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## **Introduction**

This Paper responds to the problematic areas outlined by the Ministry of Finistry as potential issues to be addressed by the SuFTAR working group. It summarises the initial responses of the DFID specialists based on international experience. It is intended as a basis of discussion with the Working Group and not as definitive proposals of reforms to be adopted in Ukraine.

## **General Comments**

The proposed territorial administrative reform would amalgamate the smaller village and settlement Administrative Territorial Units (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. This makes it possible to consider reassigning to this level some of the competences currently exercised by the rayon.

However, reforms also in progress provide for the election of the heads of rayon administrations and give rayon councils greater control over their executive. This should give rayon administration the proper character of local self government and would justify retention of those competences where it can provide better economies of scale and closer approximation to the optimal catchment areas of service institutions than the town/village level.

The specific issues raised by the Working Group relate to the responsibility for delegated competences. It is appreciated that the budgetary relations established by the Budget Code cover the delegated competences and that own competences are not covered by the equalisation arrangements. This recognises that in the case of the delegated competences 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 discretion. 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 should leave scope for local choice how best to do so. The Budget Code made two fundamental changes which are consistent with the best international practice and are worth preserving in any further reforms. Firstly, 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 which could not be met

within the income realised, thereby discouraging realistic budgeting and maximising 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.

## **Responses to the specific issues raised**

1. *Feasibility (and desirability) of direct calculation of transfers from the state budget to the budget of each administrative-territorial unit (ATU). Ways to minimise the cost of errors in such calculations (the probability of such errors would increase because of the increased number of the ATUs).*

*Response:* International experience suggests that it is highly desirable for the State Budget to relate directly to the budget of every autonomous local government. If an intermediate elected authority is involved in distributing money to lower tier administrations, political bias is unavoidable. There is either a bias in favour of authorities governed by the same political party, or a consensual “equal shares” approach which ignores the purpose of the subsidy. In Romania, for example, the equalisation subsidy to municipalities is allocated by the *judets* administrations which are elected; such is the political manipulation that municipal revenues are even less equal after receipt of this subsidy than before.

The feasibility of direct budget relations with each tier of local government depends on the complexity of the formulae which govern them, and the data which it requires. It is simpler when the criteria relate mainly to independently recorded facts such as the size and structure of the population, more difficult where it is based on information which the local administrations themselves provide. We assume that TAR will simplify the task by a drastic reduction in the number of ATUs to which the State Budget would have to relate.

One interesting system operates in Hungary where a State agency, TAKIS, responsible jointly to the ministries of Finance and the Interior, maintains an office at county level to verify the data on which distribution of subsidies is based. This involves it in relations with all municipalities and scrutiny of their accounts. The practical consequence is that TAKIS provides much technical assistance to the smaller municipalities in accounting and budgeting. In Poland the regional chamber of accounts checks the municipal financial reports and therefore the information which may be used in grant calculation.

2. *Analysis of the current system of service provision by each sector and development of proposals on optimal allocation of expenditure responsibilities between the various tiers of ATU under the reformed administrative arrangement.*

### **A. Health Care**

- *Is it appropriate to create a basic office of outpatient care or family medicine care at each ATU? If this is appropriate, what will be the cost of creating them and providing all the necessary medical equipment?*

*Is it possible to allocate the financing of such institutions as orphanages, medical rehabilitation centres for TB patients and other rehabilitation centres to the state budget?*

- *Is it appropriate to create a first-aid & obstetric or a first-aid centre in each ATU at the basic level and if so, what will be the cost of creating, equipping*

*and maintaining them.*

*Is it appropriate to develop to introduce additional coefficients into the formula for transfer calculation which would account for the age-gender structure of the population, the state of environment in various regions and its affects on the levels of morbidity and sickness rates, or other factors such as cost of service provision in mountain areas.*

**Response:** Assignment of responsibility for health care between levels of government varies between countries. In some countries (eg Hungary, Slovakia) the basic municipal level is responsible for primary health care, while upper tiers (counties, regions etc) manage hospitals and specialised institutions according to their catchment area. Where there are two higher tiers, as in France or Poland, general hospitals would be managed at the district/county level, while regions operate hospitals specialising in specific conditions (e.g. cardiology, oncology).

Where institutions serve a wider catchment area than the highest level of ATU they can either be funded direct by the State Budget or jointly by the ATUs covered.

In some other countries such as Denmark and Sweden responsibility for the entire network both of primary and hospital care is assigned to the upper, county tier of local government. This stems from the belief that health care should be operated as an integrated service. Fragmentation between levels of local government provides incentives for patients to be referred to the primary or hospital level inappropriately, and also puts obstacles in the way of technological innovation in methods of care.

