have little responsibility for setting the rates of the taxes on which they rely, whether assigned (basket 1) or “own” (basket 2). They can always blame the State for the inadequacy of their services, even if it is their own incompetence which is really at fault.

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? Four issues in particular need examination and additional research – they are subsequently presented in following sections.

IV.1. Land tax

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. More data on this issue can be found in section II of this report together with the discussion of the territorial disparities in revenues.

IV.2 Personal Income Tax

The assignment of Personal Income tax (PIT) yields to local budgets by the Budget Code is a major advantage to fiscal decentralization in Ukraine. This is the only source of tax whose yields can be clearly located territorially and can be sufficient to cover a large proportion of the costs of the major services carried on local budgets

There are two drawbacks, however. One is the assignment of the tax to the local budget where the employer is registered. This distorts the revenue base of Kiev and other major cities and necessitates a high degree of horizontal redistribution, with resulting tensions. In most countries where PIT revenues are shared by local government, assignment is to the territorial unit in which the payer lives (this includes such countries as Poland, Croatia, or Sweden – in the latter one PIT is the major source of local government income and local governments have large discretion to decide upon PIT tax rates).

The Budget Code introduced a number of budgetary measures that were designed to strengthen the accountability structures of local governments in Ukraine. Ironically, however, the Code’s

treatment of where the proceeds of the personal income tax should be directed has acted to weaken accountability. Prior to the introduction of the Code many local governments were financed in part by the personal income tax that was levied on a residence basis. The residence principle is generally felt to be the correct approach in assigning revenues to local governments because most people consume the public services they enjoy where they live rather than where they work. Local governments are apt to be more responsive to the public service wishes of their residents when those residents are an important source of the local government's revenue stream.

A further argument favouring the residence principle is found in article 5 of the Ukrainian Personal Income Tax law. Under this article taxpayers who are entitled to a tax refund are required to claim it from the local government in the area where the taxpayer resides. Thus not only does the local government not benefit from the tax paid by its residents, it also shoulders the burden of paying tax refunds.

The change of the current situation is not a difficult process. In sending tax deductions to the State Tax Administration (STA), employers have to include an individual code number for the territory in which each payer lives. The STA then transmits the payments to the various territorial units using computer software developed for this purpose. Application of this process in Ukraine would greatly increase the fairness of PIT sharing.

Assigning PIT by residence would also reduce levels of disparity in revenue collections and thereby the extent of horizontal redistribution. This would lessen the resentment of donor cities and the resulting disincentive to revenue collection.

The second drawback is that local governments spend the yields of PIT without accountability for the rates imposed on their citizens. Assigning PIT by residence would also make it possible over time to amend the Tax Code to give local government units power to vary the rates of PIT payable by their citizens within legally prescribed limits. Such power of surcharge would apply to the percentage share of PIT assigned to the particular level of local government, not to a taxpayers' total liability. This is practised in states such as Denmark, Sweden, Finland and Croatia, and substantially enhances both the accountability and the budgetary discretion of local government.

It must be emphasized that the first reform – the assignment of PIT to places of residence – is the first priority. Introducing rate setting powers would be a second and later stage, dependent in any case on the completion of the first stage.

These changes are desirable whether or not territorial reform takes place. However, any substantial shift of competence from the rayon to the *hromada* would need to be accompanied by some revision of the percentages shares of PIT between levels of government.

IV.3. Property Tax

Territorial administrative reform can be expected to increase pressure to improve the funding of those competencies dependent on “own” (basket 2 revenues). Can this base also be increased?

An obvious possibility, much discussed in Ukraine already, would 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. A single rate per square metre would be adjusted by 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 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. International experience suggests that restrictions would be necessary to prevent local governments imposing this tax more harshly on business payers than on individual households; it is also very questionable whether exemptions should be decided at local rather than national level. (Annex 1 presents the case in greater detail).

Can households or businesses afford an extra tax burden? This is ultimately a political judgment. If property tax is a basket 2 revenue, each local government council could be left to make that judgment itself, balancing the demand for improved services with the public ability to pay more. The decision would have no implications for the State Budget.

Whether the tax should fall on owners or occupants is a matter of administrative convenience, depending on ease of identification.

IV.4. State Budget Allocations

Apart from introducing property tax and the possibility for local councils to surcharge PIT, these suggestions do not increase the overall funding of local public services.

One possibility under current discussion is the introduction of compulsory health insurance. We are unable to comment on the desirability of this, but from the experience of some other countries the extra burden on payers might be partially compensated by cuts in PIT, which in Ukraine would reduce local government revenue.

Otherwise the main possibility for increasing the funding of local public services lies in increasing the share of local government spending in the consolidated budget, resulting in a higher volume of equalization transfers. That would require a judgment on relative State Budget priorities which is beyond the scope of this paper.

Both PIT and property tax issues are discussed below on the basis of the empirical investigation undertaken in the Ivano-Frankivsk and Luhansk oblasts.

IV.5. The Allocation of the Personal Income Tax: Residence versus Employment Registration in Selected Oblasts

If the Budget Code were amended to convert the Personal Income Tax into a residence based tax, what would be the magnitude of the revenue shifts that would accompany this change? Two efforts to answer this question are described below, first for the Krasnodon rayon where data are readily available and secondly for the Halickij and Verhovinskij rayons in Ivano-Frankivsk where the data are somewhat more problematic.

