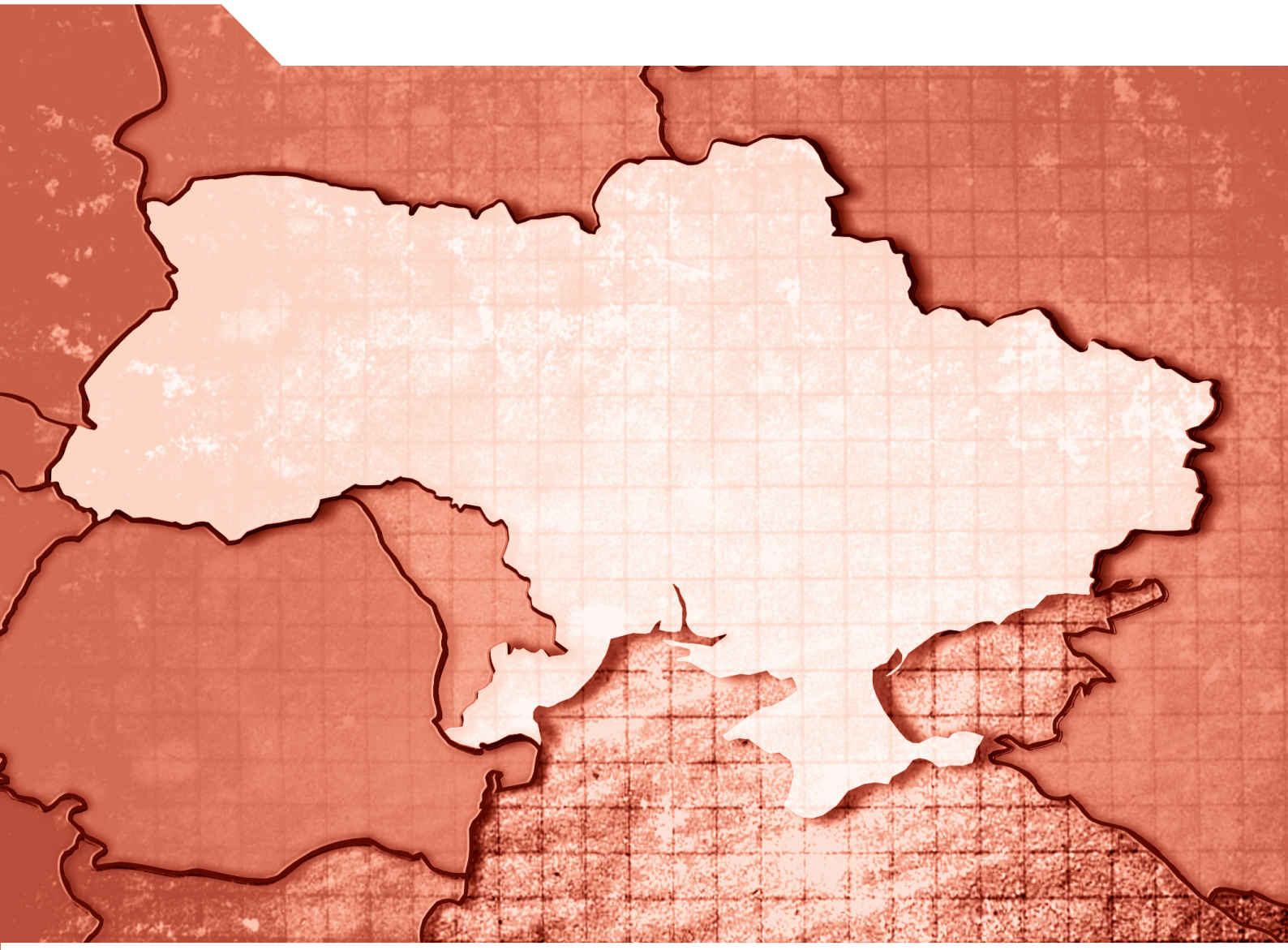
OECD Territorial Reviews

UKRAINE



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OECD Territorial Reviews: Ukraine 2013

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Foreword

At the beginning of this new millennium, regional economies are confronting momentous changes. The globalisation of trade and economic activity is increasingly testing their ability to adapt and maintain their competitive edge. There is a tendency for income and performance gaps to widen between and within regions, and the cost of maintaining social cohesion is increasing. Rapid technological change and greater use of knowledge are offering new opportunities for local and regional development but demand further investment from enterprises, reorganisation of labour and production, more advanced skills and environmental improvements.

Amid this change and turbulence, regions continue to follow very different paths. Some regions are doing well and are driving growth. Others are less successful at capturing trade and additional economic activities. Many territories with poor links to the sources of prosperity, afflicted by migration and ageing, and lagging behind with respect to infrastructure and private investment, are finding it difficult to keep up with the general trend.

At the same time, central governments are no longer the sole provider of territorial policy. The vertical distribution of power between the different tiers of government needs to be reassessed, as well as the decentralisation of fiscal resources in order to better respond to the expectations of citizens and improve policy efficiency. Public authorities need to weigh up current challenges, evaluate the strategies pursued in recent years, and define new options.

Responding to a need to study and spread innovative territorial development strategies and governance in a more systematic way, in 1999 the OECD created the Territorial Development Policy Committee (TDPC) as a unique forum for international exchange and debate. The TDPC has developed a number of activities, including a series of national Territorial Reviews. These studies follow a standard methodology and a common conceptual framework, allowing countries to share their experiences and disseminate information on good practices.

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Acronyms and abbreviations

AUC	Association of Ukrainian Cities
CAGR	Compound annual growth rate
CIS	Commonwealth of Independent States
CMU	Cabinet ministers of Ukraine
CPI	Consumer price index
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
EPZ	Export processing zone
EU	European Union
Euro 2012	UEFA European Football Championship
FDI	Foreign direct investment
FIRE	Finance, insurance and real estate
FTZ	Free trade zone
GDP	Gross domestic product
GRP	Gross regional product
HCs	Housing co-operatives
HOAs	Homeowners associations
ICPS	International Centre for Policy Studies
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IT	Information technology
KS	Norwegian Association of Local and Regional Authorities
MME	Municipal management enterprise
MOU	Medical-obstetrical unit
NARDA	National Association of Regional Development Agencies
NERC	National Electricity Regulatory Commission
NIBR	Norwegian Institute for Urban and Regional Research
NUTS	Nomenclature of territorial units for statistics
ODA	Official development assistance

PIT	Personal income tax
PME	Private management enterprise
PPP	Public-private partnership
RDS	Regional Development Strategies
SFRD	State Fund for Regional Development
RSEDS	Socio-economic Development Strategies
SEZ	Special economic zone
SZ	Specialised zone
SME	Small and medium enterprises
SNG	Sub-national government
SOE	State-owned enterprises
SSRD	State Strategy for Regional Development
SWOT	Strengths, weaknesses, opportunities, trends
TL2	Territorial level 2
TPD	Territories of priority development
UAH	Ukrainian hryvnia (national currency)
UEFA	Union of European Football Associations
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
VAT	Value-added tax
WDI	World Development Indicators
WEF	World Economic Forum
WHO	World Health Organization
WTO	World Trade Organization

Executive summary

Key facts and policy issues

Key facts

- Ukraine's regions continue to struggle economically, having failed to regain the growth momentum they enjoyed in the years before the crisis hit in 2008-09. Export demand remains muted, and domestic demand growth is constrained by slow credit growth, lack of fiscal space and an institutional environment that is not conducive to investment.
- Inter-regional disparities are large by OECD standards and they continue to increase. However, they are not out of line with those of Ukraine's peers. The increase in disparities has been driven almost entirely by the city of Kyiv, with most other regions' contributions to growth being roughly in line with their size.
- There is evidence of significant disparities in access to basic services, especially education. Moreover, the human development index deteriorated in most Ukrainian regions during 2000-10, and only 12% of the population lived in regions where it improved.
- Productivity performance in much of Ukraine has been relatively poor. The industrial capital stock is limited and deteriorating. The large informal labour market makes it difficult to assess labour-market trends with precision but the link between education and productivity appears to be weak.

Key policy issues

- Ukraine is a highly centralised polity. There is wide agreement on the need for greater decentralisation, but sub-national governments often face capacity challenges and they are extremely fragmented at lower levels, making it impossible to realise economies of scale or even to perform some basic service-provision functions effectively.
- Sub-national governments tend to depend heavily on central transfers, the allocation of which they find at times to be both unpredictable and less than transparent. Reforms to sub-national public finances have been in preparation for some time and need to be taken forward. Lack of resources combined with weak arrangements for the assessment of service quality mean that access to good-quality public services remains a challenge for many.
- Regional development policy is undergoing a major legislative and institutional overhaul, after a decade of incomplete reforms. This presents both a challenge and an opportunity: the governance of regional development policy needs to be strengthened, the range of instruments used needs to be broadened and clarified, and the mechanisms for performance monitoring and evaluation need to be enhanced.

Key recommendations

- **Revise the formulae for the allocation of transfers** to sub-national tiers of government in order to make it simpler and less discretionary, by reducing the number of indicators used in the formula. Resources allocated for the provision of

local public services should be based on the needs of the population in each area, not input indicators.

- **A territorial reform should be implemented prior to any decentralisation of functions** to lower levels of government; such a reform should facilitate municipal mergers and the further development of new forms of inter-municipal co-operation; simplify the legal procedures involved in transferring competences to joint bodies or companies; and provide additional incentives to jurisdictions that implement new types of co-operative relationships.
- **Revise the revenue structure** of the *oblasts*, Crimea and the cities of Kyiv and Sevastopol to allow them to retain any extra revenue generated at the oblast or local level.
- **Introduce a property tax** to enhance municipal financial capacity; its introduction should be preceded by the creation of a reliable cadastre.
- **Create a monitoring system** for the effectiveness of the policies implemented, with special reference to local public goods and services.
- **Revise the allocation rules** for the State Fund for Regional Development (SFRD) so as to avoid sharp differences in the treatment of similar places. This should be accompanied by steps to enhance the transparency of allocation of other central transfers to sub-national governments.
- Use the SFRD as **an instrument to foster inter-regional co-operation**; link such efforts to broader national projects and priorities.
- Make greater use of SFRD allocations to **promote experimentation with "softer", more flexible instruments** for regional development. Issues related to disparities in the provision of basic services should be addressed via equalisation transfers and/or safety nets.
- Make **a rigorous cost-benefit analysis of any special zones or industrial parks**, designing them with reference to international best practice, particularly by working to:
  - **minimise spatial distortions** and maximise the zone's integration with the wider economy;
  - **focus on "non-addictive" forms of support** that will foster new, self-sustaining activities rather than on-going dependence;
  - **use special zones to pilot reforms** that could then be scaled up, possibly including the piloting of decentralisation reforms that could empower regions and cities.
- Better **focus the support to entrepreneurship on underused labour** in different regions (e.g. women) and further promote social entrepreneurship through partnerships with local and regional authorities.
- Strengthen **the co-ordinating and strategic role of central co-ordinating bodies** (like the inter-departmental commission) that deal with regional development policy, vis-à-vis both other ministries and with lower levels of government.
- Implement **stronger contractual arrangements to support Regional Development Programmes**, with an obligatory status and integration into national and sub-national budgets. Use the contracts as an instrument for agreeing on medium-term SRDF priorities.

Assessment and recommendations

Ukraine's regions have struggled since the onset of the global crisis

Overall, Ukraine's regions have struggled to regain growth momentum since the global crisis erupted in 2008-09. After contracting through the 1990s, the economy returned to growth just before the turn of the century, and all regions enjoyed a period of positive – and in some cases very strong – growth through 2007. In 2008, the economy more or less stagnated as the world economy slowed, and it experienced a sharp contraction in 2009. The downturn was fairly broad-based – all regions contracted – but it was severest in the country's main economic centres: roughly half of the output loss recorded in 2009 took place in four regions, accounting for 37% of pre-crisis GDP. This outcome reflected to a great extent the collapse of world trade, which hit major exporting regions disproportionately. This, in turn, underlies to a significant extent the shakiness of the subsequent recovery: export demand has remained muted, and domestic demand growth is constrained by slow credit growth and a lack of room for fiscal stimulus. Ukraine as a whole, as well as its constituent regions, must therefore find a growth model that is less exposed to volatile external markets and yet is not based on an unsustainable growth in domestic credit or government spending.

Inter-regional disparities are large and growing but not out of line with those of Ukraine's peers

While there has been some widening of inter-regional disparities in both growth performance and levels of GDP per capita in recent years, the increase in disparities was driven largely by the dynamism of the capital region: the city of Kyiv accounted for roughly 20% of aggregate growth over the decade to 2008: most other regions' contributions to growth were roughly in line with their size, implying little change in the geographic concentration of activity, apart from the rapidly growing concentration around Kyiv. The widening of inter-regional disparities amid the strong growth of the pre-crisis decade was in any case typical of economies in transition. Inter-regional disparities in Ukraine, though high by OECD standards, are lower than those found in some OECD members, including Chile, Mexico and Turkey, not to mention such emerging market peers as Brazil, Russia, Indonesia, India and China.

Non-monetary indicators also reveal significant inter-regional disparities, as well as some disturbing trends, in well-being. Analysis of the components of the human development index at regional level shows large disparities in living standards and education, in particular. Education is particularly worrying, as current disparities can have dynamic implications for growth over the longer term. Moreover, the relationship between human capital, as measured by educational attainments, and labour productivity is weak, suggesting that something fundamental is amiss with either the educational system or the functioning of the labour market. Overall, just 12% of the population live in regions where the overall human development index improved between 1999 and 2010.

Tapping further agglomeration economies could help raise aggregate growth

Concentration of both population and economic activity is increasing steadily, against a backdrop of falling aggregate population and slow aggregate growth. This pattern, moreover, is replicated at different levels: increasing nation-wide concentration of people and activity in Kyiv is accompanied by growing concentration within regions, as well. This trend has prompted growing concern in places that are losing population, particularly because it is often the most productive who move first. Nevertheless, given the relatively dispersed settlement pattern inherited from the Soviet Union, it is not clear whether or to what extent this reallocation should be resisted. On the contrary, although Kyiv's contribution to aggregate growth is far greater than that of any Ukrainian region, it is not particularly large by the standards of other OECD countries. Moreover, there are as yet few if any indications that the potential growth and productivity benefits of agglomeration in the capital region or the other major cities of Ukraine are exhausted. Deepening agglomeration effects in Kyiv, as well as in Ukraine's other big cities, could lead to improved aggregate performance.

The role of these second-tier cities could be especially important. Despite Kyiv's large growth contribution, around half of aggregate growth was generated by eight non-capital regions, suggesting that policies that could synchronise and exploit potential complementarities among them could be very good for aggregate growth and a move towards more multi-polar development.

Productivity growth is the key to regional and aggregate performance

With an ageing and declining population, large-scale overseas migration, tight public finances and limited investment, both labour and capital inputs are in short supply in Ukraine. The labour force is set to shrink for some time to come, and investment rates remain well below those seen in fast-growing emerging economies, despite the fact that the industrial capital stock is both limited and deteriorating. Foreign direct investment (FDI) inflows are limited and are heavily concentrated in Kyiv, which accounts for almost half of all inflows, and, to a lesser extent, the cities of Dnipropetrovsk, Kharkiv and Donetsk, which account for somewhat over one-quarter. Regional growth in Ukraine therefore is likely to depend heavily on productivity improvements.

Advances in productivity will, however, not emerge easily from the current climate. Progress along a number of fronts, to enhance competition and innovation, will be necessary. At the base of all this, politically stable and transparent institutions will be a pre-requisite. Raising productivity in Ukrainian regions will require increasing both technical and allocative efficiency – i.e. enhancing the efficiency of production and improving the allocation of resources. Stronger competition can contribute to both these ends. Yet competition is currently impeded by the poor business environment prevalent in the country. Important sectors are highly concentrated and are characterised, to a large degree, by high barriers to entry and exit – both natural and political – that limit competition. Furthermore, difficulty in accessing credit, and the widespread uncertainty – policy, legal, and regulatory – limit the development of small and medium-sized enterprises (SMEs) and the dynamism of the Ukrainian private sector.

Many of the challenges associated with raising Ukraine's productivity performance will have to be addressed by the national government, on an economy-wide basis. This is

true of important structural reforms, particularly those affecting the business environment, tax policy and monetary policy. It is also likely to be the case that national action will be the primary determinant of overall policy stability. Nevertheless, there are important aspects of these challenges that have a territorial dimension, particularly when it comes to addressing infrastructure provision, the supply of basic public services such as education and health care and matching problems on labour markets.

Labour markets appear to work poorly

Relatively low job turnover and job reallocation rates indicate that the Ukrainian labour market is less dynamic than its neighbours. In 2007, only 8.3% of all jobs were either destroyed or created, less than half the rate of, for example, Lithuania, Moldova, or Bulgaria. Similarly, less than 3% of all jobs moved from contracting forms to expanding firms. This reflects a larger pattern identified in previous OECD work on Ukraine: despite the strong growth observed before the crisis, there were important factors impeding the Schumpeterian process of creative destruction, which was and is vitally necessary to the restructuring and renewal of the Ukrainian economy. Stimulating robust productivity growth and increased innovation will also require profound reform of product markets in order to enable the process of creative destruction to unfold.

The very large informal labour market also poses challenges for policy. While much of this informal work takes place in private agriculture, a large proportion is comprised of wage workers, working under oral contracts – particularly in construction. Informal workers can be further disaggregated into those working informally in informal firms – often small and medium-sized enterprises – and those working informally in formal firms (at least 6% of wage work in formal firms is estimated to be informal). In addition, there is evidence of widespread under-declared work, in which part of earnings are concealed in collusion with the employer.

This large informal labour market ensures that much of the reaction of unemployment and wages to changes in the demand for labour is subdued in the data. Thus, even in the face of the favourable labour market conditions between 2000 and 2007, employment rates remained low. This apparent sclerosis of the participation rate is more likely to reflect the large number of informal workers than rigidities in the labour markets. Informal labour is more flexible and is, therefore, more likely to alter to take up the slack when labour demand increases. However, the informal workers are also more vulnerable in times of low labour demand, and the informality of the labour market reduces both the tax base and incentives for human capital development. Firms that remain in the shadows are also less likely to invest and grow.

Much needs to be done to improve Ukraine's business environment

Poor framework conditions for business constitute perhaps the principal challenge facing Ukrainian firms in all regions. The problems most frequently cited by entrepreneurs and officials alike can broadly be grouped into three categories: policy uncertainty, legal uncertainty and regulatory uncertainty. In short, the actions of public institutions are perceived as being neither stable nor predictable, with the high level of unpredictability stemming in many cases from a lack of transparency. These factors, in turn, fuel widespread corruption and undermine property rights. The limited evidence available suggests that such problems are common across Ukrainian regions.

Entrepreneurs' assessments of factors like infrastructure and technological sophistication vary widely across regions but they tend to converge in assessments of institutional quality. That said, the worst assessments of institutional quality are reported in the most developed regions: Kyiv, Khar'kiv, L'viv and Odessa score particularly badly. It is, of course, difficult to interpret this finding. The survey data may imply that the situation really is worse in these places, or they may reflect greater demand for improvement on the part of businesspeople in the largest cities. Either way, it appears that institutional constraints may be costlier where firms see more activity and more opportunity.

The government has identified a wide range of reforms intended to address these problems, most of them on a nation-wide basis. Most recently, the draft State Strategy for Regional Development covering the period to 2020 highlights the need for key cross-cutting improvements to the business environment, touching on many of the issues discussed above, such as a reduction in licensing and permits, streamlining bureaucratic procedures for firms (including a "one-window" approach to such formalities) and a reduction in the number and frequency of inspections. It also underscores the importance of medium-term budgeting and other improvements to budgeting procedures (programme-based budgeting, capital budgeting) that can further increase the transparency and predictability of public action. All of these points reflect an acute awareness of the need to embed regional development within a larger framework of reforms that will reduce the three types of uncertainty described above, as set out in President's programme of economic reforms and the State Programme for the Activation of Economic Development in 2013-14. The discussion of regional development policy which follows must be seen in this context: if the critical economy-wide reforms are neglected, the impact of regional policy instruments will be blunted, if not nullified altogether.

Ukraine's governance structure is excessively centralised

The country's governance structure is fairly centralised. Sub-national tiers of government depend on the central administration in terms of both functions and resources. The analysis shows that, although there are considerable resources in sub-central government budgets – a share comparable to OECD countries – sub-national governments have not much room to decide on the allocation of resources. Moreover, the executive bodies (state administrations) of *oblasts* and *rayons* are directly appointed by the central government, thus making them more responsive to the central government than the local population. The central allocation of resources to functions is based on historical data and input indicators. It is the central government which decides what type of policies and services sub-national tiers provide, based on past experiences, often with insufficient knowledge of the actual needs of the population. This mechanism produces inefficient use of resources.

Excessive discretion in the allocation of funds to regions generates uncertainty

The allocation of transfers to sub-national governments is not transparent. The allocation is based on a formula that takes into account many socio-economic indicators. Indeed, the excessive number of indicators makes the mechanism opaque and vulnerable to manipulation. In some cases, discretion in the allocation of funds can help dealing with unexpected funding problems. In general, however, the lack of transparency generates

uncertainty in the lower levels of government, hindering the possibility to make medium-/long-term plans. Furthermore, uncertainty reduces the incentive of each administration to take initiatives for making policies work at their level of government – a sudden reduction of funds may jeopardise any project that requires more than one year of funding.

Prior to a decentralisation reform, there is a need for a territorial reform

While the foregoing would point to the need for greater decentralisation of power in Ukraine, the empirical evidence concerning the impact of decentralisation on economic performance is not unequivocal. In fact, recent studies show that the success of a decentralisation reform depends on the capacity of local administrations to manage their new functions. This is clearly an issue for Ukraine: at the lowest levels, its local government institutions are far too fragmented. Very small elected authorities lack the budget, expertise and scale needed for effective service provision. Any decentralisation reform should thus be preceded by a **territorial** reform that allows towns and local communities to reach the necessary scale. It will also be important to make co-operation among local governments easier and more attractive: richer and larger settlements can provide services that are unaffordable for others. In this situation, a decentralisation reform that increases the functions at local level and assigns taxing powers can be difficult to implement in municipalities that have neither the administrative capacity nor a sufficient tax base to provide the delegated functions to citizens.

For these reasons, it is more urgent to deal with the bottlenecks that could hamper a successful decentralisation reform than to implement a reform that would replicate the current problems of the central administration at the sub-national levels. A territorial reform, in terms of amalgamation (merging) of municipalities or the creation of new or expanded mechanisms for inter-municipal co-operation, would mitigate the problems associated with the delegation of expenditure and taxing responsibilities. The administrative process for mergers should be simplified and alternative forms of co-operation among municipalities should be facilitated, also with financial incentives.

Horizontal co-operation between tiers of government (for instance, between municipalities) should be facilitated, providing platforms for discussion where to exchange information and experiences on the process of amalgamation. In fact, the process of amalgamation should be guided through incentives from the central government but the decision should be left at the local level. This would allow the central government to take advantage of specific information available at the local level, and avoid the trap of imposing unnecessary (or insufficient) mergers.

The implementation of a territorial reform should take into consideration the following steps:

- **Show the benefits of the reform to citizens**. The implementation of the National Programme of Reform and Development of Housing and Municipal Economy should be co-ordinated with the local government reform; this could entail adequate financial support to those localities that get involved in the reform process.
- **Offer several ways to attain the goals of the territorial reform**. Amalgamation into one municipality or integration into an inter-municipal body taking over key

municipal functions in joint institutions with the possibility of further integration to form a new and larger municipality voluntarily.

- **In the case of amalgamation, offer the possibility of maintaining the identities of the former municipalities in the new one.** This could be done, for example, by opting for an indirectly elected council for the larger entity, a delegated mayor, or an advisory council.

A reform of municipal finance could facilitate the provision of local public goods

The current revenue structure of municipalities heavily relies on transfers from the central government. Since those transfers are mainly allocated on a historical basis, there is no incentive for the local administrators to improve efficiency in the use of the resources. It would be important to modify the revenue structure in order to increase own revenues. In several OECD countries, municipalities rely on property taxes in order to finance services to the population. The property tax is intrinsically linked to the territory, as real property is among the least mobile assets. In order to implement an efficient property tax scheme, the reform should be preceded by the creation of a cadastre, which would also facilitate better urban and spatial planning.

Promote mechanisms to measure the quality of the services provided

The analysis of two important services provided to citizens, namely health care and education, shows the presence of structural problems linked with their organisation.

Both sectors are in important respects oversized. Maintaining such inefficient network size and staffing leaves few resources to spend on the training and re-training of teachers and medical personnel, the provision of adequate educational and treatment materials and medicines, the renovation of equipment and laboratories, and other infrastructure needs. This situation may lead to a "segregation" of the population by level of income and place of residence, thus contradicting the constitutional guarantee of universal health care provision. As a result, the current education and health-care systems deliver poor results and lack equity. Furthermore, the service seems not to be managed in a way that can promptly satisfy the needs of the population; and there are few resources or incentives for personnel to improve the quality of the service.

There is indirect evidence of increasing dispersion in the quality of schooling as a result of increased reliance on non-budget financing, which is consistent with widespread reports of deteriorating quality (according to interviews of academic and business experts). Many important educational quality-enhancing inputs, such as teacher training (and re-training), educational equipment and materials, programmes for poor students and at-risk students, and school maintenance, are usually underfunded.

Both health care and education systems lack a comprehensive assessment of the quality of the service. Measures should be put in place to gather information about the actual effects of policies on the quality of such services. This information is essential to make the service more respondent to the needs of the population, thus using the resources in a more efficient way.

Ukraine's regional policy has reached a potentially important turning point

A significant and potentially very positive overhaul of regional development policy is now under way. The government is at work on a new framework law on regional policy; a new State Fund for Regional Development was established in 2012, and the regional branches of the country's investment-promotion agency, the State Agency for Investment and National Projects, have become increasingly active. There are now one-stop shops for investment support in all of Ukraine's regions. In addition, the transition to multi-year budgeting is under way, offering the prospect of far greater predictability with respect to financing. Finally, the preparation of a new State Strategy for Regional Development, to cover the period 2020, highlights some important shifts in the way the government thinks about regional development. Each of these developments is welcome in its own right, and together they create an important opportunity to enhance Ukraine's regional policy institutions and instruments. Success will depend, in addition to the broader governance and policy reforms mentioned above, on clarifying policy goals, strengthening policy co-ordination and streamlining the range of instruments involved.

Regional policy priorities need to be clarified

Many countries struggle to define the goals of regional policy, and Ukraine is no exception. There is a persistent lack of clarity about the relationships among these different ambitions and how the tensions among them are to be managed, particularly as regards the tensions between growth and equity goals when it comes to funding. The result is a dispersion of effort and resources across the country. Given limited funds, administrative capacities and other resources, Ukraine urgently needs to define its policy priorities more clearly, to acknowledge, where appropriate, the tensions that may exist between them, and to focus its efforts around them. They key to setting priorities lies in the recognition that **regional policy should ultimately contribute to aggregate national performance**. In addition, central policy makers must be sensitive to the incentives that central interventions create for lower-level actors – it is for this reason that assistance to under-performing places **should generally be time-bound and should facilitate (not forestall) structural adjustment and promote the capacity for endogenous growth in the long term**. Otherwise, the risk of dependency is all too real, even in cases where, at the start, the case for support was very strong. What matters is that the balance among different priorities must be shaped by a focus on aggregate national outcomes over the long term.

Defining – and, when appropriate, redefining – major goals for regional development is likely to grow easier and more efficient to the extent that policy makers develop more sophisticated strategic planning capacities. Current planning approaches across much of Ukraine remain relatively static – focused on devising "plans", which are to be fulfilled – and often suggest a lack of faith in markets. International evidence suggests that planning regimes that focus on periodic updating of designated spatial or development plans tend to be static and highly technocratic, with a limited number of actors engaged in a highly specialised, largely technocratic and top-down exercise. In many instances, the resulting plans are out-dated before they are completed, let alone approved. By contrast, more dynamic approaches see planning primarily as a **co-ordination instrument**, involving a large number of public and private sector players. Any actual "plans" produced tend to be temporary and/or evolving documents. Where there are high levels of uncertainty about

the future, such approaches are vital, since strongly directive approaches to economic and spatial planning tend not to reduce uncertainty but create – at best – the illusion of having done so.

This is a task for the regions no less than the national government

Part of the challenge will involve improving the priority-setting that underlies **regional** development strategies, by getting regions to think more about the provision of **growth-promoting public goods** rather than viewing regional development funds chiefly as one more way to obtain the resources needed to address immediate social problems. This means fostering a broader sense of what regional policy is about. It is not just a device for regions to tap exogenous resources and channel them into infrastructure investments, however important those may be. Effective regional development strategies need to address issues like human capital development and efficient labour markets, conditions for entrepreneurship and private-sector development. They should, moreover, seek to identify the fields in which a degree of regional specialisation might make sense, rather than trying to support incumbent firms and sectors come what may.

Improving the quality of the State Strategy for Regional Development (SSRD) and regional-level strategies implies, at national and regional level, refining the economic and other analysis so as to produce a diagnosis of each region's strengths and weaknesses, on the basis of which regions might define a limited number of high, medium-to-long-term priorities. It will also imply acknowledging the trade-offs that exist and indicating that some other, worthy objectives are, for the time being at least, regarded as less urgent. These priorities would then form the basis for an operational plan for some limited period, linked to a concrete budget. Such a sharpened diagnosis should enable policy makers to make the discussion of instruments and mechanisms much more concrete – a medium-term strategy need not specify everything in detail, but it would give some direction as to the means and methods that will be used to address particular problems. Hitherto, there has often been little clear analysis or argumentation linking diagnosis to treatment – policy interventions have not mapped clearly onto the market or state failures they were meant to address. Better analysis of causal relationships, instruments and expected outcomes, in turn, will allow national and regional actors to re-focus the indicator framework on the evidence needed for effective monitoring and evaluation of regional policy interventions.

The governance of regional development policy needs to be strengthened

Much more can be done to foster national-level policy coherence for regional development. Above all, this will require strengthening regional development policy at the national level. There is still no national-level focal point for regional development policy capable of bringing together the key elements that are required: political authority, funding, planning and effective administration. The experience of many countries shows how difficult it can be to ensure such co-ordination, particularly at different territorial scales. Co-ordination of regional development policies at the central level is challenging and OECD countries approach arbitration among different line ministries in different ways. Approaches range from bodies charged with co-ordinating the activities of sectoral ministries, fully-fledged ministries, to ministers in charge of specific regions, or specific territorial lenses in sectoral policies. Often, countries adopt several institutional

arrangements. Overall, the experience of OECD countries suggests that **what is crucial is not where precisely the responsibility for managing regional development is vested; what matters is how functions are distributed and implemented.** Whatever the type of instruments, they broadly aim to reach three primary objectives: *i*) improving efficiency and avoiding redundancies and overlap (short-term); *ii*) building co-operative partnerships (medium-term), and solving asymmetries of information in cases of interdependency in policy making; and *iii*) building capacities for addressing new types of issues (long-term).

The Ukrainian authorities are well aware of the need for better cross-sectoral co-ordination of regional development and aim to increase policy coherence at the national level. The formation of the Council of the Regions and, more recently, the Inter-Service Commission reflects this awareness, as does the preparation of the State Strategy for Regional Development itself. A number of OECD countries have formed cross-sectoral bodies of this type at national level in an effort to achieve a coherent approach to regional development. The general rule seems to be that the higher the leadership within these types of commissions, the stronger the incentives to participate and the greater the engagement of the other actors. The fact that the President chairs the Council of the Regions, therefore, gives that body great weight, but its composition means that it can meet only infrequently. There is still a need for an apparatus able to support day-to-day co-ordination. Ensuring strong leadership of the Inter-Service Commission is thus likely to be critical to any attempt to foster greater cross-ministerial co-operation on regional development at national level. Ultimately, the institutional framework for co-ordination is a political choice to be taken by the Ukrainian authorities. In practical terms, what matters is that the functions of such a structure be supported by implementation mechanisms and amendments to the relevant decision-making procedures.

As a complement to these bodies, Ukraine may wish to further consider territorial "proofing mechanisms". Territorial proofing is a mechanism that monitors government policies to prevent them from having a negative impact on certain types of territories. For example, Finland's multi-year Rural Policy Programme also seeks to draw attention to the specific needs of rural areas. "Broad" policies proactively integrate these needs into central government decision making in different sectors. "Narrow" policies specifically target rural areas. It is important to note that if the proofing is not implemented in the early stages of the policy designing process, the opportunity for influencing policy decisions might be drastically diminished. A consultation exercise conducted relatively late in the policy process is thus likely to be of limited value.

The government must also take the lead in promoting more horizontal co-operation

Inter-regional and inter-municipal co-operation is also weak. There are practically no horizontal relations among regions. Connections among cities would appear to be somewhat stronger but are also quite limited, and co-operation among cities on specific development priorities is still very weak. A large body of OECD work on horizontal collaboration suggests that cross-jurisdictional co-operation, whether among regions or local authorities, is difficult, even in situations where the actors involved clearly recognise the need for it. Transaction costs, competitive pressures, resource constraints, differing priorities and fears that the distribution of costs or benefits from co-operation will be one-sided can all impede efforts to bring regional or local governments together. Thus, **leadership from above is often critical in resolving the collective action**

problems that such co-operation poses. This can be done in a variety of ways, such as by reserving a portion of central investment funds exclusively for collaborative investments. Regional policy instruments may need to be devised so as to encourage cross-sectoral and cross-jurisdictional collaboration for investment. In Ukraine, therefore, it may make sense to reserve some portion of the State Fund for Regional Development for inter-regional projects or to make additional state funding more readily available where regions or cities are prepared to pool their investment resources to develop projects of wider importance. However, although the financial incentive mechanism seems a necessary condition, it is not sufficient. Building the capacity of sub-national levels to engage with other governmental agents and creating a collaborative culture conducive to cross-jurisdictional engagement are essential for facilitating horizontal and vertical co-ordination.

Enhanced performance monitoring and systematic capacity building need to go hand in hand

Well-developed information systems can strengthen vertical relations among levels of government by narrowing information gaps which inevitably emerge between national and sub-national actors. They can also help to reveal, generate, and distribute information among the network of regional policy actors at all levels of government. The aim is to improve the information base throughout the cycle of policy design and implementation. Yet there is still no adequate indicator system for monitoring, evaluation and control of regional policy initiatives in Ukraine. Hitherto, there has been a heavy reliance on basic socio-economic indicators overall, like regional GDP, foreign investment inflows and indicators of mortality and morbidity. The system of evaluating *oblast*-level state administrations has tended to rest heavily on such basic data, despite the fact that many socio-economic and demographic developments are largely beyond their power to influence except over the very long term. Critics have also argued that both the selection of indicators and the weights attached to them have been insufficiently grounded in analysis and evidence.

Devising and implementing an adequate system of indicators poses a number of challenges. The most important of these stems from the fact that **incentive effects are inevitable when monitoring performance** even if there are no explicit rewards or sanctions linked to performance data. It could be tempting, when cascading elements from the national to the sub-national level, to try to "measure everything", resulting in an abundance of indicators of limited usefulness. In fact, it is better to identify a core set of indicators that have clear usefulness and that reflect a sound understanding of the expected causal relationships underlying policy interventions. Links to targets should be selected with care, as target setting is a difficult exercise prone to unintended consequences. It will also be important to recognise that implementation of a performance indicator system will be an iterative process, evolving as information about its usefulness and any unanticipated effects are revealed.

Mechanisms are in place to support sub-national capacity building, but they could be strengthened. Underlying all of the recommendations here is the idea of enhanced policy performance – in terms of better design, better informed decision-making, more capable actors, stronger partnerships, and greater efficiency. The central government can take an additional, explicit step to alter incentives in a way that encourages innovative approaches to policies and programmes. The use of pilot initiatives can be highly useful as a way to

ensure a gradual institutional change and learning by-doing. Non-monetary incentives, such as administrative flexibilities, can also be used to promote innovation and reveal good practice. For example, the government could consider allowing regional actors or municipalities to apply for "waivers" from administrative requirements that actors suggest stand in the way of efficiency or effectiveness. Such waivers could require specific proposals to the central government regarding alternative means of implementing and monitoring existing policies or programmes, which – if applied on a pilot basis – could reveal new, useful approaches that could potentially be extended or expanded to other actors or regions.

The creation of the State Fund for Regional Development is an important and welcome step

Ukraine in 2013 launched its State Fund for Regional Development, created following an amendment to the Budget Code adopted in January 2012. The fund, which is projected to amount to UAH 3.4 billion in 2013 (equivalent to around 0.3% of GDP), is effectively an aggregate of various funds earmarked for development. By law, it is to receive at least 1% of the income of the State Budget each year. This, in turn, is allocated to the regions on the basis of a simple formula: 70% of the money is allocated among all regions, according to population, and 30% is divided – also according to population – among those regions with per capita GDP less than 75% of the national average. The fund thus serves the joint objectives of extending regional development funds to all regions, while concentrating resources in the places of greatest need. The formation of the fund is a promising development, not least because it offers the prospect of stable, multi-year funding for regional development projects and because it relies on a clearly defined competitive allocation process that, once established, should do much to improve the quality of project selection. In drafting the fund regulations, the ministry drew heavily on EU principles and strategy documents.

A number of issues arise in connection with the further development of the fund:

- The 70/30 split with a cut-off at 75% of average per capita GDP introduces a very significant discontinuity into the distribution: regions just above and just below the threshold are treated very differently. The Ukrainian authorities have already indicated a desire to refine the formula, and this should involve some efforts to ensure a smoother redistribution. Some observers argue that the allocation formula for the fund could be adjusted so as to focus more on the socio-economic challenges and capacities facing particular types of place (e.g. rural regions, mountainous western regions, etc.).
- The fund could be better integrated with other central spending, so as to ensure that the overall pattern of transfers corresponds to central priorities. This would complicate central government decision-making, but it would also help reduce the risk that the uncoordinated actions of different ministries and departments would result in an allocation of central government transfers that tended to reinforce inter-regional disparities. Transparency and the goals of regional policy might be well served by a gradual transition towards creating a single channel for all grants/subventions to the regions for capital expenditure.
- So far, projects supported by the fund have been concerned largely with physical infrastructure and with the socio-cultural sphere. These are real needs, but there is room to question whether or not the fund is the appropriate instrument. In future

years, the allocation of the fund should favour projects that unlock growth potential, rather than addressing problems with current service provision.

- At regional level, the criteria for fund allocations could be linked to state-region contracts and regional development plans.

The fund could be used to expand the range of instruments used for regional development

While a great deal of attention has focused on the potential of the State Fund for Regional Development to support investment in physical infrastructure, one of the most important potential uses of the fund might well be to facilitate the emergence at regional or local levels of "softer" regional development instruments. A number of policy instruments commonly used in OECD countries remain seriously under-developed in Ukraine. These include the creation of business incubators – both within and apart from institutions of higher education and the use of more direct support for start-ups, particularly in high-tech sectors. For such initiatives to bear fruit, the national authorities would need to address many of the business climate issues discussed above in tandem with the development of such programmes. At present, the regulatory barriers to connecting up with the wider world are daunting for entrepreneurs, owing to regulations governing things like setting up companies or even opening bank accounts abroad.

In devising new instruments for business support, those involved in regional development should bear in mind the weaknesses of the current institutional environment and the lessons of past experience with business support in Ukraine and elsewhere. Contrary to what is sometimes suggested, this does not mean that nothing can be done. It **does** mean that public interventions need to be realistic in the context. Criteria, priorities and processes for business-support programmes need to be clarified in advance. Otherwise, it will be very hard to reconcile consistency of treatment with respect for diversity. In other words, for an instrument to be flexible without appearing to be an ad hoc uses of public resources to support favoured actors, it must be very clearly designed from the start, with ex post evaluation built into the ex ante design. In addition, policy makers should focus on forms of support that have a natural phase-out period, to avoid "addiction" to public support.

More can be done to develop contracts as an effective regional development instrument

Ukrainian law provides for regional development contracts between regions and the centre, but little use has yet been made of this mechanism. Indeed, some national-level officials fear that reliance on a contractual approach will lead to the fragmentation of Ukraine as an economic space, as regions individually negotiate bilateral deals with the government that give them special privileges or powers. Such fears are not without foundation, as the history of Ukraine's special economic zones and territories of priority development attests. More recent attempts to employ state-region contracts in the context of regional development in Ukraine have also been disappointing. The contracts have typically been linked to existing state and regional targeted programmes but not in a way that deepens or grounds those priorities into a coherent structure. Neither the state budget nor regional budgets contained separate programmes or budget lines for funding contracts, although there has been widespread discussion about how to create separately budgeted programmes for financing them.

Nevertheless, a growing number of countries have found such contracts to be a useful way to structure co-operation between central and sub-national governments. The challenge here is to balance consistency/coherence across the whole of the country with the need to allow for a place-based approach. Study of the use of cross-governmental contracts for regional (local) development in the OECD highlights two common lessons that Ukrainian policy makers should bear in mind when devising any further arrangements for contract-based approaches to regional development:

- Contracts need to be closely integrated with existing administrative and budgetary arrangements. Many contracts remain largely unsuccessful in changing existing fragmented and compartmentalised structures, because the relevant competences that go along with the strategies embodied in the contracts remain unchanged. In addition, contracts may not be undergirded by stable, reliable financing, so implementation is not assured. This has generally been the case in Ukraine hitherto. In future, **contract priorities could form the basis for project selection under the State Fund for Regional Development**. This would not preclude the use of **other** resources to fund contractually agreed priorities, but it would ensure a basic level of resource while also providing a foundation for the delineation of the criteria on which competing proposals for the Fund might be judged.
- While contractual arrangements can be employed as a capacity-building device, they sometimes also over-stretch existing capacity, both at the local and the national level. They can create "parallel" structures to existing administrative processes, which increase the administrative burden and also the need for "know-how" at the local and higher levels to engage in these new structures. Therefore, **it is crucial to ensure that contractual arrangements are, as much as possible, aligned with existing ways of "doing business" and are accompanied by training for all levels of government in how to implement them**.

Thus, it is possible to envisage the use of regional development contracts based on agreed priorities and objectives, identified on the basis of a shared diagnosis of a region's challenges, as well as agreed procedures for fund management, evaluation and reporting. These, in turn, should rest on ex ante assessments of regional challenges and potential, involving both bottom-up and top-down input. Such contracts would specify the main objectives of policy, the instruments to be employed and the kind of benchmarks or indicators that would be used to assess progress with respect to institutional or policy changes, programme implementation and outcomes along the way. They might also specify the procedures by which programme priorities were identified, emphasising, for example, the inclusion of a wide range of stakeholders and the need to ensure that the local process is effective at revealing information about local potential. In the Ukrainian context, this would entail, above all, strengthening the procedures for concluding state-region contracts, linking contracts to real, multi-year budgets and other funding sources, and integrating contractual processes with the elaboration of sectoral strategies.

The creation of special economic zones, industrial parks or other special territories should be approached with caution

There has been considerable discussion in some quarters about the development of a number of new industrial parks or new forms of special zones in an effort to stimulate investment and job creation and to reverse the fortunes of declining territories. Under legislation adopted in late 2012, the government plans to create ten parks focused on

major national projects, as well as other parks at the initiative of the regions and other actors. The criteria for granting industrial park status are still evolving, but the State Agency for Investment and National Projects, which will register the new parks, sees them as a critical mechanism for jump-starting investment in new industrial developments by offering tax incentives and ready infrastructure with a view to reducing operating costs and cutting the time it takes projects to reach the market. Access to the parks will be equal for foreign and domestic investors. According to the State Agency, the proposed tax benefits include duty-free import of equipment not produced in Ukraine, an 8% rate of corporate income tax (as compared to the general rate, which will fall from 21% to 16% in 2014), and some reimbursement of VAT. The parks are to last for 30 years and, according to officials, the privileges will be extended for the lifetime of the park. To avoid the transformation of the parks into trading zones (as happened in the past), the authorities plan minimum requirements for the share of land devoted to industrial production, for greenfield investment and for job creation.

