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Recommendations for Consideration by the Ministry of Finance of Ukraine on Changes to the Intergovernmental Transfer Formula with specific Reference to Residential and Community-based Social Services

A Technical Paper

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Abbreviations

| | |
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| CERC | Community-based Early Rehabilitation Centres |
| CoM | Cabinet of Ministers |
| DFID | Department for International Development |
| FRSSU | Facilitating Reform of Social Services in Ukraine |
| LSS | Law on Social Services |
| MoES | Ministry of Education and Science |
| MoH | Ministry of Health |
| MoLSP | Ministry of Labour and Social Policy |
| MinFin | Ministry of Finance |
| SBL | State Budget Law |

Executive Summary

This technical paper, prepared by the DFID project *Facilitating Reform of Social Services in Ukraine [FRSSU]*, looks at the financial implications of the current arrangements under the Budget Code, and the manner in which successive amendments introduced under annual State Budget Laws, have generated and reinforced biases towards residential social service institutions and impede the development of community-based alternatives that are responsive to demand. The paper argues – with supporting evidence – that the bias in the expenditure needs formula has profound implications for:

- The implementation of the Law on Social Services [LSS]
- The Future design and delivery of cost-effective and efficient community-based social services

The paper demonstrates that a simpler expression of expenditure needs in the intergovernmental transfer formula for social services –which is based on relative demand rather than the number of residents/clients is required for residential and community-based social services that fall under the legislative and regulatory mandates of the Ministry of Labour and Social Policy [MoLSP], the Ministry of Education and Science [MoES], the Ministry of Health [MoH], and the Ministry of Family, Youth and Sport [MoFYS].

The paper also demonstrates that harmonising the transfer formula across all types of social services that come under the legislative and regulatory mandates of the MoLSP, the MoES, the MoH, and the MoFYS - and which fall under the delegated competencies of various tiers of local government – would generate economies of scale, improve efficiency and enable government to respond to demand led need on a more rational basis.

The findings and recommendations in this technical paper suggest that policy makers need to plan for the future demand for social services, and that the current system of equalisation transfers and the system used to assess expenditure needs in social services is in urgent need of reform. Any changes in the budget formula for social services need to:

- Take account of the need to use demand related information based on the demographic profile and structural characteristics of the population of each local government area;
- Address the systemic weaknesses and inadequacies for estimating the financial needs for social services by developing a single equation for the overall expenditure need for social services of local governments relative to the average national need.

Recommendations for Consideration by the Ministry of Finance of Ukraine on Changes to the Intergovernmental Transfer Formula with specific Reference to Residential and Community-based Social Services

A Technical Paper

Introduction:

1. This technical paper has been prepared for the Ministry of Finance [MinFin] with:

- a specific focus on options for the future development of funding social services, and
- the financial regulation of both residential and community-based social services within the framework of the Budget Code.

In particular the paper looks at the financial implications of the current arrangements under the Budget Code and the manner in which successive amendments, introduced under annual State Budget Laws [SBL], has generated and reinforced biases towards residential services at the expense of community-based social services that respond to demand. The bias towards residential services has profound implications for the:

- implementation of the Law on Social Services [LSS]; and
- for the future design and delivery of cost-effective and efficient community-based social services.

The technical paper **builds** and **elaborates** on *The Preliminary Assessment of Public Expenditure Management for the Reform of Social Services* prepared by the DFID Project on Facilitating Reform of Social Services in Ukraine [FRSSU].

2. The technical paper is divided into two parts:

Part 1 focuses - with supporting evidence – on recommendations for:

- A simpler expression of expenditure needs in the intergovernmental transfer formula for social services, based on relative demand rather than the number of residents/clients;

Part 2 focuses – with supporting evidence – on recommendations for:

- Harmonising the transfer formula across social services that fall under the legislative and administrative remits of the Ministry of Labour and Social Policy [MoLSP], the Ministry of Health [MoH], and the Ministry of Education and

Science, and which fall under the *delegated* competencies of various tiers of local government [i.e. Oblasts, Municipalities, and Rayons]

3. It is anticipated that the pragmatic recommendations set forth in Parts 1 and 2 of this technical paper will be considered by the Ministry of Finance [MinFin] in the context of future changes that can be introduced in the context of future annual State Budget Laws.