(a) Krasnodon rayon, Luhansk Oblast

The change from a residence to a place of employment or origin basis for allocating personal income taxes has highly predictable consequences. Villages and cities with a large employment base would be expected to gain revenue at the expense of residential villages with small employment bases resulting in a much more unequal distribution of revenues. This expectation is clearly borne out in the case of Krasnodon rayon for which village level personal income tax data are available for 2001 when the residence principle operated and for 2002 when the Budget Code took effect. Table 6 below indicates the size of the revenue shifts that occurred in each of the rayon's sixteen villages between 2002 and 2001. Krasnodon is similar to Antratseet in that coal mining is the dominant economic activity. Krasnodon's coalmines, however, are much more successful than those found in Antratseet, and Krasnodon consequently is one of the few donor rayons in Ukraine.

Due to the change in income tax principle in 2002 nine villages suffered declines in their Personal Income Tax base and in a few that base virtually disappeared. Six other villages experienced expansion in their income tax bases and for four of them with very large coalmines the change was a fiscal bonanza as their tax bases grew by over a thousand per cent. The gains exceeded the losses by a large margin indicating that the city of Krasnodon and perhaps other rayons as well, where miners reside, also lost revenue.

Table 6. Budget Code Revenue Redistribution: Krasnodon Rayon

Village	Change in Personal Income Tax Base 2001-2 (%)
Novosvetlovsky	-29
Velykologovsky	-89
Novoalexandrovsky	-90
Semenetsky	-8
Myrnynsky	1,135
Parhomenkovsky	-74
Devedo-Nikolsky	-56
Novoannovsky	-26
Samsonovsky	2,401
Biloskelevatsky	4,823
Verhnererachemovsky	-15
Velykosuhodolsky	968
Verhneshevervsky	103
Hrashevatsky	31
Porechensky	-81

If this exercise were repeated in other rayons, especially ones without coalmines, less dramatic revenue shifts would probably be observed but the general pattern would likely be the same. Large cities and towns with factories and services would be seen to gain revenue at the expense of smaller villages.

If the residence principle were adopted, or readopted, the revenue effects shown in Table 8 would run in reverse. Smaller residential villages and cities would reclaim personal income tax revenues from the more industrialized villages. From the perspective of territorial administrative reform this would be a desirable outcome as it would reduce the degree of transfer dependence in many villages.

(a) **Halickij and Verhovinskij rayons in Ivano-Frankivsk Oblast**

Available data allow for only a very rough estimation of the impact of changing from a registration-place of employment to a residence basis for the personal income tax (PIT). The methodology of calculation is based on following steps:

1. For 1997 we have data on the allocation of revenues from PIT based on place of residence (it is the last year for which such data is available).
2. We calculate the share of PIT revenues of each *hromada* (or rayon) in overall PIT revenues in 1997.
3. We assume that the change to residence base in 2005 would result in the same territorial distribution. With this assumption, the share calculated in step 2 can be multiplied by the total amount collected in 2005.

One may notice that this methodology is very much a simplification, since it assumes no major change in territorial allocation of wealth and in territorial allocation of firms between 1997 and 2005. Moreover, our data for 1997 tell us about revenues from PIT in individual territorial budgets. In 1997 the local governments share in PIT revenues was not standardized, i.e. it could be different for two different territorial units. This variation is another source of potential errors in our estimations. But even such a simplified calculation has not been possible for every area in question. For Kosivskij rayon it was impossible to find 1997 data, so estimation has not been performed.

Table7. Estimated impact in 2005 tax year of the change of revenues due to allocation of PIT on residence base

a. Halickij rayon

	By work place	Estimation - by residence	By residence as % of by work place
Galytska, the City of Galych	662,0	1979,5	299,0
Butshytynska, City of Burshtyn	3098,0	1393,2	45,0
Bilshivtsivska, the town of Bilshivtsi	91,74774	177,7	193,7
Blyudnykivska, the village of Blyudnyky	23,39211	87,7	374,9
Dubivetska, the village of Dubivtsi	85,09587	54,8	64,4
Zadnistrianska, the village of Zadnistriansk	38,83433	77,3	199,1
Kinashivska, the village of Kinashiv	32,41505	100,1	308,8
Komarivska, the village of Komariv	54,71139	145,4	265,8
Maryyampil'ska, the village of Maryyampil	54,57557	125,1	229,2

b. Verhovinskij rayon

	By work place	Estimation - by residence	By residence – estimation by rayon administration	By residence (estimation on the basis of 1997 data) as % of by work place	By residence (estimation by rayon administration) as % of by work place
The town of Verhovyna	581,7	520,2	549,3	89,44	94,4
Iltsivska	59	74,0	76,0	125,36	128,8
Zelenska	23,9	34,5	23,9	144,18	100,0
Verhnio-Yasenivska	44	64,7	54,0	147,08	122,7
Usterikovska	89,6	59,7	92,1	66,60	102,8
Yablunyska	55,4	74,8	55,7	135,02	100,5
Grynyavska	27	47,1	27,0	174,32	100,0
Krasnoyiliska	58,2	62,2	57,7	106,86	99,1