Given Ukraine's unhappy history with special economic zones, territories of priority development and other such instruments, such projects should be approached with extreme caution. The risks of corruption, spatial distortions and fragmentation of the economic space are real. International experience suggests that special zones are, at best, a second-best policy option. The first-best option is generally to improve the overall investment climate. Zones may make sense as an intermediate step, if their creation will facilitate progress towards that goal. Moreover, the costs can easily outweigh any benefits. International experience also points to a number of best-practice principles that Ukraine should follow in connection with any such spatial instruments of industrial policy:

- Spatial distortions should be minimised by ensuring that the zone is well integrated with the wider economy.
- Incentives for zone investors should focus on "non-addictive" forms of support that will foster new, self-sustaining activities rather than on-going dependence and demands for further support. If direct tax incentives are considered, for example, they should be linked to the process of capital formation. Thus, accelerated depreciation, investment tax credits or temporary exemptions from duties on capital goods would be preferable to VAT or profit tax breaks.
- Studies of successful zone programmes in other countries suggest that fiscal incentives are not the primary attractors: the main concerns for investors are access to good quality gate-way infrastructure, utilities and labour supply. This should be the focus of policy.
- Where possible, special zones should be used to pilot reforms that can then be scaled up to the rest of the economy. Given the evidence that zone residents attach particular importance to administrative and regulatory issues, it could be very useful to pilot reforms to the regulatory environment. This would be the most direct way to use zones to address some of the major barriers to investment.
- Zones, industrial parks and other such instruments should be subject to rigorous ex ante and ex post cost-benefit analysis. This analysis should focus, in particular, on the **additionality** of the proposed zone. Few things are easier than creating zones that subsidise activities or investments than agents would have undertaken anyway.

- As a rule, zones should be relatively large with free entry. Where zones are very small and conditions within and outside the zones are very different, they tend to lead to far more displacement than generation of new activity.

Successful zones could aggravate inter-regional disparities

The creation of zones in the context of regional development policy poses particular challenges. The aim of such zones should be to catalyse development that builds on a place's real comparative advantages. Where incentives and privileges are used in an effort to entice firms to locate in places where their activities would otherwise make little commercial sense, the result is likely to be an endless flow of support to keep them from exiting. In many countries, zone failures have been the product of poor site location. Success is often linked to proximity to gateway infrastructure, and remote location may also reduce the possibility to profit from agglomeration economies. Zone initiatives thus throw into sharp relief the tension that underlies many facets of regional policy, between trying to raise the performance of lagging regions and seeking to foster the success of growth poles. More peripheral locations are unlikely to succeed unless zones are organised around specific, place-based sources of comparative advantage – usually, sources rooted in relatively immobile assets. Yet politics often makes it hard to manage site selection well. Often, the result is a process that seeks to spread zone sites relatively evenly across the country, regardless of the efficiency of such a process.

Zones with a regional development focus need to be situated in larger regional development strategies. This must be a part of any decision about zone location or zone type. It should also contribute to the co-ordination of infrastructure development inside and outside the zone, as well as investments in skills development and other complementary policies that may transcend the zone and yet be critical to zone success. Declining regions may also benefit from the presence of infrastructure and other assets that are under-utilised and can reduce the costs of zone development, while increasing the chances of success.

To sum up

Overall, Ukraine has taken a number of steps to bring its regional policy framework into line with the kind of approach reflected in the OECD's "New Regional Paradigm", focusing on investment, competitiveness and a multi-sector horizontal approach, as opposed to using subsidies and transfers to pursue compensatory objectives via a top-down sectoral policy. However, the current regional policy framework still lays great stress on traditional compensatory measures, and the degree to which the shift towards the new paradigm is reflected in day-to-day practice will depend on how the authorities tackle the implementation challenges associated with recent and currently pending reforms, as well as their success addressing the governance and policy gaps described above. The current tight fiscal environment will make it even harder to meet these challenges but it also makes implementation success more important than ever.

Chapter 1

Regional trends and Ukraine's productivity challenge

This chapter looks at regional socio-economic trends in Ukraine since the late 1990s. It begins with a look at the macroeconomic context and then turns to an analysis of regional growth performance, inter-regional disparities and other socio-economic outcomes. This is followed by a look behind the trends and the determinants of Ukraine's productivity performance, in particular. Specific attention is paid to the labour market, which appears to work poorly, for a variety of reasons. Given an ageing and declining population, tight public finances and limited investment, regional growth in Ukraine depends ever more on productivity improvements.

Introduction

Chapter 1 provides a summary of the main strengths and challenges Ukraine faces at the sub-national level. The chapter compares sub-national trends in Ukraine and the performance of its regions to those observed in other OECD countries and regions. The chapter comprises four main sections. The first section presents an overview of the macroeconomic context. The second analyses trends in concentration and inequality in demographic and production patterns. It also benchmarks the performance of Ukrainian regions, including the recent impact of the crisis to comparable OECD regions and examines the links between the regional and aggregate level. The third section looks behind these trends to examine the main drivers of performance at regional level in Ukraine. The fourth and final section explains why the primary economic policy priority for Ukraine must be total factor productivity growth.

The macroeconomic context

The crisis has exposed important structural weaknesses in Ukraine

Since the onset of the global financial crisis, Ukraine's accumulated fiscal, financial, and structural vulnerabilities have come to the fore. The 2008/09 financial crisis pushed Ukraine into one of the deepest recessions in Europe, with gross domestic product (GDP) contracting by 15% in 2009. A cyclical recovery took hold the following year, supported by a stronger external environment, the economy's response to a sharp devaluation of the hryvnia, and substantial public capital investment ahead of the 2012 Union of European Football Associations (UEFA) European Football Championship (Euro 2012). However, the recovery has since weakened considerably, owing to weaker external demand and unfavourable domestic developments. In the context of a high current account deficit and concomitant external financing requirements, consumption-led growth can do little to assuage the country's vulnerabilities. While public debt fell from 40.5% to 36% in 2011 and a long overdue pension reform improved medium-term fiscal prospects, the fiscal stance loosened appreciably in 2012, and energy-price reforms – one of the most contentious issues in Ukrainian economic policy debates – stalled. The state-owned gas company's deficit is projected to reach 2% of GDP this year, adding to the weight of the general government deficit on public finances.

The external position has remained delicate throughout the post-crisis period, not because Ukraine's debt stock is particularly large but because it lacked the resources needed to service rapidly growing debt: gross reserves in 2010 stood at just five months' imports, a very low level indeed, and buffers remained low through 2011 and 2012 on any number of measures of reserve adequacy (e.g. exposure to external liabilities, export earnings, and particularly short-term debt) (IMF, 2012). Consequently, the country has called upon the IMF for support, with two stand-by arrangements put in place (in 2008 and 2010) despite continuing tension over economic policies between the government and the Fund.

The vulnerabilities exposed when the crisis hit had accumulated over the preceding decade, as favourable external conditions and a boom in steel and chemical prices ensured sustained gains in the terms of trade that allowed increases in national income in the absence of productivity growth. These conditions enabled the country to move away from export-driven industrial growth to rely increasingly on domestic consumption. This

was never likely to prove sustainable. As OECD (2007) argued at length, the strong growth of the early-to-mid 2000s was supported by essentially transitory factors, and the structural reforms needed to shift to a more productivity – and competitiveness-oriented model of sustained growth were largely stalled. The result, once the crisis hit, was the emergence of a substantial current account deficit and rapidly mounting public debt (Table 1.1). The recent slowdown has helped to reduce external deficits, but it has also made the fiscal situation harder to manage.

Table 1.1. **Selected economic indicators, 2009-12**

	2009	2010	2011	2012 (est.)
Real economy (percentage change, unless otherwise indicated)				
Nominal GDP (billions of UAH)	913	1 083	1 317	1 473
Real GDP	-14.8	4.1	5.2	3.0
Contributions:				
Domestic demand	-26.4	7.3	11.5	4.1
Consumption	-10.2	5.6	9.2	4.9
Investment	-16.2	1.7	2.3	-0.8
Net exports	11.6	-3.1	-6.4	-1.1
Social indicators				
Unemployment rate (ILO definition; %)	8.8	8.1	7.9	7.8
Consumer prices (period average)	15.9	9.4	8.0	3.8
Core inflation (period average) 1/	19.4	8.6	7.7	5.2
Nominal monthly wages (average)	5.5	17.7	17.5	13.8
Real monthly wages (average)	-8.9	7.6	8.8	9.6
Public finance (percentage of GDP)				
General government balance 2/	-6.3	-5.8	-2.7	-3.3
Structural general government balance	-2.6	-3.1	-2.3	-3.8
Public debt (end of period) 4/ 5/	35.4	40.5	36	34.7
Balance of payments (percentage of GDP)				
Current account balance	-1.5	-2.2	-5.5	-6.4
Foreign direct investment	4.0	4.2	4.2	4.6
Gross reserves (end of period, USD billion)	26.5	34.6	31.8	24.4
External debt (% GDP)	88.2	86	76.4	69.8
Goods exports (annual volume change, %)	-24.2	9.3	7.1	4.4
Goods imports (annual volume change, %)	-41.6	18.1	20.3	7.3
Goods terms of trade (% change)	-13.8	0.3	7.6	-1.3
Exchange rate				
Real effective rate (CPI, % change)	-17.6	6.0	0.1	2.6

Note: Excludes unprocessed food, fuel, and administrative services.

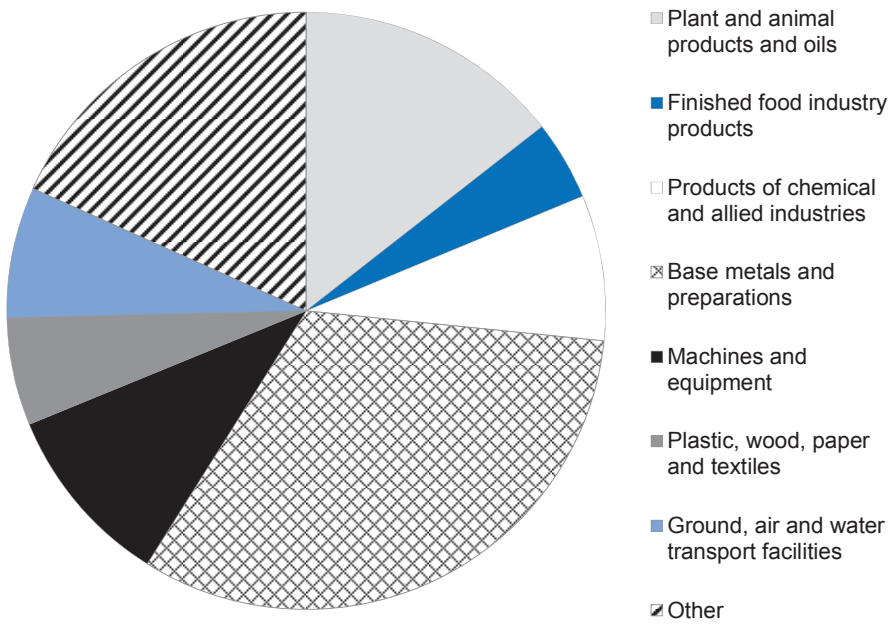
Source: IMF (2013), World Economic Outlook (database), accessed April 2013, www.imf.org/external/pubs/ft/weo/2013/01/weodata/index.aspx.

The favourable conjuncture of the pre-crisis decade also allowed political leaders frequently to succumb to pressure for easier fiscal policies and to delay structural reforms. This is not to suggest that nothing was done: the years preceding the crisis witnessed Ukraine's entry into the World Trade Organization (WTO) (with the many reforms that accession entailed), the monetisation of an economy previously characterised by high levels of barter and non-payments, and the adoption of important legislation in such diverse fields as company law and land law. In the wake of the crisis, further important changes included the adoption of new tax, budget, and customs codes; the modernisation of tax services; and the pension changes mentioned above. Nevertheless,

the range of structural reforms still to be implemented is daunting, as is clear from both external assessments and the government's own reform programme.

Base metals – in particular, steel – account for over 30% of Ukrainian exports rendering the balance of payments heavily dependent on demand for commodities and exposed to world economic conditions. About 1/3 of Ukraine's export revenue comes from trade with Europe (Figure 1.1) – though this figure has been falling since 2003 and saw a marked decline with the onset of the financial crisis in 2008. Exports to Commonwealth of Independent States (CIS) countries, on the other hand, have been rising (CIS countries have been the largest destination for Ukraine's goods exports since 2006), and the recently signed free-trade agreement with the CIS[1] is likely to ensure that this trend continues.

Figure 1.1. **Composition of exports (2011)**



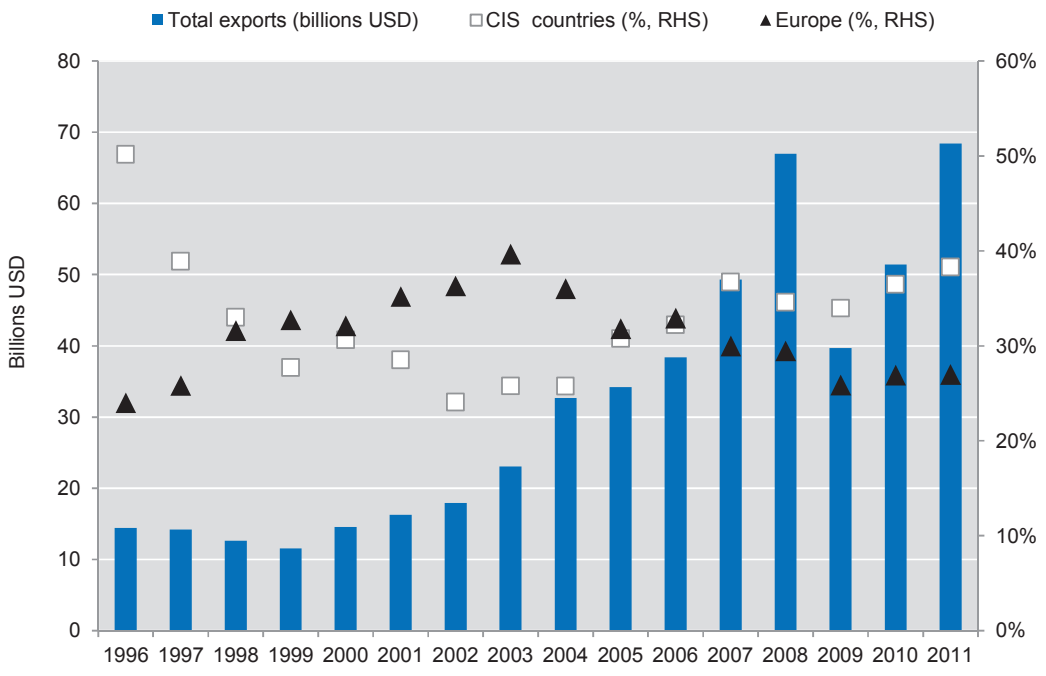
Source: State Service of Statistics of Ukraine.

Ukraine's recovery will continue to be tempered by the country's exposure to international markets. The financial crisis and its aftershocks have had – and continue to have – a profound impact on the strength of the economy. Low global demand for Ukraine's exports combines with domestic demand that is stymied by slow credit growth with the result that the economy contracted in the first quarter of 2013 and the IMF revised its projection down to no growth for the year; even more optimistic forecasts envisaged growth in the 1%-2% range. Recent exchange rate policy has, more or less, ensured nominal stability of the hryvnia against the U.S. dollar, and the government has played down the prospects of devaluation. While such a nominal anchor provides agents with a least one relatively stable point of reference in a highly uncertain environment, it also creates a number of problems:

- As OECD (2007) and IMF (2012) have argued, reliance on such a nominal anchor has contributed to financial dollarisation and over-leveraging of Ukrainian households and corporates. Forex-denominated credit to corporates and households increased from 7% and 0.1% GDP, respectively, in 2000 to 23% and 22% of GDP in 2008. As a result, the nominal devaluation that occurred in 2009 had dramatic effects on many balance sheets.
- The current regime makes inflation control and domestic liquidity heavily dependent on the external conjuncture.

Nevertheless, there was widespread expectation of hryvnia depreciation in early 2013, as the government shifted towards greater support for industry. At the same time, wage pressures and rising food prices were creating inflationary pressures, prompting the government to maintain a tight monetary stance that further limited credit growth. Taken together with the state of public finances, this implies that growth based on domestic consumption and government spending is not sustainable in the long-run. Yet moving away from consumption-led growth is unlikely to be straightforward in the context of an ageing population, weak external demand, and a business climate that limits investment. The ratio of private investment to GDP, which peaked at around one-quarter in 2008, fluctuated around 17% to 18% during 2009-12, reflecting the failure of investment to bounce back from the crisis. Such an investment rate is significantly lower than those of most fast-growing emerging economies. Given Ukraine's ageing capital stock and the scope for capital deepening – as well as the constraints on labour supply, which will be discussed below – the current ratio appears to be far lower than that needed to sustain rapid catch-up over a long period.

Figure 1.2. **Destination of exported goods (1996-2011)**

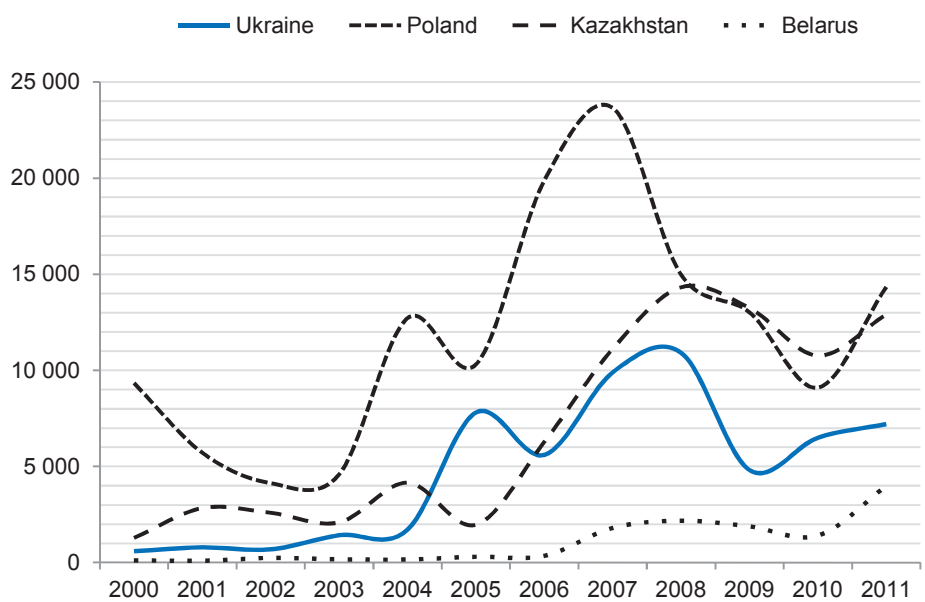


Source: State Service of Statistics of Ukraine.

Foreign direct investment (FDI) inflows grew by a compound average of 43.9% between the years of 2000 and 2008 – among the fastest growth rates in Europe – peaking at over 10.9 billion USD in 2008 (Figure 1.3). And while FDI inflows to Ukraine have recovered somewhat since 2009, the growth of FDI inflows in 2011-12 implies that Ukraine's FDI recovery is slightly underperforming neighbouring countries – inflows into South East Europe, the CIS and Georgia rose by 25%, to 92 billion USD, over the same period (United Nations Conference on Trade and Development [UNCTAD] World Investment Report, 2012). Furthermore, on a per capita basis, Ukraine's performance in attracting FDI is significantly worse than that of neighbouring countries, both in terms of stocks – where Ukraine underperforms compared to European neighbours and Russia – and flows – where Ukraine is underperforming in comparison to its former CIS neighbours and Georgia (Figure 1.4).

Ukraine's ability to attract foreign investment into new sectors is stymied by the weak investment climate, which continues to offset the country's many attractions as a potential investment destination (see Chapter 3 for details). That potential is considerable, and it is important not to overlook it: while there has been much grim economic news in the last five years, Ukraine remains a country with many strengths on which to build. It is located close to major markets, well placed to develop as a logistics hub, and relatively well endowed in terms of transport (especially rail) infrastructure – due, in part, to extensive post-war reconstruction, although, as will be seen, under-investment is increasingly eroding this potential strength. Its natural resource base is considerable: not only metals and coal, but extremely fertile agricultural land and significant reserves of (mostly unconventional) oil and gas. It also has much to offer in terms of human capital: the population is generally better educated than those of most other lower-middle income countries (OECD, 2007). To realise its potential, Ukraine will have to shift away from its reliance on terms-of-trade windfalls, reform its state institutions, and create an economy much more open to robust competition. The tasks of regional policy must be seen in light of these fundamental national challenges and resolved in tandem with them.

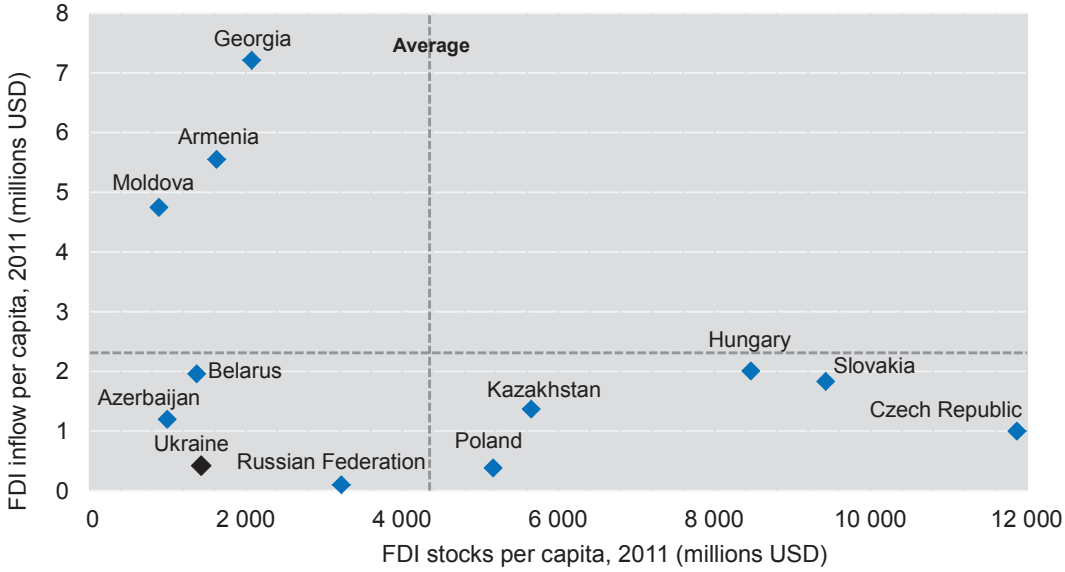
Figure 1.3. **Foreign direct investment, net inflows (current prices, million USD)**



Source: World Development Indicators.

A long-term growth strategy will need to focus on diversifying and enhancing the productivity of exports, while at the same time improving the business climate to attract increased investment. The former is likely to be difficult in the absence of progress on the latter, particularly as the reduced appetite for risk, resulting from uncertainty in international financial markets, has limited access to international capital. In this context, the country's poor investment climate and concerns over the sustainability of fiscal imbalances render the impact particularly acute.

Figure 1.4. **Stocks and flows of FDI per capita, 2011**



Source: UNCTAD (2012), *World Investment Report*, UNCTAD, Geneva; UNCTADstat.

A shift towards a more sustainable long-term growth model will probably require some downsizing of the Ukrainian state. The general government expenditure-to-GDP ratio has fluctuated around 42% to 44% for close to a decade, approaching 50% in 2012 (IMF, 2013) – very high given Ukraine's GDP per capita. While the authorities have announced their intention to reduce the size of the state over the medium term and are committed to a shift from consumption to investment-oriented spending, progress has been limited. Government revenue and expenditure have fluctuated sharply in real terms and as a share of GDP, but the trend for the last decade has been upwards. Such high levels of tax pressure are likely to deter investment, and there is much evidence to suggest that the efficiency of public expenditure is low. Curbing public spending while sustaining – and, indeed, improving – public service provision will require reforms of state institutions and considerable capacity building. A number of the challenges linked to this task are explored in Chapter 2.

Sub-national trends

Ukraine is the largest country in Europe in terms of territory and, after Russia, is the second most populous post-Soviet country. The country administrative structure is somewhat complicated comprising, at the TL2 level, 24 *oblasts*, the Autonomous Republic of Crimea and two cities with special status – Kyiv and Sevastopol. There are 490 districts (*rayons*) at the TL3 level, with an average area of 463 square kilometres and an average population of 52 000.[2]

Strategically located at the intersection of Russia, Europe and Central Asia, with access to the Black Sea through ports in Odessa and Sevastopol, Ukraine enjoys substantial geographic advantages and operates as an energy transit country for Russian oil and gas exports to Western Europe. In addition to these geographic advantages, the country is home to abundant natural resources. Ukraine encompasses the largest manganese ore fields in the world, the second-largest quantity of mercury deposits, and over 300 000 square kilometres of fertile arable land.[3]

Table 1.2. **Ukrainian administrative units**

	Districts	Cities	Of which cities of republican or regional importance (governments with special status)	Districts within city	Rural settlements of urban type	Rural districts	Rural settlements
Ukraine	**490**	**459**	**180**	**114**	**885**	**10 278**	**28 450**
Crimea (Aut rep)	14	16	11	3	56	243	948
Vinnytsya	27	18	6	3	29	661	1 466
Volyn	16	11	4	-	22	379	1 054
Dnipropetrovsk	22	20	13	18	46	288	1 435
Donetsk	18	52	28	21	131	253	1 118
Zhytomyr	23	11	5	2	43	579	1 613
Zakarpattya	13	11	5	-	19	307	579
Zaporizhya	20	14	5	7	22	263	914
Ivano-Frankivsk	14	15	5	-	24	477	765
Kyiv	25	26	13	-	30	605	1 126
Kirovohrad	21	12	4	2	27	376	996
Luhansk	18	37	14	4	109	206	782
Lviv	20	44	9	6	34	632	1 850
Mykolayiv	19	9	5	4	17	287	894
Odesa	26	19	7	4	33	439	1 125
Poltava	25	15	5	5	21	467	1 811
Rivne	16	11	4	-	16	338	1 000
Sumy	18	15	7	2	20	384	1 466
Ternopil	17	18	1	-	17	580	1 023
Kharkiv	27	17	7	9	61	381	1 680
Kherson	18	9	3	3	31	259	658
Khmelnytskiy	20	13	6	-	24	568	1 414
Cherkasy	20	16	6	2	15	525	824
Chernivtsi	11	11	2	3	8	252	398
Chernihiv	22	16	3	2	29	525	1 482
City of Kyiv	-	1	1	10	-	-	-
Sebastopol	-	2	1	4	1	4	29

Source: State Service of Statistics of Ukraine.

Regional specialisations largely reflect historical east-west divisions

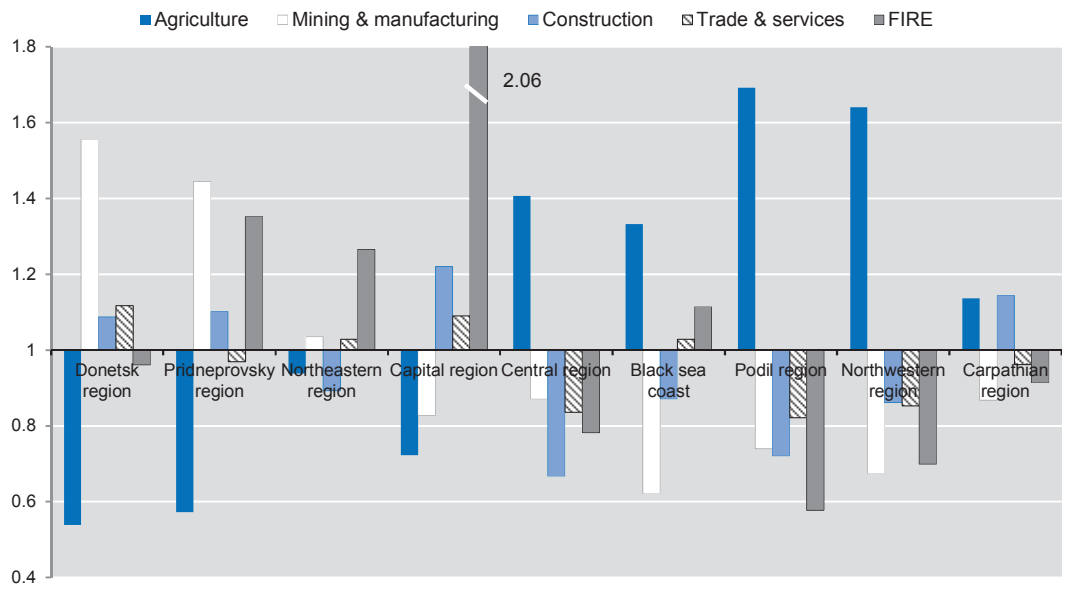
Ukraine's *oblasts* have traditionally been divided into those in the east, historically characterised by greater Russian political and economic influence, and those in the west, which were long under Polish and Austrian rule. This history continues to find reflection in contemporary politics, culture, and economics. The highly populated east – focused around Donetsk – is heavily specialised in industry, including energy, coal, metals (particularly in Dnipropretrovsk), chemicals, construction materials, and heavy

engineering. It has well-developed transport networks and has generally exhibited strong industrial performance. The north-eastern region, at whose centre is the major hub of Kharkiv, is more diversified, with a stronger service sector and a degree of specialisation in financial intermediation, real estate, and trade second only to the capital.

The west of the country can largely be divided into the Carpathian region (focused around L'viv but also covering Zakarpattya, Ivano-Frankivsk and Chernivtsi), the poorer northwest of the country (Volyn and Rivne), and the Podil region in the central west. The Carpathian region, rich in water and forest, specialises in engineering, construction, metal processing, chemical products, and woodwork; in addition, the region surrounding L'viv has substantial and developing potential for tourism – particularly since the investments in infrastructure in the run up to Euro 2012. The Podil region, spanning Vinnitsa, Khmelnytskiy and Ternopil in the central west, is the least urbanised part of the territory and is heavily specialised in agriculture (Figures 1.5 and 1.6). In the northwest, Volyn and Rivne are also largely specialised in agriculture but are moving increasingly towards trade and services.

The central region – Cherkasy and Kirovohrad – is less urbanised than most and, lacking industry and cross-border activities, depends heavily on agriculture. In the north, Kyiv (the city and the *oblast* of the same name) and the surrounding *oblasts*, Zhytomyr and Chernihiv, exhibit a strong and growing specialisation in construction and, particularly, high-level services (financial intermediation and real estate). In the south, the Black Sea coast is relatively poor in natural and water resources. However, fertile soil ensures that agriculture remains a dominant area of specialisation. Regional specialisation has remained relatively constant over the past decade or so (Figures 1.5 and 1.6) and the polarisation between the agricultural centre and west and the industrial east has, if anything, increased.

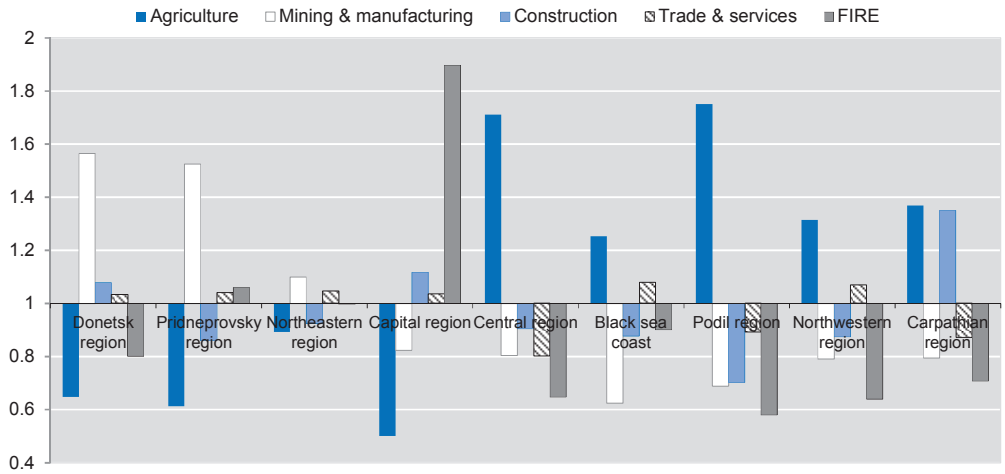
Figure 1.5. **Regional specialisation (2000)**



Note: A region's degree of specialisation in an industry is measured according to the Balassa-Hoover index, which is computed as the ratio between the weight of an industry in a region and the weight of the same industry in the country. Values of the index above reflect a specialisation higher than the national average.

Source: OECD calculations based upon data provided by State Service of Statistics of Ukraine.

Figure 1.6. **Regional specialisation (2010)**

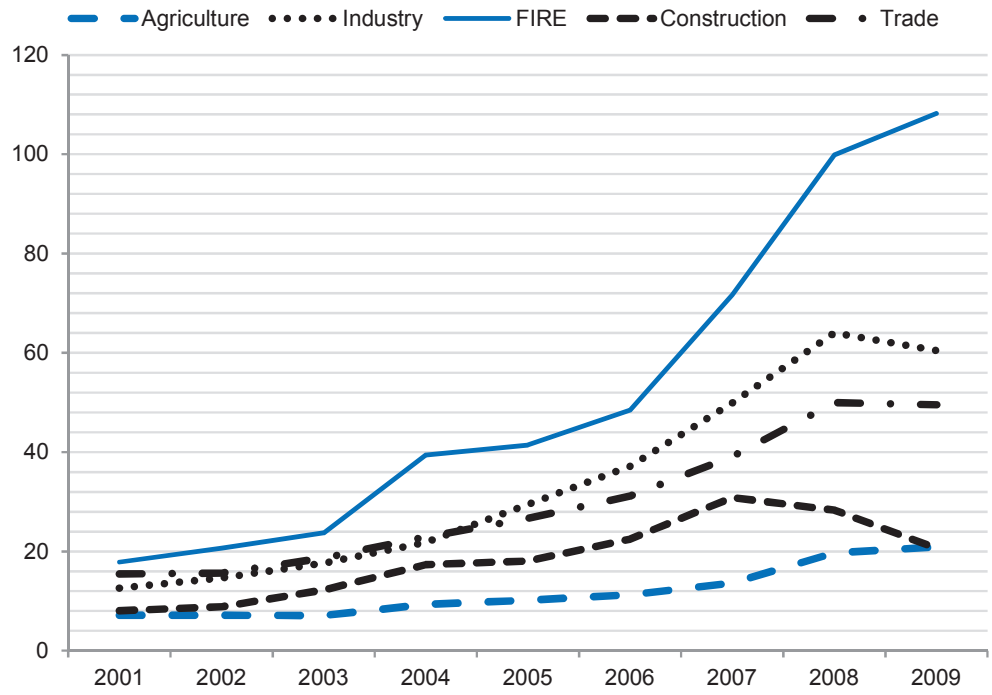


Note: A region's degree of specialisation in an industry is measured according to the Balassa-Hoover index, which is computed as the ratio between the weight of an industry in a region and the weight of the same industry in the country. Values of the index above reflect a specialisation higher than the national average.

Source: OECD calculations based upon data provided by State Service of Statistics of Ukraine.

Figure 1.7. **Sectoral growth trends**

Sectoral gross value added, current prices



Source: OECD calculations based on data from the State Service of Statistics of Ukraine.

Differences in regional economic performance mirror differences in specialisation

Disparate and diverging regional specialisations translate into divergent regional growth prospects through large differences in labour productivity across sectors in Ukraine (Figure 1.7). Productivity growth – as measured by gross value added per employee – in financial intermediation, real estate, and industry has outpaced growth in trade and agriculture by some margin. These sectors have registered compound annual growth rates over the period 2001 to 2009 of 25% and 22% respectively compared to just 16% and 14% in trade and agriculture.

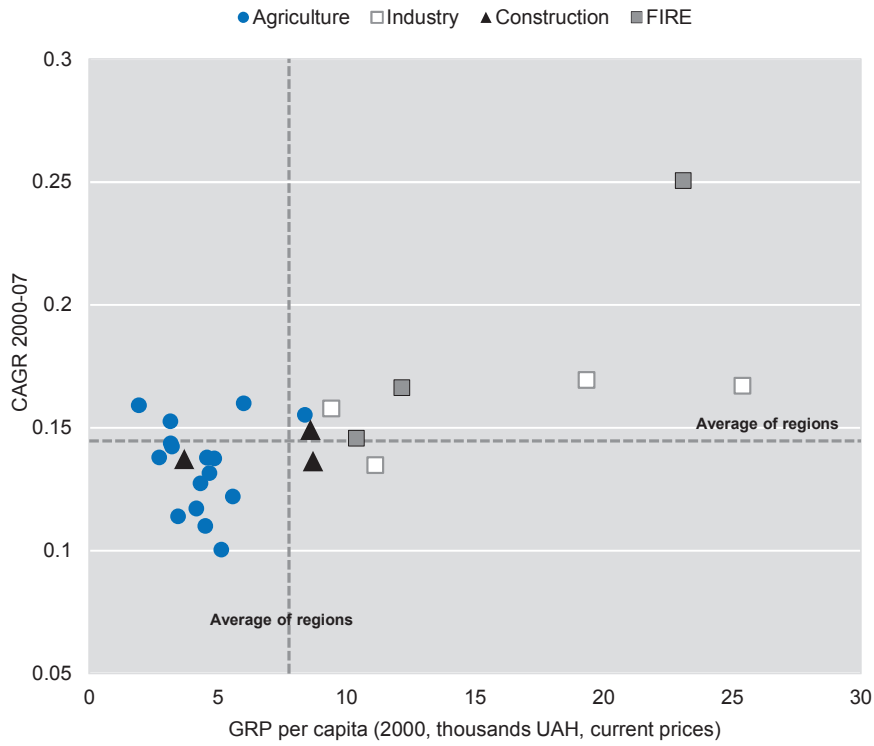
The sectoral specialisation patterns can be seen mirrored in diverging regional growth paths in Figure 1.8, where those *oblasts* specialised in agriculture (represented by the diamond-shaped markers) are concentrated in the lower left-hand quadrant – i.e. they have lower **levels** of GDP per capita and have also experienced slower **growth** over time. Conversely, industrial *oblasts* (round markers) and those *oblasts* specialised in financial intermediation and real estate (square markers) are concentrated in the top right quadrant, indicating that growth in these *oblasts* – already wealthier than average in 2000 – was, on the whole, pushing ahead prior to the crisis. In short, increasing inter-regional disparities were, prima facie, related at least in part to differences in regional specialisation.

National growth has been driven largely by the capital, Kyiv, and the industrialised *oblasts* of the east (Figure 1.9). In the ten years prior to the crisis (1997-2007), just three regions – the city of Kyiv and Donetsk and Dnipropetrovsk *oblasts* – accounted for 43% of aggregate growth. With the exception of Kyiv, the growth contributions of Ukraine's regions align closely to their share of GDP. The larger economies, such as Donetsk, Dnipropetrovsk, are incrementally above the 45 degree line in Figure 1.9 – indicating that they are "punching above their weight" in terms of growth contributions – but the differences are relatively small except in the case of Kyiv. The capital apart, pre-crisis growth trajectories seem to have been preserving rather than transforming the country's inter-regional "pecking order".

The global crisis that erupted in 2008/09 hit Ukraine's affluent industrial regions hard, with gross regional product in Donetsk, Zaporizhzhya, and Luhansk falling far faster than the national average (Figure 1.10).

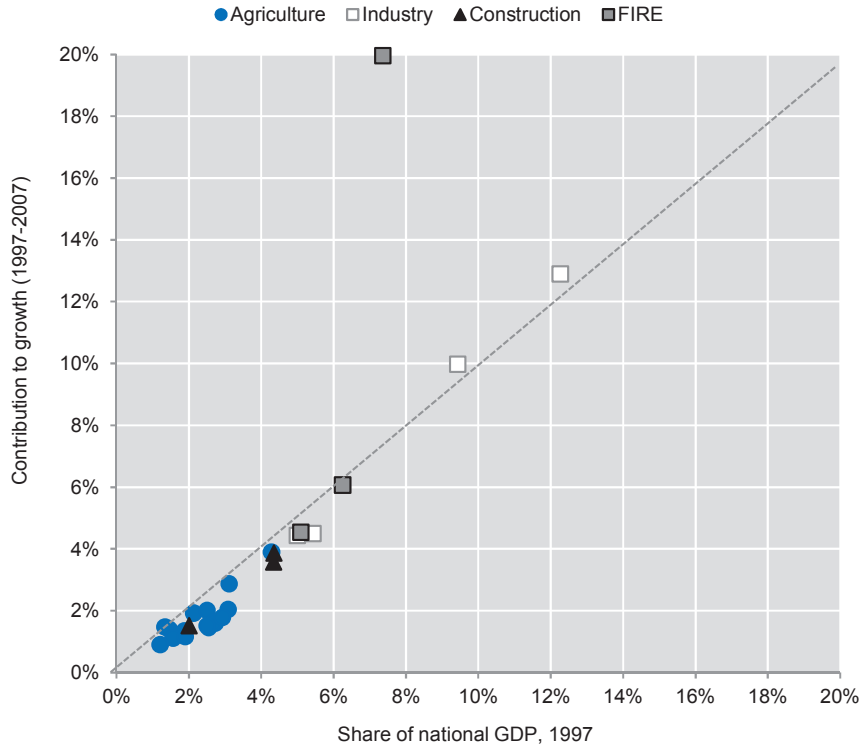
As the crisis persists in the Eurozone, industrially-focused regions are likely to continue to struggle to find external demand to fuel growth, and the recent trend towards regional convergence, prompted by the crisis, may continue, at least in the short run. Yet convergence driven by a faster fall in leading regions is hardly to be welcomed. Most of Ukraine's less affluent (largely agricultural) regions are also failing to grow, and only substantial capital upgrading to boost productivity in the agricultural sector – likely to be difficult in the current fiscal and economic context – is likely to have a profound effect on long-run regional growth trends in Ukraine.

Figure 1.8. **Gross regional product prior to the crisis (2000-07)**



Source: State Service of Statistics of Ukraine.

Figure 1.9. **Contribution to growth (1997-2007)**

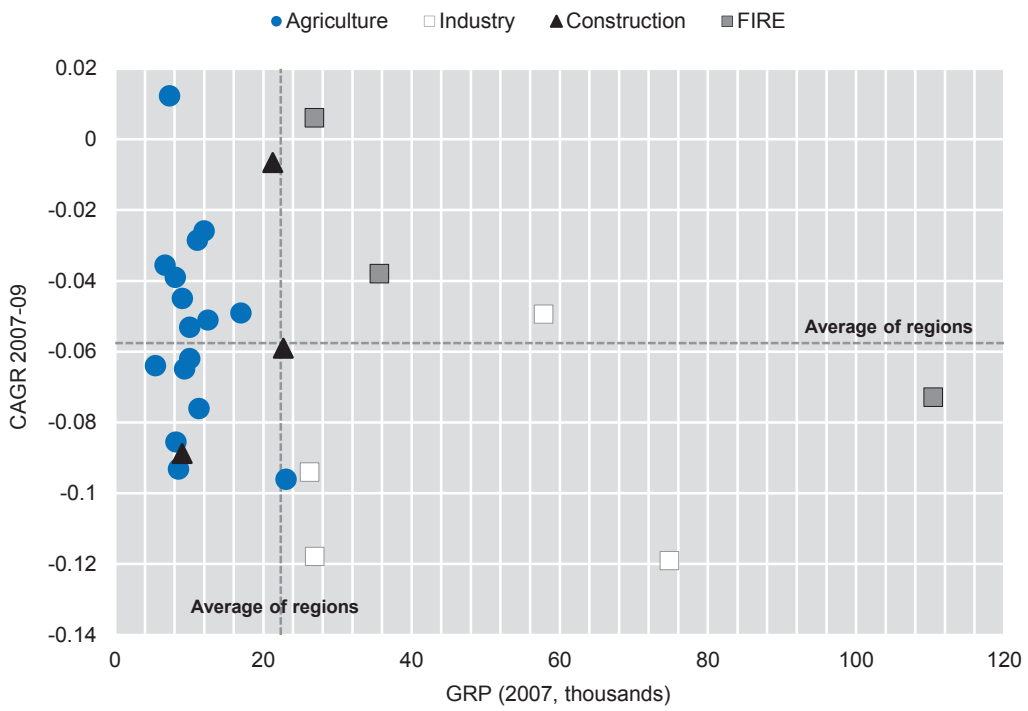


Source: OECD calculations based on data from the State Service of Statistics of Ukraine.