4. The recommendations take full account of the fact that the Budget Code *delegates* competences for public services – such as social services – that absorb significant levels local government expenditure. However, in keeping with need to ensure that the changes can be implemented, the recommendations reinforce the budget principles set forth in Article 7 of the Budget Code, and do not involve changes to Articles 88 to 91 of the Budget Code – which enshrine the principles of the distribution and accountability for functions that are *delegated* to local governments.

Part 1: The Case for a Simpler Transfer Formula for Social Services

5. The problems confronting social services require attention being given to the way financial resources are allocated by government. The Budget Code performs a significant role in the way resources are planned and allocated for the performance of core functions at central and local tiers of government – including functions for the provision of social services. The budget system introduced under the framework of the Budget Code certainly has a number of strengths – including the use of objective criteria for assessing and determining *expenditure needs*.

However, from the perspective of local tiers of government the most important fiscal decisions affecting the amount of budgetary resources at their disposal are the *expenditure norms* used to determine subventions from the State Budget. These *expenditure norms* are expected to meet several criteria:

- Common applicability across all tiers of local government;
- Establish a framework for objective measurement;
- Reflect, and take account of, observable differences in the level of local government expenditures; and
- Control on demand for public services should rest on demand/need for public services rather the way local tiers of government may choose to cater to demand/need.

6. Currently the primary methodology for equalisation transfers is based on the following mathematical structure:

- V = Volume of total local government spending in the State Budget;
- V_i = Volume of estimated expenditure needs in the i 'th Oblast (“ i ” is used to refer to an entire Oblast, while “ j ” is used to refer to the oblast level administration and cities and rayons within an oblast).

- P_i = Population of a given Oblast
- P_u = Population of Ukraine
- K_i = A co-efficient measuring the extent to which health needs in a given Oblast differ from the national average need.
- S_i = The weighted number of students in the i 'th Oblast
- S_u = The weighted number of students in Ukraine
- R_i = The number of social protection recipients in a given Oblast
- R_u = The number of social protection recipients in Ukraine
- φ_k = The share of total expenditure "V" allocated to the k 'th expenditure function.

7. The formula determines the pattern of local government spending, given that that each Oblast is a sum of its local government parts – i.e. the Oblast level administration itself plus all the cities and rayons within the territorial boundaries of the Oblast. To determine per capita expenditure needs in the i 'th Oblast the composition of expenditure is primarily defined by five broad expenditure functions which are denoted as follows: state administration – V_a ; health - V_h , education - V_e , Culture and Sport - V_{cs} , and social protection – V_s . The expenditure norms are then applied to allocate these functional amounts among oblasts according to the formula. The expenditure formula is represented in the following expression:

$$V_i/P_i = V/P_u (\varphi_a + \varphi_h K_i + \varphi_e (S_i/P_i \div S_u/P_u) + \varphi_{cs} + \varphi_s (R_i/P_i \div R_u/P_u))$$

8. The formula states that per capita Oblast spending for transfer related expenditures will be equal to the average per capita spending in all Oblasts [V/P_u], and modified by the degree to which a particular Oblast's expenditure needs – in different functional areas – departs from the national average. In other words, the sum of terms in the large brackets of the expression provide an objective measure of the extent to which the expenditure needs of a particular oblast depart from average need, based on an account of economic, demographic and environmental factors in the Oblast. However, the Budget Code also deals with the calculation of expenditure needs of Oblast level administrations', cities and rayons. Thus, the formula disaggregates the constituent expenditure needs [based on the core expenditure functions of state administration, health, education, culture and sports, and social services] of the different local government tiers within an Oblast, based on weighted data [e.g.; S_i for education, and R_i for social protection], and on the share of Oblast spending on particular functions.