International practice may distribute primary care units, hospitals etc according to some notion of optimal population size, distance etc, but not on the basis of the administrative structure. Stipulating that every ATU should have particular facilities does not, in practice, lead to equity or efficiency. This is because ATUs 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 proliferating the number of ATUs, often in contravention of the criteria.

It is far more efficient and equitable to fund ATU services on the basis of the number of potential clients and leave ATUs discretion as to the optimal distribution of institutions providing health care providers. International experience suggests that reverting to the stipulation of institutional norms would be a retrograde step.

The expenditure needs formula should recognise exogenous differences in demand and cost. Age gender composition and morbidity were identified in previous discussions with LARGIS as major internationally recognised variables. Environmental status was recognised as important but its impact on health care demand should be reflected in relative morbidity. The mountain area cost factor has to be recognised if Ukrainian legislation continues to award higher salaries to staff working in these territories.

## **B. Education**

- *Is it appropriate to create a primary and secondary educational institution in each ATU at the basic level and what will be the cost of creating, equipping and maintaining them (showing averages separately for rayons and cities)?*
- *Is it appropriate to shift the responsibility for financing higher education on to local budgets?*

- *Is it appropriate to include expenditures on extra-curricular education into expenditures taken into account in calculation of transfers?*

## **Response**

There is no uniform practice in the assignment of responsibility for managing schools. It is frequently divided with the municipal level responsible for primary education but upper tiers (sometimes including larger cities) running secondary and vocational schools (the pattern in Hungary, Poland and Slovakia, for example). In countries with large municipalities such as Bulgaria or Sweden, they may manage all schools except the most specialised. In UK, on the contrary, all schools are run by 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 which must be offered to specific age groups. It does not usually govern the distribution of schools which is left to local discretion. In UK, for example, there are wide differences in the number of age groups combined in a single school. We imagine that the sizes of ATU envisaged by TAR would mean that every ATU would already have at least one basic school. Stipulating, however, that every ATU must have primary and secondary schools could lead to inefficiency and inequity, particularly in the case of secondary education.

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.

Higher education is normally funded by state budgets, although local governments may manage some higher education institutions with specific grants. There are several reasons. Benefits are not confined to the local jurisdiction; universities etc may well draw their students from a wide catchment area and their graduates are likely to work all over the country; National funding leaves scope for a high degree of diversity and specialisation.

The current system under the Budget Code provides for local government expenditure on adult, extra curricular education. This is basically in accordance with international practice. However, some modification may become justified to allow for the increasing role of the internet in providing access to this. Options include some access through local libraries, state subsidies or local payment of fees paid by students for internet courses.

## **C. Culture**

- *Is it appropriate to create and maintain a library in each ATU at the basic level? Is it possible to substitute permanent libraries with a travelling library service financed from the rayon level ATU?*
- *Is it appropriate to create and maintain village halls (“clubs”) in each ATU at the basic level?*
- *What is the appropriate tier of government to finance the following institutions: theatres, museums, natural reserves, zoos etc? What are the appropriate sources of financing such institutions (own or delegated revenues of the local budgets?)*

**Response:** Responsibility for culture is not normally exclusive to any level of government. It is usually a permissive competence with intergovernmental finance providing for equal levels of per capita funding, but some times weighted in favour of larger population centres because their cultural institutions tend to serve a wider catchment areas. Major institutions such as theatres and galleries are frequently funded jointly by upper and lower tiers of self government.

Referring specifically to libraries, there are international examples of both upper and lower tier management. However, British experience suggests that administration at county (rayon/oblast) level provides flexibility to combine both fixed and mobile libraries as well as supporting this with better stocks of literature , internet access etc.

The creation and maintenance of village halls would normally be treated as a permissive competence left entirely to the discretion and initiative of individual ATUs or of village or suburban communities within ATUs.

#### **D.Social Protection and Social Care**

- *What is the list of basic services of social protection and social care which should be provided at each level of ATU?*

**Response:** information on this issue will be presented at the next meeting in Kiev.

#### **E .Physical Culture and Sports**

- *What is the minimal level of sports-related services that has to be provided from the budgets of basic level ATU?*

**Response:** Legislation may give local government a power or a duty to provide sporting facilities, but does not normally prescribe any particular type or standard. Intergovernmental finance would assume equal per capita expenditure. Campaigns to improve performance in individual sports might involve matching grants for construction of new facilities such as stadia, running tracks, swimming pools etc, and national sporting associations might offer matching funds for particular types of coaching or competitions.

#### **F. Local government administration**

- *Is it necessary to introduce additional staff numbers into the councils of each levels of the ATU after it assumes the new functions?*
- *What corrections should be introduced into the staff numbers of local government units at each level of the ATU?*

*What should be the sources of financing for the newly created positions in such cases? What is the international experience in this respect?*

**Response:** If a competence is transferred from one level of administration to another the supervisory staff would normally be included.