Inter-regional disparities are high by OECD standards

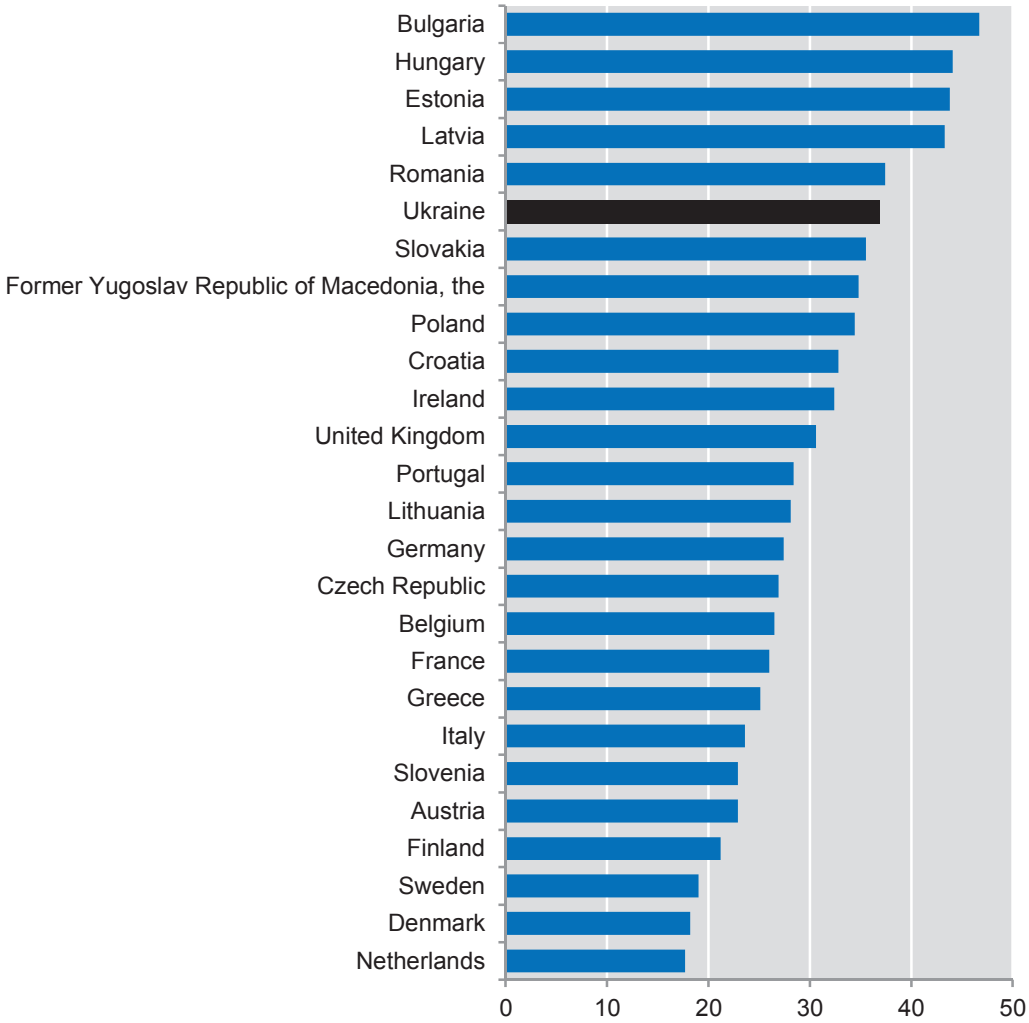
Regional dispersion in GDP per capita in Ukraine is high when compared to OECD countries – both at the macro level in terms of regional GDP (Figure 1.11) and at the micro level, in terms of disposable household income (Figure 1.12). Ukraine inherited already substantial regional imbalances from the Soviet era, and these imbalances were exacerbated following independence by the profound recession of the 1990s. The recovery that followed in the 2000s did not see a catch-up among Ukraine's lagging regions – as noted, there was little change in relative positions apart from the growth of Kyiv. Nor did the impact of the subsequent crisis on outward-oriented regions like Kyiv (city) and Donetsk do much to reduce household income disparities. Moreover, the trend towards greater regional divergence resumed through the initial recovery. Figure 1.13 shows how dispersion in regional GDP and household income was increasing for ten years prior to the crisis – regional GDP dispersion has been more volatile, but the trends were similar. Real wage dispersion, conversely, fell consistently over the same period, in large measure thanks to increasing dispersion in living costs between richer and poorer *oblasts*.

Figure 1.10. **Gross regional product (GRP) growth (2007-09)**



Source: OECD calculations based on data from the State Service of Statistics of Ukraine.

Figure 1.11. **Dispersion of regional GDP (2009)**

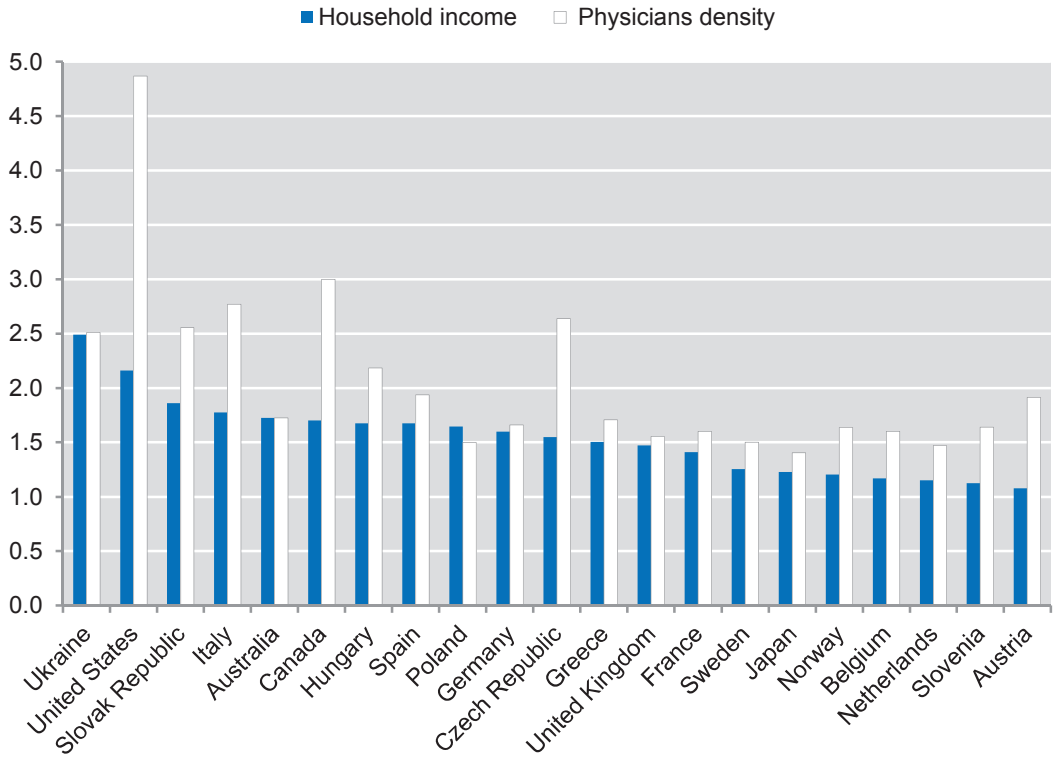


Note: The dispersion of regional GDP (at NUTS level 3) is measured by the sum of the absolute differences between regional and national GDP per inhabitant, weighted with regional share of population and expressed in percentage of the national GDP per inhabitant.

Source: OECD calculations based on data from the State Statistics Committee and Eurostat.

Disparities in regional income are often assuaged by the movement of people from places where wages are lower and opportunities fewer to regions where prospects are better. In this way¸ adjustments in regional labour supply help to limit the growth of regional wage and income dispersion. In Ukraine, however, growing dispersion in household incomes suggests that such labour market adjustment may not be taking place – not, at any rate, on a scale sufficient to check rising inter-regional inequality. This may reflect a number of factors. First, it may be that Ukrainians are insufficiently (inefficiently?) mobile – that institutional and cultural limits to mobility are substantial enough to prevent workers from moving to enhance their employment prospects (World Bank, 2012b). Yet Figure 1.13 suggests that dispersion in real wages (insofar as these are

Figure 1.12. **Inter-regional inequality: Income and services (2007)**

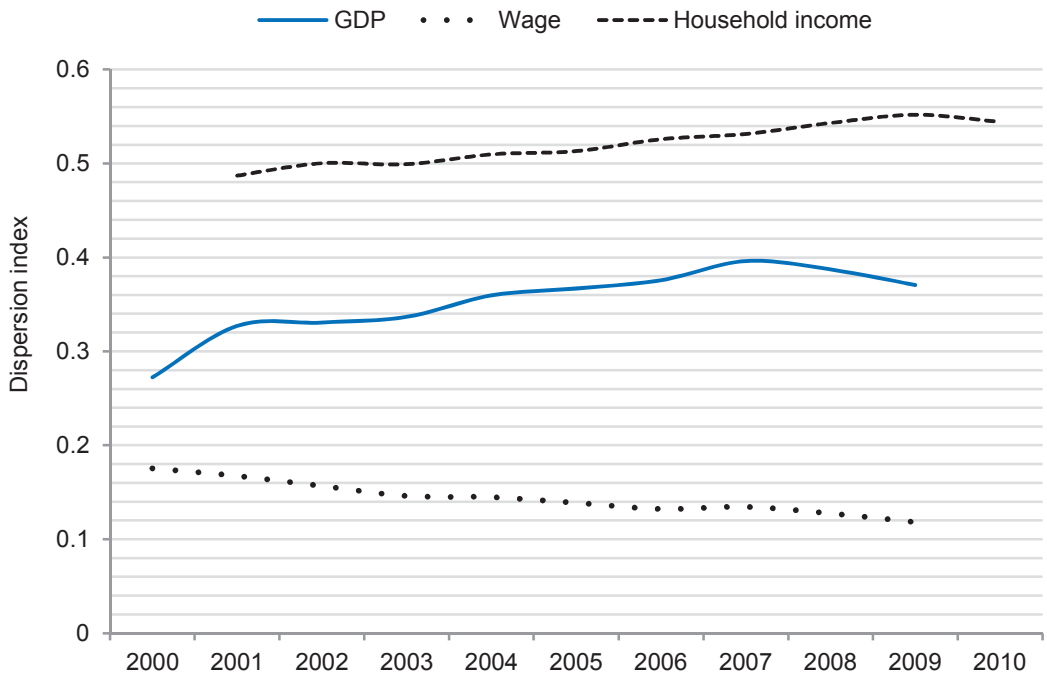


Note: Ratio between the largest and smallest TL2 regional values.

Source: OECD.Stat and State Service of Statistics of Ukraine.

captured by official data) has been falling. It is thus unlikely to be driving the increasing income dispersion. It is therefore likely that much of the labour supply adjustment takes place (if at all) on the informal labour market. Another potential explanation for increasing income dispersion alongside falling wage dispersion may be that wage disparities exist alongside substantial disparities in the cost of living, implying that higher wages in Kyiv and Kharkiv do not translate into higher disposable incomes. In the absence of regional-level data on the prices of non-tradables it is, unfortunately, not possible to ascertain the extent to which real disposable incomes differ across regions.

Figure 1.13. **Regional dispersion trends in Ukraine (2000-10)**



Note: The dispersion index is measured by the sum of the absolute differences between regional and national per inhabitant value, weighted with regional share of population and expressed in per cent of the national figure per inhabitant.

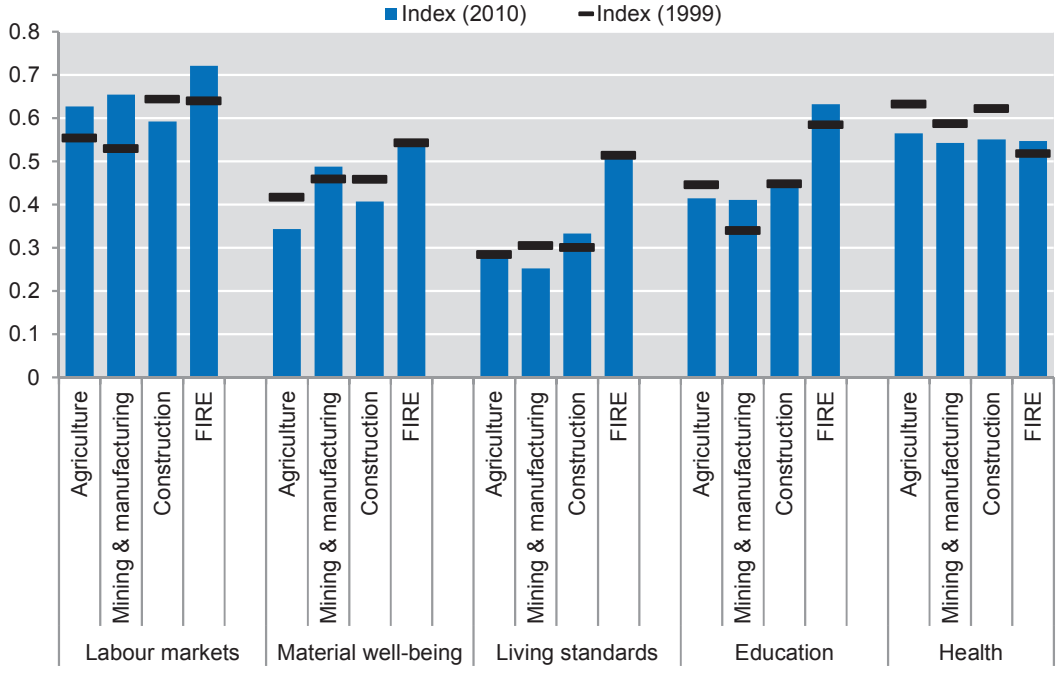
Source: OECD calculations based on data from the State Service of Statistics of Ukraine.

Non-monetary indicators reveal significant differences, and some disturbing trends, in well-being

In the absence of data on disposable incomes or the prices of non-tradables, the human development index can provide an indication of differing living standards across Ukraine. Figure 1.14 illustrates that along various human development measures, those *oblasts* specialising in agriculture score systematically lower than Kyiv and Kharkiv – city *oblasts* specialising in the high-skilled services involved with financial intermediation and real estate. Material wellbeing – incorporating indicators of wages, pensions, expenditures, disposable income, purchasing power, and ownership of consumer durables – is highest in those cities/*oblasts* specialising in finance, insurance and real estate (FIRE). However, in line with the labour market index, the largest **increase** in material well-being has been seen in those regions specialising in mining and manufacturing. Material well-being in agricultural regions, conversely, has fallen in the past decade from an already low base. The index for labour market development, however, exhibits far less regional disparity. This index is based upon employment, unemployment and participation rates as well as working conditions, average job search and turnover rates. And while labour market conditions are, according to this index, best in those regions specialising in FIRE (Kyiv city, Kharkiv, and Odessa), the score of *oblasts* specialising in FIRE is only 10% better than those specialised in agriculture. This suggests that there is some degree of risk involved in migration to expensive city centres in search of work.

More worrying is the education index, where substantial current disparities can have dynamic implications for growth over the longer-term. This index incorporates both measures of education **stocks** – such as the proportion of the adult population with a higher education – and education **flows** – such as enrolment and completion of basic education, as well as the proportion of students who go on to higher education and the length of their studies. To the extent to which changes in the education index are likely to represent declines in the latter indicators, the large degree of disparity in education has worrisome implications for the future dynamism of those *oblasts* (largely agricultural) experiencing declines in this index.[4]

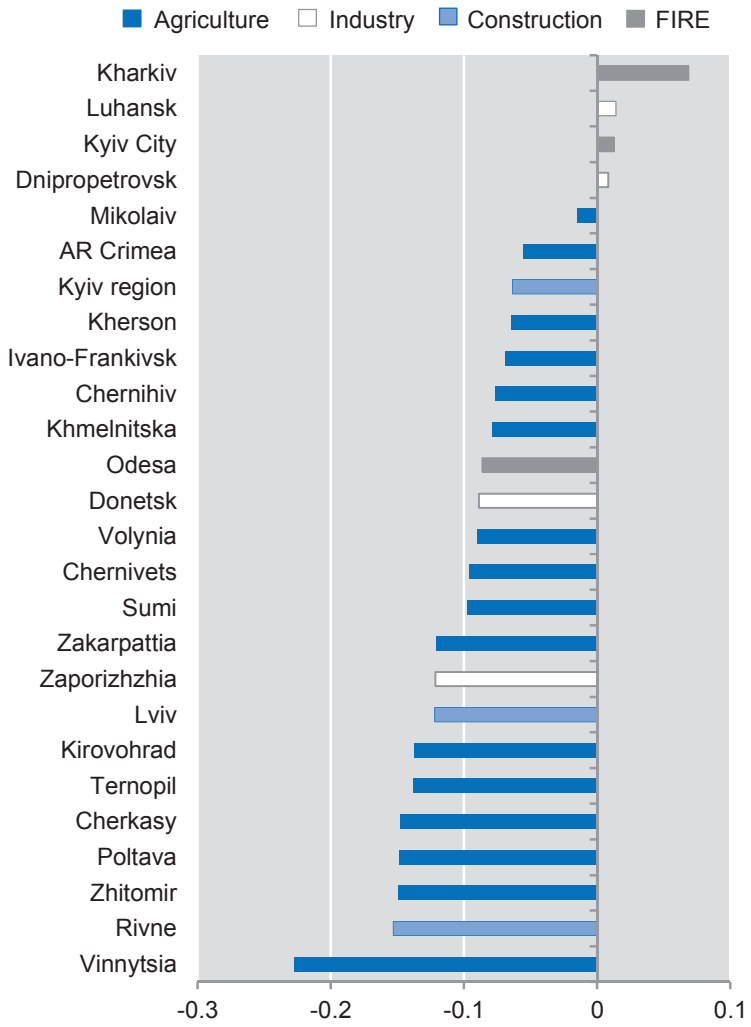
Figure 1.14. **Disaggregated regional human development index (2009-10)**



Source: State Service of Statistics of Ukraine.

Only 12% of the population live in *oblasts* in which the regional human development index improved over the previous decade. Such improvements were seen largely in the major cities of Kyiv and Kharkiv and, to a smaller degree, in the industrial *oblasts*. Agricultural *oblasts* appear to have performed the least well in terms of the evolution of human development indices over the previous decade. No agricultural region experienced an improvement in the aggregate index, and agricultural regions, taken as a whole, have seen notable declines in health, education, and material well-being (Figure 1.15).

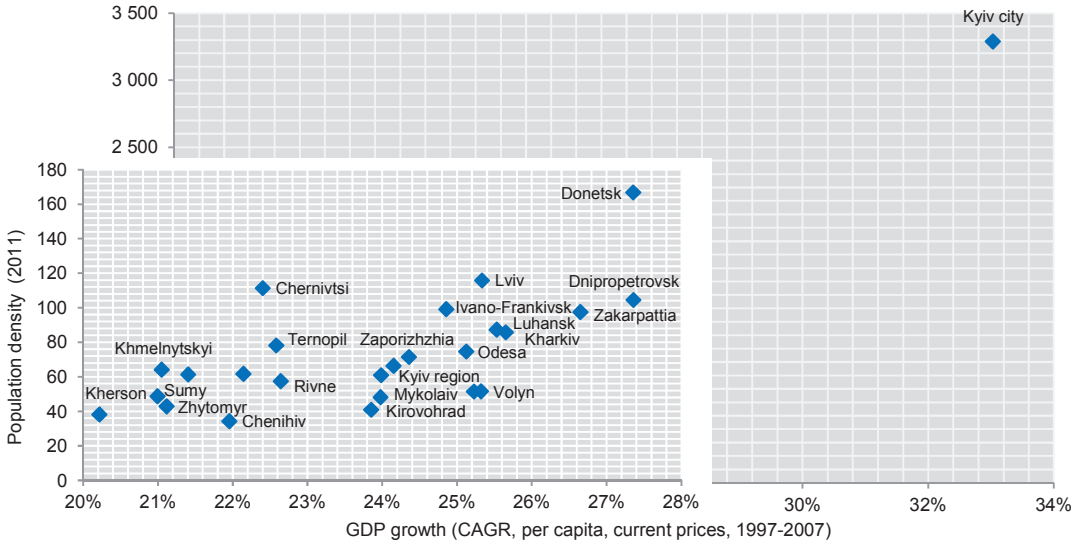
Figure 1.15. **Regional human development index growth (2009-10)**



Source: State Service of Statistics of Ukraine.

Furthermore, there remains a stark correlation in Ukraine between density of population and per capita output (Figure 1.16). This correlation is hardly surprising. Overall, and with the exception of rural regions rich in natural resources, productivity and incomes tend to be higher in cities than in less dense places, and they tend to be higher in larger cities than smaller ones. The strength of the link between city size and productivity holds across the world, though the strength of the connection varies (see Duranton et al., 2008 for analysis based on French data; Glaeser and Maré, 2001 on U.S. data).

Figure 1.16. **Agglomeration and growth**



Source: State Service of Statistics of Ukraine.

A number of different mechanisms underlie this link, collectively known as "agglomeration economies" (Box 1.1). Agglomeration processes can be important determinants of national performance, particularly in times of structural change. However, they arouse great political sensitivities in Ukraine, as in many countries, because rural areas and smaller towns and cities often feel threatened by the growing concentration of population in a few urban centres. Such tensions can be particularly acute when, as in Ukraine, the overall demographic picture is one of decline. When a country's population is growing strongly, there is less concern if it grows faster in some places than others, but when the population is both shrinking **and** increasingly concentrated – as is the case in Ukraine – there is a risk that policy makers will come under pressure to intervene in order to impede migration rather than seeing it as a potential opportunity.

Box 1.1. **Agglomeration economies**

Economic activity is not naturally dispersed; rather it tends to concentrate in certain geographic spaces. This uneven concentration in the context of high land and labour costs in metropolitan areas has a number of explanations, including: the presence of natural advantages (i.e. natural resources, location, etc.); distortive policy interventions (e.g. the decision to create a capital city or fiscal incentives); or the presence of agglomeration economies that induce firms and labour to co-locate. In addition to the transport cost savings associated with physical proximity, scale economies can be roughly divided into four types.

Economies resulting from sharing

- Co-location facilitates the sharing of local public goods and facilities that serve several individuals or firms, including laboratories and universities.
- Locating alongside firms with demands for similar skills, agglomeration also facilitates the sharing of risk. Firms are more able to adjust to changes in demand if

Box 1.1. **Agglomeration economies** (*cont.*)

they have access to a thick labour market that allows them to expand or contract their demand for labour (Overman, 2010).

Knowledge spillovers

- The greater intensity of communication between proximate agents has been associated with increased innovation and technological advances.
- Working in proximity is also associated with enhanced learning among workers – particularly in more skilled agglomerations (Glaeser and Resseger, 2009).

Matching mechanisms

- Labour markets for specialised workers with industry-specific skills pool in urban areas, allowing firms and workers to match more effectively, thus reducing the distance between the skills of the workers and the requirements of the job (Amiti and Pissarides, 2005). An increase in the number of agents trying to match in the labour market also improves the probability of matching.
- Delays are alleviated. There is a possibility that contractual problems arising from renegotiation among buyers and suppliers will result in one of the parties losing out to the other party in a renegotiation. However, if the agglomeration is extensive enough, agents can find an alternative partner.

Specialisation

Economies resulting from intra-industry specialisation allow a finer inter-firm division of labour, increasing the number of forward and backward industrial linkages.

OECD metropolitan regions benefit from agglomeration effects and thus tend to display higher levels of productivity, higher rates of employment, and higher levels of GDP per capita than other regions. These benefits, however, are limited by congestion costs, dis-economies of scale, and oversupply of labour, among other potential negative elements, and many metro regions have in recent decades tended to underperform national economies.

In Ukraine

- Geographical concentration of industrial activities likely reflects the forces of agglomeration that arise through the sharing of local public goods and facilities.
- The concentration of finance and business services in the cities of Kyiv and Kharkhiv reflects the role of knowledge spillovers – the increased communication and knowledge sharing that occurs among individuals located in close proximity.

Source: Overman H.G. and D. Puga, (2010), "Labour pooling as a source of agglomeration: An empirical investigation", in *Agglomeration Economics*, Edward L. Glaeser (ed.), University of Chicago Press, Chicago, IL, April, pp. 133-150; Glaeser, E.L. and M.G. Resseger (2009), "The complementarity between cities and skills", *NBER Working Paper*, No. 15 103, June; Amiti, M. and C.A. Pissarides (2005), "Trade and industrial location with heterogeneous labor", *Journal of International Economics*, Vol. 67, No. 2, pp. 392-412, Elsevier, December; Duranton, G. and D. Puga, 2004. "Micro-foundations of urban agglomeration economies," in: J.V. Henderson and J.F. Thisse (ed.), *Handbook of Regional and Urban Economics*, Edition 1, Volume 4, Chapter 48, pp. 2063-2117, Elsevier; OECD (2009), *How Regions Grow: Trends and Analysis*, OECD Publishing, http://dx.doi.org/10.1787/9789264039469-en.

The benefits of agglomeration are neither linear nor infinite, and the major urban hubs may eventually suffer from congestion costs in the medium and longer term. That said, there is nothing to suggest that Ukraine has reached the point of diminishing returns when it comes to agglomeration economies, and, indeed, labour mobility is currently below the levels that would be expected given current productivity disparities (see Box 1.2 below). Furthermore, appropriate investment and land use regulation can assuage the costs associated with scale, and further geographic concentration of economic activity should not be viewed as a threat.

Box 1.2. **Migration – If inequality is pronounced, why not more migration?**

Internal labour mobility in Ukraine is low. Indeed, a recent World Bank study (2013) found that, in relation to other countries in the region, internal mobility in Ukraine should be expected to be about twice as high as is actually observed. Such low labour mobility is particularly notable in Ukraine because the significant inter-regional disparities in wages and unemployment rates (outlined above) could be expected to draw workers to those regions in which they could most profit from the opportunities provided by these disparities.

However, while migrants do appear to be leaving those regions that are lagging behind, they do not appear to be moving to those regions where economic opportunities are most widespread. Migration can enhance productivity; by enabling people with relevant skills to match with appropriate jobs, geographical mobility can tackle skills shortages, improve productivity, and encourage individuals to invest in their own skills. In the context of continual changes in skill demand, internal migration can represent an important source of flexibility. However, while the inefficiencies involved in Ukraine's low internal migration are manifold, the causes of this geographical scleroticism are less well understood.

The fact that commuting – capturing non-residential labour migration – is more responsive to disparate economic opportunities suggest that price differentials – particularly in non-tradables such as housing– may erode the potential benefit in terms of wages to such an extent that moving to economic opportunity is no longer a rational course of action. Very high rates of home ownership, combined with a lack of affordable (rental) housing and limited access to credit, put the possibility of migrating to opportunities out of the reach of many of those who would most benefit from it.

Another potential explanation for the apparently low labour mobility in Ukraine may be that the data on formal employment does not represent the true mobility of the informal labour force. Indeed, the system of social benefits creates little incentive for migrant workers to register in their new geographic location if they do not intend to undertake paid formal employment. And weak and bureaucratic institutions, involving long administrative procedures, imply sufficient costs to dis-incentivise registration.

A final factor underpinning the low internal migration rates stems from current regional policy. In discussions with the secretariat, regional policy makers explained the goal of policy as "creating employment where the labour supply exists rather than attracting labour where it is demanded". In addition to blunting the market signals that guide resource allocation, such production planning requires large-scale investment resources that, in the current climate, Ukraine will struggle to muster.

Behind the trends: Inputs to growth and productivity

Like national growth, regional growth is dependent on the availability of inputs – capital and labour – but in addition it also hinges on regional productivity. With an

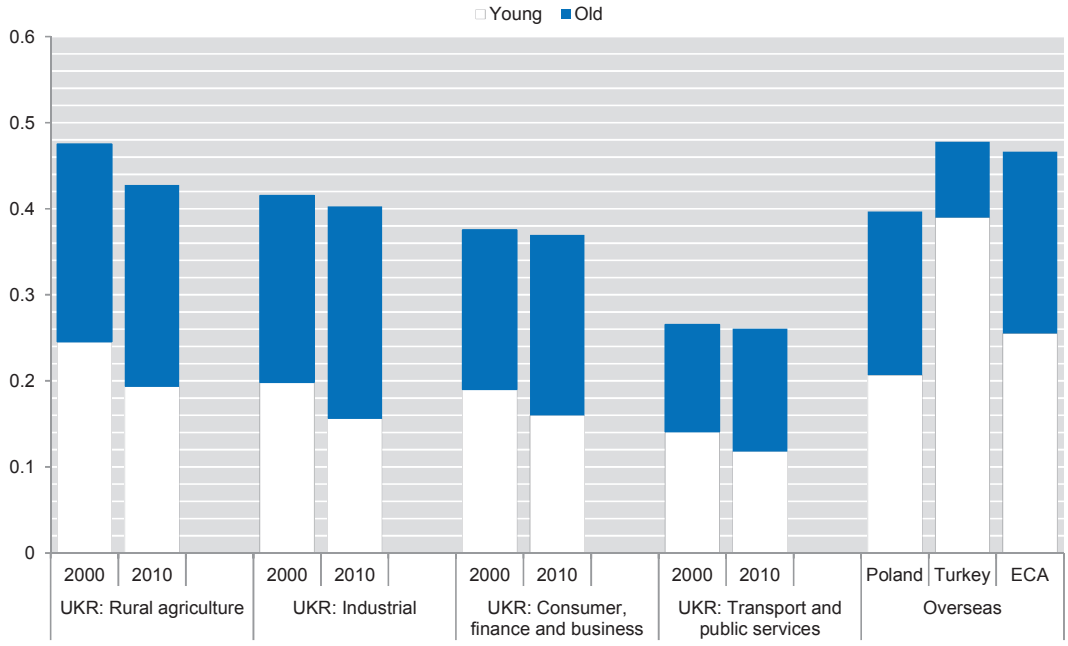
ageing population, large-scale overseas migration, tight public finances and limited foreign investment, both labour and capital inputs are in short supply in Ukraine. Regional growth in Ukraine, therefore, is likely to depend heavily on productivity improvements.

Labour input is unlikely to be the primary driver of growth

The Ukrainian labour force has traditionally been not only highly skilled but relatively inexpensive. An average wage of approximately 300 USD a month, compared to 1 135 USD in Poland (Polish Ministry of Statistics), combined with the Soviet legacy of a rigorous and scientifically oriented education system ensured that skills had a strong potential to drive Ukrainian growth. However, impediments to investment and mobility have constrained this potential somewhat; the share of unskilled jobs in total employment *increased* by 6.3 percentage points between 2000 and 2010 at the same time as the share of white-collar and office jobs fell from 39.2% to 36.9% (World Bank, 2012b). Yet the changing demographic composition of the country is likely to impede the future ability of Ukraine to rely on relatively cheap skilled labour to drive growth. In the context of an ageing population, if labour is to play a substantive role in promoting growth – both regional and national – it will have to do so through improvements in labour productivity and quality. Relying on quantity will not be an option.

The dependency ratio in Ukraine is below that of regional competitors, yet the population of Ukraine is relatively old and ageing (Figure 1.17). The decline in the dependency rate between 2000 and 2010, from 0.35 to 0.33, is almost wholly accounted for by a decline in the proportion of the population aged between 0 and 14. This trend is particularly pronounced in those regions of Ukraine specialised in agriculture and industry.

Figure 1.17. **Dependency ratio**

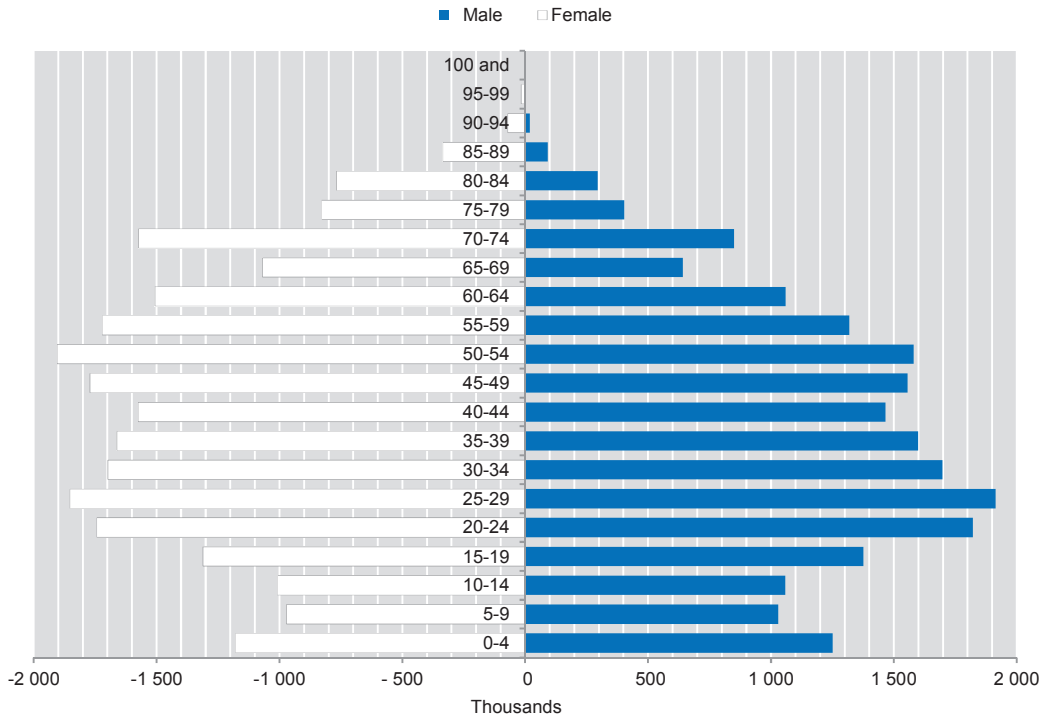


Source: OECD calculations based upon State Service of Statistics of Ukraine.

Mortality rates in Ukraine are among the highest, not only in Europe, but also in the world. Despite a short life expectancy of just over 70 years, an extremely low fertility rate

and large levels of migration of the working-age population (Figure 1.18) have ensured that Ukraine's population "pyramid" looks rather more like an oak tree.

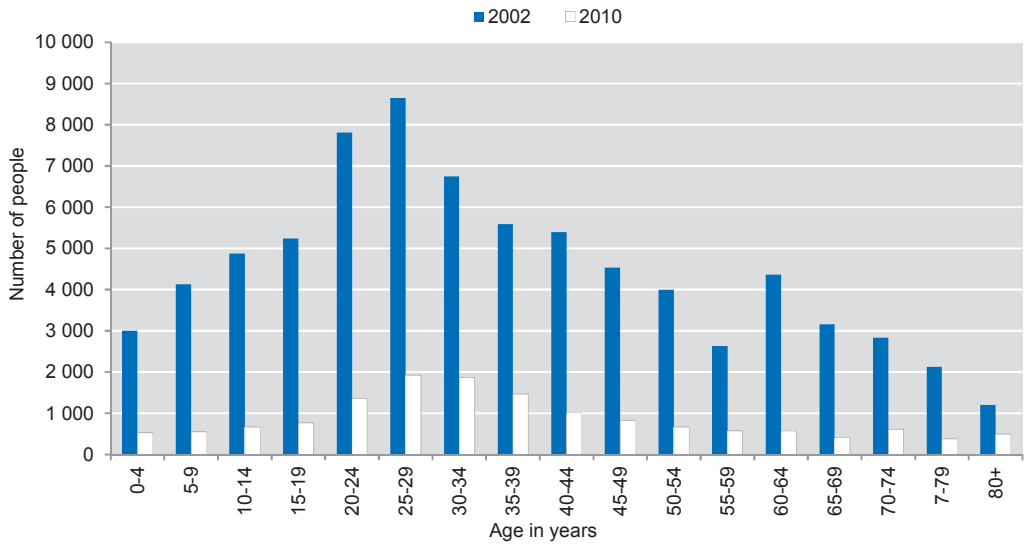
Figure 1.18. **Population age structure, Ukraine (2011)**



Source: State Service of Statistics of Ukraine.

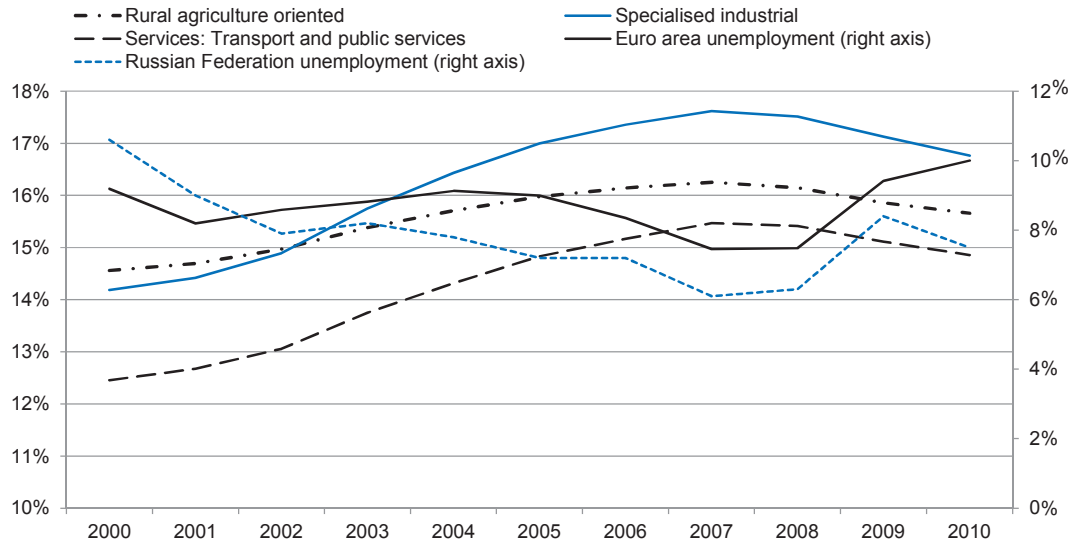
Migration rates declined in the latter half of the 2000s (Figure 1.19) as the onset of the financial crisis dampened global demand, and, indeed, old-age dependency rates exhibit an inverse correlation with unemployment rates in Russia and the Euro area (Figure 1.20).

Figure 1.19. **Migration**



Source: State Service of Statistics of Ukraine.

Figure 1.20. **Population 65+ (proportion of total)**

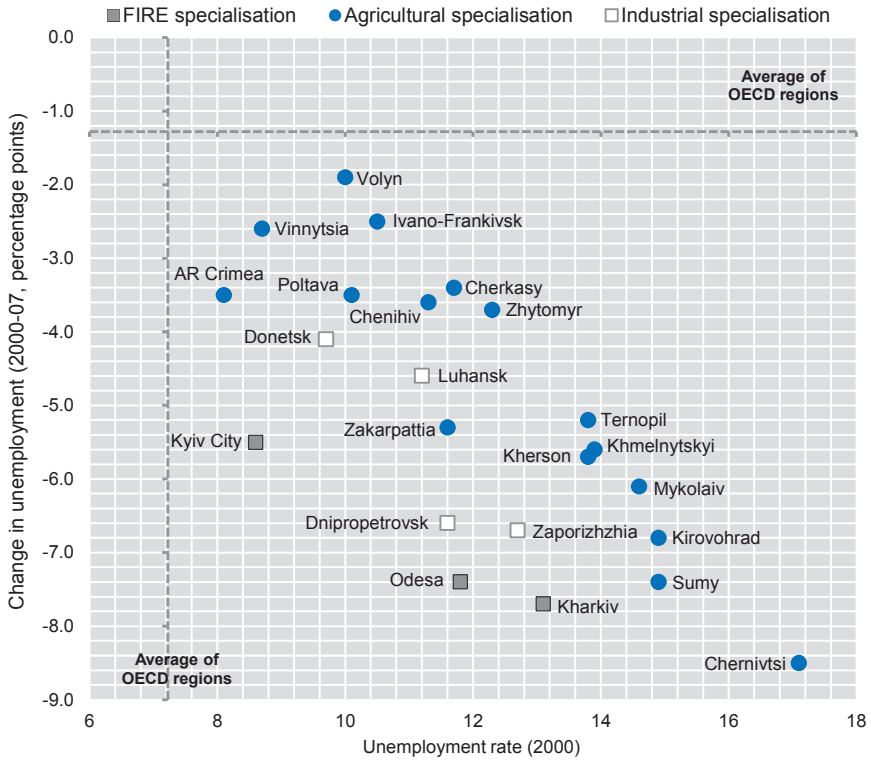


Source: State Service of Statistics of Ukraine and WDI (labour/dependency ratio).

Unemployment fell rapidly between 2000 and 2007, as productivity gains and large inflows of private finance fuelled demand. Such was the extent of the fall in unemployment that while all Ukrainian regions exhibited an unemployment rate above the average of OECD regions in 2000, the fall in unemployment in all Ukrainian regions without exception was faster than the OECD average. The pattern of unemployment in Ukraine, prior to the crisis, largely followed the pattern of regional specialisation (Figure 1.21). Regions specialised in agriculture tended to exhibit higher unemployment rates – with an average unemployment rate of 10% between 2000 and 2007, whereas regions specialised in financial intermediation and real estate and industry were characterised by lower rates – 7% and 8.2% respectively. At the same time, with a few exceptions, such as Sumy and Kirovohrad, agricultural regions saw

smaller falls in unemployment leading to increasing polarisation in employment prospects across the country over the years prior to the crisis. Relatively low job turnover and job reallocation rates indicate that the Ukrainian labour market is less dynamic than its neighbours. In 2007, only 8.3% of all jobs were either destroyed or created, less than half the rate of, for example, Lithuania, Moldova, or Bulgaria. Similarly, less than 3% of all jobs moved from contracting forms to expanding firms (World Bank 2012b). This reflects a larger pattern identified in OECD (2007): despite the strong growth observed before the crisis, there were important factors impeding the Schumpeterian process of creative destruction, which was and is vitally necessary to the restructuring and renewal of the Ukrainian economy. Stimulating robust productivity growth and increased innovation will also require profound reform of product markets in order to enable the process of creative destruction to unfold. Cross-national empirical studies find that higher firm turnover (i.e. higher entry and exit) is growth-enhancing. Because the restructuring of large state-owned enterprises (SOEs) is fraught with difficulty and often subject to considerable delay, reducing barriers to entry and allowing the growth of new activities has been a crucial engine of transformation in the more successful transition economies. Barriers to entry and exit are still substantial in Ukraine. The economy – particularly the industrial sector – is still dominated by energy-intensive heavy industrial sectors, and this is one reason why so much past policy has been oriented towards averting rather than facilitating needed structural change. Empirical analysis of entry and exit in OECD (2007) confirmed the impression that Ukraine had particular problems with exit: in particular, the relationship between productivity and survival/exit was remarkably weak.

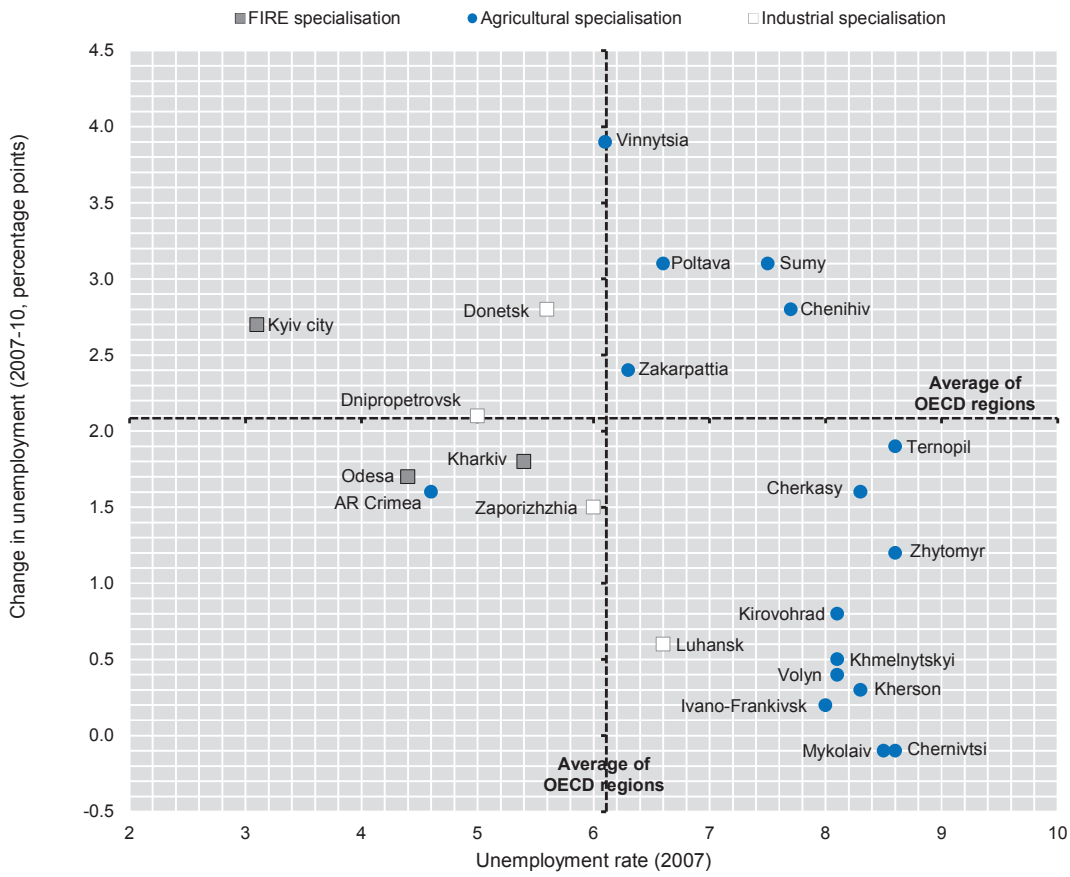
Figure 1.21. **Regional unemployment prior to the crisis (2000-07)**



Note: Excludes Sevastopol.
Source: State Service of Statistics of Ukraine.