9. The purpose of calculating needs according to expenditure norms is to determine the transfer amounts [from central government] that will – at least in theory – ensure that every local budget has sufficient resources to achieve the expenditure levels envisaged by the norms. The formula used for the calculation of equalisation transfers is based on the equalisation transfers [T_i] which is defined as the difference between estimated delegated expenditures and forecasted delegated revenues [D_i]. The difference is then multiplied by the equalisation coefficient [α_i]. The formula was initially based on Cabinet of Ministers

[CoM] resolution 1195¹. The equalisation transfer formula is represented in the following expression:

$T_i = \alpha_i (\text{Exp} - \text{Rev})$, where:

T = Equalisation Transfer

Exp = Estimated expenditure needs

Rev = Forecasted revenue capacity

α = Coefficient of equalisation

10. The *coefficient of equalisation* is used to determine the amount of equalisation grant and transfers to the State budget of Ukraine². According to the Budget Code [Art. 98], the design of formula for equalisation transfers has to be defined by resolutions of the CoM, and these resolutions are expected to be based on the following parameters:

- The financial normative and corresponding corrective coefficients,
- The number of residents or number of recipients of social services,
- The index of relative fiscal capacity and forecasted delegated revenues,
- The coefficient of equalisation.

11. However, the expenditure side of the formula has been elaborated and amended for social services institutions - that fall under the legislative mandates of the MoLSP, the MoES and the MoH - by a variety of CoM resolutions³. These resolutions have - over time – resulted in further separate calculations for different types of social services. Thus the ways in which residential institutions [mainly Baby Homes] under the legislative mandate of the MoH are funded within the formula differ significantly from those residential institutions the legislative mandates of the MoLSP [mainly residential services for the elderly and the disabled and territorial centres]; and the MoES [mainly residential services provided in special schools]. The cumulative effects of these amendments now mean that expenditures for residential institutions that fall under the legislative mandate

¹ CoM Resolution 1195 on The Approval of the Formula for the Distribution of Inter-governmental Transfers between the State Budget and Local Budgets.

² The coefficient of equalisation is the policy variable that defines the level of equalisation. Thus when the equalisation co-efficient is equal to 1 the transfer from or, to the central budget, is to cover 100 per cent of the either positive or negative gap between expenditure needs and revenue capacity. Similarly, when the equalisation coefficient equals 0.9 – the transfer is to cover 90 per cent of the gap.

³ See: CoM resolutions 1569-2001-n (22 November 2001); 1746-2001-n (27 December 2001); 1382-2002-n (14 September 2002); 1426-2003-n (9 September 2003); 1761-2003-n (12 November 2003); 1203-2004-n (14 September 2004); 1652-2004-n (13 December 2004); 1787-2004-n (31 December 2004) and 196-2005-n (23 March 2005).

of the MoH is based on the population profile of an administrative unit, while institutions that fall under the MoLSP and MoES are based on the number of actual residents in institutions [or in the case of territorial centres – the number of users].

12. Moreover and crucially, some services – such as community-based early rehabilitation centres [CERCs] – are entirely overlooked in the formulae, resulting in ad hoc funding arrangements being made by Oblasts, cities and rayons; and community-based social services for children, the elderly and the disabled are also overlooked and assigned to the financial competencies of municipalities and rayons. This is a de facto assignment of some community based services (such as CERCs) to the financial competencies of local governments, although, according the BC, social care is a “delegated” function.

Theory and Practice: Discrepancies

13. The purpose of calculating needs according to expenditure norms is to determine the transfer amounts [from central government] that will ensure that every local government budget has sufficient resources to realise the expenditure levels envisaged by the expenditure norms. In theory the budget system – including the system for the allocation of equalisation transfers - provides a degree of freedom for a particular tier of local government to decide whether to spend a little more of its budget on delegated function ‘y’ as opposed to ‘x’ [e.g., more on social services than culture]. However, because of the limited scope open to local tiers of government to raise marginal revenues there is a discrepancy between the theory and practice, which means that most important features in the budget system are:

- The total amount of spending set forth in the State Budget;
- Spending priorities, which are measured by expenditure shares, which have lead to the growth in un-funded mandates due to the emphasis given to past expenditure trends rather than demographic demands, and the evolution of legislative directions such as the Law on Social Service

Technical Observations:

14. The discrepancy between theory and practice has a number of direct consequences for social services:

- It reinforces the use of residential institutions, because the number of residents in institutions is used as the basis for calculating intergovernmental budgetary transfers for residential institutions that fall under MoLSP and MoES;
- It brings about and reinforces un-funded mandates which are generated by separate line Ministries. The un-funded mandates arise because – in the context of limited marginal revenues that can be generated by local tiers of government – municipalities, cities and rayons have limited means to provide community-based alternatives to residential institutions

- The development of norms and standards for social services - by different line Ministries - creates dissonance between expenditure obligations and a local budgets' revenue base. This is to the degree that, in many cases, the revenue base turns out to be insufficient to fully carry out expenditure assignments specified in norms, standards, and regulations. This, in turn, creates an imbalance in the distribution of responsibilities and accountabilities between centralised and decentralised functions, and reduces opportunities for diversifying service provision to meet demand.

Recommendations:

15. In view of the identified discrepancies and technical observations, the FRSSU Project puts forward the following measures for consideration:

- Given that expenditure norms for social services are integral to the equalisation transfer formula - and in view of the fact that social services fall across the legislative mandates of MoLSP, MoES, MoH and MoFYS – a new approach to the formula for social; services is required. This requires the use of **demand related information** based the demographic profile and structural characteristics of the population of each local government area which would be used to compile the basic determinants of expenditure need for every functional category covered by the formula. The application of demand related information would ensure that an objective measurement of the actual, or potential, users of each type of service [including residential and community-based social services] is used in the formula for the country as whole and each local government area. This would remove the variation that currently exist where equalisation transfers use different *expenditure norms* for similar types of social services that are provided under the discrete legislative mandates of the MoLSP, the MoES and the MoH.
- For assessing social services, the formula would be captured by referring to the population groups for whom the government have a constitutional and legislative duty to provide residential and community-based social services – including children, the disabled [i.e., physical and mental disabilities] and chronically ill [i.e., HIV/AIDS, TB], the elderly [aged 65 years and above], homeless people, and ex-offenders. Per capita income, levels of unemployment and the number of people in receipt of old age and disability pensions would be key variables in determining the assessment of expenditure needs for social services.
- For assessing administrative costs, the population would be weighted, as currently accounted for in the formula, by a set of coefficients that can be used to reflect economies of scale.

16. Establishing demand related information should not be too difficult, given that all Oblasts, Rayon, cities and municipalities have access to the demographic data which is relevant to social services. The table below provides an overview of the demographic data required for demand related information:

Table 1: Demographic Data Requirements:

| Data Needed | Source | Updating and Comments |
|--|----------------------------------|---|
| 1. Total Population of local government unit | Population Census | Should be adjusted by information from Annual Household Budget Survey, or by other statistics on all territorial levels, such as natural change of population by the Statistical Committee. |
| 2. Population of local government unit of Working Age (18 – 60) | Population Census | Adjusted by Information from Annual Household Budget Survey and other statistical information |
| 3. Number of school age children enrolled in schools in local government unit | Population Census | The original decennial census data could be adjusted annually using Statistical Committee data and Ministry of Education and Science data on school enrolment |
| 4. Percent of households in local government unit living in flats and private homes | Population Census | Adjusted by Statistical for annual information provided by local self-government units. Adjusted by Information from Annual Household Budget |
| 5. Per capita household income | Population Census | Survey and other Statistical Committee data. |
| 6. Percent of household expenditures used for food among population of local government unit | Annual Household Budget Survey | Data at present published only on national level. Updated by Information from Annual Household Budget Survey. |
| 7. Annual average number of Unemployed residing in local government unit | Employment Service local offices | Updated annually from local office data. |
| 8. Annual average number of households in receipt of cash benefit programmes | MoLSP local offices | Updated annually from local office data |
| 9. Number of recipients of old age and invalid pensions living within local government units | Pension and Disability Fund | Updated from Pension Fund annual data |

17. Calculating the expenditure needs for social services would draw on a significant part of the methodology used in the current formula, and would entail using the population profile as the expenditure norm, rather than the number of clients in residential institutions. However, these recommendations will need to be expressed in a single equation that represents the overall expenditure needs of a local government relative to the national average need. It is to this feature that **Part 2** of this technical paper now turns.