Data in table 7 present results of estimation in accordance with the methodology referring to 1997 data, as presented above. In both Halickij and Verhovinskij rayon there are two *hromady* which would lose by the change to a residence based PIT, while the rest of the territorial units would gain. The loser is usually the central *hromada* of the rayon (like Verhovina in the Verhovinskij) and/or the unit with the largest employer on its territory (like Burshtyn with a big power plant or Dubivce with a big stone-pit). More peripheral *hromady* would gain from the change of the system. In Halickij rayon the largest increase in individual *hromada* revenue represents more than a tripling of revenues. On the other hand, the losers might lose around half of their present PIT revenues. Changes in peripherally located Verhovinskij rayon would be much lower. We may expect the largest change in the capital city and surrounding *hromady* (in this case Ivano-Frankivsk city which would probably lose heavily, and surrounding *hromady* which might gain a lot), but unfortunately we do not have relevant data for these territorial units. But the estimation presented in two paragraphs above is very imprecise. There are two cases which are analysed much more precisely on the basis of contemporary data. First is estimation made by rayon administration for Verkhovinskij rayon. Such a calculation based on contemporary data has not been very difficult, since there are no big companies operating in the rayon, most of population is rural-agricultural, so the impact of change in the PIT system would not be very big in this rayon. Calculation presented in the table 8 suggest that Verkhovina town would slightly lose, while other *hromady* would slightly gain as a result of the suggested change, but the difference between present and proposed system would not be very significant.

Much more interesting is the case study of employees of the Burshtyn power plant – the largest enterprise in all three selected rayons. The detail study of employees place of residence allowed an estimation of the impact of the proposed change. Revenues from PIT of employees of the power plant provide over 62% of total PIT revenues in the Burshtyn *hromada*. A more detailed illustration is provided in table 8.

Table 8. Impact of PIT by residence on *hromada* revenues from PIT of Brurshtyn power plant employees

	Present revenues from PIT (2005)	Present revenues from PIT of power plant employees	Revenues from power plant PIT as % of total revenues from PIT	Revenues from PIT of power plant employees – residence base	Change in total PIT revenues as % of present PIT revenues
Galytska	662,0	0	0	59,7	+9,0
Burshtynska	3098,0	1923,9	62	1453,1	-53,1
Bilshivtsivska	91,7	0	0	44,5	+48,5
Blyudnykivska	23,4	0	0	9,7	+41,4
Dubivetska	85,1	0	0	4,5	+5,3
Zadnistrianska	38,8	0	0	168,3	+433,8
Kinashivska	32,4	0	0	9,2	+28,4
Komarivska	54,7	0	0	1,6	+2,9
Matyyampilska	54,6	0	0	0,6	+1,1
Other (in other rayons)	NA	0	0	172,8	NA

The table 7 shows that even change introduced for employees of one company might have a significant impact on revenues from PIT in several territorial units in the whole rayon. Revenues from PIT in Burshtyn *hromada* would drop more than twice, while the revenues in Zadnistrianska *hromada* would increase more than 4 times. In a few other *hromady* the change of revenues would exceed 40%. We are unable to provide more case studies of this kind, but one may assume that the extent of changes would be similar in other locations with similar concentrations of employees in one big company.

IV.6. New Property Tax in the Light of Empirical Data from Selected Oblasts

The question is whether there is a sufficient database on properties, which would allow introduction of such a tax. Data provided below demonstrate that available set of information is not very far from what is required. The collected information allows even for some simulations on what yields might be possibly collected by the new tax. The simulation is based on the assumption that the maximal tax rate would be equal roughly to 10% of the rate currently applied in Poland. It means that the maximal rate for residential buildings would be 0,10 hryvna per annum for 1 square meter; for commercial buildings the rate would be 2,90 hryvna per annum for 1 square meter. The assumed difference between rates in Poland and in Ukraine is both to reflect the lower “ability to pay” of Ukrainian taxpayers and to avoid any excessive shock of the new tax burden, which could lead to a taxpayers revolt. It is not to say that we treat the Polish model of the property tax as ideal. For example, the difference between rates of taxation for housing and commercial buildings in Poland is probably excessively high. But this model seems to be good enough for the first set of rough estimations.

(a) Ivano-Frankivsk Oblast

Our pilot study suggests that the situation, although far from perfect, is better than we initially expected. There are four major sources of necessary of information:

1. BTI (*Byuro Tekhnichnoj Dokumentacji*), which has data on privatized properties. In Ivano-Frankivsk there are two BTI’s – one located in Ivano-Frankivsk and one in Kolomyja – and they cover the whole territory of the oblast. Altogether in Ukraine there are over 300 BTIs, which indicates that in some other oblasts the service is much more fragmented – for example there are about 25 BTIs in the Odessa oblast.

According to our information, Ivano-Frankivsk BTI is among the best organized in the country, but still the level of advancement in collecting required information is around 60%, but it varies from 30 to 80% in individual rayons. The weak point is availability of data in electronic form. For example in Ivano-Frankivsk BTI there are 180 employees, but they have only 45 computers.

2. *Zhek* (municipal housing companies), which have information on housing and other stock in cities.
3. City halls have information on private housing buildings (not necessary privatized, also those which were built as private).
4. Form 1 of *Pohospodarska kniha* and form 3 of *Alfavitna kniha domohospodarstw*, which are excellent sources of information on rural areas.