The impact of the crisis has, however, been felt the strongest in Ukraine's major agglomerations leading to some limited employment convergence of the years since 2007 (Figure 1.22). Furthermore, given that a large proportion of informal, service sector, workers are working in Kyiv these official employment statistics may underestimate this trend.

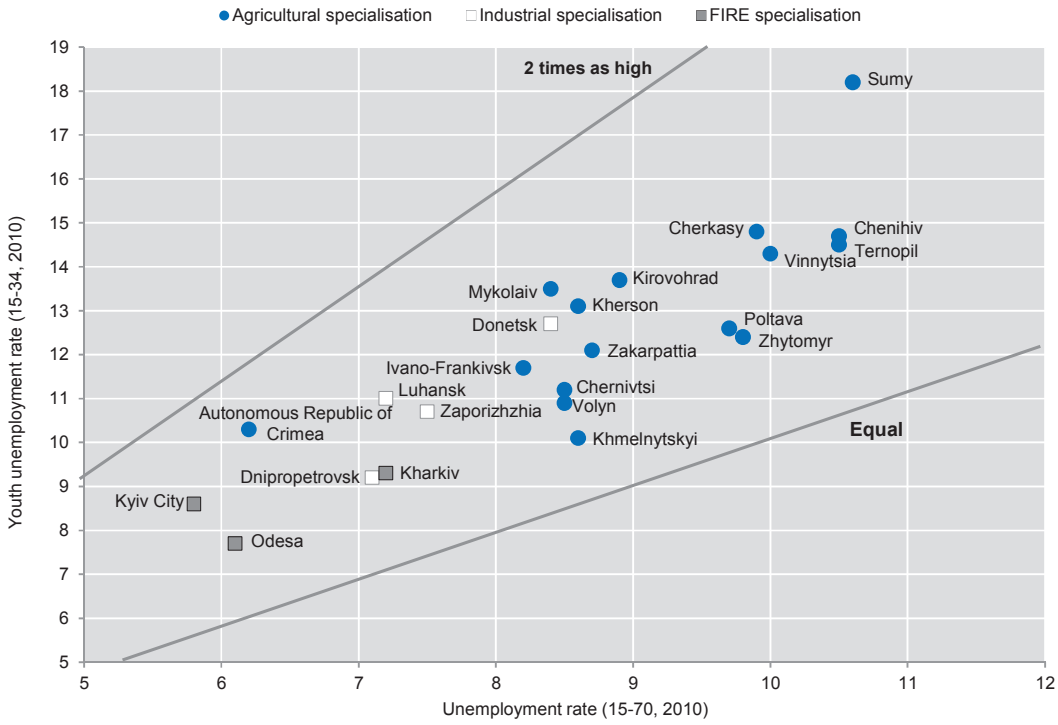
Figure 1.22. **Impact of the crisis on regional unemployment**



Source: RDP database and State Service of Statistics of Ukraine.

The unemployment rate among youth is higher than the overall unemployment rate (Figure 1.23). However, in the absence of reliable data on informality or participation rates, it is difficult to say more about what is behind this trend.

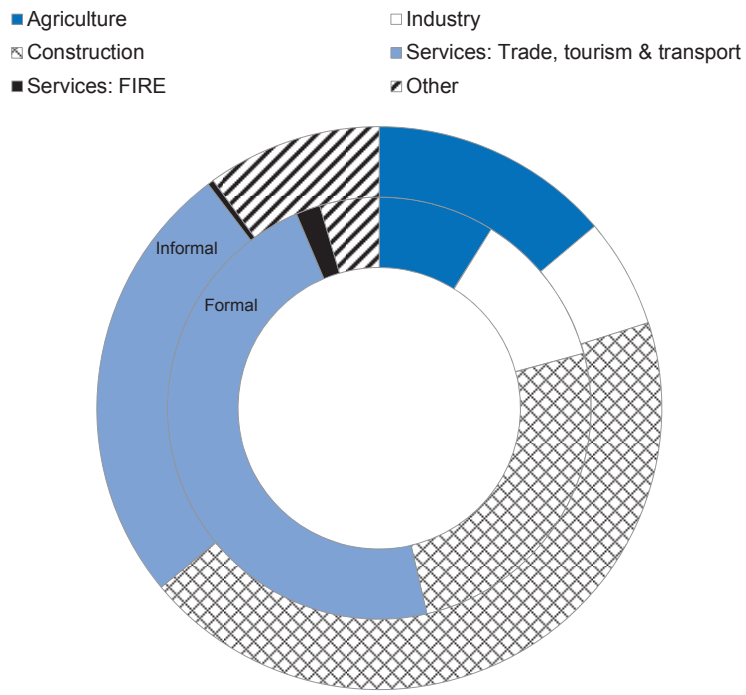
Figure 1.23. **Youth unemployment**



Source: State Service of Statistics of Ukraine.

The World Bank estimates that in 2009, there were approximately 4.5 million people, aged 15-70, working in the informal sector – over 22% of total employment (World Bank, 2011). While much of this informal work takes place in private agriculture, a large proportion is comprised of wage workers, working under oral contracts – particularly in construction (Figure 1.24). Informal workers can be further disaggregated into those working informally in informal firms – often small and medium-sized enterprises – and those working informally in formal firms (at least 6% of wage work in formal firms is estimated to be informal). In addition, there is evidence of widespread under-declared work, in which part of earnings are concealed in collusion with the employer. This large informal labour market ensures that much of the reaction of unemployment and wages to changes in the demand for labour is subdued in the data. Thus, even in the face of the favourable labour market conditions between 2000 and 2007, employment rates remained low (61.5% in 2007, compared to an OECD average of 66.3%). This apparent sclerosis of the participation rate is more likely to reflect the large number of informal workers than rigidities in the labour markets. Informal labour is more flexible and is, therefore, more likely to alter to take up the slack when labour demand increases. However, the informal are also more vulnerable in times of low labour demand.

Figure 1.24. **Informal and formal wage employment by economic sector (percentage of total)**



Source: World Bank (2011), "The Scope and Main Characteristics of Informal Employment in Ukraine", Washington D.C.

The large informal labour market renders the observation of true employment capacity difficult. However, taking the working age population as an upper bound, labour capacity in Ukraine will be limited going forward. Despite having some of the highest mortality rates, not only in Europe but in the World, and a short life expectancy of just over 70 years, Ukraine is relatively old and ageing. Combine this with an extremely low fertility rate, and large levels of migration of the working age population and it becomes apparent that future labour supply will be a constraint on growth rather than a contributor.

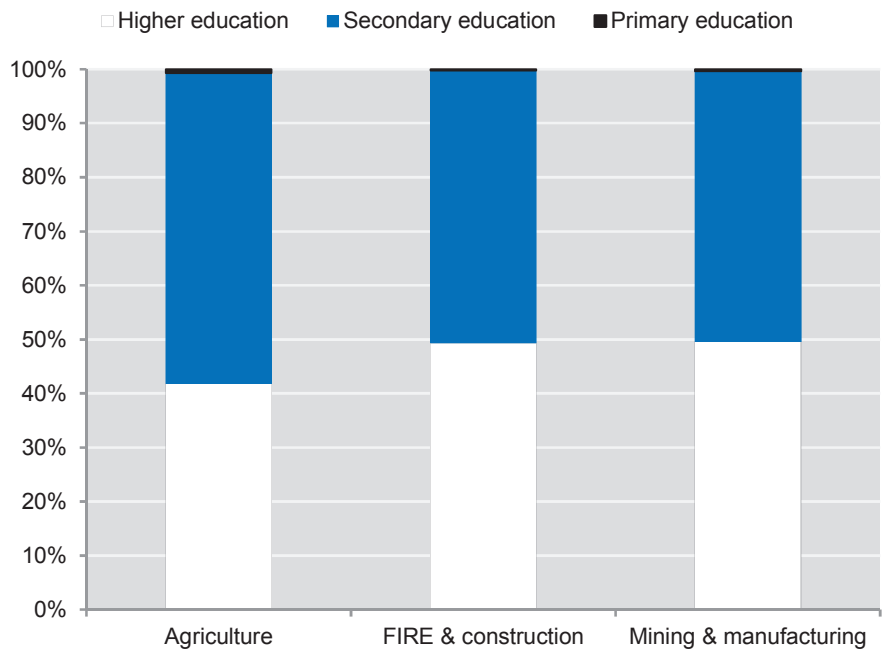
The link between education and productivity is weak

Literacy and school enrolment rates are high and growing in Ukraine. The proportion of the economically active population aged 15-70 holding some form of higher education degree ranges from 29% in Chernivtsi to 72.6% in the city of Kyiv, and the proportion holding only a primary education degree is below 2% in all regions (Figure 1.25). Not only is the workforce relatively educated but the number of students enrolling in tertiary education is growing in most *oblasts* (the exceptions being the Autonomous Republic of Crimea, Kirovohrad, Kherson and Chernihiv). This growth is, unsurprisingly, largest in those regions specialising in financial intermediation and real estate, and construction. It is lowest in those regions specialising in agriculture (Figure 1.26).

However, despite increasing numbers of tertiary graduates there is little evidence of increased labour productivity. Larger budget allocations to education do not appear to have resulted in improvements in the quality. Low returns to education may suggest either that constraints are not binding, or that the supply of skills is mismatched to demand. However, there are no available data on the quality of education, and wage data are problematic due to wage compression, underreporting of income and informality. This

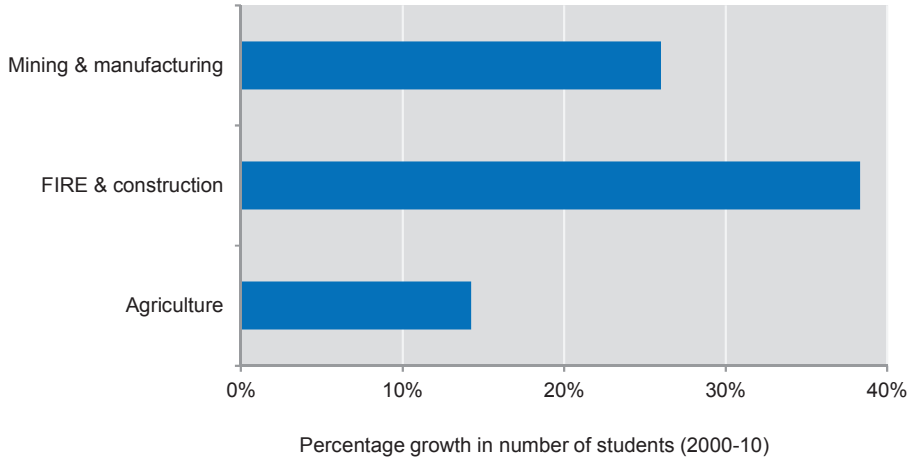
makes any deeper assessment extremely difficult. Nevertheless anecdotal evidence is suggestive of a mismatch in many regions between the subjects that students are graduating in and the requirements of the labour market. The result is a degree of "brain waste" as graduates are, in many instances, choosing to retrain as, relatively low-skill, IT technicians.

Figure 1.25. **Economically active population aged 15-70 by educational attainment (2010)**



Source: State Service of Statistics of Ukraine.

Figure 1.26. **Percentage growth in number of students enrolled in tertiary education, by regional specialisation (2000-10)**

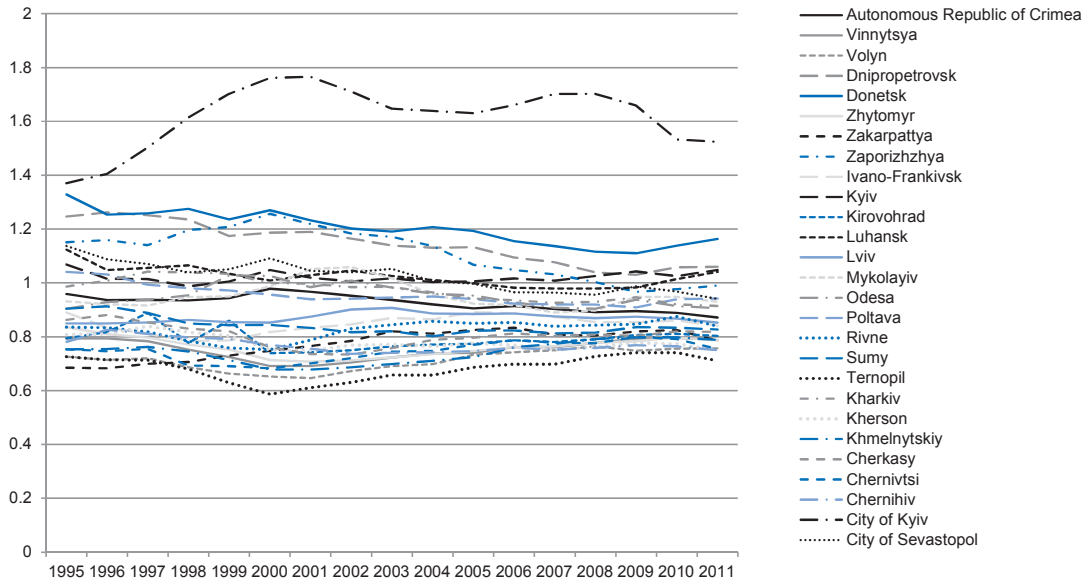


Source: State Service of Statistics of Ukraine

Regional wage disparities can provide a good proxy for the productivity of labour. In Ukraine, wages in Kyiv are substantially higher than elsewhere in the country, peaking

nearly 1.8 times the national average in 2000 and since falling off to just under 1.6 times the national average (Figure 1.27). Elsewhere in the country higher, wages are observed in the industrial east, whereas lower wages prevail in the west. While nominal wages have been diverging, there has been a tendency, over the past ten years, for real wages to converge.

Figure 1.27. **Regional wage disparities (ratio of average regional wage to national average)**

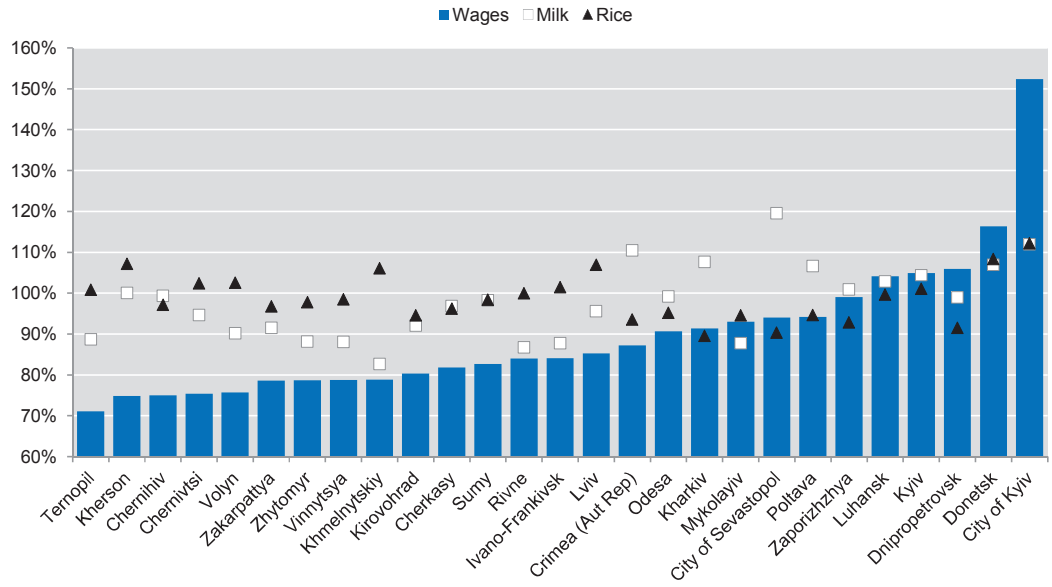


Source: State Service of Statistics of Ukraine.

After accounting for disparities in the cost of living, the dispersion in wages is likely to be even smaller still. Figure 1.28 shows the regional price disparities in rice and milk against the regional disparities in wages. Given that rice and milk are easily transportable tradable goods, one would not expect to observe much in the way of regional price disparities, but the differences are in fact quite significant. The largest disparities should be observed in non-tradables, of course, for which no data are available. In the absence of regulatory or other barriers to internal trade, tradable price differences should reflect the non-tradable components of the price (e.g. retail mark-ups) and transport costs. The differences observed in the figure below should thus be taken as a *lower bound* in estimating overall price disparities. Despite this, there is some degree of correlation; the correlation between the price of milk and wages is more pronounced still.

Figure 1.28. **Regional wage and price disparities (2011)**

National average = 100%



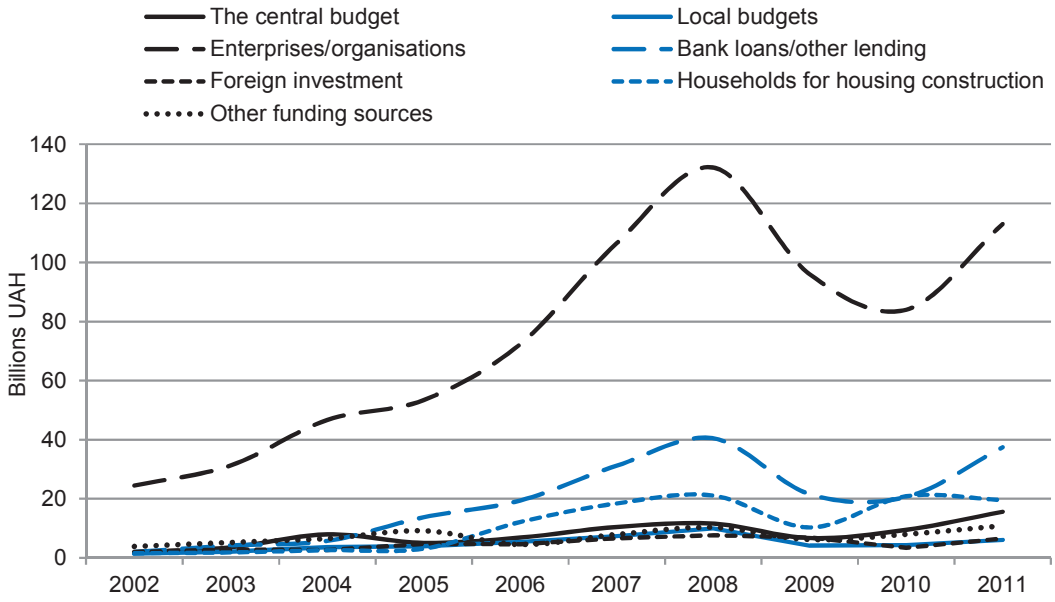
Source: State Service of Statistics of Ukraine.

The industrial capital stock is limited and deteriorating

Long-term growth in Ukraine will require boosting investment. Given the state of the country's public finances, much of this investment will need to come from elsewhere. Attracting investments to promote business and new and growing sectors, however, may not be straightforward in a context of an ageing infrastructure and a weak business environment.

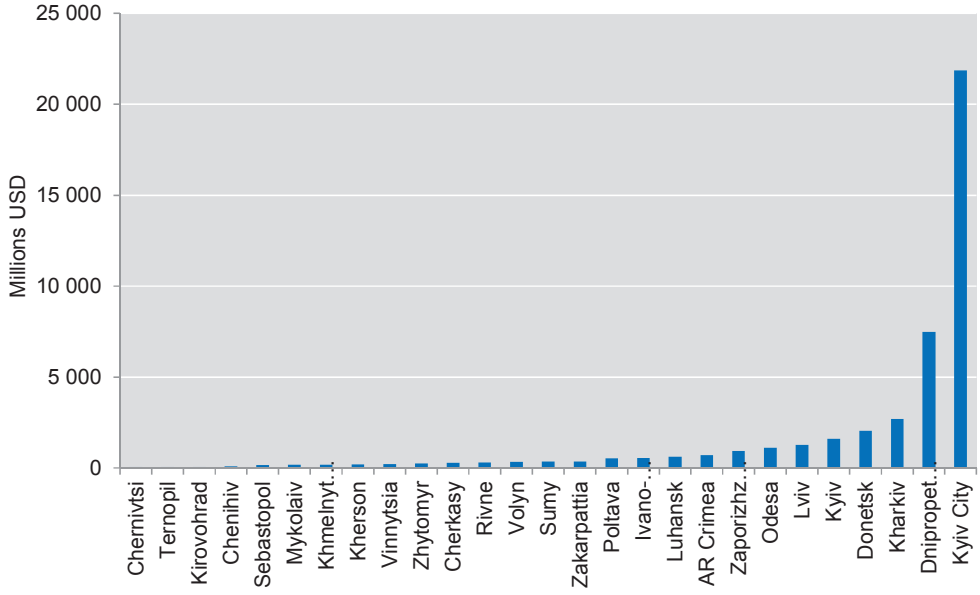
Private sources contribute a substantial proportion to fixed capital investment in Ukraine (Figure 1.29). However the proportion of fixed capital investments originating from the enterprise sector has been falling consistently in all years except 2009 – from 66% in 2002 to 54% in 2011. These investments in fixed capital are largely concentrated in the city of Kyiv and in Dnipropetrovsk and Donetsk *oblasts*. Indeed, though these regions account for less than 24% of the population, they are the destination of over 35% of total fixed capital investment. Foreign direct investment (FDI) has also been decreasing as a proportion of total fixed investment. Overseas finance, which had been contributing a greater share towards fixed capital investment until 2008, has fallen away since the crisis. Furthermore, outside the major cities of Kyiv, Dnipropetrovsk and Kharkhiv, access to foreign direct investment is limited (Figure 1.30).

Figure 1.29. **Fixed capital investment, by source of financing (2000-11)**



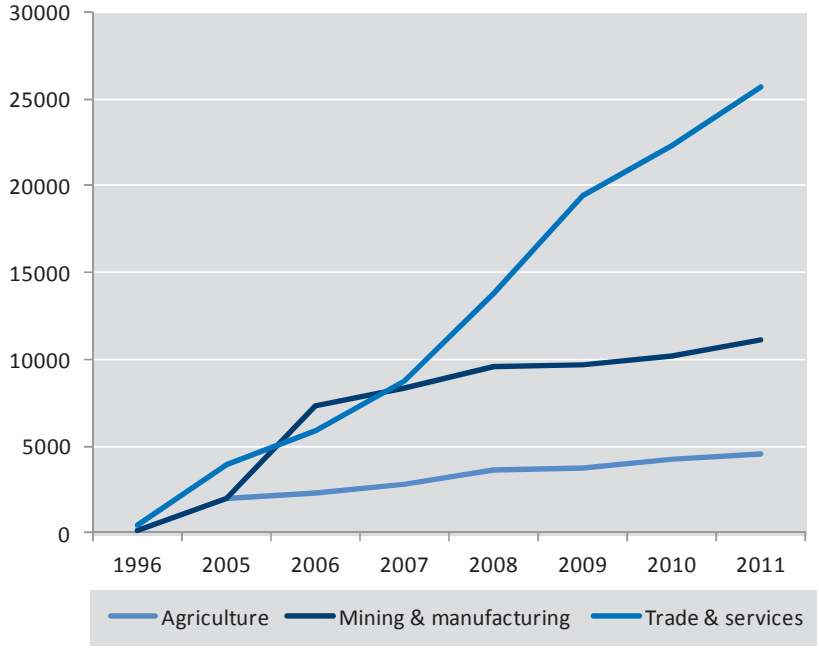
Source: State Service of Statistics of Ukraine.

Figure 1.30. **Stock of regional FDI, 2011**



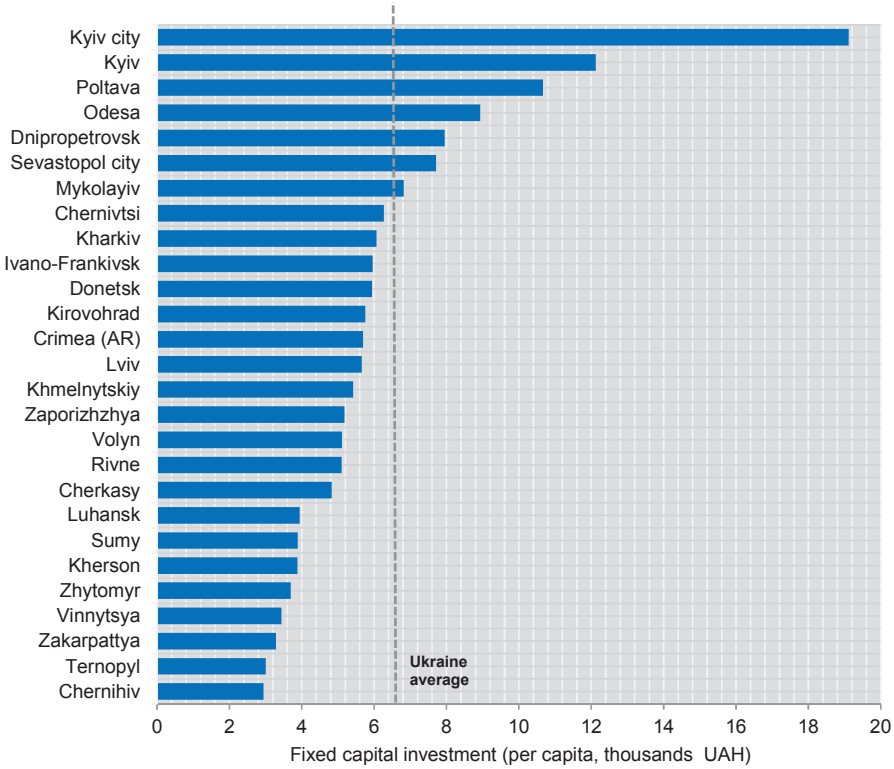
Source: State Service of Statistics of Ukraine.

Figure 1.31. **Regional FDI by sectoral specialisation as measured in 2005**



Source: OECD calculations based on data from the State Service of Statistics of Ukraine.

Figure 1.32. **Fixed capital investment (per capita, thousand UAH)**

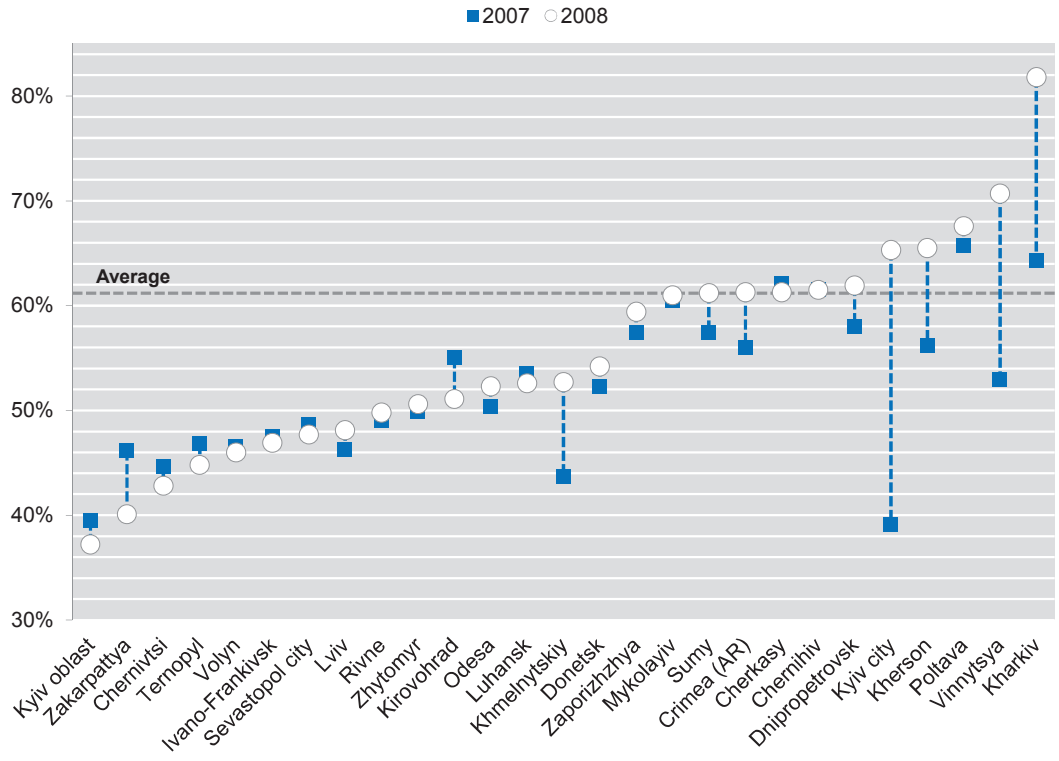


Source: Ministry of Economic Development and Trade.

Levels of capital exhaustion, measured in terms of the share of fixed assets in operation beyond their foreseen lifespans, are high in Ukraine – above 35% in all

Ukrainian regions compared to an average of 25% across the developed world. Exhaustion rates are particularly high in the economic hubs of Kharkiv, Kyiv and those regions – such as Vinnitsa and Kherson – that receive particularly limited levels of new investment (Figures 1.32 and 1.33). Such inter-regional disparities may be indicative of the extent to which central government investments hinge upon personal political relationships.

Figure 1.33. **Capital exhaustion by *oblast* (2007, 2008)**



Source: Ministry of Economic Development and Trade.

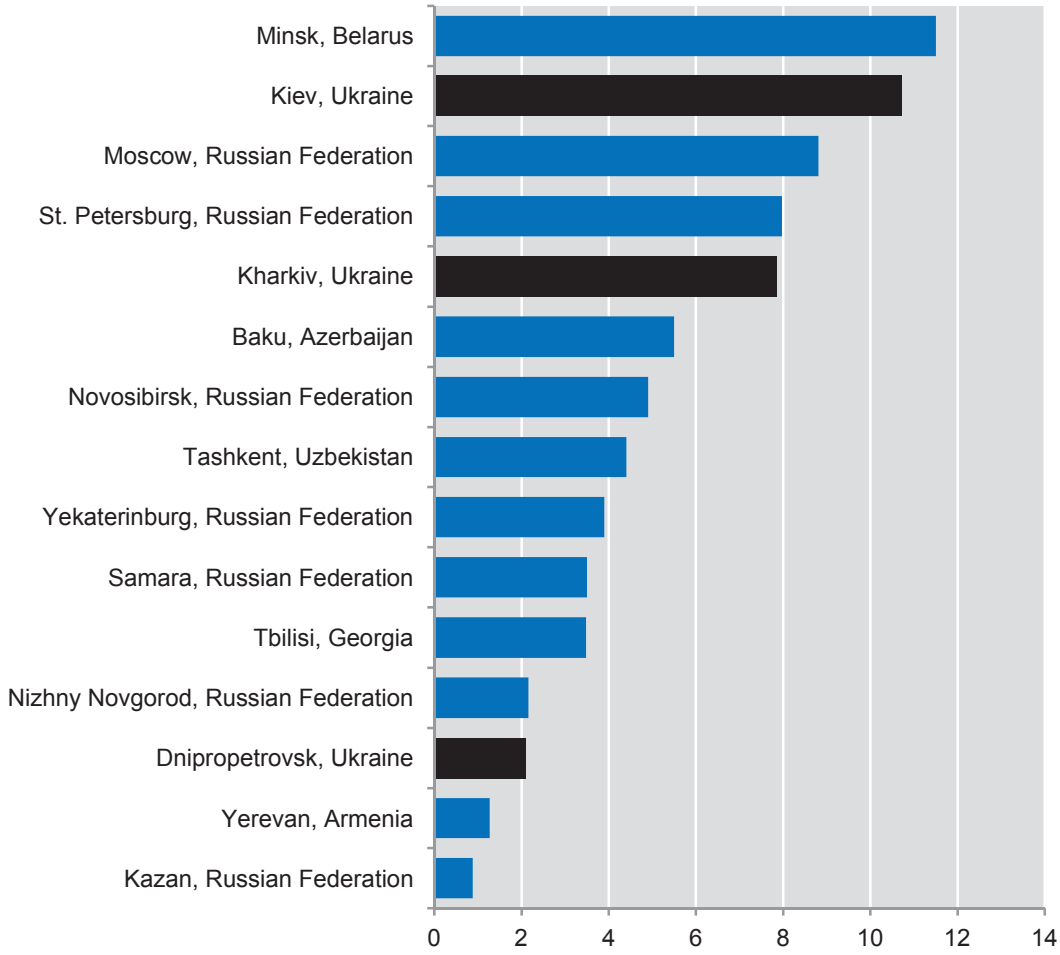
Infrastructure bottlenecks have become an impediment to growth

The quality of Ukraine's infrastructure is currently insufficient to support adequate public service provision and private sector growth. Furthermore, levels of spending on infrastructure in Ukraine are approximately 30% of those in lower-middle income countries elsewhere in the world. Lack of maintenance combines with poor planning to ensure that even the infrastructure that exists is rapidly deteriorating. Infrastructural investments in Ukraine experienced a temporary boost in the run-up to Euro 2012 and the parliamentary elections of October 2012. Yet despite agreement that infrastructural investments must remain a priority, ambitious deficit targets (1.7% in 2012) are likely to limit the room for manoeuvre in the coming years.

Ukraine occupies a strategic location encompassing four key Pan-European corridors. Yet with a road network of only 170 000 km, only half of which is paved, the density of Ukraine's road network is roughly 1/3 of the average of Eastern Europe and Central Asia (Ministry of Infrastructure, 2011; World Bank, 2010). The rail network consists of less than 22 000 km of track (less than 10 000 km of which is electrified). It remains more reliable than the road system, but limited revenues are used largely for operating costs leaving little for further investment and upgrading (Ministry of Infrastructure, 2011).

Furthermore, cross subsidies from industrial users to passengers increase the cost of freight and, concomitantly, reduce export competitiveness. With the exception of the Dnipropetrovsk metro, Ukraine's metros are among the most heavily used in Europe and Central Asia (Figure 1.34). Ukraine has 4 roads and 4 rail border crossing points. Average waiting times range from 30 minutes to 2 hours for passenger trains and from 5 to 21 hours for freight trains. There are 18 commercial sea ports.

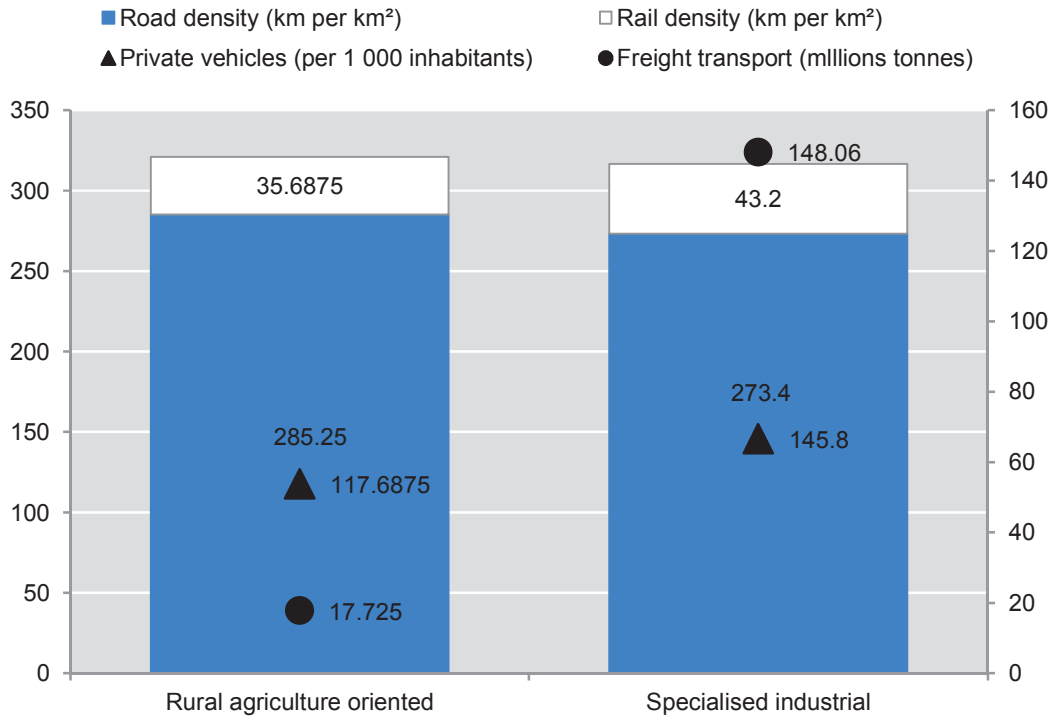
Figure 1.34. **Metro usage (millions passengers per square km)**



Source: World Bank (2012b), "Eurasian Cities: New Realities along the Silk Road", Eastern Europe and Central Asia Report, Washington D.C.

The link between transport usage and government investment does not always appear to be automatic (Figure 1.35). Rural agricultural regions have similar infrastructure levels as industrial regions despite quite disparate usage. Indeed, in 2012, the government successfully applied for a loan of EUR 152 million from the European Bank for Reconstruction and Development to extend a metro line in the city of Dnipropetrovsk.

Figure 1.35. **Transport infrastructure and usage (2011)**



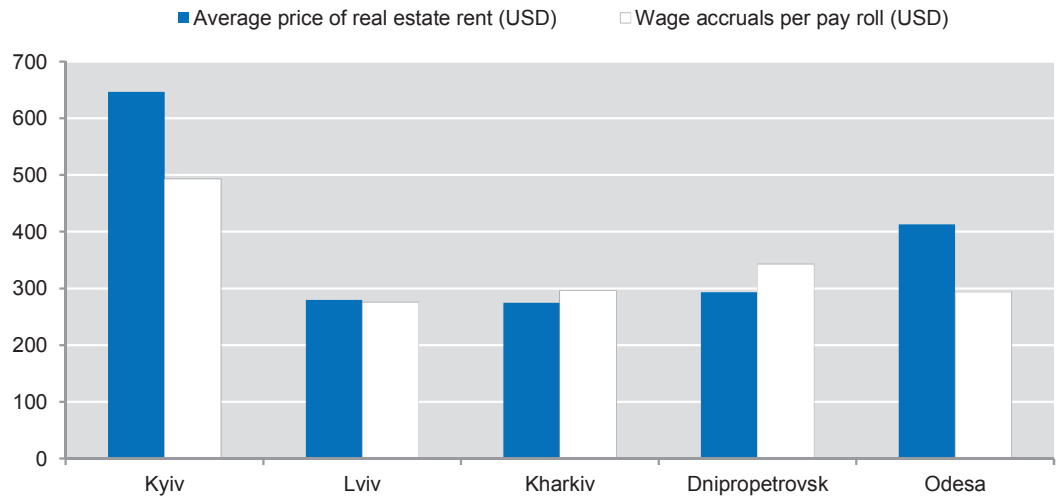
Source: State Service of Statistics of Ukraine.

Housing markets have seen little supply response to rising prices

The supply of new housing has seen only very limited increases in recent years, despite substantial increases in prices. This is largely due to the difficulties involved in securing a construction permit. Real estate developers need to obtain project documentation that includes town planning documentation, official project requirements, and approval of the construction project itself and receipt of construction work permits. As a result, in the World Bank's 2010 *Ease of Doing Business* report, Ukraine ranked 181st out of 183 countries for the ease of obtaining construction permits. The hurdles in securing construction permits ensure that new developments, particularly in major cities, are largely dominated by a small number of companies, often with links to local authorities. In Kyiv, nearly 70% of the new residential buildings are built by companies that belong to the KyivMiskBud holding company, in which the Kyiv City State Administration has a large stake.

Affordability of housing, particularly in the major cities, has emerged as a concern. Indeed, looking at urban housing prices within the context of local wage rates, housing affordability in Kyiv is close to cities such as London and New York. Indeed, in 2007 the monthly rent for a moderately priced three-bedroom apartment in Kyiv was higher than in every European city except London. At the same time, the average hourly cost of labour, in the same year, was more than ten times higher in Western cities than in Eurasian ones (World Bank, 2012a). Regional price differentials in housing represent a significant drag on mobility – particularly in the context of the high house prices that characterise many of the former Soviet states.

Figure 1.36. **Housing prices, rents, and wages across Ukraine, 2011**

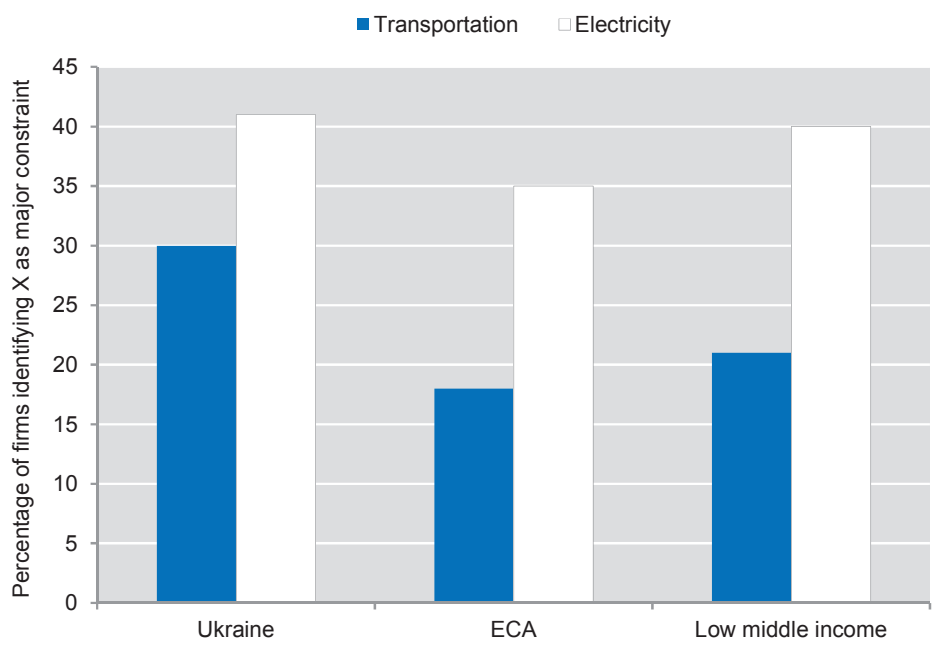


Source: State Service of Statistics of Ukraine, Ukrainian Society of Appraisers.

A poor business environment limits the productivity of capital

Insufficient public investment and the resultant anachronistic public infrastructure impede the inflow of new capital through its contribution to an unproductive and unprofitable business environment. Indeed, according the Ukraine Enterprise Survey – produced by the International Finance Corporation – transportation and electricity provision represent a major constraint to 30% and 41% of firms respectively (Fig 1.37)

Figure 1.37. **Perceived constraints to business (2008)**

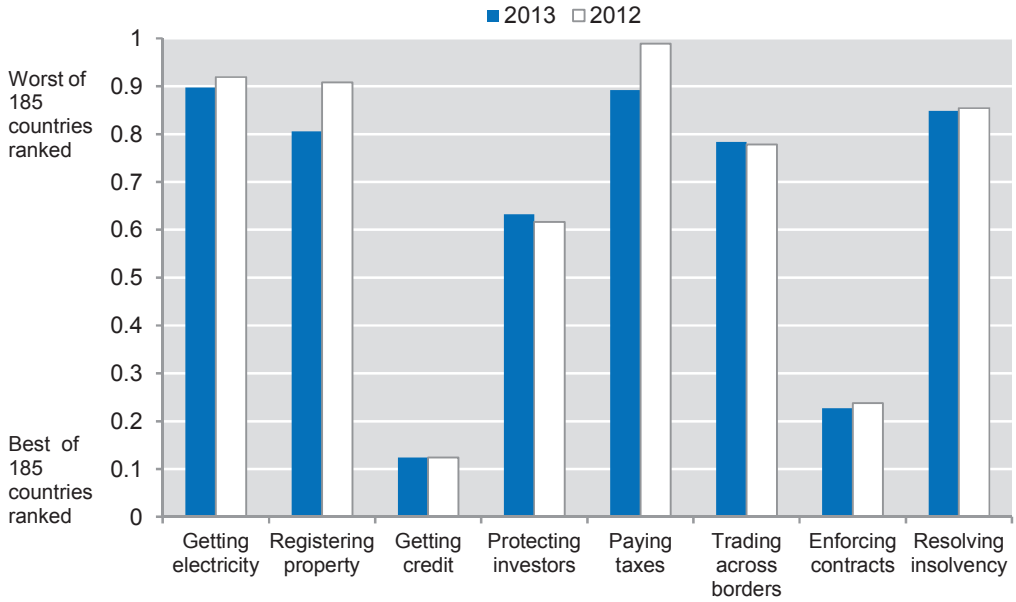


Source: IFC Enterprise Survey: Ukraine Country Profile 2008.