Part 2: The Case for a Single Equation for Determining Overall Expenditure Needs of Local Government Relative to National Average Needs for Social Services

18. This technical paper has argued that the existing system of fiscal equalisation for social services is not fully consistent with the principles of Ukrainian budget system as defined by the Budget Code. This mismatch between declared principles and actual practice has a deleterious effect on policy development for social services. In specific terms, features introduced under various annual SBLs, into the methodology for defining the equalisation transfers for social services, has lead to:

- Insufficient and inefficient provision of social services in local governments;
- Redundant provision in residential services;
- Weak incentives for the provision of alternative community based social services in keeping with the policy goals of the LSS.

18. These features in social service provision are reinforced by systemic weaknesses in the current financial system of local governments in Ukraine which, in turn, adversely affect the public expenditure policy, especially for social services:

- Local governments have limited avenues for generating marginal revenues. Although local taxes can be altered by local governments, existing local taxes and fees usually contribute about 2 per cent to the revenue of local budgets.
- Local governments have substantial expenditure obligations. Namely, local governments are expected to finance the most expensive public functions i.e. health care, education and social services.
- As a result of these features, there is a significant gap between the capacity of local governments to raise revenues and their ability to finance their public obligations.

19. Given limitations in the ability of local governments to raise revenues from local sources, they are highly reliant on the system for equalisation transfers, and have become vulnerable to biases and errors that have emerged despite the following core principles embodied in the Budget Code:

- The principle of **balanced budgets** [Art. 7 of the Budget Code]
- The principle of **equity and impartiality** [Art. 7 of the Budget Code]
- The principle of **independence** [Art. 7 of the Budget Code]
- The principle of **effectiveness** [Art. 7 Budget Code]

20. These principles are designed to ensure that Central Government:

- Delegates expenditure responsibilities only with corresponding financial support, and the distribution of the financial resources should be based on transparent and objective criteria,
- Local governments have the authority to spend their revenues as they want and to take account in the efficiency of their spending.

21. The system of intergovernmental financial relations is supposed to be compatible with these principles, and the approach for defining equalisation transfers [based on the formula] was expected to ensure that these principles were implemented in practice.

Given that central government *delegates* social service expenditures to local government – and at the same time, strives to assure some minimum quality and equal access to the services - central government provides financial resources to equalise [via estimated expenditure need] the capacity of local governments in providing “delegated” expenditures. The estimated expenditure need is defined as a product of the financial normative. However, for social services the formula – as outlined above – uses (a) the demographic profile of a local government to determine expenditures for residential services that fall under the legislative mandate of the MoH, but uses (b) the residents and the corrective coefficients for residential institutions under the legislative mandate of the MoLSP and MoES. In general terms, the formula for assessing of expenditure needs is reflected in the following expression:

$Exp_i = H * N * K$, where:

H – The financial normative

N – The population or the number of clients

K – The corrective coefficient

22. The table below summarises the technical detail of the variables used for social services that fall under the legislative mandates of the MoH, the MoEs and the MoLSP.

Table 2: Variables used for Obtaining Estimates of the Financial Needs for Social Services

| | Financial normative | Calculation of Structural Characteristics | Corrective coefficients | Comments |
|--|--|--|---|-----------------|
| Health care | | | | |
| Health for oblast | Financial normative depends on the: - total expenditure on health care - total population - part of oblasts budgets on health care (according to Art. 14 BC, equal 0.354) - coefficient of ratio of wage in expenditure on health care (equal 0.951) | Population | Coefficient of age structure Coefficient of relative cost for health care due to age and gender (defined by the World Health Organization) | |
| Health for cities and rayons | * The Financial normative depends on the - total expenditure on health care - adjusted population (minus population served by national and ministerial institutions) - part of rayon/cities budgets on health care [according to Art. 14 of the Budget Code, equal 0.646) - coefficient of ratio of wage in expenditure on health care (1.027) | Adjusted population (minus the population served by national and ministerial institutions) | Coefficient of age structure Coefficient of relative cost for health care due to age and gender (defined by WHO) Coefficient of differentiation of cost per client between rayons and cities (0.934; 1.065) | |
| Education for oblast | | | | |
| - Residential institutions for children without parental care. | * Unified financial normative for education per | Number of pupils. | Corrective coefficient for this type of institution (12.02). | |