Normally local governments are free to decide on their staffing structure and numbers and this is not an issue for state policy. Legislation may, however, define the qualifications necessary for staff undertaking particular functions, whether delegated or not. It may also determine salaries and other conditions of service for local government staff, though local governments usually have wide discretion in placing staff posts within

salary scales.

Grants for specific competences would normally include a standard administrative overhead and equalisation formulae would cover a population based expenditure on general administration. There may well be a case for simplifying the spending norms used in Ukraine in this field.

3. *Development of standardised norms (in costs and numbers) for provision of medical services at each level of ATU and by each type of medical care? The same question for education and other types of public services.*

**Response:** the type of standardised cost norms used under the previous Soviet systems are generally regarded as inefficient and unrealistic since they are not related to the revenues available to the budget and do not encourage local governments or service institutions to cut costs. Equalisation formulae used in countries such as Sweden and UK are based on estimates of the revenue accruing to local governments from own or assigned resources plus the amount of additional subsidy which the State Budget can afford. The total is then disaggregated to individual ATU budgets according to relative rather than absolute expenditure needs.

4. *The list of budget services delegated by the state and provided by ATUs of the same level should be the same.*

**Response:** This is a difficult issue on which international practice varies since there are always differences between the size and capacity of individual ATUs. In some states the assignment of competences is uniform, but smaller local governments are encouraged to join together with neighbours to run a specific service beyond their capability. The extreme example is France which has 36,000 communes, of which 29,000 have less than 1,000 people, but their competences are identical. They overcome this by extensive cooperation with neighbours; there are 19,000 intercommunal associations, running schools, collecting refuse or maintaining roads cooperatively. States often provide incentives for cooperation between small municipalities including improved access to investment subsidies. Alternatively small municipalities may contract large companies to manage services like water supplies and sewerage.

The alternative is to assign competences asymmetrically. Britain has a single tier of local government in some urban areas, but a two tier system in other more rural regions. In Hungary the county is responsible for hospitals and secondary schools, but municipalities have the right to manage those institutions located within their boundaries if they wish, a right exercised normally only by large towns.

Assymmetric assignment may be more politically acceptable, particularly to cities which do not want to be restricted to the competences conferred on smaller ATUs. It does make funding arrangements more complex, however, and can lead to ATUs having to fund services which serve a much wider catchment area without adequate compensation. One partial solution practised in Czech Republic and Slovakia (as also in Austria, Germany and Spain) is to weight expenditure need calculations by population size so that larger towns and cities get more money per capita to reflect the services they provide to surrounding areas outside their boundaries. But even if the funding can be resolved, people who depend on a service provided by another local government have no say in how it is managed.

5. *ATUs of the same level should have the same, typical infrastructure.*

**Response:** This was an objective of a centrally planned economy but does not accord

with the principles of decentralisation in a democratic state. The Charter of Local Self Government envisages that local governments will have a combination of legal obligations to provide certain services and freedom to provide others. Legislation may prescribe the minimum level to be attained, particularly where national interests are involved, but local governments should have discretion what infrastructure is needed to meet these requirements and to exceed them if they wish.

It is likely that a certain level of infrastructure will in practice be typical if minimum standards are to be met but this should not result from central planning.

**6.** *.Budget services provided by ATUs of the same level should have the same level of quality (Should there be a cost differential depending on the different circumstances of service provision, in other words, should there be additional criteria in allocating the pull of resources between the various functions?).*

**Response:** In the case of mandatory competences it is normal to prescribe a minimum level of quality, but this does not usually represent an average level since that results from local choices to exceed the minimum. Equalisation funding, however, should enable local governments to meet average standards of quality, compensating for differences in revenue bases, in exogenous demand (e.g through demographic structure) and cost variables (such as population density). An adequate equalisation formula should enable local governments to achieve comparable standards of service at similar costs to local taxpayers. The actual standards provided (over any prescribed minimum) should be a matter of local preference.

**7.** *The size of budget services should be based on social standards.*

**Response:** This will be discussed at the forthcoming meeting since the consultants are not sure how social standards are defined in Ukraine.

**8.** *Analysis of appropriateness of existing social privileges to the various categories of population. Revision of the structure of privileges by categories of population, income groups and types of privileges. Defining appropriate tiers of government to be responsible for financing of the privileges. Feasibility of introducing targeted benefits to replace some of the privileges.*

**Response:** the consultants sympathise with the arguments of the Working Group and agree that targeted benefits are generally more equitable and efficient than privileges. There has been a general move towards income related benefits in our own countries. However, this is a very complex subject which does not relate directly to the financial implications of TAR, and we would prefer to exclude it from our cooperation with the Working Group at this stage.