There are at least three problems with current data availability. One is that data is incomplete, especially for urban areas. Second, is fragmentation of sources of information which makes data processing much more time-consuming. Third is a poor availability of data in an electronic form, which access very time-consuming, frequently requiring “manual” access to files on each, individual property.

The pilot study in Ivano-Frankivsk oblast was able to collect concrete (although incomplete) data on areas of buildings in each of the *hromady* of the three selected rayons. The data on Verkhovinskij rayon, which is mostly rural, is the closest to be complete, although we miss data on Verkhovina, which is a village of urban character (*selishche miskovo typu*). For Kosivskij rayon we miss data on industrial properties. For Halickij rayon we failed to collect any data on non-housing properties.

Table 9. Possible impact of the tax on building on revenues of *hromada*

a. Halickij rayon

<i>Hromada</i>	Tax yield on residential buildings	Tax yield on commercial buildings	Present revenues of general fund (without transfers)	Tax on buildings as % of present revenues
Galytska, the City of Galych	14972,90	NA	1281200,00	1,17
Butshtynska, City of Burshtyn	43046,00	NA	3907300,00	1,10
Bilshivtsivska, the town of Bilshivtsi	8955,30	NA	199100,00	4,50
Blyudnykivska, the village of Blyudnyky	11505,10	Na	50800,00	22,65
Dubivetska, the village of Dubivtsi	12051,10	NA	174600,00	6,90
Zadnistrianska, the village of Zadnistriansk	9206,20	NA	275600,00	3,34
Kinashivska, the village of Kinashiv	9578,30	NA	60800,00	15,75
Komarivska, the village of Komariv	14228,50	NA	124500,00	11,43
Maryyampilska, the village of Maryyampil	12253,80	NA	84700,00	14,47

b. Kosivskij rajon

<i>Hromada</i>	Tax yield on residential buildings	Tax yield on commercial buildings	Present revenues of general fund (without transfers)	Tax on buildings as % of present revenues
Brusturivska	18339,4	559,7	52000	36,34
Verbovetska	24567,4	2383,8	167900	16,05
Kobakivska	29238,6	1400,7	70000	43,77
Kosivska	34025,2	11948	1893600	2,43
Kosmatska	30610,4	1966,2	122900	26,51
Kutska	24364,9	5489,7	424500	7,03
Nuzhnioberezivska	84381,6	1815,4	119000	72,43
Pistynska	29475	3610,5	177400	18,65
Rozhniivska	18716	1403,6	152900	13,16
Serednioberezivska	30536,6	1223,8	134800	23,56
Sokolivska	28519,2	4561,7	127100	26,03
Starokutska	63330	3445,2	461100	14,48
Tyudivska	26195,2	1432,6	157700	17,52
Hymchynska	23178,2	1722,6	77100	32,30
Sheshorivska	14444,4	1493,5	117400	13,58
Yablunivska	20638,5	3970,1	276700	8,89
Yavorivska	15673	440,8	61000	26,42

c. Verhovinskij rayon

<i>Hromada</i>	Tax yield on residential buildings	Tax yield on commercial buildings	Present revenues of general fund (without transfers)	Tax on buildings as % of present revenues
The town of Verhovyna	NA	NA	NA	NA
Iltsivska	9577,20	23214,50	199400,00	16,45
Zelenska	4976,70	4431,20	79900,00	11,77
Verhnio-Yasenivska	12308,20	18174,30	111200,00	27,41
Usterikivska	8401,70	17298,50	171400,00	14,99
Yablunyska	10985,30	13470,50	172000,00	14,22
Grynyavska	6112,20	4874,90	77000,00	14,27
Krasnoyiliska	9069,70	18357,00	162900,00	16,84

d. Summary for three selected rayons

	Total – from residential properties	Total – from commercial properties	% of additional revenues to zahalnyj fond (without transfers)
Halickij	135,797 hryvna	NA	Median – 6,9% (*) Minimum – 1,1 % (*) Maximum – 22,7% (*)
Kosivskij	516,233 hryvna	48,868 hryvna(**)	Median – 18,7% (**) Minimum – 2,4 % (**) Maximum – 72,4% (**)
Verhovinskij	61,431 hryvna(***)	99,821 hryvna(***)	Median – 15,0% Minimum – 11,8 % Maximum – 27,4%

Notes: (*) – without commercial properties, (**) - data on commercial buildings are missing in Kosivskij rayon (only buildings related to service activity, such as cafeterias, shops, but not industrial buildings), (***) – no data for Verhovina town

Table 9 demonstrates that the impact of the tax on local revenues might be very significant. Despite the fact that only partial data is available we see that the tax has the potential to add a significant amount to local revenues. In Verhovinskij rayon (in which data seem to be the most complete) the increase of general fund revenues (without transfers) would be between 11,8 and 27,4%. In Kosivski rayon in individual *hromada* it varies from 2% to an extra 72% of revenues (in spite of lack of data on industrial sites). In Halickij rayon's *hromady* the residential property tax might raise additional funds ranging from 1,1 to 22,7% of general fund revenue.

In conclusion, introduction of the tax would require some more effort in data collection, but a big proportion of the needed information is already available. The tax might considerably increase revenue collection of local governments in the lowest tier.