| | | | | |
|---|--|-------------------|--|---|
| | pupil. * The normative depends on available financial resources. * The Methodology is regulated by separate legislation. | | | |
| - Residential institutions for disabled children. | Same as above | Number of pupils. | Corrective coefficient for this type of institution (6.6). | |
| - Specialised schools for disabled children. | Same as above | Number of pupils. | Corrective coefficient for this type of institution (2.5). | |
| Education for rayons and cities | | | | There is a special coefficient for general schools. This coefficient depends on the number of pupils in a class. The coefficient is higher for classes with fewer pupils. Thus this coefficient encourages classes with fewer pupils. |
| - Specialised schools for disabled children. | Same as above | Number of pupils. | Corrective coefficient for this type of institution (2.5). | |
| Education for Kyiv/Sevastopol | | | | The number of children in orphanages of a family type was in formula but only for Kyiv/Sevastopol. However, this variable was eliminated from the formula by recent amendments to the formula in Sept. 2005. |
| - Specialised schools for disabled children. | Same as above | Number of pupils. | Corrective coefficient for this type of institution (2.5). | |

| Social Services | | | | |
|---|--|---|---|--|
| - Residential institutions for elderly, disabled, disabled children | Financial normative per client in a specific institution. | Number of clients at January 1. | No corrective coefficients. | |
| - Shelters for minors | Financial normative per client in a specific institution. | Number of places at the end of the year | No corrective coefficients. | |
| - Territorial centres | Financial normative per client for residential care. Financial normative per client for domiciliary care. | Number of residential clients at January 1. Number of domiciliary clients in urban area at the January 1. Number of domiciliary clients in rural area at January 1. | Corrective coefficient for rural domiciliary clients (for year 2006 – 1.4). | |

Weaknesses and Inadequacies in the Methodology for Estimating the Financial Needs for Social Service:

23. The number of clients within institutions that provide social services [which are mainly residential] is an ineffective measure for assessing the demand for social services. This is because the parameter does not correctly reflect the demand for social services within local governments, given that the number clients within residential institutions represents the existing supply of these services, rather than the demand or need for social services among the population. Although the social services that fall under the legislative mandates of the MoH, MoLSP and the MoES may differ in their emphasis, it is notable that the client groups they serve, and the types of presented demands they deal with, are similar. Indeed, while these public functions have similar features concerning the content and focus of the services they provide, the current formula applies different approaches for measuring demand for these services; and uses different normative measures for similar services based on the department that is deemed to have the legislative mandate for delivering the service. This **disintegrated** approach to measuring demand for **interrelated** and **similar** services has a number of perverse effects and consequences:

- The number of registered clients within residential institutions is not an adequate mirror of demand for social services in a local government area;
- The use of different variables for similar services creates opportunities for manipulation of the system⁴;

⁴ The proclivity for manipulation is enhanced by the fact that if 70 per cent of residents in a residential institution originate from the locality of city or rayon administration, then a greater proportion of the funding for such residential institutions will fall under the

- The dominant position of residential institutions in the formula reinforces the use of residential institutions for providing social services across the board;
- The manner in which the formula disregards community-based services discourages local initiatives to provide alternative cost-effective community-based social services⁵.

24. These observations are supported by evidence assembled, by the DFID Project on FRSSU, in the three case studies presented below:

Case Study 1: Territorial Centres and Expanding the Client Group to Children

Territorial centres are formally responsible for providing residential and domiciliary services to elderly and disabled people.

A territorial centre, in one local government area, which provides services for elderly and disabled people, also provides services for the early rehabilitation of disabled children, even though the budget formula does not formally allocate equalisation transfers for territorial centres to provide early rehabilitation to children. This situation arose because several years ago, central government encouraged local governments to create ‘centres for early rehabilitation’. At the time, central government indicated that it would arrange adequate financial support for maintenance of these newly created centres for early rehabilitation. Unfortunately, financial support was not arranged and the centres [which exist in most local government areas] appear to have become “unfunded mandates” – given that they are not included in the formula for equalisation transfers and are not formally attributed to the authority of any tier of government.