Ukraine's business environment is characterised by cumbersome bureaucratic procedures and concomitant high entry and exit costs.[5] Ukraine ranks 112th of

174 countries on the World Bank's *Ease of Starting a New Business 2012* (Figure 1.38). New businesses must obtain a panoply of permits and certifications as well as complying with a protracted licensing process. It takes almost three years to close a business in Ukraine. Prior to the crisis – in the context of high profits and limited competition – such inefficiencies may have appeared manageable, but in the current environment of weak external demand and strong international competition for investment, such inefficiencies are likely to put-off much foreign investment.

Figure 1.38. **Doing business in Ukraine (2012, 2013)**



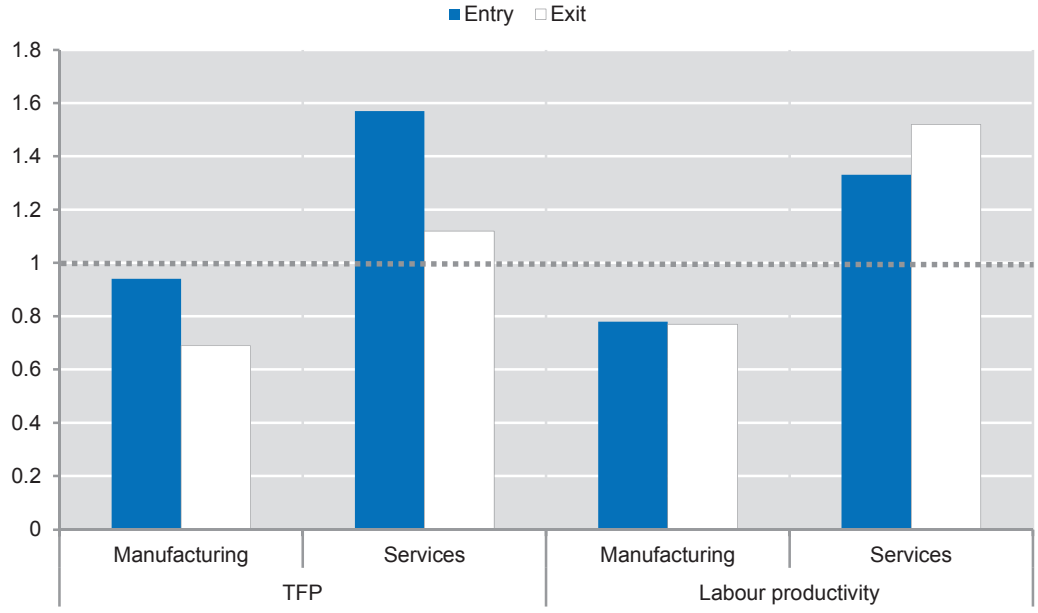
Source: World Bank (2013), Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises, Washington, D.C.

Service sector entrants are, on average, significantly more productive than incumbents, suggesting entry barriers in this sector. Productivity of manufacturing firms entering the market is, on average, marginally below the productivity of incumbents but, given the benefits stemming from market experience**,** this is more in line with expectations. It is also a marked improvement on the past – even as late as the early-to-mid 2000s, entering firms in manufacturing were more productive, on average, than incumbent firms (OECD, 2007). The productivity levels of manufacturing firms **leaving** the market are now substantially below those that remain (Fig 1.39). While low productivity levels are to be expected in exiting firms – and indeed may be the cause of the exit – the size of the gap observed is likely to point towards weak market pressures that allow for the long survival of low productivity firms (Bartelsman et al. 2010). In short, many of these are likely to be firms that should have been compelled to exit sooner.

Since 2010, the government undertook a number of measures to improve the business environment: alleviating the tax burden, simplifying the customs code and speeding up business registration and licensing. Measures included the adoption of a new anti-corruption law, a reduction of the number of executive bodies, and reductions in the regulations pertaining to construction permits, VAT refunds and taxation. Adopted reforms, however, often remain on paper and poor implementation frequently undermines progress on the legal framework. Businesses are yet to feel the impact. Improvement of the business climate remains a key priority, but policy design progresses in the context of limited consultation with the private sector. For example, the newly adopted Tax Code (as

of 1 January 2011), which is intended to streamline the complicated tax system and reduce corporate income tax, is seen as highly controversial and is considered to pose a serious threat to small businesses (OECD, 2012). Given the difficult business environment, it is perhaps not surprising that the Ukrainian economy is characterised by concentrated ownership and dominated by large firms: in a weak institutional environment, large incumbents are better able to protect and pursue their interests that small firms or new entrants (Tompson, 2011).

Figure 1.39. **Ratio of the average productivity of entrants and exiters to incumbents**

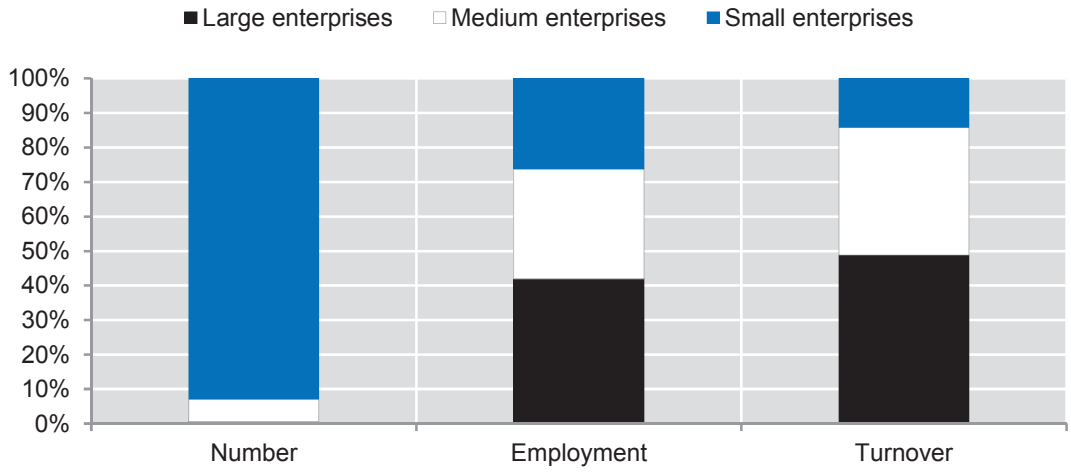


Source: Ukraine Firm Census data; Bartelsman et al. (2010) prepared for "Strategic Choices to Accelerate and Sustain Growth", World Bank.

The complex nature of business regulation has contributed to the decision of many businesses to choose to remain informal. As such they are not accounted for in official statistical data. While there are no official numbers for the size of the informal sector, informal employment, as noted above, is estimated at about 4.5 million, or 22.1% of total employment. The majority these (61%) work in micro and small-sized enterprises (World Bank, 2011).

Small enterprises are concentrated in large cities, particularly Kyiv (City and *oblast*), and Kharkiv and Lviv.[6] Sectors with a large share of SMEs are real estate operations, engineering, business services (96.3%), construction (95.6%) and hotels and restaurants (95.3%). Agriculture, hunting and forestry, and industry have a large proportion of medium-sized firms – 20.4% and 11.7%, respectively (OECD, 2012). Thus, the higher-than-average concentrations of small firms in the three main cities probably reflects their sectoral specialisation and the fact that larger cities tend, *ceteris paribus*, to provide more hospitable "eco-systems" for small firms (average firm size tends to be larger in smaller towns and cities).

Figure 1.40. **SME sector in Ukraine, 2010**



Note: Individual entrepreneurs not included.

Source: State Service of Statistics of Ukraine.

Productivity growth is the key to regional performance

Given the low levels of labour and capital input available in Ukraine, recovery and sustained growth will have to come from higher productivity. Advances in productivity will, however, not emerge easily from the current climate. Progress along a number of fronts, to enhance competition and innovation will be necessary. At the base of all this, politically stable and transparent institutions will be a pre-requisite. Raising productivity in Ukrainian regions will require increasing both technical and allocative efficiency – i.e. enhancing the efficiency of production and improving the allocation of resources. Stronger competition can contribute to both these ends. Yet competition in Ukraine is currently impeded by the poor business environment prevalent in the country. Important sectors are highly concentrated and are characterised, to a large degree, by high barriers to entry and exit – both natural and political – that limit competition (Gianella and Tompson, 2007). Furthermore, difficulty in accessing credit, and the widespread uncertainty – policy, legal, and regulatory – limit the development of SMEs and the dynamism of the Ukrainian private sector.

Innovation is one key driver of productivity growth. In Ukraine, historically renowned for its innovation performance and endowed with significant innovation assets, the innovation system has been under-performing. Poor alignment of property rights and economic incentives combine with weak links to private sector and an ageing science base to limit the passage of research ideas to the market. While a general strategy for innovation was approved in 2011, policy remains fragmented in over 70 legal documents and acts (OECD 2012). The development of entrepreneurship skills have received increasing attention among training providers across various levels of the education system and some sectors – such as IT programming – show signs of potential growth. Yet the administrative costs imposed by the regulatory burden ensure that many SMEs still choose to operate informally.

Increasing productivity will require long-term planning and investment – **planning** that will rely on predictable budget streams and a stable policy environment, and **investment** that will result only in the presence of appropriate incentive structures. In the public sphere the ability of regional government to plan for the development of regional

productivity is currently hampered by the volatile case-by-case nature of the allocation of large central government transfers. Furthermore the centrality of funding gaps in determining allocations undermines investment incentives as efficiency improvements necessarily stymie future transfer receipts.

Many of the challenges associated with raising Ukraine's productivity performance will have to be addressed by the national government, on an economy-wide basis. This is true of important structural reforms, particularly those affecting the business environment, tax policy and monetary policy. It is also likely to be the case that national action will be the primary determinant of overall policy stability. Nevertheless, there are important aspects of these challenges that have a territorial dimension, and the chapters that follow seek to look at the ways in which changes to territorial governance and regional policy can help Ukraine rise to this productivity challenge. Chapter 2 will investigate further the institutions of territorial governance in Ukraine, with particular reference to the efficiency and effectiveness of basic service provision, the incentives these institutions engender and their impact on regional development. Addressing these challenges can reduce barriers to entry and production costs for incumbent firms, while enhancing the public sector's performance in contributing to productivity growth via such channels as human capital formation. Chapter 3 will then focus on regional development policy, looking at the constraints under which it operates, its recent evolution under these constraints and how current policy shifts might contribute to a significant improvement in regional development policy outcomes.

Notes

1. Ukraine is an observer member.
2. Discussion of administrative reform is currently ongoing (see Chapter 2).
3. Not fully exploited due to depressed farm incomes and lack of modernisation in the sector.
4. The index of living standards includes measures of population density, urbanisation, housing floor space per capita, percentage of population living in cities larger than 100 000, share of population with access to services (water, waste, heat, gas) and share of the population in rural areas with access to these services, road density, presence of sanatoria and hospital beds per 10 000 people, polyclinic capacity per 10 000 people, and telephones and payphones per 100 families. The health index contains measures of accident rates, average duration of hospital stays, vaccination rates, per capita health care personnel, and availability of emergency primary care.
5. Entry barriers: Low entry exit (ORBIS DATA compare to other countries). Service sector: entrants more productive than incumbents suggestive of barriers to entry. Other sectors? Exit barriers: compare productivity gap (b/w those that exit and those that don't) with other countries.
6. Kharkiv has 76 small firms per 10 000 inhabitants; Lviv has 70 per 10 000 inhabitants, and Kyiv, 65.

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Chapter 2

Improving Ukraine's sub-national level governance and service provision

This chapter examines territorial governance in Ukraine, focusing on the ability of sub-national governments to support the implementation of national policies and to provide the local goods and services needed to support economic development and ensure an adequate quality of life for citizens. The chapter pays particular attention to the interplay between three strands of reform – decentralisation, territorial reforms and reforms to the system of intergovernmental fiscal relations – arguing that success depends not on any one reform in isolation but on aligning the three. It also looks closely at the challenges of monitoring and evaluation the quality of public services.

Introduction

The term "territorial governance" is broadly used to encompass the administrative structures of a country and the relationships between those structures. This chapter focuses on the sub-national tiers of government and their role in promoting growth and development by facilitating both the implementation of regional development policies and the efficient provision of local public services. In this context, the vertical relationships between different levels of government and the horizontal relationships across jurisdictions at the same level play a crucial role for the co-ordination and implementation of national and regional development policies. The aim of the chapter is to identify the strengths and weaknesses of the system. The provision of local public goods and services is a key element for unlocking growth potential at the local level and for improving the quality of life of citizens. The efficient management of utilities such as water, sewage, and energy, for example, is critical to both economic performance – as these are key elements for commercial and manufacturing plants – and for quality of life insofar as these services are provided directly to households. It is in this area that the involvement of the local community is crucial: by providing the necessary incentives and information to the public administration, the local community can shape the provision of these services in the most efficient way.

The structure of sub-central government has been the subject of much debate in Ukraine. There are several projects that aim to decentralise to the local level functions that are currently assigned to the central government. At the same time, the territorial structure itself is also under discussion, particularly with reference to the size of local governments and the need to merge small local communities. Although it is not yet clear when, or indeed whether, a further step in this direction will be taken, it is important to understand and evaluate the impact of possible decentralisation and territorial reforms on the multi-level governance structure of Ukraine.

This chapter is organised as follows: the first section provides a detailed account of the current structure of governance, along with comparisons to other countries; the second part focuses on the proposal of decentralisation and territorial reform; and, finally, the third part analyses the provision of public goods and services at the local level.

The current system of territorial governance in Ukraine

Ukraine is a fairly centralised state

Ukraine is a unitary state where public administration is organised in a central government and three tiers of sub-national government. The first tier refers to the regional (*oblast*) level, which comprises 24 regions along with the Autonomous Republic of Crimea and the two cities of Kyiv and Sevastopol. The second tier consists of countries/districts (*rayon* level) and cities of *oblast* subordination; finally, the last (and, arguably, most heterogeneous) tier consists of small cities and settlements. Table 2.1 provides a visual synthesis of the structure of sub-national government in Ukraine.

Table 2.1. **Territorial structure of sub-national authorities**

Level	Unit		
First	Cities of republican subordination	*Oblasts*	
Second		Cities of *oblast* subordination	*Rayons*
Third			Settlements

Source: World Bank (2012b), "Eurasian Cities: New Realities along the Silk Road", Eastern Europe and Central Asia Report, Washington D.C.

Oblasts and *rayons* have a similar administrative structure, consisting of a council with legislative powers,[1] whose members are elected, and an executive body (state administration), whose members are appointed by the central government. By contrast, the executive bodies of cities of *oblast* subordination are elected. The capital city, Kyiv, has a peculiar status, where the mayor is elected, while the executive body is nominated by the President of Ukraine.

The main feature of the administrative structure is that the sub-central government (the executive branch) is mainly an extension of the central government. It is only in cities and towns subordinate to the regional level that the executive body and the mayor are elected (this tier of government is defined as local self-management). In all the other parts of the administration, the executive is appointed by the central government: the President of the Ukrainian Republic nominates the head of the *oblast* state administration in *oblasts*. This difference between *oblast* government and city government is important in terms of accountability. Regional government is accountable to both the elected regional legislature and the central state, i.e. the president. On the other hand, city administrations are accountable to the electorate. This difference implies that cities tend to be more responsive to the needs of the population than the regional government, which mediates between the interests of the regional population (represented by the regional legislature) and the interests of the central government (represented by the president).

Analysis of the structure of territorial governance in Ukraine shows a striking difference with that found in most (though by no means all) OECD countries. In Ukraine, the territorial structure is asymmetric. There are territories that are at the same sub-central level but which have different competences and resources. Large cities, referred to as cities of *oblast* sub-ordination, perform the tasks and receive the revenues of *rayons* and cities of *rayon* sub-ordination. Thus, the number of sub-national tiers varies in the country according to the presence of those cities. In the territory belonging to the city of Kyiv there is no other sub-national tier of government; the city performs the function of *oblast* and *rayon*. By contrast, in the great majority of OECD countries the division of the territory into sub-national territorial administrative entities is symmetric. For instance, in France and Italy the national territory is divided into regions, each of which has its own administrative and political body and performs functions for the whole territory, irrespective of the size of cities in such a territory.[2] Each regional territory is further divided in provinces (districts), and each province is divided into municipalities. In this way the whole territory is covered by the same number of sub-central tiers of government.

This is not to suggest that Ukraine's territorial structure should be rationalised in the interests of uniformity. On the contrary, in some cases, an excessive number of sub-national tiers of government may present an impediment to economic growth at the regional level because of problems of co-ordination and overlapping functions. Findings in a recent study (Bartolini, forthcoming) point to the advantages in some circumstances

of an asymmetric structure of sub-national government, where more tiers can be an efficient solution in rural areas but not in urban areas, and where the overlapping of functions may outweigh the benefits of an extra tier of government.

The main challenges are the organisation of sub-national tiers of government and the need to reduce the costs of co-ordination involved in implementing economic and social policies. It is important, therefore, to understand the role that sub-national tiers of government play in the general governance structure of Ukraine. To this end, the resources and functions that are assigned to the sub-national tiers of government are analysed in the next section.

Box 2.1. **The Communist Party and the Soviet political structure**

The Soviet political structure had some of the trappings of Western democracies. At the republic level, legislative bodies (congresses of people's deputies) were elected by universal adult suffrage. As these congresses met infrequently, each republic also had a smaller standing legislature, whose chair functioned as head of state and oversaw the council of ministers, which acted as the government's executive branch. A parallel structure existed at each sub-national level. Each unit had its own council, elected by universal suffrage. Like their counterparts at the republic level, these councils met infrequently. Between sessions, each council delegated its authority to an executive committee, whose chair acted as chief executive and oversaw the functioning of the various administrative departments.

Actual political power, however, was concentrated in the hands of the Communist Party, which had branches at each level of sub-national administration. In theory, the leadership of a local branch of the Party was chosen by local Party members. In practice, the Party leadership designated the people who would be put on the ballot to elect it. In the classic characterisation, the Party set policy and the state administration implemented it. The relationship between the Party and the government was, in practice, more intimate. The Party determined which candidates would be on the ballot for local councils and appointed the key officials of the administration. Management controls reflected the spirit of democratic centralism, with sector managers at the local level subordinate to both their local executive and their sector counterpart at the central level. This remains a relevant concern today, precisely because, despite the undemocratic nature of these arrangements, they vested a good deal of responsibility for inter-governmental co-ordination in Party structures; with the end of one-party rule, the full complexity of the territorial administration created before 1991 came into view.

Source: World Bank (2012b), "Eurasian Cities: New Realities along the Silk Road", Eastern Europe and Central Asia Report, Washington D.C.

Fiscal relations lie at the heart of vertical inter-governmental relationships

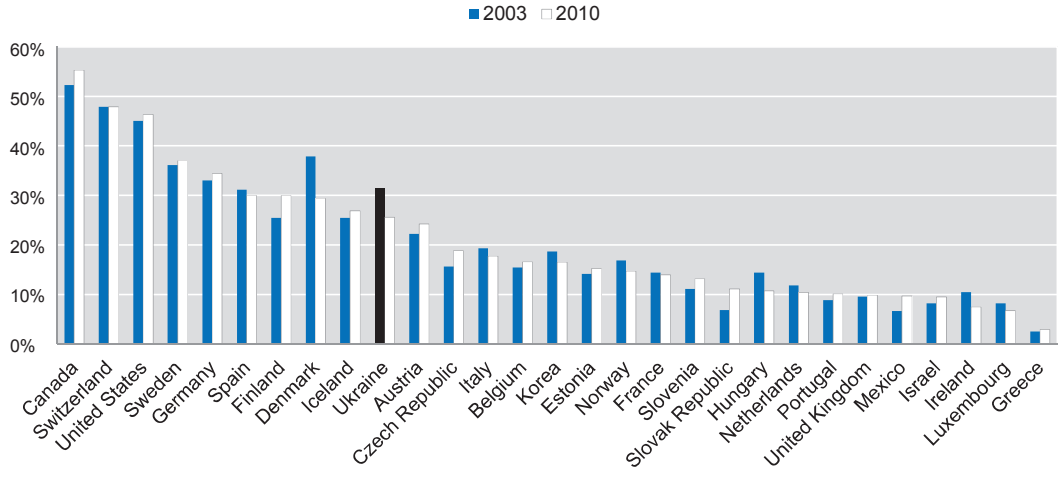
The fiscal structure of Ukraine is characterised by a high degree of centralisation. The national budget prescribes the transfers that constitute a large share of the budgets of subordinate governments. This top-down approach has the advantage of making local finances consistent with central planning, but a big drawback is that sub-central levels of government have little autonomy and rely heavily on central government decisions. This problem has been exacerbated by the fact that budgeting in Ukraine was basically done on an annual basis and that short-term changes in budgetary priorities were common, which created problems for planning at all levels.

The analysis presented here of the sub-national government structure of Ukraine has been conducted using both quantitative indicators, i.e. the amount of resources managed at the sub-national level, and qualitative indicators, i.e. the degree of autonomy and the

relationship between the different tiers of government. An important part of this analysis is the benchmark with other OECD countries. In terms of revenues imputed at the sub-national level, the amount of resources is higher than in most OECD countries. Although the share of resources of sub-national governments is lower than the corresponding share in federal countries such as Canada, Switzerland and the United States, it is higher than in many other countries, including Italy, France and the United Kingdom. As Figure 2.1 shows, this figure was decreasing during 2003 to 2010, showing a tendency towards centralisation in the management of public resources.

The amount of resources assigned at the sub-national levels, however, is not sufficient to define the level of decentralisation of the country. It is important also to assess the level of autonomy in the management of those resources. In this respect, Ukraine does not seem to allow much autonomy at the sub-national levels. In terms of expenditures, the services and goods provided by the local level are mainly decided by the central government in the Budget Code. Expenditures in the local budget are divided into delegated functions and exclusive functions. Delegated tasks concern the provision of public services such as education, health, and social welfare. The central government is formally responsible for those functions and provides subordinate governments with targeted funds to carry out these tasks. The local administration does not have much autonomy in the management of these functions. The key principle is that of equal access and standards across the population. However, as will be seen, per capita expenditure on education and social services is not homogeneous across regions (Figure 2.5). "Exclusive functions" refers mainly to local public goods such as utilities, housing, and social protection. In these areas, local government has more autonomy in the management of services, which are financed from general transfers and own resources.

Figure 2.1. **The share of sub-national government (SNG) revenues with respect to total revenues of each country**



Source: OECD Fiscal Decentralisation database and Ministry of Finance.

Most taxes (especially PIT and the land tax) are controlled at the central level through the tax code, which does not leave any degree of autonomy to subordinate governments with respect to adjustments in tax bases or rates. Centrally controlled taxes are shared with lower levels of government according to fixed shares. The cities of Kyiv and

Sevastopol constitute an exception here, as they retain the entire revenue from PIT and the land tax collected within their jurisdictions.

The structure of taxation in Ukraine follows the tax assignment structure shown in Table 2.2. The Verkhovna Rada (the national parliament) defines the tax rate and the tax base of the most important taxes in Ukraine, including PIT. Therefore, the local government has no autonomy in deciding the amount of resources for their budget. Own taxes also follow rules determined at the central level, and the rest of the budget consists of transfers whose size depends on criteria determined at the central level.

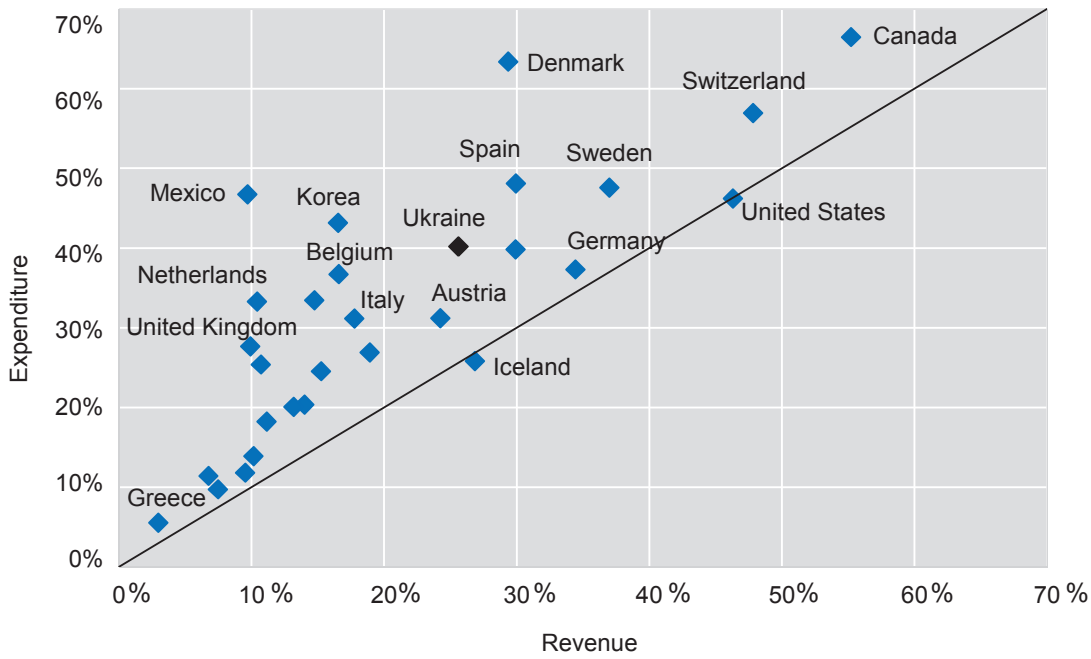
Table 2.2. **Tax assignment in 2011**

Name of Tax	National taxes		Sub-national taxes		Authority in charge of defining/changing of the:	
	million UAH	%	million UAH	%	Tax rates	Taxable base
Total tax revenue	**261 605.0**	**100**	**73 086.9**	**100**	**Verkhovna Rada**	**Verkhovna Rada**
Personal income tax	6 159.5	2.35	54 065.1	73.97	Verkhovna Rada	Verkhovna Rada
Corporate Income Tax	54 739.4	20.92	357.5	0.49	Verkhovna Rada	Verkhovna Rada
Value added tax	130 093.8	49.73	0	0	Verkhovna Rada	Verkhovna Rada
Land fee	0	0	10 700.9	14.64	Verkhovna Rada	Verkhovna Rada
Excise duty	33 011.2	12.62	908.0	1.24	Verkhovna Rada	Verkhovna Rada
Rental fee	16 822.4	6.43	0	0	Verkhovna Rada	Verkhovna Rada
Local taxes and fees assessed till 1 Jan 2011	0	0	45.7	0.06	Local authorities	Verkhovna Rada
including uniform tax	0	0	1 987.9	2.72	Local authorities	Verkhovna Rada

Source: Ministry of Finance.

Although local governments cannot, as a rule, modify tax rates or bases, each territory could increase the amount of tax revenue by attracting firms and people, i.e. an expansion of the tax base. This incentive, however, is undercut by the fact that central transfers tend to be based largely on assessments of the gap between sub-national budgets' income and the finance ministry's assessment of their spending obligations under delegated tasks. Thus, increased own revenues may be substantially, or even totally, offset by reduced transfers. Cities of *oblast* subordination have another source of financing: the possibility to issue bonds. This activity, however, is strictly controlled and co-ordinated by the central government.

Figure 2.2. **SNG share of expenditures and revenues in 2010**



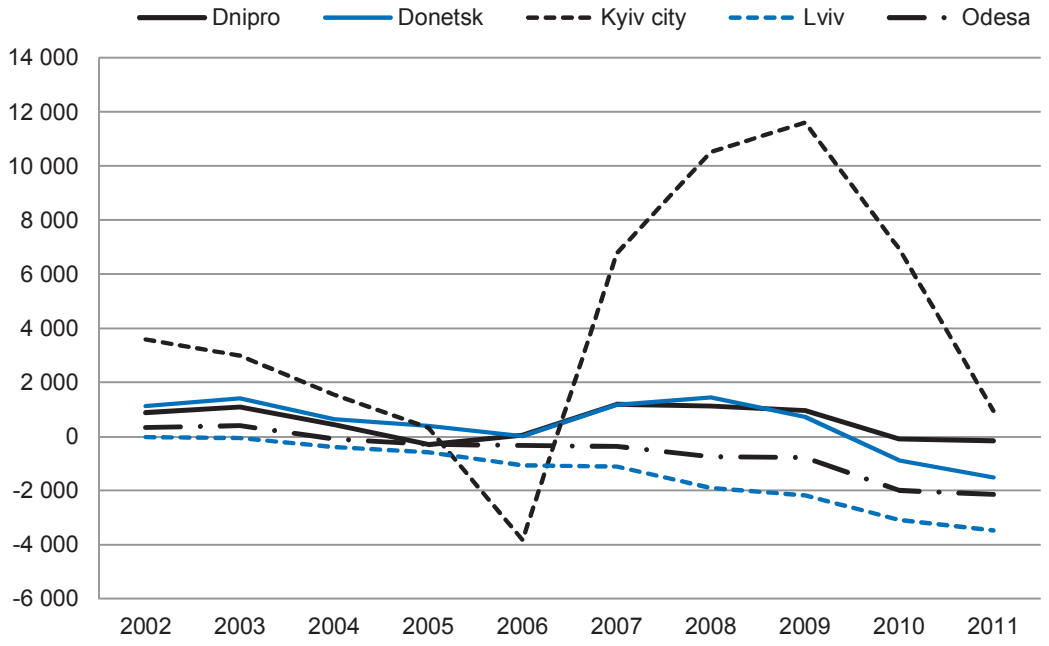
Source: OECD Fiscal Decentralisation database.

Figure 2.2 compares the shares of revenues and expenditures of sub-national tiers of government in OECD countries and Ukraine. In most OECD countries, the share of expenditures is larger than the share of revenues, suggesting that revenues are more tightly controlled and that the difference represents additional transfers that go from the central government to local government, increasing debt exposure. There is a tendency for countries with a higher share of expenditure at sub-national level to present a larger difference between expenditures and own revenues, with the exception of some federal states (e.g. the United States, Germany, Switzerland and Canada).

Large central government transfers may create problems in the relationship between central and the local governments. In Ukraine, the level of transfers is decided on an annual basis that introduces extreme uncertainty at the lower level, creating a strong hold-up problem. Local administrations have little incentive to invest in improving the services if such investment may be underfinanced in future. In fact, the system is based on expenditure gaps, and any efficiency improvement would result in fewer resources for the local government.

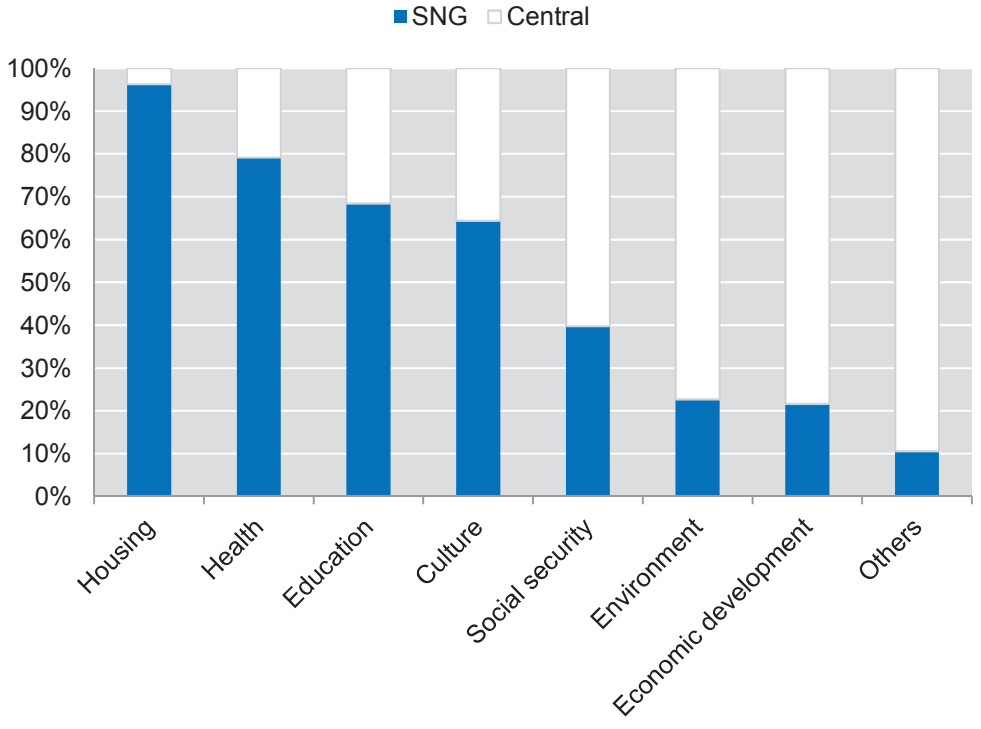
In terms of revenues and expenditures at the *oblast* level, there is a potential mismatch as can be seen in the Figure 2.3. Per capita deficits have been increasing in many regions but not in the city of Kyiv. The capital city shows great volatility in terms of revenues with respect to expenditures. In the period after 2006 and before the global crisis, there was an increasing excess of resources with respect to expenditures in the city's budget, which has moved back sharply in recent years towards balance. This pattern is not replicated in other regions. For instance, both the L'viv and Odesa regions show a constant decline in the ratio between revenues and expenditures. The negative difference between revenues and expenditures is financed by additional central transfers or by debt accumulation. Unfortunately, the OECD Secretariat was unable to obtain access to official data on the amount of debt at the sub-national level.

Figure 2.3. **Evolution of the budget balance at the regional level (*oblasts*)**
Revenues minus expenditures, in per capita terms



Source: OECD elaboration on data from the Ministry of Finance.

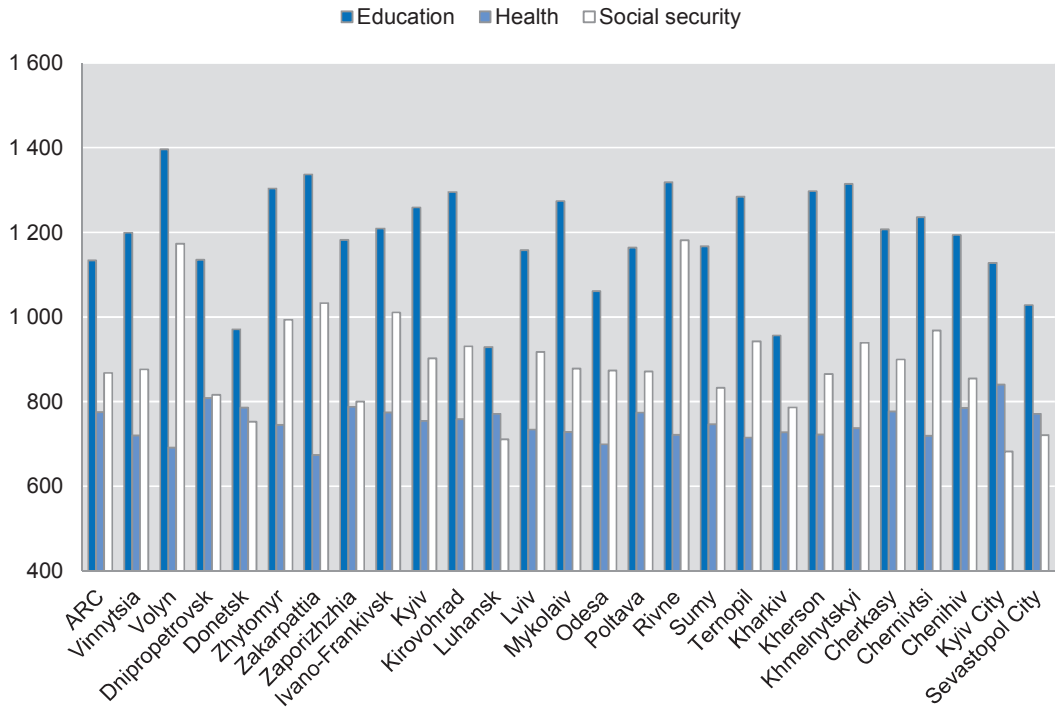
Figure 2.4. **Share of resources for selected functions (2011)**



Source: OECD elaboration on data from the Ministry of Finance.

In terms of functions, Figure 2.4 shows that housing services, health-related services, education, and culture are mainly financed through sub-national budgets. The sub-national tiers of government, however, do not have much freedom in managing those services since key features are centrally decided by the responsible ministries. Although most of the decisions on the provision of services are taken at central level, there is still heterogeneity among regions in terms of per capita spending. Figure 2.5 shows that per capita expenditure on education and social security varies significantly between regions, while per capita expenditure on health-related services is quite homogeneous.

Figure 2.5. **Per capita expenditures in selected services at the regional level (2011)**



Source: OECD elaboration on data from the Ministry of Finance and the State Statistics Service of Ukraine. They refer to the budgets of the *oblasts*.

Local budgets remain highly constrained

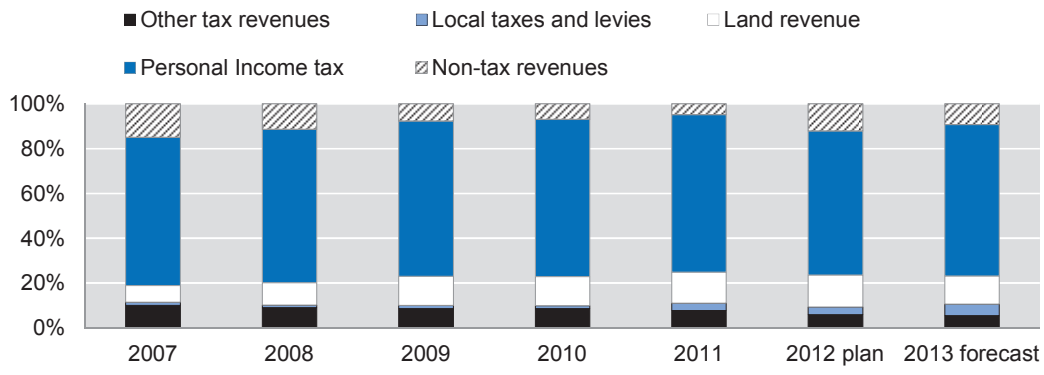
According to the Ministry of Finance, tax payments to local governments in 2013 (excluding transfers) are projected to reach UAH 103.1 billion, 5.3% higher than the estimate the local governments approved in 2012 (see Table 2.3). Tax revenues in 2013 will make up 90.8% of local government own-source revenues (i.e. excluding inter-budgetary transfers) or UAH 93.6 billion with an 8.9% increase year-on-year (Figure 2.6).

Table 2.3. **Comparison of key revenues of sub-national tiers of government (millions UAH)**

	2012 as of 01.10.2012	2013 forecast	+/-	Percentage
Tax revenues	86 029.04	93 646.5	7 617.5	8.9
Personal income tax	63 045.71	69 823.1	6 777.4	10.7
Land payments	14 028.01	13 035.9	-992.1	-7.1
Local taxes and levies	3 421.49	5 328.2	1 906.7	55.7
Other income revenues	5 533.8	5 459.3	-74.5	-1.3
Non-tax revenues	7 829.76	6 555.0	-1 274.8	-16.3
Revenues from transactions with capital	3 454.62	2 670.3	-784.3	-22.7
Special purpose funds	590.71	269.5	-321.2	-54.4
Total income (excluding inter-budget transfers)	97 904.1	103 141.4	5, 237.2	5.3

Source: Ministry of Finance.

Figure 2.6. **Local government own-source revenues**



Source: Ministry of Finance.

Among own-resources, personal income tax remains the most significant source of revenue for local governments. For 2013, PIT revenues are projected at UAH 69.8 billion, almost 10.7% higher than the planned value in 2012. The national budget prepared by the Ministry of Finance is based on a 5.1% increase in nominal GDP, a 5% increase in the base-level pay, and a 5.1% increase in payroll payments. It is clear that if those figures do not materialise in 2013 (especially in terms of GDP growth), there might be an overstating of resources assigned to the local budgets.

Land payments account for another significant source of income for local governments. This source is expected to generate UAH 13 billion, 7.1% lower than the planned value in 2012. The calculations are based on the history of revenues for the previous years, the estimated land payments in 2012, and the average income growth rate for the last three years.

Other tax revenues and levies paid to local governments are expected to rise by 55.7% to reach UAH 5.3 billion in 2013, compared with the estimate of UAH 3.4 billion in 2012. This is because a new tax has been introduced by the Tax Code of Ukraine. Labelled the "single tax", this is a simplified tax regime that applies to individual entrepreneurs and is subject to certain requirements[3].

According to Ministry of Finance calculations, total spending of sub-national governments (general and special purpose funds, including transfers) will amount to UAH 221.7 billion in 2013, an increase of 2.2% compared with the estimated value in 2012. Thus, sub-national governments might have a hidden deficit of about UAH 10 billion. This includes UAH 6.5 billion, arising from a failure to meet the plan for PIT collection, and UAH 3.5 billion, resulting from a rise in the inflation rate (4.8%) and social standards, which lowers the real value of tax revenues.

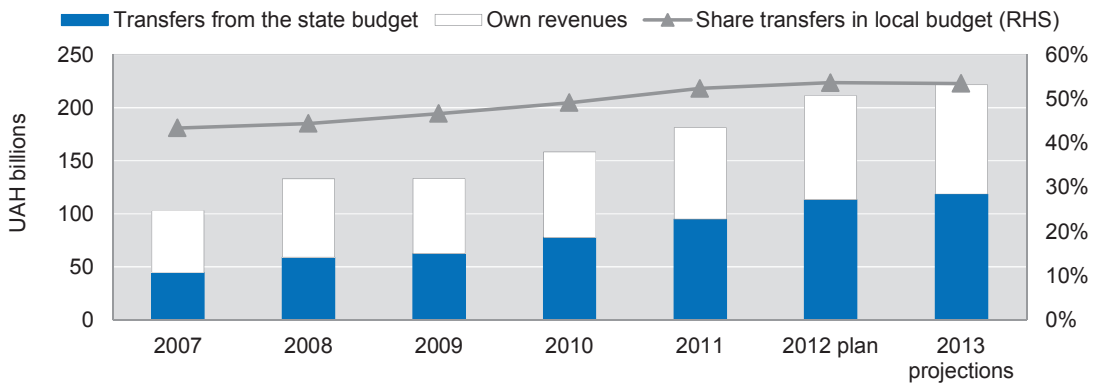
The total volume of inter-budgetary transfers that sub-national governments receive from the central government will increase by 4.7%, reaching UAH 118.6 billion according to the key provisions of the Law "On State Budget of Ukraine 2013" No. 5515 dd. December 6, 2012 (Table 2.4). The Ministry of Finance calculates that transfers will account for 53.5% of the sub-national budgets' revenues in 2013, roughly the same level as in 2012.

Table 2.4. **Budgetary transfers**

	2012 approved with account of amendments	2013 approved	+/-	Percentage
Equalisation payments	51 649.9	55 695.4	4 045.5	7.8
Additional subsidies	4 534.4	1 312.1	-3 222.3	-71.1
Total targeted grants, including:	57 083.8	61 545.7	4 461.9	7.8
Targeted grants from the general fund	46 992.1	53 751.8	6 759.7	14.4
Targeted grants from the special fund	10 091.8	7 794.0	-2 297.8	-22.8
Social grants	41 003.0	50 402.5	9 399.4	22.9
Capital grants	6 611.4	3 922.6	-2 688.8	-40.7
Other grants	9 469.4	7 220.7	-2 248.7	-23.7
Total transfers from the state budget	113 268.2	118 553.3	5 285.1	4.7

Source: Law of Ukraine "On State Budget of Ukraine 2013" No. 5515 dd. December 6, 2012.

Figure 2.7. **Dependence on central government transfers** (values in UAH billions)



Source: Ministry of Finance.

Equalisation payments are expected to account for the biggest share of transfers from the state budget this year – 47.0%. This exceeds the comparable figure in the 2012 budget – 1.4 percentage points. The share of social grants is set to grow 6.3 percentage points to

42.5%. In absolute terms, these grants will make up UAH 50.4 billion, 22.9% higher than the in 2012. Capital grants will account for 3.3% versus 5.8% in 2012, going down 40.7% to just UAH 3.9 billion.

In 2013, a formula approach[4] distributes targeted grants from the state budget to local budgets for construction, reconstruction, repair and maintenance of community-owned streets and roads in inhabited localities (UAH 2.4 billion). Despite these improvements, there is still a lack of transparency in the distribution of grants for social and economic development. For instance, it is not clear why there is a difference between the projected and the approved level of grants. Providing transfers in a more objective way would improve the trust of local government in the central administration and would allow sub-national tiers of government (especially *oblasts* and *rayons*) to make long-term plans for resource use.

Unfortunately, there seems to be reluctance among some segments of the central administration to make the full picture of central transfers to subordinate levels of public authority really transparent. This may reflect the political sensitivities involved. At any rate, the OECD Secretariat was unable, despite repeated requests over a period of months, to obtain from the Ministry of Finance any breakdown of *oblast*-level budgets by source of revenue and destination of expenditure for each of the *oblasts*, the Autonomous Republic of Crimea and the cities of Kyiv and Sevastopol. Only a single table showing the *consolidated* budget of the regions for the period to 2011 was made available by the ministry. Indeed, most of the Finance Ministry data cited in this chapter have been taken from other publications or provided by third parties. Data on city budgets was obtained from the Association of Ukrainian Cities. Lack of access to systematic and comprehensive data on sub-national finance limits the scope of the analysis in the present chapter and also underscores the need for transparency in inter-budgetary relations.