(b) Luhansk Oblast

In Krasnodon rayon it was possible to collect a complete set of data on the property tax base in all of the villages and to therefore simulate the revenue consequences of introducing a new property tax for each of the proposed *hromady*. This information was assembled through the joint efforts of the village radas and the local offices of the BTI, suggesting that similar results could be generated for other rayons in Ukraine. However, in the case of Antratseet rayon only partial information on the components of the non-residential portion of the property tax base was available so these revenue calculations were done on a village by village basis and represent under-estimates of the full revenue potential of the property tax.

The revenue simulations rely on the same tax rate structure as has been used for Ivano-Frankivsk oblast. Turning to the simulation results in table 9, it can be seen that four of the seven *hromady* would experience a revenue gain in the range of 6-10 per cent. However, two *hromady* would reap exceptionally large gains of 33 and 105 per cent because of the concentration of non-residential property on their territories. For all *hromady* taken together the projected increase in total revenue is about 17 per cent.

In Antratseet rayon data were not available on the quantity of non-residential property in three villages and was incomplete in three others resulting in an underestimation of the true property tax yield in all of these villages. Even taking into account this underestimation, the results shown in table 10 indicate that the property tax has considerable revenue promise. Collectively, the villages in this rayon would enjoy a revenue increment of over 10 per cent and that number has to be considered a minimum estimate. Four of the largest villages where underestimation of the base was not a problem could achieve revenue increments of between 25 and 48 per cent. However, if we consider only current revenues without the equalization transfer, the average gain would equal to almost 23% of present revenues, and in two of villages the own revenues would more than double.

**Table 10. Prospective Property Tax yields for selected rayons in Luhansk oblast
a. Krasnodon *Hromady***

	<i>Hromada</i>	Residential Revenue	Non-Residential Revenue	Total Property Tax	Percent Extra Revenue of Zahalnyj fond
1	Novosvetlovsky	12,708	29,197	41,905	6.2
2	Biloskelevatsky	14,252	119,361	133,613	10
3	Velykosuhodolsky	7,489	71,948	79,437	7.8
4	Samsonovsky	7,192	78,440	85,632	7.2
5	Simeykynsky	13,672	171,743	185,415	32.9
6	Verhnesheverivsky	12,444	53,544	65,998	7
7	Verhnegarasymivsky	6,806	461,373	468,179	105
	Total	74,563	985,463	1,060,026	17,4

b. Antratseet Villages

	Village	Residential Revenue	Non-Residential Revenue	Total Property Tax	% of extra revenue of Zahalnyj fond	% of extra revenues to zahalnyj fond (without transfers)
1	Esaulivka	4,778	351 ♦	5,129	2.2	8.2
2	Ivanovka	23,379	149,495	176,874	14.4	20.7
3	Krasny-Kyt	12,158	3,370	15,528	3.1	9.7
4	Malomykolaivsk	3,898	24,563	28,461	17.5	114.0
5	Nyzhny Nagolchyk	4,203	5,655	9,858	2.5	7.8
6	Fashivka	9,555	58,667	68,222	20.9	96.0
7	Bobrykovo	4,675	NA	4,675	0.7	1.2
8	Dyakovo	7,483	262,679	270,252	33.5	216.2
9	Koshari	1,901	NA	1,901	0.6	1.3
10	Krasnalutske	2,692	5,571 ♦	8,263	2.4	3.1
11	Mykytivka	1,384	151	1,535	1.4	15.0
12	Rafaelivka	2,375	NA	2,375	0.6	0.8
13	Rebrykovo	4,799	1,006 ♦	5,805	1.7	6.2
14	Chervona Polyana	10,570	9,411	19,981	4.1	10.9
	Total	147,164	497,808 ♦	644,972	10.6	22.9

♦ - under estimated

One general conclusion from this part of the pilot study should be highlighted. There is a widespread belief that the main beneficiaries of the property tax would be cities, while rural *hromady* (or *silske rady*) will gain very little. It is not quite correct. This belief might be correct in absolute terms (absolute revenues from property tax will be higher in cities). But in relative terms – expressed as a proportion of present revenues from own sources – the gain might be much larger in rural than in urban local governments. It is so, because the present base of local taxation in rural areas is extremely low, so even a very modest taxation of residential properties would make a significant difference.

Comparison of results obtained in Ivano-Frankivsk and Luhansk oblasts shows also that while in the rural, non-industrial regions the bulk of revenues would be from the tax on residential properties, while in the industrial regions non-residential properties would bring a vast majority of revenues. The balance between these two types of revenue sources may be modified by the decision on the relation between the maximum tax rates for different types of properties.

IV. 7. 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.
- 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. Data collected in pilot exercises in two oblasts prove that it is neither too difficult nor costly to introduce such a tax relatively soon.