The local government administration decided to “shelter” this neglected institution under the resource framework of the territorial centre, trying to maintain these financially neglected institutions by attaching them to existing structures, to save administrative and utility costs.

Case 2: Territorial Centres, Mission Creep and Manipulating Defects in the Budget Formula

A local government planned to extend its network of territorial centres, by opening new centres that would offer medical services to the elderly. This new ‘medical service’ included such specialised services in cardio-vascular check-ups, oncology, and respite care. The new centres, in fact, basically duplicate some of the services provided by hospitals and medical clinics. The financial rationale behind this “innovation” was based on the fact that the health care portion of the equalisation transfer is calculated on the basis of population rather than the number of clients. Therefore, closing or opening a

budgets of these particular administrative units. This provision within the rules means that local administrations have vested interest in ensuring that the 70 per cent limit and the absolute level of finance are not breached.

⁵ Technically speaking and in the absence of an assessment of unit costs for residential and community-based services it is difficult to make informed judgments on the extent to which community-based services can be deemed cost effective. The DFID FRSSU Project is currently developing the framework for work in this particular field with the World Bank. It is anticipated the World Bank will fund this work through the social services component of the USIF loan.

health care institution does not affect the size of equalisation transfer – indeed, if a local government wanted to open a new hospital, it would have to find the additional money from local sources. However, because the social services part of the equalisation transfer is calculated on the basis of the number of clients in existing institutions, an increase in the network of territorial centres automatically results in an increase in the amount of the equalisation transfer. This manipulation allows local governments to finance a significant part of additional health care expenditures via the social services part of the equalisation transfer.

Case 3: Overcoming Disincentives towards the Expansion of Community-Based Social Services: The Example of Foster Care

In a local government area, last year social workers criticised the head of a local administration because of a reluctance to promote local initiatives that would, in keeping with government policy, provide alternatives to residential services to children. In this instance, the head of the local administration stated that that support of foster families and family type orphanages was a “real additional headache” for the local administration. This attitude, on the part of the local official, can be seen as rational - from an economic point of view – given that foster families and family type orphanages are not recognised in the equalisation formula and are expected to be financed from local budgets. Thus alternatives to residential care – which may be more effective and yield better outcomes for children and other client groups - create additional fiscal pressure on local budgets.

Furthermore, given that the majority of local governments do not have significant marginal revenue sources other than equalisation transfers and “delegated taxes” such local initiatives cannot be afforded under current budgetary arrangements. This type of problem is compounded by the current equalisation formula, which allocates finances for children in residential institutions but does not do so for children in community based institutions/alternatives. Therefore, channelling children from residential institutions to community based institutions [e.g. foster families or orphanages of family type] leads not only to a decrease in revenues for the local budget [via the loss of equalisation transfers] but also to an increase in local expenditures. Thus the budget formula, as currently constructed and applied, mitigates against policy reforms that will support the diversification of social services provision and provide incentives for the emergence of a *Balance in Service Provision* between residential and community-based services.

However This year foster families and family type orphanages are financed via targeted subvention. Therefore, foster families and family type orphanages are now not an “additional headache”.

Thus alternatives to residential care – which may be more effective and yield better outcomes for children and other client groups - create additional fiscal pressure on local budgets.“ Thus Minfin finances “delegated” functions within social care - specifically “foster families and family type orphanages” via targeted subventions. And it is a consideration that this temporary solution will become permanent practice.