Is decentralisation the solution?

The analysis of the fiscal relations between different levels of government shows that the administration of resources is quite centralised, and sub-national tiers of government rely on transfers from the central government. In this context, is decentralisation reform a good policy? World Bank (2008) stresses the need for a profound reform in intergovernmental fiscal relations as a prerequisite for improving the efficiency and efficacy of providing local public goods. The report focuses on four main problems:

1. Overlapping expenditure responsibilities and the small scale of many local government units create inefficient duplication and insufficient scale economies.
2. Revenue autonomy is very limited, leaving subordinate governments highly dependent on shared revenues and transfers from the central government.
3. Lack of predictability and transparency affect medium- and long-term planning.
4. Sub-national government borrowing is underdeveloped.

Similar issues have emerged during the OECD study missions in Ukraine. The main problem seems to be the lack of a well-defined administrative structure with clear centres of responsibility. This in turn contributes to a lack of transparency and predictability at all levels of government. Not only is planning difficult, but the lack of any incentive at the sub-national (and national) level to invest time and effort in the implementation of policies is also a negative consequence. As a result, the sub-national level is not prepared to take responsibility for most local public services. Even where there is an efficient scale

of production, the lack of capacity can undermine the efficient provision of these services. The capacity gap may in part reflect a long tradition of governance in which the role of sub-central tiers of government was merely to implement policies devised at higher levels. The incentive in such situations is for bureaucrats to execute higher-level directives instead of taking any initiative to improve the outcomes of such policies at the local level.

One of the aims of the World Bank (2012a) report on fiscal relations in Ukraine is to improve the **intergovernmental fiscal framework**. The current system of intergovernmental fiscal relations reduces opportunities for local government to provide services efficiently. Ukraine is highly centralised in terms of fiscal, administrative and political instances. The Bank argues for a higher level of decentralisation, whereby local government would have more fiscal, administrative and political autonomy. Perhaps the report's most important policy recommendation is to transfer the responsibility for education and health services provision to the *rayon* level. The report maintains that the *rayon* represents the **optimal** level in terms of geographical dimension and capabilities. The size of *rayons*, however, varies considerably, as does their population density. Where population is scattered in the territory, there is a clear problem of access to services and co-ordination. However, if the population is concentrated in a few areas, the *rayon* is not necessarily the optimal level.

Ultimately, the conclusions of World Bank (2012a) rest on the ex ante assumption that services like housing, education and heath should be provided at the local level. This is not necessarily true. For instance, it is not efficient to assign the provision of a service at the local level without the necessary capacity in terms of financial and human resources (OECD, 2009). Bardhan (2002) argues that lower levels of government typically have less administrative capacity, and Bird (1995) points out that, while the central government might not know **what** to do, the local government may not know **how** to do it.

One of the advantages claimed for decentralisation is that it achieves greater political accountability. Citizens should be more aware of the activity of local politicians, rather than central government politicians, as local policies land physically closer to them. As put by Triesman (2002), accountability via local elections is a substitute for accountability via bureaucratic hierarchy; thus, the argument is that the former type of accountability is more effective than the second. Although there is truth to this argument, it mainly rests on the capacity of citizens to actually monitor local politicians. It is not automatic for decentralisation to bring greater accountability. Firstly, to have effective monitoring of the local government there is need of an efficient accounting system, which may be lacking at the lowest levels of administration (Devas, 2006). Secondly, it requires an efficient diffusion of information. One of the most important potential benefits of decentralisation is increased accountability; however, for this effect to be realised, the necessary condition is that the lower tier of government must actually have the necessary autonomy and responsibility over management of public services. Many examples show that decentralisation does not automatically bring greater accountability, which depends on the general quality of governance in the country and the possibility for citizens to clearly identify responsibility. Besley and Pratt (2006) argue that the role of the press is fundamental for political accountability, at any level of government. They show that changes in the media (for instance, concentration of ownership) affect welfare not only through the usual market channels but also because they affect the degree of government accountability. Finally, accountability in a decentralised context also requires a dynamic civil society that can engage with the local government. Enikolopov and Zhuravskaya

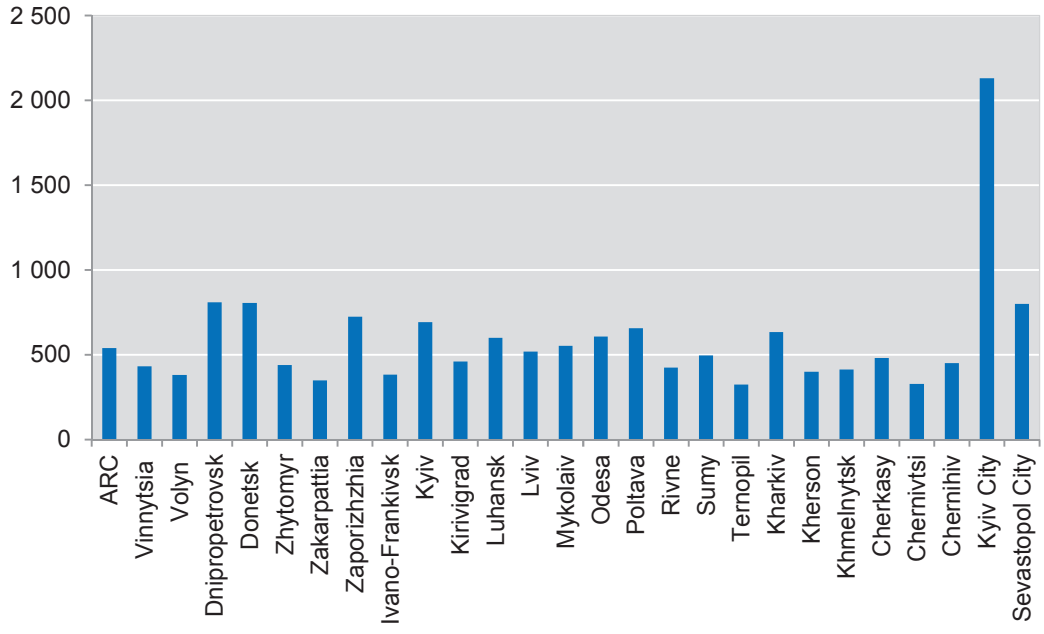
(2007) thus argue that the outcome of a decentralisation process depends on the role of political institutions.

In short, fiscal decentralisation per se does not bring the desired benefits to the governance structure. In the words of Tanzi, "Decentralisation is more likely to lead to positive outcomes when some conditions are met **before** the process of decentralisation starts" (Tanzi, 2001, p. 3).

Inter-regional disparities imply differences in fiscal capacity

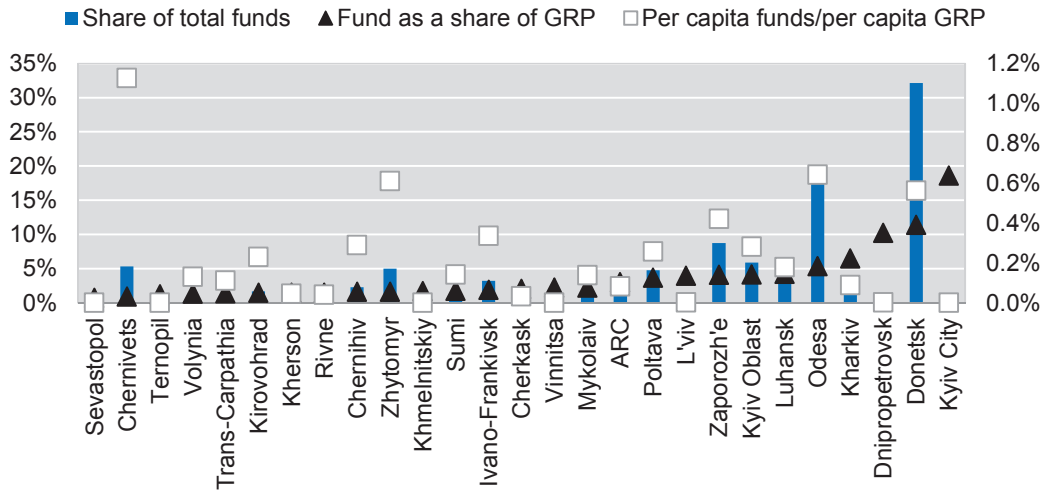
Figure 2.10 shows the very large disparities that exist among Ukraine's regions in terms of revenues from personal income tax. The city of Kyiv stands out with respect to all other territorial units. This is a direct reflection of the inter-regional disparities in productivity and income discussed in Chapter 1. The picture also provides a good approximation of the economic importance of the region for the Ukrainian economy. Strikingly, the allocation of transfers overall (Figure 2.11) and the distribution of development funds, in particular (Figure 2.13), do not follow a strategy of equalisation and support of lagging regions. On the contrary, regions with higher income also receive larger transfers, at least as regards general and special funds. In fact, it is not clear what criteria are used to assign those funds. It may be that formulae are applied to different funds but that the different formulae used interact with each other in such a way that other criteria more than offset any equalisation agenda.

Figure 2.8. **Revenues from personal income tax (PIT)**



Source: Ministry of Finance.

Figure 2.9. **Distribution of Development Fund in 2012 with respect to gross regional product (GRP)**



Source: Annex 7 to State Budget of Ukraine, 2012. Regions are ordered according to their share of national GDP; columns represent the share of the development fund assigned to each region in 2012; the dotted line is the ratio between the per capita share of the development funds and the per capita gross regional product.

Decentralisation reforms in Ukraine

Decentralisation reforms have been undertaken across the world in a variety of contexts

During the last decade there has been a strong movement towards decentralisation of fiscal and administrative powers to sub-national governments across a wide range of countries. The main goal of most of these reforms has been to increase efficiency in service provision and resource use. At the core of this approach is the idea that local government can better satisfy certain needs of the population than a centralised administration. In reality (as in theory), things are more complex, and there is no universal consensus on the optimal structure of multi-level governance. More or less identical decentralisation reforms may – and sometimes do – have very different impacts in different countries (Box 2.2). Clearly, it is important to understand the terms of the decentralisation reform. What types of powers are decentralised? To what level? How should sub-national governments be financed? How should local administrators be selected? How will co-ordination be assured across levels of government? And how can adequate levels of service provision be assured across the country, despite sometimes large differences in local resources and capacities? These are among the key questions that make the difference between a successful and a disastrous decentralisation reform. Other important factors concern the characteristics of the country in terms of business environment, trust in government institutions and in other citizens, and the constitutional structure.

Box 2.2. **Advantages and drawbacks of decentralisation**

The theoretical approach to fiscal decentralisation is rooted in the seminal papers of Oates (1972) and Tiebout (1956). They both focus on allocative and productive efficiency. According to Oates's principles of decentralisation, the delegation of fiscal powers to local government is justified by the possibility to better match the preferences of a limited number of people in a localised area. Tiebout argues that, under certain circumstances, competition between jurisdictions allows people to reveal their preferences for public goods by "voting with their feet". In both cases, the idea is that a local community is characterised by a more homogeneous set of preferences (in the case of Tiebout there is a process of self-selection that leads people with similar preferences to locate to the same jurisdiction) than is the national community.

The first wave of analysis overlooked the incentives that drive the activity of politicians. In particular, it was simply assumed that the objective of the government (central and sub-national) was the maximisation of social welfare. This is at odds with real-world examples. Brennan and Buchanan (1980) develop an approach where politicians are rent seekers, and the process of decentralisation is seen as a way to "tame the leviathan", i.e. if the incumbent politicians are rent seekers, then limiting their powers can only be beneficial. In this case, the competition that arises between jurisdictions is beneficial. In this setting decentralisation can be beneficial also because it may increase the level of accountability of elected politicians towards the electorate (Seabright, 1996; Besley and Case, 1992).

The drawbacks of decentralisation relate to the presence of spillovers between jurisdictions and the need to find an efficient scale of production, which can constitute an argument for more centralisation. The provision of public services tends to have an impact on the well-being of citizens living in neighbouring jurisdictions; these externalities, which can be either positive or negative, are not likely to be taken into account when policy is decided at the local level. In the same vein, the provision of some services with high fixed costs (such as network services) requires a scale of production that is large enough to be economical. Another potential source of problems concerns the capacity of local government to manage functions that are decentralised. This concern has been raised with special reference to developing countries that embark on a process of decentralisation. The key idea is that local government lacks the necessary human resources to manage complex tasks that were previously managed at the central level. An additional potential cost of decentralisation is the risk of capture of the sub-national government by local elites (Bardhan and Mookherjee, 2000). This is the case where the pressure of interest groups is higher at the local than at the central level. The idea is that the central administration is not easily captured by local elites since those from different places would actually compete to influence the central government decisions. By contrast, at the local level they have less competition and can easily influence the decisions of local politicians.

The term "decentralisation" is general enough to include at least three distinct aspects of governance: fiscal, administrative and political.

- **Fiscal decentralisation** consists in the delegation of taxing and spending responsibility to sub-national tiers of government. In this case, the degree of decentralisation depends on both the amount of resources delegated (tax base and spending) and the autonomy in managing such resources. For instance, autonomy is great if the local government can decide both the tax base and the tax rate. In the case of Ukraine, sub-national revenue autonomy is very limited since the tax base and the tax rate are decided by the central government and are the same for the whole country.
- **Administrative decentralisation** relates to the delegation of planning, financing, and management decisions on some public functions to lower levels of

government. It is possible to distinguish three types of administrative decentralisation: deconcentration, delegation, and devolution. Deconcentration is the weakest form of decentralisation because the functions are assigned to local "branches" of central government agencies (e.g. local offices of a ministry). Devolution is the strongest type of decentralisation since the responsibility for a whole public function is allocated to a territorial entity by the central state.

- **Political decentralisation** refers to the way in which local administrators are selected. There are two main forms of selection: local administrators can be appointed, usually by higher levels of government, or they can be elected, usually by the residents of the local jurisdiction.

The empirical literature has not reached an unequivocal prediction on the outcome of decentralisation. Many resources have been devoted to studying the impact of decentralisation on economic performance (economic growth), the quality of government, and the efficiency of public services provision. In terms economic growth, there are studies that find a positive correlation with decentralisation. For instance, Akai and Sakata (2002) find that fiscal decentralisation, in the form of revenue and expenditure powers, produces a positive and statistically significant effect on economic growth; Lin and Liu (2000) found a similar positive effect on the economic performance of Chinese provinces; and Iimi (2005) shows that the positive effect on economic growth is present also in a cross-country analysis (51 countries, in the period 1997-2001). There are other studies, however, that find no correlation (Davoodi and Zou, 1998; Thornton, 2007). Finally, there are studies that find a negative correlation with decentralisation. The work of Zhang and Zou (1998, 2001) on China shows a negative and statistically significant impact of decentralisation on economic performance; Baskaran and Feld (2009) consider a sample of 23 OECD countries and show a negative – although not statistically significant – relationship.

Therefore, it is difficult to justify embarking on decentralisation with the aim of increasing economic growth. The reason may lie in the difficulty of clearly defining the process of decentralisation and in the importance that the details of the reform and the political/institutional features of the country have on the success of the reform.

Another strand of research focuses on the impact of decentralisation on the quality of governance. The idea is that through decentralisation the quality of institutions may increase and, through this channel, lead to better economic and social performance. Some empirical studies show a positive correlation between decentralisation and quality of governance; for instance, Kyriakou and Roca-Sagales (2011) have found a positive relationship between the amount of resources allocated at the local level and the quality of government. However, other studies argue the contrary. Bartolini and Santolini (2013) have found that the relationship is not that clear once the degree of autonomy of the sub-national government is taken into consideration. Their empirical analysis, conducted on a sample of OECD countries, shows that there is a negative correlation between tax and expenditure autonomy and the quality of governance. A positive correlation is found only with respect to political autonomy, i.e. the possibility to elect the local administrators.

These findings show that it is impossible to generalise, and the effect of a decentralisation reform should be analysed considering the specific characteristics of the reform and the institutional specificities of the country. In terms of the type of decentralisation, it seems that political decentralisation is important for the success of a reform, at least with respect to the perceived quality of the institutions. The success of political decentralisation ultimately depends on the capacity of citizens to make

politicians accountable for their actions. This may be undermined by local interest groups' capture of the government or the impossibility to access information regarding the activity of policy makers (Bardhan, 2000). Again, the institutional environment seems to play a crucial role.

Recent debate on the merits of decentralisation focuses on the political structure of the country as one of the key determinants for its success. One of the main concerns delegating powers at the local level is the oversight of the (negative) spill-over effects of local policies. When deciding on the implementation of a policy, a local administrator does not necessarily take into account the spillover of effects on other regions that the policy may generate. Riker (1964) argues that the presence of strong central political parties can alleviate this problem because local politicians tend to look at central parties for legitimacy and for career advancement. Enikolopov and Zhuravskaya (2007) provide empirical evidence for Riker's hypothesis, showing that decentralisation produces better outcomes in countries with strong national parties, while the way in which local administrators are chosen (appointed or elected) does not have any significant impact on the outcome of decentralisation. According to Enikolopov and Zhuravskaya (2007), the success of the decentralisation process in China with respect to the failure of the decentralisation process in the Russian Federation is likely to be related to the presence of a strong central political party in China. Chinese local governors would look to the central party for approval and career concerns.

Ukraine has seen mounting pressure for some degree of decentralisation

The Ukrainian authorities' willingness to decentralise some administrative functions to the local level is embodied in the Law on Self-Government and the Constitution. In Ukraine, there seems to be a strong demand for a reform of the state in a decentralised fashion. For instance, Luksha (2011) maintains the need for a territorial and local governance reform in order to increase the efficiency and effectiveness of the public administration. Moreover, the same report indicates the existence of a strong demand for a system of reforms that has formed since independence in 1991. The report claims that the rigid centralisation of budgetary resources and the loss of competence of the sub-national level of government are the main causes of declining leaving standards and public infrastructures. The report looks at Poland and Slovakia as examples of successful models of reform for Ukraine. Ultimately, the reform will need to reflect the specificities of Ukraine: its success or failure is likely to depend on getting the details right rather than on any overarching vision.

The sub-national structure of the Ukrainian administration, i.e. local government powers, local self-government, and budgetary relations, are framed by several legal acts, including the Budget Code, the Law "On Local Self-Government in Ukraine", and the law "On Local State Administrations", among others.

The first Ukrainian Budget Code was adopted in 2001, and its implementation provided a rational basis for the financing of sub-national tiers of government. The 2001 Budget Code addressed some issues of fiscal decentralisation, including the distribution of revenues and expenditures between different levels of government, and introduced the formula for the equalisation transfers among regions. In general, it improved the transparency and predictability of inter-budgetary relations. Until January 2011, the amount of inter-budgetary transfers was settled by the Law "On the inter-budgetary relations between the district budget and territorial communities of villages, towns, cities and associations" and by two Resolutions of the Cabinet of Ministers of Ukraine (CMU).[5] In 2010 a new Budget Code was prepared, coming into force on 1 January 2011. It

introduced several changes, among which the most important from the point of view of inter-budgetary relations are: the re-assignment of tasks (removal of primary health care functions from lower-level communities, introduction of more detailed lists of social tasks for the *rayon* level – *rayon* and cities of *oblast*/republican significance); and the provision of a list of resources taken into consideration for the calculation of the tax potential index.

The system of inter-budgetary relations resulting from the 2010 Budget Code has some drawbacks:

- The distinction between expenditures taken into account for the equalisation formula and those not taken into account can increase discrepancies between sub-national tiers of government that have significant own resources and those that do not in the sector outside the equalisation mechanism (for instance, housing services). Therefore, it might be useful to reconsider the equalisation system in terms of the amount of tax revenues that each local government can count on.
- The equalisation system does not take into account investments. Those investments depend on subsidies granted by the central government. This can explain the debate around the definition of investments that can be financed with the State Fund for Regional Development (see Chapter 3 for a discussion of the fund's design and operation). A broad definition could fill the financial gap in term of general purpose local investments, but it may also undermine the purpose for which this Fund has been created, financing regional development plans. In fact, it might be better to create a general purpose investment fund alongside the State Fund for Regional Development. The new article 103-1 of the Budget Code on subsidies to construction, reconstruction, repair and maintenance of local roads of municipal property is one step in that direction, but there is a need for a more global solution to support municipal investments, which represent in most countries a major part of public infrastructure investments.

Raising the investment capacity of local governments may help to overcome the infrastructure deficit in Ukraine. In most European countries, a major part of public investments is carried out by sub-national tiers of government (OECD, 2012). Yet decentralisation is not enough; the OECD work points out that the capacity of the local administration to implement policy and co-ordinate with other government tiers is fundamental for the investment policy to be successful.

The amendments to the Tax Code on local tax revenues adopted in 2010, and implemented in 2013, introduce several changes in the direction of increasing the sub-national shares of tax revenues:

- assigning to sub-national tiers of government a locally derived part of the profit tax;
- removing several land tax breaks; and
- assigning a property tax to sub-national tiers of governments.

The locally derived portion of the profit tax could generate considerable disparities between regions; as regards the land and the property tax, the main obstacle is a clear definition of the tax base and the creation of a cadastre. Furthermore, the recent hiatus in the process of decentralisation creates a climate of uncertainty. For instance, repeated postponement of the introduction of local property tax makes planning at the sub-national level impossible, not least because postponements have often been announced at short

noticed and for short periods. High levels of uncertainty have also been fuelled by frequent changes to revenue assignment; the issue here is not merely the uncertainty about income sources over relatively short time horizons.

Territorial reform is most urgently needed at the lowest levels

Ukraine is characterised by a very fragmented municipal pattern. Small settlements mean less capacity to manage the allocated functions. There is also a problem in terms of financial capacity, where richer settlements can provide services that are unaffordable for other settlements. In this situation, a decentralisation reform that increases the functions at local level and assigns taxing powers can be difficult to implement in municipalities that have neither the administrative capacity nor a sufficient tax base to provide the delegated functions to citizens. A territorial reform, in terms of amalgamation (merging) of municipalities or the creation of new or expanded mechanisms for inter-municipal co-operation, may help mitigate the problems associated with the delegation of expenditure and taxing responsibilities.

One of the main problems in Ukraine is the discrepancy between local communities and administrative territorial units. Solutions have been proposed several times in reform bills and in the constitutional review of 2004. The local community (*gromada*) could be defined as the basic territorial unit covering settlements and the surrounding territory. By contrast, under the present system, the municipal authority encompasses only the urban settlement whereas authority over the surrounding areas is assigned to the *rayon*. This represents a serious obstacle for municipal governments when planning urban development or land use.

There are several ways of implementing a territorial reform. The simplest (in principle, if not always in practice) is the amalgamation of municipalities according to a plan established by the central government. However, such an approach is likely to encounter strong resistance at the local level. An alternative solution is to develop inter-municipal bodies able to take over and exercise the main and strategic functions of the municipalities. In this case, the direct election of the council should be contemplated from the beginning as the most democratic option in order to avoid the difficulties encountered in France with the move from the election of delegates of municipal councils to the direct election of the members of the inter-municipal board.

The implementation of a territorial reform should take into consideration the following steps:

- **Show the benefits of the reform to citizens**. The implementation of the National Programme of Reform and Development of Housing and Municipal Economy should be co-ordinated with the local government reform; this could entail adequate financial support to those localities that get involved in the reform process.
- **Offer several ways to attain the goals of the territorial reform**. Amalgamation into one municipality or integration into an inter-municipal body taking over key municipal functions in joint institutions with the possibility of further integration to form a new and larger municipality voluntarily.[6]
- **In the case of amalgamation, offer the possibility of maintaining the identities of the former municipalities in the new one**. This could be done, for example, by opting for an indirectly elected council for the larger entity, a delegated mayor, or an advisory council.

Dollery and Robotti (2008) provide an account of the process of amalgamation in several countries. Their analysis shows the importance of a bottom-up approach in the merging and creation of supra-municipal organisations. It is important that citizens participate in the decision process through public meetings with politicians and, eventually, with a referendum.

Provision of local public goods

Local public goods and services are an important component of the public budget and contribute to the quality of life. Furthermore, the efficient provision of local public services can enhance economic competitiveness of the territory. For instance, infrastructure and education influence the productivity of the regions – access to electricity in a reliable way is essential to all commercial and industrial activities. An important aspect of local provision of public goods is the capacity of the municipality to provide the service, both in terms of necessary know-how and skills, and in terms of scale of production. This issue has been at the centre of political and economic debate on regional development in many countries (See Dollery and Robotti, 2008).

Ukraine's Constitution attributes to local self-governance the following functions: municipal property management, adoption of local budgets and social/economic and cultural development programs, surveillance over their realisation, establishment of local taxes and duties, creation of municipal enterprises, conducting local referenda, and other local-level issues. All authorities can be subdivided into delegated and own authorities; they are specified in detail in the law "On Local Self-Governance in Ukraine". There are two types of delegated functions:

- The first includes functions belonging to the regional level that are delegated by law to the local administrations;
- The second includes functions delegated by the central government to local self-governments. These are conditional on two factors: firstly, the state must compensate for resources spent by local self-governments to execute these functions, and, secondly, organs of local self-government are accountable to the central government for the performance of these functions.

In practice, however, lower governments have very little flexibility with respect to the performance of delegated functions, so the potential benefits of delegation in terms of adaptation to local conditions, proximity to citizens are largely unrealised.

Local budget expenditures are also classified according to funds spent for the exercise of own functions, and funds spent for the implementation of delegated functions. Spending on the exercise of delegated powers accounts for the great majority – and in many cases, 90% or more – of municipal budget expenditures. A major part of this spending, in turn, is to cover the payrolls of public institutions. Money to fund the exercise of the powers delegated to local governments is allocated by the *Verkhovna Rada* (parliament) during the adoption of the state budget for the coming year. However, in deciding the ultimate volume of transfers to local budgets, parliament does not take into account either the financial state of local governments or the range of powers delegated to them. Consequently, the transfers are not always enough to fully finance the delegated powers.

Table 2.5. **Local government responsibilities in public service delivery**

Own authorities	Delegated authorities
Management of community property	
Managing and disposing of community property	Consultation regarding the nomination of managers of state-owned enterprises
Establishing procedures and exercising control over the use of revenues	
Housing, transport, communications and communal facilities	
Managing and maintaining local facilities	Supporting the improvement of housing and communal facilities, transport and communications
Registering inhabitants in need of housing Registering housing construction co-operatives	Control over the operation of local facilities
Supplying facilities with heating, gas, electricity and water	Protecting consumer rights
Waste collection and utilisation, municipal improvement	Registering housing stock, providing social housing and exercising control over housing registration
Organising markets	Registering non-residential property and other real estate objects
Establishing working schedules for the given services and a community transportation schedule	
Settlement construction and planning	
Organising construction, renovation and repair of community property objects	Overseeing maintenance of the land cadastre, construction and architectural control
Allocating land for urban planning and development, drafting and approving general urban development plans	Preserving historical, cultural and architectural monuments
Issuing construction licenses	
Education, health care, culture, sports and tourism	
Managing related local facilities	Ensuring that education and medical services are available and free
Establishing conditions for raising children, facilitating secondary and vocational education	Developing all kinds of services related to education, health care, culture, sports and tourism
Providing free transportation for school children	Providing medicine to special categories of citizens
Creating conditions for creative activities, developing handicraft and home industries	Registering children for pre-school and primary school, organising work with youths and orphans, ensuring state maintenance for special categories of children
Organising medical services and catering in organisations of the social and cultural sphere	Resolving issues concerning the specific rights of special categories of the population (pensioners, youths, the disabled and students) to use certain facilities
Ensuring conditions for sports in residential areas	
Regulation of land relations and environmental protection	
Determining rates for the land tax and fees for the use of natural resources	Control over compliance with land and environmental legislation
Approving environmental programs	Registering land ownership, organising the land cadastre and resolving land disputes
Organising natural reserves and sanctuaries	Taking measures to eliminate the consequences of catastrophes and natural disasters
Control over compliance with land and environmental legislation	Co-ordinating land development projects
	Allocating territory for waste disposal

Table 2.5. **Local government responsibilities in public service delivery** *(cont.)*

Own authorities	Delegated authorities
Social security	
Establishing additional guarantees	Improving the life and financial conditions of special categories of the population and providing benefits
Providing assistance to certain categories of inhabitants	Assistance to victims of natural disasters
Organising hostels, specific medical services, catering and ritual services for certain categories of inhabitants	Control over the provision of social security to workers and employees, registering collective agreements
	Employment assistance for inhabitants in need of social protection
	Approving employment and social security programs, organising public works
Law enforcement, maintenance of public order and protection of rights and freedoms	
Establishing a municipal militia	Reviewing citizens' appeals
Rendering assistance to law enforcement bodies, courts and lawyers	Maintaining public order in times of natural disaster
	Deciding on the organisation of public meetings and demonstrations
	Reviewing issues on administrative violations
	Registering acts of civil status, businesses and public organisations (NGOs)

Source: OECD based on various sources.

To a large extent, this underfunding of real needs at the local level is caused by the difficulty of assessing the costs associated with the provision of these services. The basis of any cost evaluation should be the state social standards and norms that came into force with the Law "On state social standards and social guarantees." There are, however, few criteria for evaluating the **quality** of public services in Ukraine. Nor is there a single methodology for calculating the cost of providing them. This makes it impossible to determine whether local budget revenues will match spending needs or whether local governments use their funds efficiently. Although the Law came into force more than five years ago, the Cabinet of Ministers has not developed the standards that should guide the provision of local public services. As there are no standards for the provision of public services, it is impossible to assess the size of funding gaps on any agreed basis. With expenditures for current needs outpacing spending on development, the independence of local governments is limited, as is their capacity to carry out their proper functions.

Current legislation grants broad rights to local self-governments in determining the method of service delivery. They may pool the material and financial resources of different communities in order to set up additional services. They may also delegate the provision of some services to the private sector in the interests of improving quality and a more efficient use of community resources. Additionally, they may choose to provide these services jointly with the private sector. The existing methods of service delivery may be classified as follows:

- traditional (budgetary organisations or municipal-owned enterprises (service providers);
- alternative (contracting to private companies, concessions or consumer associations); or
- joint ventures (co-operating with local governments or partnerships with the commercial sector).

Activities such as waste collection, territorial development, maintenance of the housing stock, transportation and communication provide examples of co-operation between local governments and between the private and public sectors. Mechanisms of co-operation depend on the specific service. For example, a local government may sign a contract with a private company for the provision of waste disposal services, in which it specifies the quality and cost of services. These services are paid for by inhabitants; a special local organisation collects payments and transfers them to the private company. In the case of transportation, local authorities issue licenses to private companies to provide services. The license specifies all necessary terms and conditions. The private company then retains the prerogative to determine service costs and collect fees.

The power to regulate residential services has not been clearly divided between elected local governments and local state administrations, which are part of the executive branch. The local government bodies that directly fulfil a regulatory function cannot remove themselves from political influence, which makes it difficult to regulate effectively. The reform of local governments and inter-budgetary relations has a direct impact on the formation of a regulatory system for natural monopolies. Most regulatory powers were handed over to local state administrations and local councils. Given the lack of a consolidated regulatory policy, large-scale private sector involvement in owning and managing residential services assets has been put off, while regional initiatives are running into interference. As a result, the financial standing of service providers and the quality of their services have been deteriorating. Moreover, there has been no proper division of powers among bodies that:

- manage assets in the residential services sector;
- develop and carry out government and regional policy; and
- regulate natural monopolies.

Thus, local governments often combine the functions of: (1) a property owner, (2) an asset manager, and (3) a regulator. Combining the first two functions in a regulatory body leads to a conflict of interests when implementing regulatory policy. The local government tries at the same time to protect consumers and to protect the corporate interests of the companies it owns. It is not always possible to maintain the necessary balance under these conditions. Once water supply and sewage departments and central heating departments were changed into independent companies and handed over into community ownership, the problem arose as to how state administrations and local governments would be able to work together, especially in setting tariffs.

The legally established procedure for compensating the costs of water supply and heating does not take into account, inter alia, necessary major repairs, reconstruction and development, the replacement of worn-out pipelines, pumping equipment and filtering plants, or the costs of upgrading to modern water purification and disinfection systems. Most of Ukraine's water purification facilities were built 20–60 years ago, using now-outdated construction standards. The current water purifying system, which uses pipes that draw water from open reservoirs, cannot ensure the necessary quality of water. Overly centralised heating and the use of inefficient, poorly insulated and worn-out equipment in boiler rooms, heating junctions and networks mean significant heat losses and unreliable heating. Service providers also suffer substantial losses because of frequent accidents and large volumes of repairs.

The heat distribution networks of residential buildings and community facilities such as hospitals, kindergartens and schools have long passed their standard lifespan. The rate

at which worn-out network pipelines are replaced is below norm and does not match reliability standards. As funding shrinks, worn-out heating systems are replaced less and less regularly.

An independent authority has recently been created with the aim of regulating the activity of companies in the utility sector. The National Commission for Regulation of Utilities Markets Services of Ukraine was established by a presidential decree in July 2011. The intention of the central government is for the Commission to play a central role in the control of prices and quality in the utility sector. The commission will establish prices of public utility services and monitor the activity of economic agents operating in the water and heat supply sectors. The activity of the commission is inspired by the activity of the National Electricity Regulatory Commission (NERC).[7] However, the new regulatory body has not yet started exercising its powers and functions to a full extent.

Maintenance of residential buildings is another area where municipalities combine functions of regulation and service provision. Key maintenance services are identified in the Law of Ukraine "On housing and public utility services" (Table 2.6).

Table 2.6. **Housing maintenance services**

Physical environment	Condition of the building and adjacent territory (incl. elements inside the building, e.g. porch, stairway enclosure, basement and roof) Cleaning conditions in public spaces (stairway enclosure, adjacent territory) Lighting in public spaces Garbage removal
Maintenance services	Emergency service Utilities-related services (plumbing and heating installations, electricity supplies)
Safety and sanitation	Disinfestation

Source: Ministry of Regional Development, Construction and the Communal Economy.

The Soviet era was characterised by state ownership of the housing stock and, correspondingly, state control over housing services provided exclusively by municipal service providers. Apart from the detrimental effects of the Soviet legacy, the process of transition to a market economy itself also negatively affected the housing sector. The prices of housing-related services increased disproportionately compared to average salaries, which aggravated the problem of affordability and led to the accumulation of significant arrears in payment for housing maintenance services. Poor maintenance of residential housing is to a great extent the result of dire financial situation of tenants and owners. The privatisation of individual dwelling units that took place in the early 1990s contributed significantly to this outcome. The problem with privatisation of residential housing was that only individual apartments could be privatised; buildings, including inner and outer elements like porches, stairway cases, adjacent territories, etc., remained the property of local communities and therefore the responsibility of municipalities. This incongruence in ownership left unanswered the question of who should take responsibility for the maintenance of the building and the immediate environment.

One way to deal with these problems was the creation of a new type of housing management enterprise – the homeowners association (HOA). The definition of the homeowners association is provided in the Law of Ukraine "On homeowners associations" No. 2866-14 of 2002, the Resolution of Cabinet of Ministers "On realisation of the Law of Ukraine "On homeowners associations" No. 1521 of 2002, and

in the Order of the Ministry of Ukraine of Housing "On approval of Typical statute of a homeowners association and Typical agreement among owners of residential units (apartments) and a manager" No. 141 of 2003. These legal acts define an HOA as a non-for-profit legal entity, created by co-owners for operation, management and maintenance of their indivisible and common property (Art. 1 of the Law). Art. 4 of the Law provides that the basic activity of a HOA is the "proper maintenance of the building and the adjacent territory and assisting members of the association in the obtaining of housing maintenance and other services of a proper quality at fair value".

This creates a vicious circle: municipal service providers are cost-oriented and concerned with maintaining physical availability of services rather their quality, and consumers have weak incentives to fulfil their obligations. Consumers do not want to pay for low quality services, but they are also not prepared to pay more because they do not trust the service providers. The main problem is that there are no direct contracts between service providers and consumers, there is no monitoring of quality, and there is no mechanism to take account of service quality when setting rates for services.

Box 2.3. **Efficiency networks in service delivery**

The Norwegian-Ukrainian co-operation project on local development provides an important example of how service delivery can be managed at the local level. The project was based on two pilot regions in southern Ukraine (Mykolaiv and Odessa), with the focus on 11 cities, located in those two regions, covering the period 2009-11.

The project is based on the concept of *efficiency networks* of municipalities, originally developed in Norway at the beginning of 2002. The main idea is to collect indicators about the efficiency and effectiveness of public service provision at the municipal level; the latter type of indicators are based on citizens' satisfaction. This information is then used to compare the performance of municipalities in the network and learn from each other. The project was very successful in Norway and was subsequently applied to Poland where it benefited from a grant of the European Union.

The project also included training for researchers and local council members, which is instrumental to successfully implement the benchmarking strategy and the policies that spur from the debate in the network. This results in an increased institutional capacity of local authorities, as well as a closer relationship with the electorate. The general evaluation of project participants is very good.

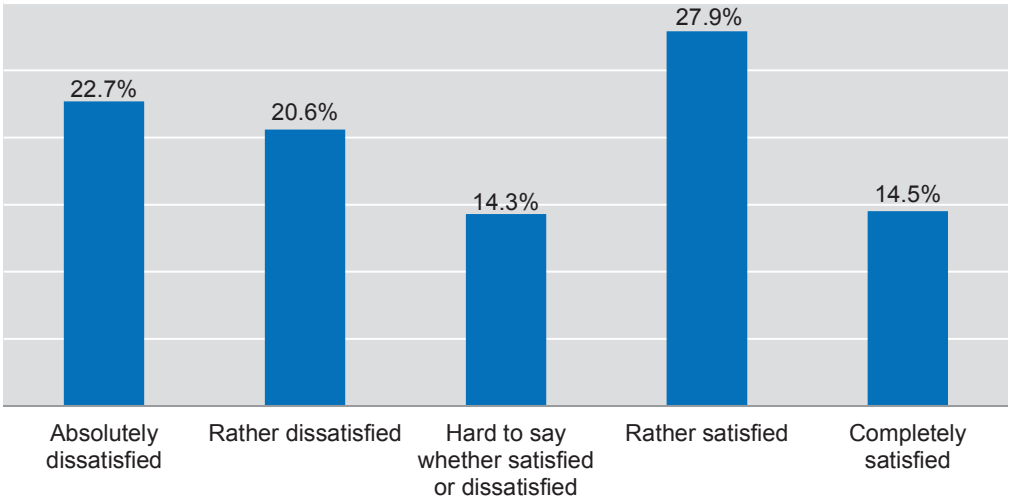
Source: Aasland and Shevliakov (2012), *The Norwegian-Ukrainian Co-operation Project on Local Development: Efficiency Networks in Service Delivery*, ICPS, Kiev.

There are currently four co-existing types of housing management enterprises on the housing market of Ukraine: municipal management enterprises (MMEs), private management enterprises (PMEs), homeowners associations (HOAs) and housing co-operatives (HCs). A recent study of residents' satisfaction with the performance of these different forms of housing management enterprises concerning the provision of maintenance services (Box 2.3) was jointly conducted by the Association of Ukrainian Cities (AUC), the International Centre for Policy Studies (ICPS), the Norwegian Association of Local and Regional Authorities (KS) and the Norwegian Institute for Urban and Regional Research (NIBR). The project developed in two consecutive stages. During the first stage (autumn 2009–Spring 2010), information about the state of the housing stock was collected from eleven participating municipalities in Mykolayiv (Bashtanka, Berezivka, Nova Odesa, Pervomays'k, Voznesens'k, and Yuzhnoukrayins'k) and Odesa (Artsyz, Bilhorod-Dnistrovs'kyi, Izmail, Teplodar, and Yuzhnyi) *oblasts*.

During the second (Spring–Summer 2010), data on satisfaction with the maintenance services provided were obtained from a survey of the resident population of the same municipalities.

Figure 2.10. **Overall level of residents' satisfaction with housing maintenance services**

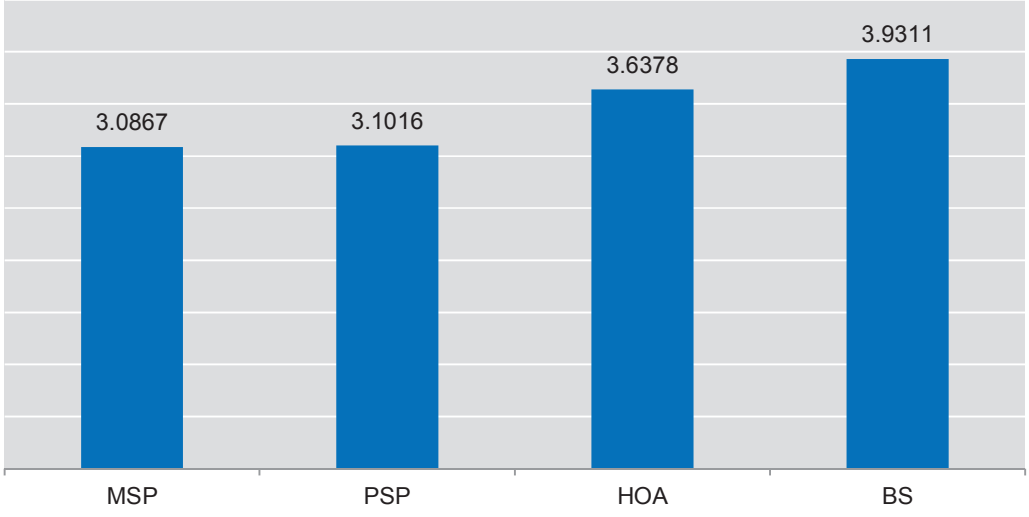
Percentage



Source: The Norwegian-Ukrainian Cooperation Project on Local Development, AUC, ICPS, KS, NIBR.

Comparison of the aggregated indices of the level of residents' satisfaction with the maintenance services they receive from their respective housing management enterprises demonstrates that those residents serviced by MMEs are least satisfied while the highest level of satisfaction is observed in the residents who receive their services from HC, and second-highest from HOAs (Figure 2.10). According to the project findings, while more than half of those who receive services from MMEs would support transition to HOAs, they are not ready to take practical steps in this direction. The main issue is, therefore, how to raise people's capacity for self-organisation and remove the existing bureaucratic barriers.

Figure 2.11. **Aggregated indices of satisfaction about provision of maintenance services by housing management enterprises**
Average values



Source: The Norwegian-Ukrainian Cooperation Project on Local Development, AUC, ICPS, KS, NIBR.

Health care and education

Ukraine's score is among the lowest of all transition economies when it comes to rating the quality of health and education services, as shown in the EBRD-World Bank Life in Transition Survey of both 2007 and 2010.The existing inefficiency and excess capacity result from an inherited over-staffing and network system that are perpetuated by regulations and incentives present in the budgeting, financing, and administrative mechanisms of local governments.

The poor health of Ukrainians might be attributed to several factors, among which are deficiencies of the health care system. Basically, the Ukrainian health care sector remained unchanged since the collapse of the Soviet Union, while neighbouring countries were conducting various health care reforms. Ukraine has a greater number of health system inputs per 100 000 inhabitants compared to the new EU member states and the EU countries in general, including more hospitals, beds, doctors, nurses and non-medical staff (World Bank, 2008).

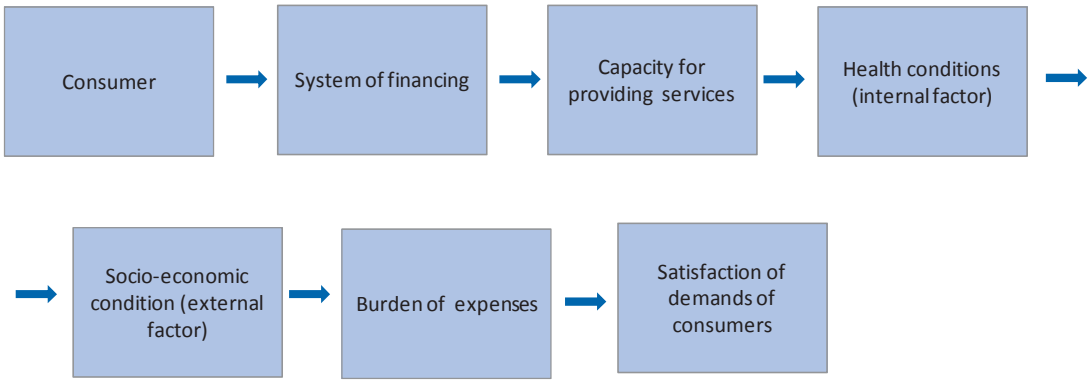
The Ukrainian health care system in 2010 was characterised by 2 840 hospitals (with 446 000 hospital beds) and 8 100 outpatient institutions (with a capacity of 994 000 visits per shift); the state health care system employed 215 000 physicians and 476 000 nurses; the average salary of a physician in the system was about UAH 1 050-1 750 per month. The ambulance system served 24.7 visits per 100 persons in 2010. This is combined with an inflated average length of stay in public facilities that is associated with low utilisation rates, average hospital stay of 14.6 days (Deloitte, 2012).