Possible estimation of the impact of change in PIT revenues allocation is at the moment only very rough and in our pilot exercise it has been far from being complete. In fact there is no data

necessary, nor methodology to make a more precise estimation in the scale of the whole country. Therefore, if the recommended change of PIT to residence based allocation is going to be introduced, it would be useful to consider a transitional period which would help to avoid a shocking change, and would allow time for analyzing data and developing properly adjusted equalizing mechanism. In Poland for example, in 1992 when the PIT was introduced, the initial allocation of local government share was based on equal per capita base calculated for every region separately (i.e. the local share in PIT was calculated for every region, and then the amount was divided among municipalities in this region on an equal per capita basis). Then in the second half of 1990s there was a gradual change (25% according to residence base in the first year, 50% in the second etc.) until 1998, when the shift towards the residence-based allocation was completed. On the other hand, such a transitional period may mean additional technical complication for both taxpayers and tax administration. This issue requires further analysis, but this should not be used as an excuse for serious delay of the reform.

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.

However, even if the enlarged *hromady* are not created and rayons and oblast cities retain their current responsibilities, reforms in the equalization system are still needed. 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. *Coverage*

The Budget Code restricts equalisation to local government expenditures on competences delegated by the State, but includes the most expensive local public services in this category, including education, healthcare, social welfare and culture. The draft local government

legislation designates these as “own” competences. What are the consequences for the equalization system if this approach were to be adopted?

Ideally the equalisation system should cover all local public services. However, this could prove extremely expensive to the State Budget and there are strong arguments for restricting equalization to those services currently covered until there has been further substantial growth in the economy and in public finance as a whole. There are constitutional guarantees of equal standards in respect of education, health care and social welfare as well as public expectations.

If the draft local government legislation is adopted, the lists of delegated and own competences in Articles 88 to 91 of the Budget Code would have to be amended. To preserve the present sectoral coverage of the equalization system, it would be necessary to amend Articles 94 and 97-99 of the Code to include education, health care etc in the local competences covered by definitions of budget sufficiency standards and equalising transfers.

V.3. Methods

The Budget Code currently equalizes local budgetary resources by a combination of State Budget subventions (mainly for social benefits and investment expenditures) and horizontal redistribution between local government units topped up by a further State Budget contribution.

There are international precedents for such combination (Swedish practice, for example) but countries where the balance between the components differs substantially. In Poland, for example, some part of PIT accrues to the State Budget but general subventions (*zahalna dotacja*) are paid to local government units, principally in support of education costs. This alternative form of redistribution could be beneficial if territorial reform results in a non-uniform assignment of competences to the three levels of local government, making a general spending needs formula difficult to apply in respect of some competences. It would also reduce the impact of current problems experienced in calculating revenue capacity.

V. 4. Expenditure Needs

The expenditure side of the current formula suffers from two major defects. It has become buried in a blizzard of equations that seriously detract from the ability to understand how it works. By becoming so opaque and complicated, the formula has also invited every local government to pressure central government into including special characteristics that might work in its favour.

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 favour 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. 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 2.

V. 5. The Revenue Capacity

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.

For the 2007 Budget performance data will be available for two full fiscal years after the PIT reform plus six months of 2006. It should, there for, be possible to return to the more objective measurement of trends over time envisaged by the Budget Code.

The assignment of PIT shares to place of residence rather than the employer's registration suggested by this Paper would once again disrupt the calculation of fiscal capacity. This could, however, be implemented in two stages. In years one and two places of residence would be reported to the State Tax Administration, which would record the amounts transferable to each local government unit but continue to transfer the tax deductions to the place of registration. In

year three the evidence from years one and two would be used to calculate revenue capacity for formula purposes and STA would actually transfer the deductions to the place of residence.

V.6. Data Needs Related to Equalization – Selected Oblasts Analysis

Creation of the new *hromada* level of local government would also require the construction of an equalization formula that takes into account the basic factors influencing the calculation of spending needs. The question is what sort of demographic and other data, needed to apply the formula, is currently available. If this information were available for all towns and villages it could be relatively easily aggregated to fit the new *hromady* structure. Also this issue (of data availability on a *hromada* level for a new formula allocation) has been investigated in two selected oblasts.

One obviously useful piece of information, which is available for every territorial unit, is population density. The Institute of Cartography provides information on number of population and total area of each of new *hromady*, so calculation of population density is very easy.

The other set of useful variables is data on age and gender structure of the local population. These basic data are more problematic. The only precise information easily available is from the recent national census, so includes data for the beginning of 2002. The newer information on gender and age structure for village/small town level is hardly available. Such information is clearly collected, however rayon level is the lowest one for which it is stored and easily available. Demand of the financial equalization for the *hromada* level would require a change in the demographic data storage, so such a data would be possible for every territorial unit.

What is also available is very precise information on beneficiaries of various social welfare services, which is useful for estimation of spending needs related to different kinds of social welfare benefits. For every territorial unit there is available information on number of residents receiving:

- Benefits related to child births
- Benefits for pregnant women
- Mother care benefits
- Benefits for single mothers
- Benefits for poor families
- Benefits for people with disabilities
- Single payments to disadvantaged people based on the decision of Rayon State Administration
- Benefits for funerals
- Supplement for pensions of people with disabilities
- Supplement for pensions of persons over 100 years old
- Benefit for care of people with disabilities
- Other benefits for poor people
- Housing benefits
- “Gas payment” benefits
- “Electric energy payment” benefits
- Benefit for the purchase of coal

It should be added that the large proportion of this information is not available in electronic or any other “user-friendly” form, so access to information is often very time-consuming. For example, collecting of information on benefits related to new born babies required checking

every individual folder established for every “case” and “manual” check of the address of each mother with a baby.