Technical Observations:

25. The following technical observations can, on the basis of the evidence delineated above, be made:

- Although the Budget Code clearly specifies the principles on which the budget system should operate, the existing practices for fiscal equalisation do not actually fit with these principles. Moreover, the mismatch between principles and practice has significant implications for the development and implementation of policy in social services.
- The principle of **balanced budgets** means that delegated expenditures should be supported by adequate financial resources. This principle is currently violated since social services provision is not based on **demand based information**. As a result, the financial requirements to meet demand are also not assessed correctly. Local budgets are, therefore, confronted with a shortage of resources that would enable them to provide minimum levels of financing for social services; and often leads to insufficient and inefficient provision of social services.
- The principle of **equity and impartiality** means that the distribution of financial resources for delegated expenditures should be based on transparent and objective criteria. This principle is also violated. The existing system of fiscal equalisation is vulnerable to manipulation. Although local government officials are indeed being imaginative in their actions to overcome weaknesses and omissions in the budget formula, the practices they engage in can also encourage ‘rent-seeking’ and a heightened risk of corruption and weak accountability in social services delivery.
- The principle of **independence** is not implemented properly. Although local government does not have any formal restrictions on their fiscal sovereignty, the equalisation system implicitly signals how budget resources for social services should be spent. In other words, the current system for equalisation transfers for social services is not neutral on the spending decisions of local governments, because the variables that are used to estimate the expenditure needs for social services clearly reinforce the use of residential institutions.
- The principle of **effectiveness** remains declarative in nature. The formula for equalisation transfer recognises only specific institutions [mainly residential]. Therefore, any local initiatives to provide social services in more diverse, efficient or effective ways that would lead better outcomes and value for money, and a contraction in the absolute number of residential institutions are penalised by the system of fiscal equalisation.

Recommendations:

26. In view of the weaknesses and inadequacies outlined above, coupled with the case studies and the technical observations, the following recommendations are advanced for consideration:

- In addition to shifting the budget formula for social services to **demand related information** [as outlined in Part 1], the second set of recommendations focus on developing a single equation for the overall expenditure needs for social services of local government relative to the national average need. This single equation would incorporate residential and community-based services and eliminate the practice of using different estimations of expenditure needs for social services that fall under the legislative mandates of the MoLSP, the MoES and the MoFYS.
- Establish a framework for determining Local Social Service Needs. This refers to the demand for social services in a specific local government unit, relative to demands in other local government units within the country. Thus, the number of clients and recipients of social services [residential and community-based] in each local government unit would need to be measured as a share of the national total. The practical and simplest way to establish relative local social service needs would be to identify the four or five most important types of social services. The share of each local government unit in "total social services" could be the weighted sum of its share of total expenditures - based on unit costs - for each category of social services, with the weights being the share of each of the selected categories of spending in the nationwide total spending for all categories included in a new equalisation formula for social services. This weighting would then give values for each participating local government that sum to 1. These coefficients would then be used to adjust the local government's share of the total population of participating local governments – using weights that take into account its relative social service needs.
- The formula should calculate, for each local government, the share of the total pool of money that has been set aside for social services. This will need to be done in a manner that takes account of the size of local government units within an Oblast [i.e.; the share of the total population of local government units within an Oblast], their relative fiscal capacity, and their relative social service needs. Thus the value of R_i , as applied in the existing formula, would be amended by removing the number of residents in residential services as a key variable for determining equalisation transfers, and replaced with a new value that reflects the demand for both residential and community-based social services. One option that the policy forums will need to consider is whether a new value (S_i) is developed specifically for social services. The new value of (S_i) would be the pool of money to be allocated to each local government where (i) would be the product of three factors:

$$S_i = (P_i).(F_i).(N_i)^6$$

⁶ Where P_i is the share of the total population of local government units, F_i is its share of total fiscal capacity of a local government unit, and N_i is the share of total social service needs of a local government unit against the national average.

- 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 social services, if a local government provides more weighted social services to elderly, children and disabled people 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 of social services, the focus is on measuring relative expenditure needs rather than on financing the existing network of residential institutions.
- 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, given that the data needed to implement the formula's expenditure side all rest on the verifiable demographic profile of a local government, the formula could be rolled out across all administrative territorial units.

Simplifying and clarifying the presentation of the expenditure side of the current formula is an important aspect of developing a simpler formula for social services.

And,

Where $\sum P_i = 1$; $\sum F_i = 1$; and $\sum N_i = 1$ ($i = 1, 2, \dots, n$ where there are n local government units participating in revenue sharing within Ukraine).