In OECD countries, the average number of physicians per thousand inhabitants is around 3.1, while in Ukraine it is 4.7; the number of hospital beds per thousand inhabitants in Ukraine was 9.74 in 2010, against an OECD average of just 4.86. These figures, similar to the indicators for the Russian Federation, show an oversized system of tertiary care that is the result of a historically centralised and input-driven health care policy.

Maintaining such inefficient network sizes and staffing leaves few resources to spend on the training and re-training of teachers and medical personnel, the provision of adequate educational and treatment materials and medicines, the renovation of equipment and laboratories, and other infrastructure needs. This situation may lead to a "segregation" of the population by level of income and place of residence, thus contradicting the constitutional guarantee of universal health care provision. As a result, the current health care system delivers poor results and lacks equity. Taking into account the social and economic transition of the last decade, the Ukrainian health care sector needs reforms and implementation of new types of relations both on the national and local levels. The main factor influencing provision of medical services is the condition of an individual consumer of medical services and their dependence on specific factors of internal and external environment.

Several studies by the World Health Organisation (WHO)[8] have shown that to ensure the best results and streamline costs, the most human and financial resources must be concentrated at the primary health care level, and the least on highly specialised tertiary care. In Ukraine, 80% of financial and human resources in the health care system are concentrated on in-patient care, 15% on out-patient and clinic-based care, and only 5% on primary and preventive care.

Figure 2.12. **Factors influencing the process of medical service provision**



Source: Ukrainian Institute for Public Policy, Barometer of Change #2. Health care Reform: Impact Assessment. Kyiv, 2012.

The main reasons given for patients' dissatisfaction are poor quality of medical service (about 40%), poor quality of customer service and the high cost of services (so-called "unofficial" payments). Patients and doctors see the system's main problems differently. According to a Ukrainian State Statistics Service poll of households on selected issues conducted in 2010, patients identify the following problems with the health care system:

- impossibility to receive quality health care without "informal payment";
- no guarantee of timely provision of quality health care even in case of "informal payment";
- insufficient qualification of health personnel; and
- the careless attitude of health personnel to patients.

By contrast, health service professionals have identified the following main problems of the health care system:

- low salaries, which do not reflect the social role of health personnel in the society;
- lack of instruments, technical and diagnostics basis of hospitals;
- low incentives for career development; and
- the careless attitude of patients to their health.

Needless to say, these two sets of problems, though different, map onto one another remarkably well in some respects, touching on the same issues from provider and consumer perspectives (e.g. low salaries and informal payments; lack of equipment and timeliness of service; low incentives for career development and insufficient qualifications). There thus emerges a fairly coherent picture in which the health care sector is characterised by structural problems linked to the organisation of the service. On the one hand, the service seems not to be managed in a way that can promptly satisfy the needs of the population; on the other hand, there are few resources or incentives for personnel to improve the quality of the service. In particular, the claim of lack of incentive to pursue a career as a doctor is probably linked to a wage structure – highly qualified doctors do not earn much more than less qualified health workers.

Recent years have seen heated discussions regarding the introduction of compulsory state health insurance. Several draft laws failed to be approved by parliament. This reform, however, does not tackle the structural problems of the health care system as it represents an additional mechanism of financing the existing system without really changing it. In fact, there are many structural deficiencies in the system, including improper allocation of funds, lack of incentives, low managerial autonomy and an absence of competition between providers, which would deserve the attention of the legislator.

In the education sector, Ukraine has low student/teacher ratios, 9.4 for primary and secondary education, extremely small class sizes, and an oversized network of facilities combined with a low number of teaching hours per teacher, around 60% of the levels in the United States and 85% of the OECD average (World Bank, 2008).

In theory, local governments are in charge of all of the functions of education except for higher education. However, the Ministry of Education continues to retain full control over the norms that govern staffing arrangements, teaching hours, non-teaching personnel ratios and class sizes – all based on the oversized network of schools and school infrastructure instead of on the actual demand for the service (e.g., enrolled children or school age population in the jurisdiction).

There is indirect evidence of increasing dispersion in the quality of schooling as a result of increased reliance on non-budget financing, which is consistent with widespread reports of deteriorating quality (according to interviews of academic and business experts). Many important educational quality-enhancing inputs, such as teacher training (and re-training), educational equipment and materials, programs for poor students and at-risk students, and school maintenance, are usually underfunded. The education system also lacks an acceptable measurement system for performance and quality to guide education policy and reform.

The problems with health care and education described above tend to be more acute outside the major cities. Schools and medical-obstetrical units (MOUs) in small communities are often understaffed. In Zhytomyr *oblast* alone, local budgets are forced to

support 16 MOUs that are understaffed and that, as a result, cannot provide quality services to the local population. This means that even the funds allocated for the provision of services are not being used effectively. It is impossible to reorganise understaffed schools and MOUs, yet the central government almost entirely regulates such issues and will not allow the network of institutions to be cut back.

Despite their large role in allocating spending, the ability of local governments to determine spending structure and to allocate expenditures within sectors is quite limited. The budget formation at the service facility level (in health and education) and its aggregation at the local budget are based on line ministries' "norms" that have their roots in the Soviet system. These norms prescribe the amount of resources (personnel and other materials) on the basis of facility, rather than on the actual demand for services. For instance, the number of doctors is based on the existing number of beds in health care facilities; non-teaching staff is based on the number of square meters of a school facility.

Because of the mandatory nature of these rules, lack of flexibility is a huge problem for municipalities. The consequences are high levels of current expenditures, particularly for wages and heating, leaving few resources for capital investments and quality-enhancing projects. Financially poor municipalities are particularly affected, creating unequal per capita levels of public investment across the territory. The problem is exacerbated by the legislation that prohibits closing health facilities and schools, and by the difficulties local governments face in firing personnel.

Current studies on organising health care actively promote the idea of integrating funding and management for primary and secondary health care services in order to maximise the flexibility of choice among various types of health care services and approaches to treatment. For example, there is no need to introduce formal divisions of functions in legislation in order to determine where and how to provide dialysis in a hospital or in out-patient clinic. Both in Denmark and in Sweden, where there is the greatest level of decentralisation in favour of local government bodies, responsibility for health care services has been transferred as a general function to the regional (provincial) level.

The analysis of the provision of local public services has shown the need to establish mechanisms to evaluate the performance of the system in terms of satisfaction of citizens' needs. In particular, input-driven policies do not take into account the actual needs of the population. This results in a waste of resources. There is also a need to change the way in which policies are decided, towards a more demand-driven approach, regardless of the level at which the decisions are taken. In this sense, incentives for the administration to conduct quality assessments and share information should be promoted.

Conclusion

The analysis of the sub-national government structure of Ukraine provides the picture of a centralised country where policies are implemented following a top-down approach, and service provision often poorly reflects the actual needs of the local population. A decentralisation of functions and responsibilities from the centre to the sub-national levels (*oblasts, rayons*, municipalities), however, is not sufficient to improve the situation. The analysis suggests that, prior to any form of decentralisation, a territorial reform that would allow local actors to acquire the necessary capacity to handle new functions should take place. In sectors such as health care and education, for instance, the decentralisation of functions would not greatly improve the situation without abandoning an input-driven

policy in favour of a demand-driven policy. Decentralisation alone will achieve little if not conducted in tandem with reforms to the mechanisms that govern resource allocation and concomitant changes in the incentives of service providers, as well as capacity building at lower levels of government.

In this context it is important to improve the flow of information both horizontally, by exchanging experiences and good practices between the same levels of government, and vertically in order to provide the necessary indicators for the superior level to move away from strategic planning based on historical data and a fundamentally input-driven approach to the assessment of funding needs.

Finally, to enable municipalities to provide public goods that better meet the needs of local citizens and firms, there should be a reform of the current revenue structure, making the local budget less dependent on central government transfers. This can be achieved by introducing a property tax, which is common in many OECD countries and represents a valid instrument for the local level to finance the provision of local public goods.

Box 2.4. **Summary of main policy recommendations**

- Revise the formula for the allocation of funds to sub-national tiers of government in order to make it simpler and less discretionary, by reducing the number of indicators used in the formula.
- The resources allocated for the provision of local public services should not be based on historical data and input indicators; rather they should be based on the needs of the population in each area.
- A territorial reform should be implemented prior to any decentralisation of functions to lower levels of government; such a reform should facilitate municipal mergers and the further development of new forms of inter-municipal co-operation; simplify the legal procedures involved in transferring competences to joint bodies or companies; and provide additional financial incentives to jurisdictions that implement new types of co-operative relationships.
- Modify the revenue structure of the sub-national levels of government by allowing them to retain any extra revenue generated at the oblast or local level.
- Modify the revenue structure at the municipal level to increase reliance on own revenues, by the introduction of a property tax; the introduction of a tax on property should be preceded by the creation of an efficient and reliable cadastre (that would also facilitate urban and spatial planning).
- Create incentives to innovate and diffuse good practices amongst municipalities and sub-national tiers of government.
- Create a monitoring system for the effectiveness of the policies implemented, with special reference to local public goods and services.
- Facilitate the flow of information from the bottom to the top of the administration, making it easier for the central administration to take decisions concerning local governance.

Notes

1. The scope of the legislative power is greater at *oblast* than *rayon* level.
2. The symmetric structure of sub-national tiers does not preclude the possibility of an asymmetry in terms of functions. For instance, in Italy there are regions with special status that can perform extra functions with respect to other regions.
3. Eligibility depends on annual income, field of activity and the degree of reliance on a single customer. Only IT service providers retain the right to register as single tax payers if 50% of their income is received from one customer. This latter requirement reflects the need to combat the use of "independent entrepreneur" status to conceal what are, in fact, dependent employment relationships.
4. Resolution of the Cabinet of Ministers of Ukraine No. 972 of 7 September 2011 "Some issues regarding distribution of targeted grants from the state budget to local budgets for construction, reconstruction, repair and maintenance of community-owned streets and roads in inhabited localities."
5. Specifically, CMU resolution No. 1195 "On approval of Formula allocation of inter-budgetary transfers between the State budget and local budgets" (5 September 2001), and No. 1782 "Some issues concerning inter-budgetary relations" (31 December 2004).
6. See Bartolini and Fiorillo (2012) for a discussion of different types of co-operation between municipalities for the provision of local public services.
7. According to First Vice Prime Minister Andrii Klyuyev on the webpage of the Ministry of Economic Development and Trade of 16 July 2011.
8. See for instance, Lekhan et al. (2004); Lekhan et al. (2007); Sheiman and Shishkin (2009); Lekhan et al. (2010).

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Chapter 3

Strengthening regional development policy in Ukraine

Ukraine's regional development policy has reached a turning point. The creation of a new State Fund for Regional Development, together with the preparation of a new legislative framework and the formation of new governance arrangements mark the start of a potentially dramatic improvement in the quality of regional policy. This chapter begins with an overview of regional policy in its broader context and a look at past and current policy reforms in Ukraine. It then turns to how Ukraine can improve both the institutional architecture for regional development and the instruments of regional policy themselves. Its overriding theme is the degree to which the success of specific regional policy reforms depends on the government's success in pursuing its broader programme of reforms to improve the business environment.

Introduction

As noted in Chapters 1 and 2, pervasive uncertainty remains one of the major impediments to investment in Ukraine, particularly investment with potentially long payback times. Much of this uncertainty is the product of weaknesses in Ukraine's institutional environment and the macroeconomic risks identified in Chapter 1. The design and implementation of effective regional development policies have also been impeded by a considerable degree of policy instability and a consequent lack of stable, predictable public financing for projects and activities that might help unlock private investment and tap the growth potential of Ukraine's regions and cities. This chapter focuses on the creation of a more effective regional development policy framework in Ukraine. It begins with a broad overview of regional development policy and its place in the broader structural policy package. This is followed by an examination of the evolution of regional development policy in Ukraine over the last couple of decades. The discussion then turns to the current changes being undertaken in regional development policy, looking first at the way regional development **institutions** can be strengthened and then at the potential for improving some key regional development **instruments**.

Two key themes run through the chapter. The first reflects the concern with uncertainty that runs through this Review and the need for greater predictability of institutions and policies. It is hard for private or public sector agents to commit seriously to long-term undertakings in an environment of policy and institutional instability. The second, related theme is that regional development policies cannot be reformed in an institutional vacuum. Real improvements in regional development policy outcomes will depend on improvements in the wider institutional environment. To say this is not to deny the importance of regional policy: it has a potentially important role to place in improving Ukraine's competitiveness and fostering greater cohesion. However, it is no substitute for things like sound macroeconomic management, the rule of law or secure property rights. Moreover, its impact will depend crucially on the success of current efforts to improve the quality of public budgeting and financial management at all levels of government.

Putting regional development policy in context

Effective regional development policy requires a broad vision…

Different countries define the remit, aims and instruments of regional development policy rather differently. Before proceeding to a discussion of regional development policy in Ukraine, therefore, it is important to define precisely what it is and to set the traditional instruments that are discussed in regional policy debates in a broader context. There is a widespread tendency in many countries, including Ukraine, to identify regional development policy with a fairly specific set of instruments designed to compensate for interregional disparities or to promote the emergence of "growth poles" or "clusters". Most of these instruments involve fiscal transfers from higher levels of authority to finance public investment in various forms of mainly "hard" infrastructure. Such instruments remain highly relevant to regional development, but they are most likely to succeed when embedded in a broader understanding of regional development that has emerged in OECD countries over the last couple of decades (Table 3.1). This shift has involved a move from top-down, infrastructure-driven policies focused on lagging regions towards more integrated and market-oriented approaches to solve national growth challenges (OECD, 2009a, 2009b). OECD (2011a) identifies the main elements of a

much broader "family" of policies to improve regional performance, including the following:

- a development strategy covering a wide range of direct and indirect factors affecting the performance of local firms;
- a greater focus on endogenous assets rather than exogenous investments and transfers;
- an emphasis on opportunity rather than disadvantage;
- attention to policy settings ("rules of the game") and soft infrastructures (networks, knowledge platforms, etc.), as well as physical infrastructure; and
- a collective/negotiated approach to governance involving national, regional and local government along with other stakeholders, with the central government taking a less dominant role.

Table 3.1. **Old and new paradigms of regional policy**

Objectives	"Balancing" economic performance by compensating for spatial disparities	Tapping under-utilised regional potential for competitiveness
Strategies	Sectoral approach	Integrated development projects
Tools	Subsidies and state aid	Development of soft and hard infrastructures
Actors	Central government	Different levels of government
Unit of analysis	Administrative regions	Functional regions
→	**Redistribution from leading to lagging regions**	**Building competitive regions by bringing together actors and targeting key local assets**

Source: OECD (2009b), *Regions Matter: Economic Recovery, Innovation and Sustainable Growth*, OECD Publishing. http://dx.doi.org/10.1787/9789264076525-en.

To put it very succinctly, regional development policy is potentially coextensive with economic policy, apart from recourse to macroeconomic instruments. Its concerns can encompass everything from human capital formation and innovation to competition, private-sector development and market regulation. Of course, this includes the traditional "regional policy" concerns with infrastructure and connectivity, and traditional instruments continue to play an important role. However, the evidence suggests that those instruments are most likely to yield good results when other elements of the policy framework are in place and the investment projects being funded are embedded within an integrated, cross-sectoral growth strategy. Investment in hard infrastructure, for example, is found to yield better returns in the presence of policies designed to improve human capital and knowledge creation efforts. Pursued in isolation, large infrastructure projects can simply turn into useless "white elephants" or even accelerate the exit of firms and workers from a region (OECD, 2009a). In similar fashion, many OECD regions have discovered that big investments in human capital formation do little to stimulate regional growth unless other growth constraints, such as barriers to private-sector development, are addressed. If suitable opportunities are not available locally, then the beneficiaries of

investment in skills may simply exit the region in search of opportunities elsewhere (i.e. a brain drain). This is good for the individuals concerned and may generate some positive spill-overs in their home regions (e.g. remittances), but it does little to unlock regional growth potential.

Note that this approach does not preclude paying particular attention to the specific needs of different types of regions. On the contrary, a regional approach is needed precisely because one-size-fits-all economy-wide approaches so often fall short. Modern regional policies are about growth and competitiveness, not merely "equalisation of outcomes" via a sort of spatially targeted social policy, and they apply to all regions, not just the laggards. Yet at times, the resilience and robustness of economic systems can depend on all their components and sometimes on the weakest links.

It is important also to recognise the limits of regional development policy

This very broad definition of regional development policy implies that the potential of traditional regional development policy instruments to deliver improved performance depends to a great extent on the broader institutional and policy environment. This is particularly true in a relatively large but centralised country like Ukraine, where sub-national governments have less fiscal and policy autonomy than they might in a federal system. Many of the binding constraints on growth that Ukrainian regions face fall within the competence of the central government and must be addressed at that level. To say this is not by any means to denigrate the importance of regional development strategies and instruments – they will be explored at length below. However, it is important to assess such initiatives with a realistic understanding of what they can achieve. Better regional strategies and improved targeting of investment funds are not a substitute for better institutions and economy-wide policies. On the contrary, as will be seen below, many widely discussed regional policy initiatives highlight the need for further structural reform rather than mitigating it.

This reality was consistently reflected in the OECD Secretariat's contacts with businesspeople in the regions of Ukraine. Although many of them expressed strong views about regional development programmes and instruments, their primary concerns were cross-cutting challenges, chiefly to do with the country's business environment. These were largely, if not exclusively, within the competence of the national authorities. Many officials likewise confirmed in discussions with the Secretariat that the main barriers to investment were cross-cutting factors like bureaucracy and corruption.

Ukraine's business environment is exceptionally difficult

Poor framework conditions for doing business constitute perhaps the principal challenge facing Ukrainian firms in all regions. In 2012, Ukraine ranked 137th out of 183 countries on the World Bank's composite "Ease of Doing Business" indicator. This was an advance on 2011 but still somewhat lower than in the mid-2000s.[1] Moreover, European Business Association in Ukraine's investment index showed deteriorating sentiment among its members through most of 2012. Ukraine's rank of 73rd out of 144 on the World Economic Forum's (WEF) Global Competitiveness Index for 2011 was rather better and represented an advance of nine places on the previous year. Unlike the World Bank assessment, which focuses solely on regulatory issues, the WEF ranking reflects Ukraine's perceived strengths with respect to such factors as human capital and market size. However, the WEF survey of Ukrainian executives finds that these advantages are largely offset by the same factors identified by the Bank: Ukraine ranked 132nd in the

WEF index of the quality of institutions and 117th on goods market efficiency. The contrast between the WEF's high rating of Ukraine on key economic endowments and its very low ratings on institutional factors underscores the price Ukraine continues to pay for weak institutions: its undoubted strengths are simply not being fully developed.

Among the most problematic features for doing business identified in the WEF's executive opinion survey were corruption, burdensome tax and labour regulations, inefficient government bureaucracy and policy instability. These findings coincide with other external assessments of governance in Ukraine (Table 3.2) and with the results of other surveys of local entrepreneurs, investors and experts.[2] Moreover, these studies offer little evidence of sustained improvement in the institutional environment over time. These concerns gain added force in light of research pointing to the importance of institutional quality for attracting foreign direct investment. Given Ukraine's numerous other attractions as a potential FDI destination, the opportunity cost of institutional weakness, in terms of investment foregone, is likely to be high.[3]

Table 3.2. **Governance indicators, 1996-2012**

Percentile ranks

	Ukraine			Poland	Russia	Sweden
Indicators	1996	2004	2011	2011	2011	2011
Voice and Accountability	34.1	29.3	46.5	79.3	22.5	98.6
Political Stability	37.0	28.8	41.5	85.8	20.8	92.5
Government Effectiveness	25.9	33.7	21.8	71.6	42.2	98.6
Regulatory Quality	38.2	39.7	31.8	80.1	38.9	97.6
Rule of Law	19.6	26.8	23.0	71.9	25.4	99.5
Control of Corruption	13.2	18.0	17.1	71.6	13.3	99.1

Note: A higher score denotes a better rank.
Source: World Bank Governance Research Indicator Country Snapshots (2012).

The problems most frequently cited by entrepreneurs can broadly be grouped into three categories: policy uncertainty, legal uncertainty and regulatory uncertainty. In short, the behaviour of public institutions is seen as neither stable nor predictable, with the high level of unpredictability stemming in many cases from a lack of transparency. These factors, in turn, fuel widespread corruption and undermine property rights. The limited evidence available suggests that such problems are common across Ukrainian regions. In survey of businesspeople in all of Ukraine's regions, the Foundation for Effective Governance (FEG, 2012) finds wide variation in assessments of factors like infrastructure and technological sophistication but much smaller differences in assessments of institutional quality.[4] These are relatively poor across all regions, with only limited variation among them. The good news in the FEG results is that regional-level assessments are somewhat better than the national assessments reported in WEF (2012). The bad news, though, is that the worst assessments of institutional quality are reported in the most developed regions: Kyiv, Khar'kiv, L'viv and Odessa score particularly badly; among the big economic centres, only Donetsk ranked above the median on this indicator. It is, of course, very difficult to interpret this finding. The survey data may imply that the situation really is worse in these places, or they may reflect greater demand for improvement on the part of businesspeople in the largest cities. This latter interpretation

would suggest that institutional constraints may be costlier where firms see more activity and more opportunity. Business people may thus make greater demands for better quality administration in such places.

Policy instability is a major source of frustration for business in Ukraine

Ukrainian executives responding to WEF surveys have consistently ranked policy instability and government instability high on the list of the most problematic factors for doing business. To a significant extent, policy instability has been the product of political turbulence: in just over 20 years since independence, Ukraine has had four presidents and fifteen changes of government. At times, these political struggles have entailed sharp swings in fiscal policy, as well as abrupt changes in structural policy settings.[5] For much of the last decade, struggles over the structure of executive power have also complicated – and at times simply stalled – economic policy-making. These concerns have receded since 2010, but in other surveys, entrepreneurs continue to point to the instability and unpredictability of government policy in specific fields, such as tax. Many businesses report that frequent changes to the tax system are more of a problem than the level of taxation itself.

Electoral competition and inter-institutional wrangling are by no means the only sources of policy instability, which also has structural roots in a rather disjointed and uncoordinated policy process (SIGMA, 2011). The executive itself has tended to be highly fragmented. Despite some recent rationalisation, Ukraine's central executive in mid-2012 comprised 77 executive bodies, down from 111 in 2010. The number of ministries was cut from 20 to 16 over the period. This streamlining was accompanied by an attempt to rationalise the functions of state executive bodies and clarify their responsibilities, including a clear separation between the roles of ministries, agencies, services and inspectorates.[6] This is a positive step, but implementation of this overhaul is still far from complete, even at the central level, and little has been done to streamline administration at sub-national levels. Lack of clarity with respect to the attribution of functions and responsibilities reduces both transparency and accountability in the policy process. Ministries and other state bodies often appear to approach policy problems with very narrow terms of reference and frequently fail to co-ordinate their activities with one another.[7] Cross-country research suggests that fragmentation, opacity and weak lines of accountability also favour the "capture" of state institutions by powerful special interests.[8] The fragmentation of the executive also tends to weaken strategic or management frameworks for policy making, so policy is often highly reactive, responding to short-term developments rather than focusing on long-term goals (SIGMA, 2006, 2011).

This situation has undoubted implications for regional development policy (Grontmij/Carl Bro et al., 2011). First, responsibility for different aspects of regional development has itself been shifted from ministry to ministry in recent years, which has made for both conflict and uncertainty. This, in turn, has reduced the incentives for actors at local and regional level to engage seriously in regional development initiatives. Secondly, such an environment makes it far more difficult to design and implement integrated strategies for regional development, which involve the co-ordination of different sectoral policies across levels of government. Cross-sectoral co-ordination remains a weak point in Ukrainian policy-making (SIGMA, 2011). Thirdly, such fragmentation underlies many of the challenges with respect to policy implementation. Implementation weakness is a pervasive problem in Ukraine, and the problems are even greater where cross-sectoral co-ordination is required.[9] This will be a critical consideration to bear in mind as regional development policy evolves in Ukraine.

Regional development is an "implementation-intensive" policy domain, inasmuch as it requires a great deal of cross-sectoral and vertical co-ordination, as well as strategic planning capacity and effective mechanisms for information revelation, monitoring and evaluation. Its effectiveness is thus likely to depend on broader improvements in implementation capacity. Until this challenge is addressed, it would be unwise to invest too heavily in such complex policies – smaller initiatives, aimed at capacity building, may be more appropriate in the first instance.

The business environment also suffers from a high degree of legal confusion and uncertainty

The second major source of uncertainty concerns the high degree of legal confusion that characterises the business environment. Surveys suggest that the courts are indeed widely perceived as both susceptible to political influence and very corrupt, even by comparison with other public institutions.[10] Such assessments may be overly pessimistic, but even the **perception** that the judiciary is weak and corruptible imposes economic costs, because it affects confidence and thus influences investment and other business decisions. Greater faith in the court system implies greater confidence about property rights and a greater willingness to engage in arm's-length transactions with other parties, two factors that should favour business restructuring and development. Greater confidence in arm's-length transactions also facilitates the emergence of business networks that are open and market-oriented.[11]

High levels of regulatory uncertainty are a problem, particularly for SMEs

Numerous international assessments have concluded that private business in Ukraine is over-regulated (OECD, 2007a and 2011b; IFC, 2011; WEF, 2012). Firms are subject to too many rules and procedures, many of which no longer serve any legitimate governmental purpose, if indeed they ever did. Regulations and regulatory procedures also tend to be more complicated than they need to be. To be sure, there have recently been palpable improvements in some fields, like technical regulation and permit procedures (IFC, 2011). Nevertheless, the WEF (2012) executive opinion survey still ranks Ukraine 135th in terms of the burden of regulatory compliance. Construction permits, for example, can involve 20 distinct steps and take up to 375 days, while getting electricity service in 2012 took an estimated 285 days. Excessive red tape, however, is only part of the problem. Firms continue to face major problems as a result of the **instability** of the regulatory frameworks they confront and **inconsistency** in the interpretation and administration of regulations, particularly at local level.[12]

Altogether, the combination of excessive regulation, frequent rule changes and inconsistent application makes it extraordinarily difficult for private businesses to be certain of remaining on the right side of the law. This makes for yet more risk and uncertainty in connection with the regulatory burden. Moreover, such a situation leaves considerable discretion in the hands of officials dealing directly with businesses and thus creates opportunities for corruption. Some formal regulatory frameworks have been substantially improved in recent years, particularly those connected with tax administration, registering property and starting a business (World Bank, 2012). However, according to businesspeople, implementation of many of the new arrangements has been patchy (IFC, 2011).

Problems of regulatory uncertainty are perhaps most acute with respect to the range and frequency of on-site inspections to which businesses are subjected (IFC, 2011). Tax

administration is another sphere in which – despite significant recent improvements – complex rules and broad scope for bureaucratic discretion can create high levels of uncertainty, not least owing to confusion about the detail of tax regulations, frequent changes to them, and perceived arbitrary behaviour on the part of tax inspectors.[13] In 2012, the IFC ranked Ukraine 165th among 185 countries in terms of the burden of tax compliance, despite the fact that Ukraine had considerably improved in this respect as a result of the introduction of electronic filing and payment for medium and large enterprises. The system for issuing official tax clarifications also works poorly, according to many firms.[14] Securing reimbursement of VAT, in particular, has long been and remains a thorny problem for companies in Ukraine (OECD, 2007a; EBA, 2012). The tax inspectorate's understandable concern with fictitious exports and other avoidance schemes means that legitimate exporters often face extremely long delays and must fight very hard to obtain reimbursement. Finally, there have been widespread complaints of official favouritism with respect to decisions concerning VAT refunds.

Corruption both contributes to, and results from, other weaknesses in framework conditions

In view of the weakness of institutions and the complexity of the regulatory environment, it is hardly surprising that endemic corruption is widely viewed as a central problem for firms in Ukraine. While measuring corruption accurately is notoriously difficult, there is a widespread consensus that it remains very high. Transparency International's 2012 "Corruption Perceptions Index" (CPI) ranks Ukraine 144th out of 176 countries.[15] To be sure, perception indexes can be a misleading indicator of corruption levels; for example, a single high-profile case can have a big impact on outsiders' perceptions, for better or for worse, but gradual improvement or deterioration may be registered only with a delay. However, this is true only up to a point. The evidence suggests that countries with a reputation for corruption generally do have serious problems with it (Movchan, 2004; Olken, 2009). Moreover, surveys of ordinary citizens also point to higher levels of corruption in public institutions in Ukraine than in neighbouring countries like Russia and Romania, even when they are asked direct questions about respondents' own experiences of paying bribes.[16] In 2013, almost half of those surveyed said that they believed corruption had increased a great deal in the preceding two years, with 16% reporting that it had increased a little. Only 15% believed it had fallen. Strikingly, citizens perceive more or less **all** public institutions, with the exception of the military, as about equally corrupt. Private business is also perceived to be very corrupt.[17]

Clearly, securing property rights and appropriating the returns to productive investment in such an environment is not easy. In addition to the constant risk of bureaucratic rent-seeking, Ukrainian entrepreneurs express concern about the kind of predatory take-overs known colloquially as *reiderstvo* or "raiding" – the use of a combination of legal processes, corruption and, on occasion, threats and intimidation to engineer hostile takeovers. The defects of Ukrainian legislation combined with the weakness of the court system make this relatively easy. While cries of *reiderstvo* are sometimes used by enterprise insiders to denounce perfectly legitimate takeover attempts, the problem appears to be widespread and the authorities are finding it difficult to curb. These quasi-judicial, quasi-criminal operations often involve the acquisition of small stakes in the target firm by individuals or front companies, which then launch a campaign of nuisance litigation against the target, frequently exploiting gaps or inconsistencies in the law.

The authorities have long acknowledged the problem of corruption in Ukraine and have recently taken steps to address it. In early 2013, parliament approved a raft of new legislation aimed at bringing Ukraine's laws into line with international standards when it comes to fighting corruption. The new measures criminalise acts previously treated as administrative transgressions and introduce criminal responsibility for bribery in private business. They also introduce a new method for handling the income statements of public officials, while providing for a range of punishments for both parties to any transaction in which officials are offered "undue advantage" in return for their services. While it is too early to comment on the implementation of this legislation, which was signed into law by the president in June 2013, passage of the measures was a signal to domestic and international actors.

The evolution of regional policy in Ukraine

Regional policy has been evolving over the last dozen years

Prior to 2000, no national-level executive or administrative structure was assigned explicit responsibility for regional development. Regional policy in difficult years of the 1990s was largely reactive and top-down, consisting to a great extent of ad hoc interventions to address the problems of particular sectors and places – particularly the struggling cities and regions that were heavily dependent on industries like coal and defence production, for which the transition recession and subsequent restructuring were particularly severe. Regional elites in some of the stronger regions also came to undertake some initiatives of their own, and in the mid-1990s a number of sub-national administrations presented proposals to the government asking for national support for their medium- and long-term development plans. Nine of these were approved by the government, but little came of the effort. Most of the proposals were for construction projects and they bore little resemblance to integrated strategies for regional development. In the end, relatively little central financing was forthcoming (Romaniuk, 2002).

The late 1990s also witnessed the creation of a number of special economic zones (SEZs) and the designation of many areas of the country as "territories of priority development" (TPDs).[18] Indeed, by 2004, just over 10% of the territory of the country fell into designated TPDs. This process, too, proceeded in a rather ad hoc fashion, although some of the special territories and zones were clearly created in places facing specific challenges (e.g. mono-branch economies whose Soviet-era specialisations were no longer viable, areas affected by ecological disasters). Nevertheless, the wide range of fiscal and regulatory privileges enjoyed by these special territories soon became a matter of controversy. It was increasingly clear in the early 2000s that the fiscal costs of such special regimes were rising fast, while the payback in terms of economic development was meagre at best. In many cases, the zones were central to "grey schemes" for avoiding taxes and custom duties, and they distorted competition in many sectors (World Bank, 2005; OECD, 2007a). The tax and customs privileges of the zones were abolished in early 2005. This move prompted much criticism, even from those who had argued against them in the first place, since this involved the government breaking promises even to legitimate businesses that had invested in the zones in good faith. Since then, there has been much discussion in Ukraine about how and in what form new zones might be created so as to avoid past abuses and generate growth. This issue is explored in depth below.

The decade from 2000 saw the institutional architecture of Ukraine's emerging regional policy regime take shape. First, in October 2000, the Ministry of Economy and European Integration (subsequently re-designated simply the Ministry of Economy) was assigned responsibility for regional development policy. In the spring of the following year, a "Concept" for State Regional Policy was approved by the president. These two steps led to little change in practice. The "Concept" was more or less a policy paper, containing a list of proposed actions but providing for neither a co-ordinated strategy nor any new institutional development. The approach was largely top-down and central subventions to the regions and municipalities for socio-economic development continued to be approved by parliament, year by year, and were thus subject to "pork barrel" lobby pressures.

The next significant steps included the adoption of a Law on Stimulating Regional Development in 2005 (Box 3.1) and the approval the following year of a State Strategy for Regional Development to 2015. A Ministry of Regional Development and Construction was created in 2007. At the same time, Ukraine became more engaged in regional development issues at international level, as the 2005 EU–Ukraine Action Plan initiated a dialogue on regional policy that continues today. Under legislation adopted in 2005, Ukraine's regions (the oblasts, as well as the cities of Kyiv and Sevastopol and the Autonomous Republic of Crimea) were required to follow the central government's lead and to define their own multi-year strategies for regional development.

Box 3.1. **The Law on Stimulating Regional Development (2005)**

The stated aim of Ukraine's regional development law was to move towards a more programmatic, goal-oriented approach, to bring services closer to citizens and to allow greater concentration of budgetary and other resources for regional development. It defines the key programming documents involved and articulates the relationships among them. These included the state strategy for regional development, regional strategies for regional development and, crucially, state-region contracts for regional development. To date, neither the strategies nor the contracts have lived up to their promise, but they remain central elements in the regional policy regime that is now taking shape.

In order to avoid the kind of ad hoc and often lobby-driven decision-making that often prevailed before, the law also defines various forms of depressed territories: regions, industrial districts, rural districts, and cities of oblast or republican (in Crimea) significance. Criteria are set out for each category. These are particularly strict for the designation of a depressed region (five years with lowest GDP per capita in Ukraine), as this is a status to be avoided: the authorities are anxious not to encourage regions to see under-performance as a way to attract resources. Depressed industrial districts are defined on the basis of employment, industrial output and wages as compared with peer locales over a period of three years. Agricultural districts are designated "depressed" in similar fashion but for agricultural employment, and a similar set of rules applies to cities. Finally, special provisions exist for territories strongly affected by the restructuring of the coal sector. The law stipulates that at least 0.2% of state budget funds to be devoted to addressing needs of depressed territories.

Source: Zakon Ukrainy (2005), "Pro stimulyuvannya rozvitku regioniv".

The results of past regional policy initiatives were largely disappointing

Although significant as signals of the growing salience of regional policy on the national agenda, these measures led to less change on the ground that was expected. In principle, the State Strategy for Regional Development (SSRD) to 2015 rightly aimed at the creation of an enabling environment for regions to increase their competitiveness. In

the spirit of the 2005 legislation, it provides for state-region contracts, programmes to address depressed territories, state targeted programmes, regional development strategies and the development of a co-ordination function for the Cabinet of Ministers in respect of regional policy. The strategy also defined the basic goals of regional policy of Ukraine:

- reducing inter-regional inequalities in socioeconomic outcomes, including salary levels and inter-regional differences in the degree to which state social guarantees are met;
- increasing fixed investments and reducing territorial asymmetries in investments;
- creating conditions for the sustainable development of regions in the interests of all the country, increasing living standards, reducing poverty and unemployment, and facilitating the growth of a middle class;
- ensuring the observance of state social guarantees for each citizen irrespective of his/her place of residence; and
- reviving depressed territories and ensuring prompt and integrated environmental solutions.

However, the ambitious agenda set out in the strategy was not underpinned by clear priorities and sequencing. The SSRD provides for the Cabinet of Ministers to approve annual action plans for implementing the strategy, but these chiefly forecast legislative/rule-making tasks for the government and have little connection to investment implementation or other programming in the regions.

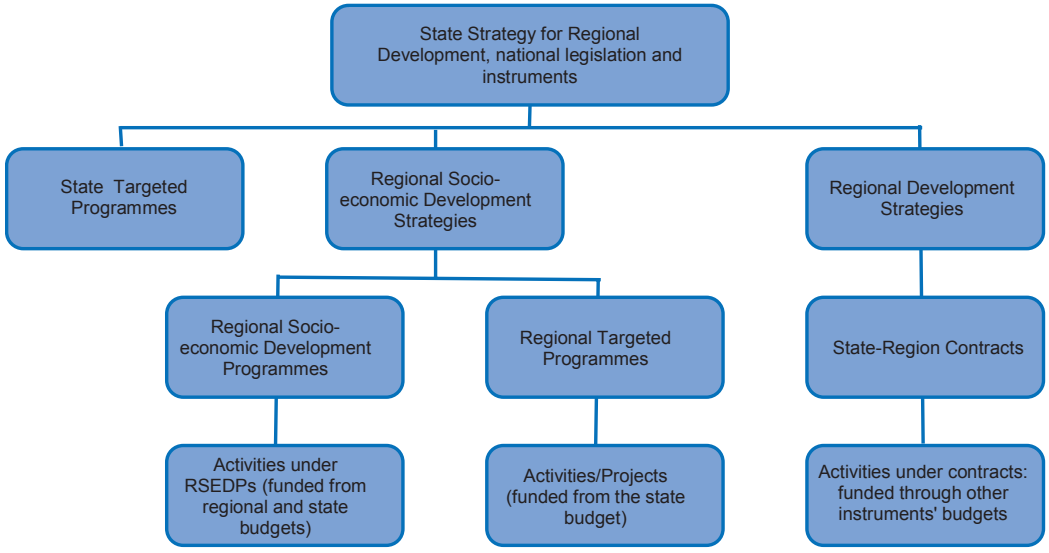
Lack of clarity with respect to priorities remains an issue. In response to a 2011 OECD questionnaire concerning the relative importance of different priorities for regional policy, the Ministry of Economic Development and Trade identified all nine of the priorities listed as "very important". They included: reducing inter-regional disparities, reducing intra-regional disparities, addressing the specific challenges of different types of territories (peripheral and rural areas, etc.), promoting regional economic competitiveness, promoting decentralisation, achieving a polycentric territorial structure, promoting inter-regional co-operation, avoiding the de-population of some territories and ensuring the quality of public services in sparsely populated areas. These are all, undoubtedly, legitimate and significant concerns for regional policy, but the tendency to assign all of them the same level of importance risks robbing policy of any real focus. This is particularly the case where there are tensions between some of the stipulated goals, such as that between promoting growth poles and reducing inter-regional disparities. The 2006 Strategy also tended to set out more broad principles than concrete mechanisms or instruments. One subsequent evaluation also concluded that it was fundamentally a National Development Strategy, lacking a regional framework and regional development structures (Grontmij/Carl Bro et al., 2009).

A number of other problems with implementation of the vision embodied in the 2005 law also emerged. First, the 2005 legislation in some respects simply added to the confused array of documents and instruments employed in the field of regional development (Figure 3.1). While the law introduced the concept of a "Regional Development Strategies" (RDS), which all regions were to adopt, these were not in fact working documents, and they were neither implemented nor funded as such. There were no operational plans binding on actors, and the relationship between the RDS and the existing regional Socio-economic Development Strategies (RSEDS) was not clarified. Monitoring and evaluation were weak, as was the link to the state-region contracts that were being concluded. In some instances, they were effectively the same, while in others

there were two regional strategies. In many places, the RDS were also poorly aligned with spatial planning instruments. In any case, actual funding remained tied not to the strategies but to annual budget allocations for sectoral instruments – state and regional targeted programmes. These were, in principle, sectoral programmes, but in the absence of medium-term funding, they were in reality highly discretionary instruments. Thus, it is perhaps not surprising that the primary sectors for funding were health and education, followed by agriculture and the environment. This pattern held across the country and did not reflect any analyses of the specific needs and potential of individual regions (Grontmij/Carl Bro et al., 2011). These are vital issues, but the lack of attention to such fields as innovation, private sector development, entrepreneurship and labour market policy was both noteworthy and regrettable. Some regions did eventually attempt to overcome the disjuncture between RDS and RSEDS: in 2010, for example, Vinnytsa Oblast adopted an implementation plan for 2011-13 that sought to bring the two strategies together in a coherent set of specific objectives, supported by a clear diagnosis, as SWOT analysis and a set of indicators to monitor progress.

Secondly, state-region contracts have yet to emerge as a truly effective development instrument in Ukraine. As of early 2012, only seven of Ukraine's regions had concluded contracts with the central government (agreements are signed by the Cabinet of Ministers of Ukraine and the regional councils of the regions concerned). The contracts themselves have been heavily focused on the same four main sectors as the RDS: education, health, environment and agriculture. They thus do reflect some coherence of priorities, even if, as noted above, they tend to leave out a wide range of regional development policies and are focused more on addressing immediate social problems than stimulating longer-term growth. These are also policy domains where regional specifics probably matter less, and what is required would probably be stronger national sectoral strategies. However, the contracts have often proven ineffective. They are typically linked to existing state and regional targeted programmes but not in a way that deepens or grounds those priorities into a coherent structure. Rather, the first contracts adopted generally involved a reorganisation or repackaging of already existing sectoral plans. Even then, instability of many regional targeted programmes means that interventions often failed to reflect any hierarchy of priorities set out in RDS or state-region contracts. An EU-sponsored assessment concluded in 2011 that the contracts did not really provide any medium-term orientation for state-region co-operation.[19] Since they were not linked to dedicated funding or institutional mechanisms to ensure performance, they largely remained declarative documents with little real impact in most regions where they exist. Initially, neither the state budget nor regional budgets contained separate programmes or budget lines for funding contracts. This may now be changing. Following years of discussion, Ukraine in 2012 created a new State Fund for Regional Development (see below), and this has the potential to provide a reliable and stable source of funding for contracts. In addition, recent government assessments point to signs that contracts are beginning to have a more positive impact on regional development, particularly in structuring joint investment activities (e.g. the Donetsk contract for 2008–11).

Figure 3.1. **Regional development documents**



Source: Adapted from Grontmij/Carl Bro et al., (2011).

Thirdly, the institutional picture was not ultimately settled with the creation of the Ministry of Regional Development and Construction. On the contrary, its formation was followed by lack of clarity and even conflict over roles of the two ministries. Moreover, in addition to these two ministries, which interact both at national and regional levels, a number of other institutions are involved in the national-level regional policy process, including an Inter-Service Co-ordination Commission for Regional Development established in late 2012,[20] a Council of Regions headed by the President of Ukraine and comprising leading national and regional officials (Box 3.2) and the Committee on Economic Reforms (a consultative-advisory authority under the president), which oversees a working group on "Regional Development and the Reform of Interbudgetary Relations", and the Co-ordination Centre for Implementation of Economic Reforms under the President of Ukraine. Almost all central ministries have a regional dimension to their activities.[21] Some have regional arms of their own, while others work via regional state administrations. Co-ordination among them has often been poor. According to some observers, co-ordination has become somewhat smoother in recent years, as the changed political situation has reduced friction between the two sets of executive structures – the regional state administrations, under the President, and the regional arms of the central ministries with a presence in the regions, which operate under the Cabinet of Ministers. However, strongly sectoral approaches to planning and funding continue to prevail among central ministries and other executive bodies. The Inter-Service Co-ordination Commission was created in an effort to address this, but it has yet to make its mark on the co-ordination of regional policy and may need to be further strengthened if it is to have any real impact.

Box 3.2. **The Council of Regions**

The Council of Regions was established by presidential decree in April 2010 as a consultative and advisory authority under the President of Ukraine. Its purpose is to strengthen co-ordination among national, regional and local public authorities in implementing the State Regional Policy, improving local government and executing administrative-territorial reforms. The Council is headed by the President of Ukraine. The Executive Secretary of the Council is one of the deputy heads of the presidential administration. Its members include: the chairman of the Supreme Council (parliament) of Ukraine, the Prime Minister, the chairs of three parliamentary committees (State and Local Self-Government; Construction, Urban Development, Municipal Economy and Regional Policy; and Budget), the Head of the Administration of the President of Ukraine, the First Deputy Prime Minister/Minister of Economic Development and Trade, the Minister of Regional Development, Construction and Municipal Economy, the Minister of Finance, the executive bosses of Ukraine's 27 regions,* the Permanent Representative of the President of Ukraine in Autonomous Republic of Crimea, the speaker of the Supreme Council of the Autonomous Republic of Crimea, the head of the Sevastopol City Council and the heads of the regional councils. Other officials, representatives of associations and leading experts may be invited to participate in the work of the council. The council meets as required but in any case not less than once a quarter. The sessions of the Council of Regions are quorate in case of presence of more than half of its members.