V. 7. Recommendations

Expenditure

The recommended adjustment to the formula is set out in Annex 2.

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.

Participants of the Working Group of the Ministry of Finance of Ukraine on Territorial Administrative Reform

Galyna Karp - Director of Territorial Budgets Department

Galyna Markovych - Deputy Director of Territorial Budgets Department - Head of Interbudgetary Regulation Division

Larysa Starzhynska - Deputy Director of Territorial Budgets Department - Head of Interbudgetary Regulation Division (till March 2006)

Galyna Gudz' - Head of Sub-Division of Regional Development, Department of Territorial Budgets

Olena Mykulyanych - Chief Specialist, Regional Development Division, Territorial Budgets Department

Volodymyr Repik - Director of Department of Budget System Reformation (till January 2006)

Inna Knishenko - Deputy Director of Department of Budget System Reformation

Ihor Bugrak - Deputy Director of the Department of Budget System Reformation - Head of Sub-Division of State Finances Management Modernization

Nila Dubenko - Deputy Head of Sub-Division of State Finances Management Modernization, Department of Budget System Reformation

Ninel' Zubareva - Chief Economist, Division of Budget System Development Strategy, Department of Budget System Reformation

Galyna Komnatska - Chief Economist, Division of Budget System Development Strategy, Department of Budget System Reformation

Nataliya Kaydash - Leading Economist, Division of Budget System Development Strategy, Department of Budget System Reformation

Vitalina Zaychykova - Head of Division of Local Finances, Scientific Research Financial Institute

Ivan Homra - Senior Research Associate, Division of Local Finances, Scientific Research Financial Institute

Iryna Popova - Deputy Head of Main Financial Department, Lugansk Oblast State Administration

Svitlana Nakonechna - Deputy Head of Main Financial Department, Lviv Oblast State Administration

Nazar Kosarevych - Deputy Head of Main Financial Department, Ivano-Frankivsk Oblast State Administration

Ivan Artysyuk - Deputy Head of Main Financial Department, Volyn Oblast State Administration

Volodymyr Myhalyak - Head of Division of Finances of Local Authorities and Management, Main Financial Department, Volyn Oblast State Administration

Kenneth Davey – Chief International Advisor

Pawel Swianiewicz – Senior International Advisor

Wayne Thirsk - Senior International Advisor

Kateryna Maynzyuk - Advisor on Economic Issues (DFID)

Duncan Leitch – SuFTAR Project Director

Tetyana Korneyeva - SuFTAR Project Coordinator

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Mariya Zderka - Head of the Revenues Section of the Financial Department

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Annex 1

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:

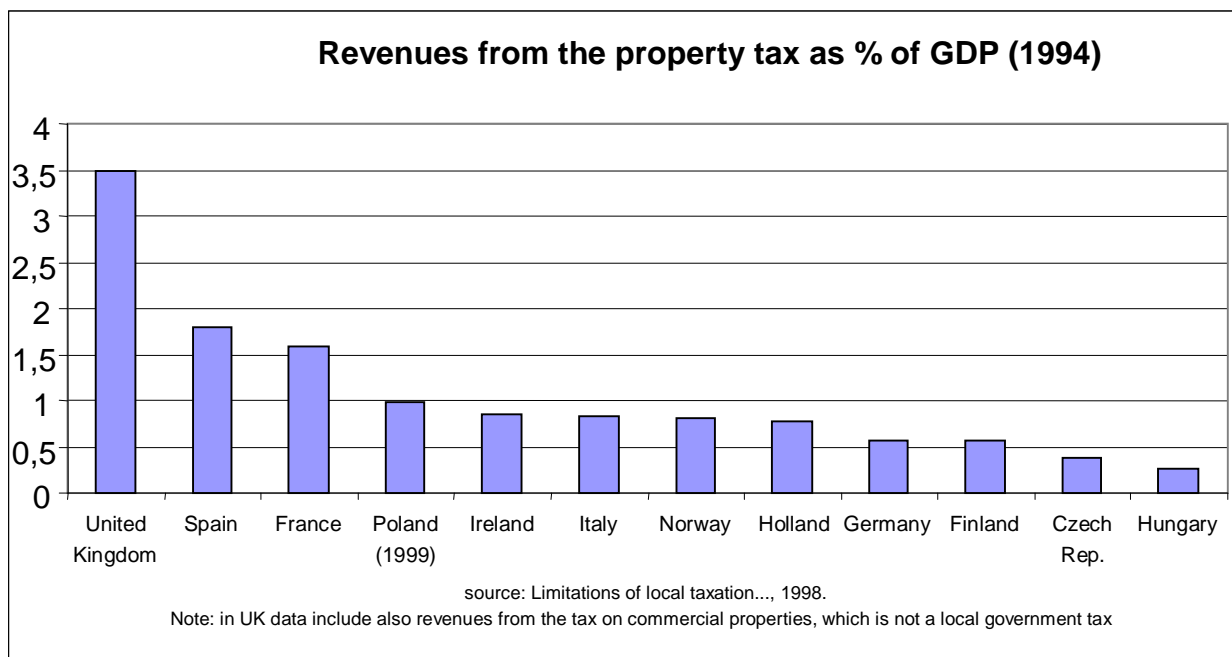
- The tax yields are unfair, since owners (or users) of properties of very different value pay the same amount; such a tax does not reflect "ability to pay" principle";
- There is a wide-spread belief that a meterage base cannot be a source of significant resources for local governments (see also point 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.

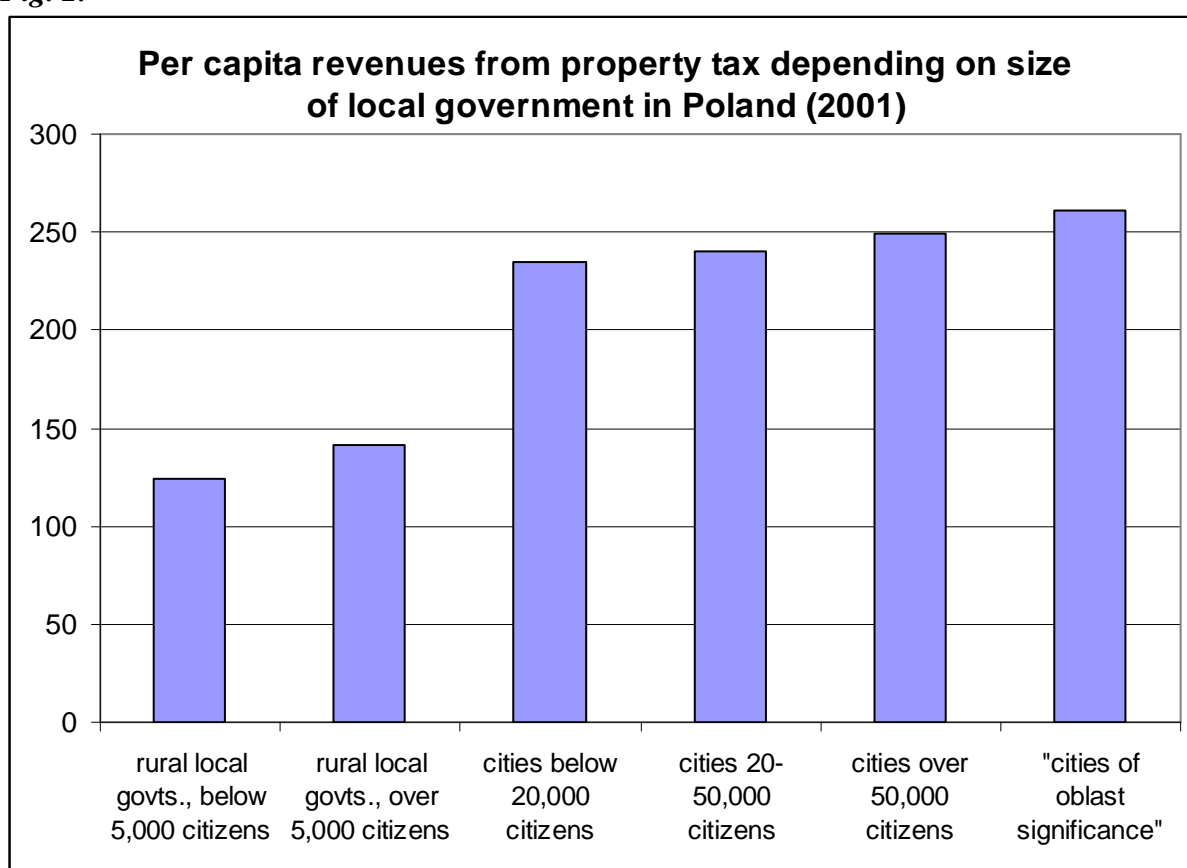
The rates vary depending on the type of property. For example in 2004 the maximum rate for residential houses was 0.52 zloty (around 0.17 \$) per square meter while the rate for buildings used for commercial activity could reach 17.31 zloty per square meter (around 5.50 \$). The most important rates are illustrated in 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 Slovakia¹ 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 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.

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

Annex 2

The Search for a Simpler Transfer Formula

The Paper argues for a simpler expression of expenditure needs in the intergovernmental transfer formula based on relative needs rather than absolute costs. This Annex suggests how this might be done.

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..

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.

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

$$(1) V_j / P_j = V / P_U \{ \varphi_A \phi_j^A K_A + \varphi_H \phi_j^H (\lambda P_j^* / P_j / \sum \lambda P_j^* / P_U) + \varphi_E * (S_j / P_j) / (S_U / P_U) + \varphi_{SC} \phi_j^{SC} ((1 + \alpha_j) P_j / \sum (1 + \alpha_j) P_j) + \varphi_S (R_j / P_j) / (R_U / P_U) \}$$

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

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

V_j = 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_j = population of the j'th oblast or the j'th city or rayon within the oblast;

P_u = population of Ukraine;

P_j^{*} = age and sex weighted population of the j'th local government;

P_u^{*} = age and sex weighted population of Ukraine;

S_i = the weighted number of students in the j'th local government;

S_u = the weighted number of students in Ukraine;

R_j = the number of weighted social service recipients in the j'th local government;

R_u = the number of weighted social service recipients in Ukraine.

φ_k = the share of total expenditure, V, allocated to the k'th expenditure function in the State budget;

φ_j = 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 0,65 for cities and rayons.

K_A = 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_j = weight given to population size in the supply of cultural services.