*Specifically, the head of the Council of Ministers of the Autonomous Republic of Crimea, the heads of the regional state administrations of the 24 Ukrainian *oblasts*, and the heads of the Kyiv and Sevastopol city state administrations.

Source: Ministry of Economic Development and Trade.

Progress has been impeded by fragmentation and capacity bottlenecks…

Inter-sectoral co-ordination problems have been aggravated by fragmentation and capacity bottlenecks at lower levels of government. Most regions and cities still lack the resources and know-how for truly effective regional development planning, including the tools and systems needed for implementation, monitoring and evaluation and audit. To a great extent, development planning is understood as a largely technocratic exercise, the aim of which is to produce plans that are to be implemented. This approach is too static, since in a fast-changing economy such plans are often out of date by the time they are completed, and, as noted above, they are rarely linked to implementation mechanisms anyway. Arguably, the **process** of planning is more important than any "plan" that results, in the sense that a truly dynamic, participatory planning process serves as a co-ordination device that can strengthen communication among public and private-sector stakeholders, reveal information and promote economic "self-discovery". However, understanding of participatory planning approaches is limited, which impedes effective engagement of the private sector and civil society organisations, and economic analysis capacities are constrained. Regional development plans tend as a result to reflect the past more than the future, focusing on heavily on support for traditional sectors (Grontmij/Carl Bro et al., 2011).

As noted in Chapter 2, there is a particular need for some degree of consolidation of the lowest tiers of local authority: there are too many very small municipal authorities, and many of them have no real functions at all. The national government is well aware of this and is working on plans for reform, but progress has been slow. In general, the focus of reform efforts has been on municipal mergers, to facilitate the efficient organisation and provision of local service, rather than on co-operation among local government units.

While there is little doubt that a reduction in the number of local authorities is ultimately needed, the potential already exists to begin realising economies of scope and scale in local service provision and local public investment via greater inter-municipal co-operation.[22] Given the obstacles facing legislation on mergers at local level, creating stronger incentives for municipalities to collaborate with one another, especially with respect to public investment for economic development, could be promising.

In seeking to foster horizontal co-operation at local level, the central government and regional authorities need to be sensitive to the factors that may prompt subordinate governments to compete rather than co-operate. This may depend on the expected allocation of direct benefits from an investment, in terms of jobs and activity generated, or on its anticipated impact on municipal budgets, which depends to some extent on the way in which those jurisdictions are financed. In general, competition is likely to be fiercest when essentially indivisible assets must be located in one community or another (hospitals, schools, R&D facilities), especially if this, in turn affects the attractiveness of a place or its tax base. This appears to be why many localities in OECD countries find it relatively easy to co-operate with respect to things like public transport or waste collection, while jealously guarding schools, hospitals and other public facilities, even when it is clear that some consolidation would be efficient and individual municipalities are struggling to sustain such services on their own (see, e.g. OECD, 2011c). Similarly, efforts to attract firms and workers to a region may be confounded by competition among local jurisdictions within that place to attract firms and workers from one another (OECD, 2012). Strong incentives may be needed to induce co-operation in such situations. Different approaches have been developed in OECD countries to provide incentives to local authorities to co-operate or even to adjust their institutional architectures, including optimal size targets, financial incentives and compensatory measures. What is clear is that, even when co-operation is clearly in the interests of local governments, the forces stimulating competition among them may be too strong, and some degree of leadership and resourcing from above is needed to make it happen.

…And by the lack of stable budgetary funding of regional development

Perhaps most problematic of all has been the difficulty of ensuring continuity of funding from year to year. The overhaul of regional policy in the mid-2000s was undertaken at a time when Ukraine had not yet even embarked on the shift – still unfinished as of early 2013 – to multi-year budgeting and a medium-term expenditure framework. Even state and regional targeted programmes were not assured of secure, multi-year funding. Moreover, recent work suggests that in Ukraine – as in many OECD countries – public investment has been an adjustment variable in times of fiscal uncertainty, rising when resources permit but falling rapidly when money is tight.[23] Investment outlays are, in essence, a residual for many public authorities. In an environment where all budgeting was, effectively, annual, it was impossible to make multi-year contracts and strategies into truly effective instruments. This is a salutary reminder, first, of the importance of uncertainty as an impediment to regional development efforts, and, secondly, of the extent to which the effectiveness of regional development policy instruments depends on aspects of the broader institutional environment.

This instability of normal funding is in large measure a function of the highly centralised character of the fiscal system. Regions and localities are heavily dependent on financing from the centre, which often cannot be assured. Their own revenue sources are extremely limited. This subsidy dependence, in turn, can warp regions' developmental

priorities, to the extent that they focus on central priorities for which funding may be available, rather than on projects formulated on a basis of their own assessment of potential. The Euro 2012 football championship, for example, ensured substantial investment in new infrastructure in four major cities and in enhanced connectivity among them, including new rail lines. While this brought some undoubted benefits, it is far from clear how well this investment really corresponded to their longer-term economic needs. The poor record of other countries and regions seeking to derive lasting economic benefit from investment in major sporting events like the Olympics and the World Cup is not encouraging (Rose and Spiegel, 2011; Perryman, 2012). Yet other regions seek to emulate the Euro 2012 experience, as it is seen as one way of securing substantial investment from the centre. A number of the OECD Secretariat's interlocutors in Odesa, for example, stressed the ambition to host the 2015 European basketball championship, precisely to make up for having missed out on Euro 2012. Hopes in western Ukraine are increasingly being pinned on attracting the winter Olympics.

The shift to multi-year budgeting should facilitate a shift to fewer but more stable instruments

The move to multi-year budgeting, which is now under way, should make it far easier to establish contracts, strategies and other instruments for regional development that are strategic in nature. As will be seen, the creation of a national Fund for Regional Development already marks a potentially important step in facilitating a more strategic, forward-looking approach. It should thus be easier to link the new State Strategy for Regional Development to 2020, which is now being prepared, to more concrete, predictable actions. This would be a major step forward. However, this process has a long way to go: the move to multi-year budgeting at national level is a critical step but its impact will be limited without improvements to sub-national – and particularly local – budgeting. Regional and municipal officials themselves are well aware of this challenge, and many readily admit that their own strategic planning and budgeting capacities need to be strengthened.

Heavy reliance on budgetary targeted programmes has led to a bewildering multiplication of instruments. In 2012, there were around 300 State Targeted Programmes, and estimates of the number of regional programmes ran to more than 700 (Odessa alone had 46 in 2012). At national level, there have been special targeted programmes for a number of specific places (the Pre-Danubian region, Crimea, Sevastopol', Odesa, Zhovty Vody, etc.) and for specific classes of place (e.g. small towns). Nevertheless, programmes have **not** been adopted in response to some of the specific priorities defined in the law. Thus, in mid-2012, there were five cities officially designated as depressed areas, two of which had rejected state support. Yet programmes for the other three had not yet been worked out. In addition, there are sometimes shorter-term programmes linked to targeted programmes. Not surprisingly, under-funding of such programmes is a chronic problem. Ensuring stable, multi-year funding is likely to require a substantial reduction in the number of such programmes. The Ukrainian authorities have been reducing the number of state targeted programmes in recent times, particularly the number of programmes for specific regions and cities.

A further problem with the multiplicity of programmes and funding instruments used is that it reduces transparency, both for outside observers and for the authorities themselves. A number of national and regional officials and experts told the OECD Secretariat that regional development spending is highly concentrated in a handful of "favoured" regions. This perception, though widespread, it is difficult to substantiate,

because of the large number of funding channels involved and the lack of transparency surrounding the allocation of central transfers to the regions described in Chapter 2. At the very least, lack of readily available data on central spending across the regions has contributed to the perception that the process is highly politicised. A final problem arising from the uncertainty that has hitherto prevailed in respect of funding is that it has led to uncertainty and delays in many cases. Since funds generally have to be used in the year received, delays in disbursement tend to result either in under-spending or in inefficient spending. Recent progress in reducing both uncertainty and delays in the allocation of such funds is thus to be welcomed.

Building a more effective regional development policy

Ukraine's regional policy has reached a potentially important turning point

A significant and potentially very positive overhaul of regional development policy is now under way. The government is at work on a new framework law on regional policy (Box 3.3), a new State Fund for Regional Development was established in 2012, and the regional branches of the country's investment-promotion agency, the State Agency for Investment and National Projects, have become increasingly active. There are now one-stop shops for investment-support in all of Ukraine's regions. In addition, the transition to multi-year budgeting is under way, offering the prospect of far greater predictability with respect to financing. Finally, the preparation of a new State Strategy for Regional Development, to cover the period 2020, highlights some important shifts in the way the government thinks about regional development. Each of these developments is welcome in its own right, and together they create an important opportunity to enhance Ukraine's regional policy institutions and instruments. Success will depend, in addition to broader governance and policy reforms to address the overall institutional environment, on clarifying policy goals, strengthening policy co-ordination and streamlining the range of instruments involved.

Regional policy priorities need to be clarified

Many countries struggle to define the goals of regional policy, and Ukraine is no exception. The stated goals of regional policy include, inter alia, reducing imbalances in regional performance and levels of development, supporting growth poles, ensuring equal access to public services and observance of state social guarantees, and fostering polycentric development, both across the country as a whole and within regions (i.e. support to small and medium-sized cities). These are all entirely understandable concerns for policy makers, but there is a persistent lack of clarity about the relationships among these different ambitions and how the tensions among them are to be managed. There appears to be some reluctance, not least for political reasons, to make policy priorities too clear, particularly as regards the tensions between growth and equity goals when it comes to funding. The result is a dispersion of effort and resources across the country. Given limited funds, administrative capacities and other resources, Ukraine urgently needs to define its policy priorities more clearly, to acknowledge, where appropriate, the tensions that may exist between them, and to focus its efforts around them.

Box 3.3. **The draft law "On the Foundations of State Regional Policy"**

In an effort to address many of the omissions left by the 2005 Law "On Stimulating Regional Development" and to strengthen the legislative basis for regional development, successive governments have been at work for several years on a new law "On the Foundations of State Regional Policy". As of early 2013, work on the draft continued, but the essential elements were already set out in the draft before the Supreme Council in late 2012. The overall goal of the new law is to ensure conditions for "the dynamic, balanced development of Ukraine and its regions", to strengthen socio-economic cohesion, to promote rising living standards and to ensure equitable access to basic public services, regardless of place of residence. The principles cited by the draft as central to this policy include constitutionality, partnership, parity, transparency, subsidiarity, co-ordination, cohesion, stable development and historical continuity. The draft focuses on the following issues:

- The draft seeks to clarify a number of basic terms and to specify the roles of different institutions in regional policy, allowing for the design and implementation of regional development policy strategies and initiatives at different scales (national, regional and local).
- The draft lays great stress on defining the basic programming documents that are to underlie regional development policy, including long-term (seven-year) national and regional-level regional development strategies and action plans for implementing those strategies, as well as State Targeted Programmes and state-region agreements on regional development, as well as state investment programmes.
- The draft law envisages a move to more medium-term financing of sub-national authorities' development budgets, as well as greater concentration of resources around key priorities and direct state investments. The draft provides for a National Fund for Regional Development (which was in fact created via amendments to the Budget Code adopted in 2012).* The fund can be used for grants or credits.
- The draft defines regional development agencies (RDAs) as non-profit bodies that are founded by regional administrations or legislative bodies. However, they can include among their co-founders associations of municipal authorities, various kinds of civil society organisations (chambers of commerce, associations of entrepreneurs, etc.) and research institutions. The text is silent as to their financing but stipulates that the government will approve a model statute for RDAs.
- The draft also includes a new section on monitoring and indicators, an area in which Ukraine's regional policy framework has hitherto been particularly weak.

Overall, then, the law is primarily a measure for clarifying and rationalising the key elements of the system. Its aims are thus modest but necessary. More ambitious provisions have been removed from earlier drafts, which contained provisions concerning the problem territories of various kinds, growth poles and other aspects of policy on which the draft before the Supreme Council in early 2013 was silent.

* An earlier draft also provided for regional level regional development funds and stipulated that the national fund would be based on 5% of corporate profit tax receipts (ca. 0.87% of state budget income in 2011) plus subventions from the state budget for regional development policy; and other sources.

Source: Proekt Zakonu Ukraini "Pro zasadi derzhavnoi regional'noi politiki", 25 June 2012.

They key to setting priorities lies in the recognition that **regional policy should ultimately contribute to aggregate national performance**. To say this is not to argue that Ukraine's policy makers should focus exclusively on a handful of "growth poles". Far from it. As OECD (2011a) points out, the major hubs in most economies account for well under half of aggregate growth, and in a number of OECD economies, lagging regions actually account for over half of aggregate growth. This finding has a number of implications for policy:

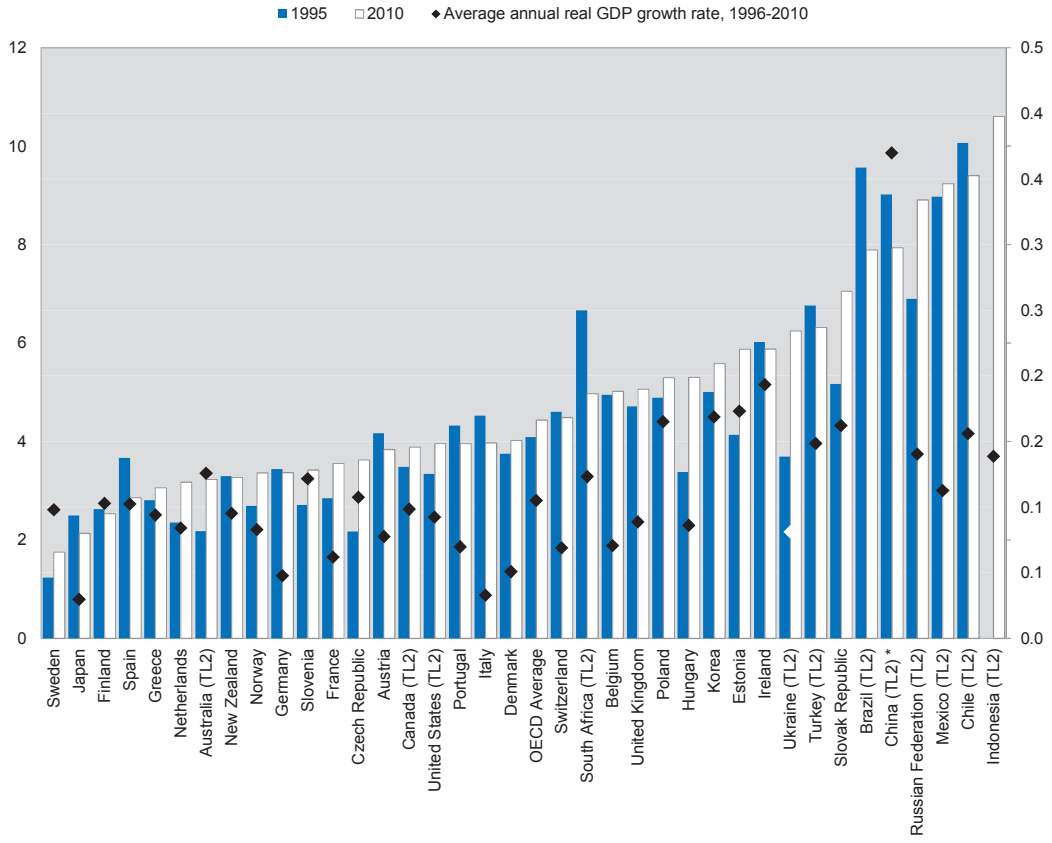
- Policy makers are right to be concerned about the performance of the big regional hubs that are their main drivers of growth. If they falter, the impact on aggregate performance will be significant.
- Nevertheless, most growth occurs outside the hubs. Indeed, many of the fastest growing regions across the OECD area are second-tier cities and intermediate regions. Thus, an exclusive focus on the hubs neglects the potential impact on growth of policies that can help the great mass of regions, where most activity still occurs, to improve their performance.
- The notion of an "average region" is effectively meaningless. It is statistically useless because there is no concentration around average values in the distribution. More importantly, it is meaningless in policy terms because analysis of the determinants of growth at regional level suggests that the constraints on growth that confront the leading regions are different from those confronting the rest.

These considerations point to the need for a differentiated policy that seeks to unlock the growth potential of all regions. However, this does not mean that all dimensions of regional policy can or should be of equal importance. Choices must still be made, and both top-down and bottom-up input will be required. In addition, central policy makers must be sensitive to the incentives that central interventions create for lower-level actors – it is for this reason that assistance to under-performing places **should generally be time-bound and should facilitate (rather than forestall) structural adjustment and promote the capacity for endogenous growth in the long term**. Otherwise, the risk of dependency is all too real, even in cases where, at the start, the case for support was very strong (OECD, 2011c). What matters is that **the balance among different priorities must be shaped by a focus on aggregate national outcomes over the long term**. This should help policy makers to assess the relative advantages of various regional priorities from a national perspective.

Ukraine is hardly unique in confronting these policy dilemmas, but it probably faces harder, starker choices than most OECD economies. The deeper problem stems from the fact that Ukraine's regional development agenda is still defined by the settlement patterns and spatial allocation of economic activity that were defined by Soviet economic planners. Across the post-communist countries of Central Europe and the former Soviet Union, the market transition has been associated with rising concentration of activity and increasing spatial disparities. Yet in Ukraine, although inter-regional disparities in per capita GDP have grown, both economic activity and contributions to growth are, even 20 years after the market transition began, far less concentrated than in some OECD and non-OECD economies (Figure 3.2), although the rise in inter-regional disparities has been far greater than is observed elsewhere. Moreover, analysis Ukraine's settlement pattern suggests that its cities are, given its level of development and urbanisation, relatively small (World Bank 2012; Rose, 2013). This implies that, in all likelihood, Ukraine has much to gain from further agglomeration, at both national and regional scales. However,

the shifts in population associated with this transition are, not surprisingly, proving difficult both for places experiencing population decline and for those facing rapid population growth. As a result, many policy makers, particularly at sub-national levels, seem anxious to check this agglomeration process by trying to prop up struggling firms and stimulate economic activity in declining places. These efforts have had little success.

Figure 3.2. **Gini coefficient for average per capita GDP by region**



Note: (*) Data for China does not include the special administrative regions of Hong Kong and Macao or Chinese Taipei.

Source: OECD Economic Outlook Database; IMF World Economic Outlook Database.

Defining – and, when appropriate, redefining – major goals for regional development is likely to grow easier and more efficient to the extent that policy makers develop more sophisticated strategic planning capacities. As discussed above, current planning approaches across much of Ukraine remain relatively static – focused on devising "plans", which are to be fulfilled – and often suggest a lack of faith in markets. In large part, this stems from the tendency to hold governors, in particular, responsible for all kinds of outcomes in their regions, from growth and investment to health and mortality indicators. Such pressures tend to lead to "manual management" – the tendency of policy makers to rely on direct, ad hoc interventions rather than stable regulatory and policy frameworks – and also to weaken incentives to take a longer-term view. International evidence suggests that planning regimes that focus on periodic updating of designated spatial or development plans tend to be static and highly technocratic, with a limited number of actors engaged in a highly specialised, largely technocratic and top-down exercise. In many instances, the resulting plans are out-dated before they are completed,

let alone approved. By contrast, more dynamic approaches see planning primarily as a **co-ordination instrument**, involving a large number of public and private sector players. Any actual "plans" produced tend to be temporary and/or evolving documents (OECD, 2001). Where there are high levels of uncertainty about the future, such approaches are vital, since strongly directive approaches to economic and spatial planning tend not to reduce uncertainty but create – at best – the illusion of having done so.[24]

The Ukrainian authorities are making progress with respect to defining strategic goals for regional development. Indeed, one of the explicit aims of the State Strategy for Regional Development to 2020, which was being drafted in early 2013, is to harmonise the "growth poles" elements of regional policy with those focused on territorial cohesion, in particular by finding ways to increase the functional linkages between the growth poles (the major cities) and their surrounding territories – in short, the aim is to evolve better arrangements for managing urban-rural linkages. The new strategy envisages three broad objectives – improved regional competitiveness, territorial social and economic integration, and more effective public management of regional development – within which are nested more specific goals (Table 3.3). These, in turn, are much more clearly focused than in the past on realising economic development potential rather than solving immediate social problems. The latter have tended to be the main focus of many, perhaps most, regional policy interventions in the past.

Nonetheless, as of mid-2013,[25] the evolving draft still defined too many goals and tasks, many of them rather vaguely, in aspirational rather than operational terms, and with little sense of a priority ordering among them. Little is said about how all these tasks might be achieved or how and to what extent they might compete with one another. Some of the goals hint at the approaches that might be adopted, but only in the most general of terms – in many cases as a commitment to "perfect" national legislation in this or that sphere. Practical realisation of strategic goals and directions will be addressed in a Plan for Implementation of the National Strategy, to be developed within six months of the strategy's approval. The implementation plan will specify and bring together in a single document the concrete objectives and activities of central and local executive bodies in respect of regional development, the financial resources for their implementation and the criteria for evaluating implementation.

Yet there remains a need to narrow the range of strategic goals set out in the document and to create a hierarchy among them; otherwise, the implementation plan risks being impossible to carry out. Policy is about making choices, and when times are hard and money is tight, it is about making very hard choices. Regional development policy is no exception. It would be hard to argue against **any** of the tasks set out in the draft strategy – all of them are worthy goals – but its very comprehensiveness suggests that the hard choices about where resources and effort should be concentrated have not yet been confronted. To that extent, the draft strategy is almost declaratory in character, a pre-strategy document rather than a strategy. The European approach to regional development, by contrast, has increasingly emphasised the need for clearer, better defined priorities. The European Commission is pressing for greater concentration of effort in the use of structural funds in the next programming period and placing renewed emphasis on the search for complementarities among the goals selected in order to maximise impact (European Commission, 2012a, 2012b).

Part of the challenge will involve improving the **regional** development strategies, by getting regions to think more about the provision of **growth-promoting public goods** rather than viewing regional development funds chiefly as one more way to lobby for the

resources needed to address immediate social problems. This means fostering a broader sense of what regional policy is about. It is not just a device for regions to tap exogenous resources and channel them into infrastructure investments, however important those may be. Effective regional development strategies need to address issues like human capital development and efficient labour markets, conditions for entrepreneurship and private-sector development. They should, moreover, seek to identify the fields in which a degree of regional specialisation might make sense, rather than trying to support incumbent firms and sectors, come what may. In any case, there is a strong argument for moving policy-making away from a **sectoral** approach altogether. The boundaries between sectors are in many cases increasingly fuzzy, particularly in advanced fields like high-tech manufacturing and knowledge-intensive services. Moreover, the development of increasingly complex global value chains, in which production processes are unbundled across the globe, means that – even in more "traditional" sectors – it makes more sense to think in terms of tasks or activities than entire sectors. The challenge in the age of globalisation is less to push into sectors on the international stage, as countries once sought to do, than to integrate into global value chains at whatever levels their endowments make them competitive (Baldwin, 2006; OECD, 2013b).

Improving the quality of the SSRD and regional-level strategies implies, at national and regional level, refining the economic and other analysis so as to produce a diagnosis of each region's strengths and weaknesses, on the basis of which regions might define a limited number of high, medium-to-long-term priorities. It will also imply acknowledging the trade-offs that exist and indicating that some other, worthy objectives are, for the time being at least, regarded as less urgent. These priorities would then form the basis for an operational plan for some limited period, linked to a concrete budget. Such a sharpened diagnosis should enable policy makers to make the discussion of instruments and mechanisms much more concrete – a medium-term strategy need not specify everything in detail, but it give some direction as to the means and methods that will be used to address particular problems. Hitherto, there has often been little clear analysis or argumentation linking diagnosis to treatment – policy interventions have not mapped clearly onto the market or state failures they were meant to address. Better analysis of causal relationships, instruments and expected outcomes, in turn, will allow national and regional actors to re-focus the indicator framework on the evidence needed for effective monitoring and evaluation of regional policy interventions.

The evolving new State Strategy for Regional Development hits many of the right themes

Despite the lack of clear, ordered priorities described above, there is much in the new draft strategy that is to be welcomed. In particular, it rightly gives very prominent place to reform priorities that might not be considered "regional development policy" in a narrow sense but without which the overhaul of regional development institutions, goals and instruments will have only limited impact. At the outset, the strategy underscores the importance of medium-term budgeting and other improvements to budgeting procedures (programme-based budgeting, capital budgeting). This will be an enormous challenge, particularly as the reforms are extended to lower and lower levels of government, but it is critical to the success of regional policy. Much the same may be said of the strategy's endorsement of greater budgetary autonomy for cities. More generally, the strategy highlights the need for key cross-cutting improvements to the business environment, touching on many of the issues discussed above, such as a reduction in licensing and permits, streamlining bureaucratic procedures for firms (including a "one-window"

approach to such formalities) and a reduction in the number and frequency of inspections. All of these points reflect an acute awareness of the need to embed regional development within a larger framework of reforms, as set out in President's programme of economic reforms and the State Programme for the Activation of Economic Development in 2013-14.

Table 3.3. **Objectives of regional policy to 2020**

Objective 1: Improvement of regions' competitiveness	Objective 2: Territorial social and economic integration	Objective 3: Effective public management of regional development
1.1 Enhance the role and functionality of the cities in the further development of regions	2.1. Prevent growth of disparities that impede development of the regions	3.1. Improve the system of strategic planning of regional development at national and regional levels.
1.1.1. Improve planning of the city infrastructure development	2.1.1. Improve coherence of the "growth poles" stimulation policy with support to economically less developed regions and depressed areas	
	2.1.2. Develop border territories	3.2. Improve the quality of public management of regional development
1.2. Create conditions for enhancing the development processes and improving the efficiency of using the potential of other areas	2.1.3. Develop inter-regional co-operation	
1.2.1. Improve transport accessibility within the region	2.2. Provide comfortable and safe living environment for a person regardless of place of residence	3.3. Enhance the inter-sectoral co-ordination in the course of formulation and implementation of regional policy
1.2.2. Support of the integrating role of cities as centres of economic growth	2.2.1. Create conditions for productive labour	
1.2.3. Use the potential of the rural development	2.2.2. Raise living standards in rural areas	3.4. Institutional support of regional development
	2.2.3. Optimise social security system for low-income persons	
1.3 Form the basis for competitiveness of territories	2.2.4. Modernisation of education and training systems	
1.3.1. Improve efficiency and competitiveness of industrial production of the regions	2.2.5. Create conditions for healthy live of the people	
1.3.2. Develop intellectual capital, including human and social capital	2.2.6. Social and cultural development	
1.3.3. Support investment attracting, including direct foreign investments	2.2.7. Transport and communication services	
1.3.4. Provide opportunities for practical use of innovations	2.2.8. Housing and communal services, provision of housing	
1.3.5. Support development of business environment	2.2.9. Improve environment	
1.3.6. Diversify energy sources and improve energy efficiency		
1.3.7. Utilise the natural potential		
1.3.8. Preserve cultural heritage and develop tourism		
1.3.9. Develop cross-border co-operation		

Source: Ministry of Economic Development and Trade (2013).

A number of other features of the draft strategy are also to be commended:

- It places strong emphasis on the infrastructure for supporting innovation and entrepreneurship, which is seriously under-developed in Ukraine. The importance of "softer" forms of support for these two key dimensions of development is often under-appreciated at regional and local levels, where policy makers too often focus on investments in physical assets and support for incumbent firms and sectors.
- It directly addresses some of the key weaknesses of the current institutional architecture for regional development and underlines the primary role of regional development policy as a co-ordinating policy that seeks to enhance policy coherence across sectors and levels of government rather than as a "residual sectoral policy" operating alongside other sectoral policies in an attempt to mitigate some of their consequences. In other words, the regional/territorial dimension should be taken into account in all development policies financed by the public budget. As the strategy argues, this co-ordination needs to take place at all levels, regional and local no less than national. Emphasis on breaking down isolation of regional markets.
- There is a strong emphasis on capacity-building for regional development.

Ukraine can learn much from the EU approach to regional policy…

In undertaking this overhaul of regional policy, the Ukrainian authorities are, in principle, committed to implementing regional development policy on the European model. While Ukraine has learned much from the European Union, not least in the context of their bilateral co-operation on regional development, such an ambition needs to be carefully qualified. There are undoubtedly principles of EU regional policy that can and should be at the heart of Ukraine's emerging regional development policy regime, including partnership, subsidiarity, the need for strategic and integrated approaches to regional development and the development of effective multi-level governance mechanisms capable of bring top-down and bottom-up initiatives together in the design and implementation of regional development policies. More generally, Ukraine would do well to follow Europe in its focus on growth and competitiveness objectives, rather than "levelling", and in trying to foster enabling environments in the regions rather than a more directive, top-down approach. Empowering local actors will be critical; it will also, given Ukraine's political centralisation and highly concentrated economic structure, be rather difficult.

On a more practical, day-to-day level, Ukrainian officials can still learn much about the "nuts and bolts" of regional development policy from their European neighbours. The on-going regional policy dialogue between the EU and Ukraine has led to a number of substantial initiatives designed to build the capacities needed for regional policy in Ukraine, often with the participation of other agencies, like Germany's GIZ. Poland has been particularly active. While lessons from Europe need to be "transposed" to Ukrainian conditions, such engagement should help accelerate policy learning and the diffusion of best practice.

…But it would be unwise to try to copy the EU's Cohesion Policy

That said, there are a number of important qualifications that need to be borne in mind when discussing the degree to which European regional policy is a suitable model for Ukraine:

- There is a tendency among many officials and other observers in Ukraine to understand regional policy on the European model very much in terms of the EU's Cohesion Policy – that is, in terms of the allocation of investment funds to regions on some sort of stable and predictable basis. Yet Cohesion Policy is not the sum and substance of regional policy in EU countries: cohesion funds are but one instrument, albeit a very significant one. Regional policy, as seen above, is understood in much broader terms (Table 3.1). Other facets of regional policy fall within the purview of member states or even sub-national units. Indeed, the effectiveness with which cohesion funds are used depends in no small measure on the degree to which they are integrated into larger regional policy frameworks.
- Ukraine will not, in the foreseeable future, be in a position to channel development funds to its regions that are comparable in scale to those allocated to "Objective 1" (convergence) regions in the European Union. Financial resources are far more limited and the number of regions with average per capita value added above the national average is too small.
- European Commission officials readily acknowledge that regional policy as it is practised in the European Union is extremely "implementation-intensive". Yet implementation capacity remains a major weakness of the Ukrainian state and a key constraint on policy.[26] This being so, it is likely that Ukraine should proceed slowly in developing such instruments as the State Fund for Regional Development, starting small and focusing in the first instance on capacity building at national and especially sub-national levels.

Improving regional development policy institutions

Important challenges lie in the **implementation** of regional policy – more than its design – and in particular with key aspects of multi-level governance. Ukraine needs in particular to address a policy gap at the regional level, linked to the complexity of the interactions among regional councils, regional state administrations and the regional branches of central ministries; a growing administrative gap at local level linked to municipal fragmentation and lack of policy and administrative capacities in many smaller towns; and an information gap that weakens policy making. Many of these challenges are common to virtually all OECD countries (Table 3.4 above), but specific features make some gaps more prominent than others in individual countries.

Table 3.4. **Mutual dependence across levels of government: Multi-level governance challenges/gaps in OECD countries**

Types of challenges/gaps	"Mind the Co-ordination challenges/gaps"
Funding	Unstable or insufficient revenues undermining effective implementation of responsibilities at sub-national level or for shared competencies **=> Need for shared financing mechanisms**
Administrative	Occurs when the administrative scale for investment is not in line with functional relevance as in the case of municipal fragmentation **=> Need for instruments for reaching "effective size" (co-ordination tools among sub-national units; mergers)**
Policy	Results when line ministries take purely vertical approaches to cross-sectoral policies, to be territorially implemented **=> Need for mechanisms to create multidimensional/systemic approaches, and to exercise political leadership and commitment.**
Information	Asymmetries of information (quantity, quality, type) between different stakeholders, either voluntary or not **=> Need for instruments for revealing & sharing information**
Capacity	Arises when there is a lack of human, knowledge or infrastructural resources available to carry out tasks **=> Need for instruments to build local capacity**
Objective	Exists when different rationales among national and sub-national policy makers create obstacles for adopting convergent targets. Can lead to policy coherence problems and contradictory objectives across investment strategies. **=> Need for instruments to align objectives**
Accountability	Reflects difficulties in ensuring the transparency of practices across different constituencies and levels of government. Also concerns possible integrity challenges for policy makers involved in the management of investment. **=> Need for institutional quality instruments;** **=> Need for instruments to strengthen the integrity framework at the local level (focus on public procurement);** **=> Need for instruments to enhance citizen's involvement**

Source: Charbit, C. and M. Michalun (2009), "Mind the Gaps: Managing Mutual Dependence in Relations among Levels of Government", OECD Working Papers on Public Governance No. 14, OECD, Paris, 5 October, http://www.oecd.org/dataoecd/37/48/43832931.pdf.

This section considers what can be done to improve the governance of regional development policy in Ukraine. Above all, this will require strengthening regional development policy at the national level. As noted above, the challenges are great but there is still no national-level focal point for the policy capable of bringing together the key elements that are required: political authority, funding, planning and effective administration. However, as will be seen, a number of changes are under way that could help move Ukraine in that direction, and they may be buttressed by broader, cross-cutting reforms that help to create a better overall framework for regional development. There is no single instrument to address each multi-level governance challenge, as the challenges are **interdependent**. Rather, governance instruments such as platforms of dialogue, contracts **or** financial mechanisms can be used together and address several challenges at once. This section examines the broad priorities that Ukraine can set with respect to three governance gaps to make the most of regional policy: *i*) improve cross-sectoral and vertical coordination; *ii*) narrow administrative gaps and strengthen regional actors; and *iii*) engage in systematic capacity development and improve the quality and use of information. Table 3.5 provides an overview of these priorities, the instruments that Ukraine can use address them, and the governance challenges/gaps that they can help mitigate.

Table 3.5. **Key priorities and governance arrangements to overcome challenges**

Broad priorities for multi-level governance	Instruments to use	Governance challenges addressed
1. Improve cross-sectoral and vertical co-ordination	• Contracts, enhanced role for Regional Development Programme (RDP) • Inter-ministerial committee on regional policy, with high level commitment • Territorial proofing mechanisms	Policy gap Objective gap
2. Narrow administrative gaps, strengthen regional actors and enhance inter-municipal co-ordination	• Strengthened regional councils • Enhanced inter-municipal coordination	Administrative gap Policy gap Accountability gap
3. Strengthen sub-national finances to reduce the bias towards small municipalities	• Change in expenditure formula, to reduce the bias that favours small municipalities • Better link equalisation with revenue-raising • Modified municipal revenue structure • Reliance on property tax	Funding gap
4. Engage in systematic capacity development and improve the quality and use of information	• Monitoring system extended beyond cohesion policy • Monitoring of RDAs • E -portal for regional development and governance • Capacity building • Pilot experiences	Capacity gap Information gap

Source: OECD (2009), Regions Matter: Economic Recovery, Innovation and Sustainable Growth, OECD Publishing. http://dx.doi.org/10.1787/9789264076525-en.

More can be done to foster national-level policy coherence for regional development

As the State Strategy for Regional Development (SSRD) suggests, regional development policy is largely concerned with co-ordinating sectoral policies in an effort to identify and pursue complementarities among various objectives, particularly the goals of reducing inequality while also increasing regional competitiveness for economic growth. Yet the experience of many countries shows how difficult it can be to ensure such co-ordination, particularly at different territorial scales. Co-ordination of regional development policies at the central level is challenging and OECD countries approach arbitration among different line ministries in different ways. Approaches range from bodies charged with co-ordinating the activities of sectoral ministries, fully-fledged ministries, to ministers in charge of specific regions, or specific territorial lenses in sectoral policies (Box 3.4). Often, countries adopt several institutional arrangements. Overall, the experience of OECD countries suggests that what is crucial is not where precisely the responsibility for managing regional development is vested; what matters is how functions are distributed and implemented. Whatever the type of instruments, they broadly aim to reach three primary objectives: *i*) improving efficiency and avoiding redundancies and overlap (short term); *ii*) building co-operative partnerships (medium-term), and solving asymmetries of information in cases of interdependency in policy making; and *iii*) building capacities for addressing new types of issues (long-term).

The draft SSRD acknowledges the need for better cross-sectoral co-ordination of regional development, and aims to increase policy coherence at the national level. The formation of the Council of the Regions and, more recently, the Inter-Service

Commission reflects this awareness, as does the preparation of the SSRD itself. A number of OECD countries have formed cross-sectoral bodies of this type at the national level in an effort to achieve a coherent approach to regional development. Their experience suggests that a horizontal commission chaired by one sectoral ministry may be limited in pursuing multi-sectoral objectives and hinder full involvement of other ministries. A more promising approach can be to rotate the chair of such a body among participating ministries or the designation of some supra-ministerial leader, such as a deputy prime minister. There can be a trade-off, however, in the case of the latter option. A chair who does not head a ministry or department of his or her own (e.g. a deputy prime minister) may have higher **status** and yet lack direct control over the **administrative resources** needed for effective action. Ensuring adequate administrative support can be critical. Nevertheless, the general rule seems to be that the higher the leadership within these types of commissions, the stronger the incentives to participate and the greater the engagement of the other actors (OECD, 2011c).

The fact that the President chairs the Council of the Regions, therefore, gives that body great weight, but its composition means that it can meet only infrequently. There is still a need for an apparatus able to support day-to-day co-ordination. Ensuring strong leadership of the Inter-Service Commission is thus likely to be critical to any attempt to foster greater cross-ministerial co-operation on regional development at national level. This is not to suggest that either the commission or the Council of Regions will supplant the presidency and cabinet as the centre of the national executive, but without high level political leadership committed to making them operationally effective, both are likely to be "talking shops". Ultimately, the institutional framework for co-ordination is a political choice to be taken by the Ukrainian authorities. In practical terms, what matters is that the functions of such a structure not be limited to conceptual/declaratory statements and documents but be supported by implementation mechanisms and amendments to the relevant decision-making procedures, if necessary. At the very least, they need the ability to ensure that ministries and other state bodies are accountable to them for their implementation of agreed decisions.

As a complement to these bodies, Ukraine may wish to further consider territorial "proofing mechanisms". Territorial proofing is a mechanism that monitors government policies to prevent them from having a negative impact on certain types of territories. For example, Finland's multi-year Rural Policy Programme also seeks to draw attention to the specific needs of rural areas. "Broad" policies proactively integrate these needs into central government decision making in different sectors. "Narrow" policies specifically target rural areas. It is important to note that if the proofing is not implemented in the early stages of the policy designing process, the opportunity for influencing policy decisions might be drastically diminished. A consultation exercise conducted relatively late in the policy process is thus likely to be of limited value.

Stronger regions could be stronger partners for the national government

Regional development in Ukraine is a responsibility shared by the central, regional and local governments, with the support of non-state actors. Mechanisms are needed to manage this vertical relationship in a way that promotes performance, even in the presence of information asymmetries between parties. In OECD countries, contracts among levels of government are used in both unitary and federal states to help do just that; they have been introduced in Ukraine as well, and are discussed at length below. However, there is more to be done when it comes to strengthening the vertical co-ordination needed for effective regional development. To a significant extent, meeting

this challenge – like so many aspects of regional development policy – depends on the authorities' success in implementing broader reforms that will create an administrative and policy-making environment more conducive to better policy formation and implementation. This is not just a question of implementation effectiveness at sub-national level: gaps in regional and local capacities also undermine their ability to provide quality **input** into national-level policy processes.

Box 3.4. **Mechanisms for national cross-sectoral co-ordination in OECD countries**

- **Co-ordinating structures such as inter-ministerial committees and commissions**. This is one of the simplest systems for horizontal governance as it is based on the existing government structure. Examples include the Ministerial Committee for Regional Policy in Denmark, the Presidential Committee on Regional Development in Korea, and the Cabinet Sub-committee on Rural and Regional Policy in Norway.

- **Fully-fledged ministries with broad responsibilities and powers that encompass traditionally separate sectors**. Some positive implications of the concentration of different responsibilities within the same authority include: a more open and coherent view, the concentration of skills and the possibility for a more integrated approach. Specific ministries for regional development were created in Chile, the Czech Republic, Poland, the Slovak Republic and Slovenia.

- **Strategic planning and programming, including agreements, frameworks and instruments.** The formulation and implementation of national regional policy programmes and/or spatial planning can provide the impetus and framework for greater central co-ordination and is widely used across OECD countries. Planning and programming have been recognised as policy tools for regional competitiveness policies. In many countries, spatial planning is gradually moving from land-use regulation frameworks towards long-term strategic documents, focusing on the co-ordination of diverse issues and interests across sectors as well as between levels of government and often incorporates monitoring, feedback and revision mechanisms. Examples include the National Strategic Reference Framework in EU countries, the National Spatial Strategy in Japan, and the Comprehensive National Territorial Plan in Korea.

- **Special units or agencies that provide planning and advisory support to facilitate policy coherence across sectors at the central level**. High-level "special units" have been created in several countries to ensure consistency among sectors. The closer such units or co-ordinators are to a chief executive, the greater the incentives are for co-operation across sectoral ministries. Examples include DATAR which is linked to the Office of the Prime Minister in France and the Austrian Conference on Spatial Planning under the auspices of the Federal Chancellery. Special units under sectoral ministries include, for example, the National and Regional Planning Bureau of the Ministry of Land, Infrastructure, Transport and Tourism in Japan and the Spatial Economic Policy Directorate of the Ministry of Economic Affairs in the Netherlands.

- **Regional ministers**. Ministers must take into consideration the territorial aspects of the programmes and policies of their portfolios. For example, Canada appoints "regional ministers" who have regional responsibilities and represent the interests of their respective regions. Ministers combine their regular (sectoral) portfolio duties with their regional political roles. France and the Netherlands have appointed a minister who represents the interest of the leading region in the country, i.e. the State Secretary for the development of the Capital Region of Paris and the Minister for the Randstad.

Box 3.4. **Mechanisms for national cross-sectoral co-ordination in OECD countries** (*cont.*)

- **Territorial proofing mechanisms**. Territorial proofing is a mechanism that monitors government policies to prevent them from having a negative impact on certain types of territories. Ideally proofing should be implemented in the early stages of the policy designing process. In addition to the rural proofing system of the U.K., Korea and Sweden recently introduced a rural proofing mechanism. In Sweden, the rural development strategy was developed in 2009, and each ministry had an assignment to look at its own policy area and put a rural perspective on it. In Finland, the Ministry of Employment and Economy has required sectoral policy makers to clarify their regional strategies and assesses regional impacts (regional proofing) since 2004. Ten key sector ministries must define regional development plans concerning their field of responsibility, which fit into the Regional Development Act guidelines defined by law and the nine regional development targets adopted by the government in 2004.
- **Combining financing and/or creating a consistent and comprehensive budget**. The budgeting system is also a powerful tool for more integrated policy-making. Integrating financial tools and programmes can contribute to improve transparency, synergy across sectors and facilitate accountability and performance monitoring. Mexico grouped together ministerial budgets for rural policies into an official rural budget under the Special Concerted Rural Development Programme. Korea transformed many specific-purpose national grants into general grants, and established the Regional Development Special Account. A block grant was then adopted to give local municipalities the authority to autonomously design projects.

Source: OECD (2010a), *Regional Development Policies in OECD Countries*, OECD Publishing, pp. 25-27, http://dx.doi.org/10.1787/9789264087255-en.

The government is currently working to address several important cross-cutting challenges that are relevant here:

- The 2010 overhaul of the central executive described above has yet to be rolled out at the level of oblasts and municipalities. These issues have already been addressed in Chapter 2, but it is important to observe here that they are of considerable importance for regional development.
- The budgetary reforms needed to ensure reliable, multi-year funding for regional development strategies need to be buttressed by efforts to strengthen budgeting and financial management capacities at regional and local levels. The on-going introduction of programme-based budgeting in regions and cities is thus a very welcome development. The introduction of this approach was extended to all cities of regional significance (346 local budgets in total) in 2012, and rayon (district) budgets were included in 2013.
- In addition, both businesspeople and state officials involved in investment attraction or promotion report that there is a considerable need for capacity-building when it comes to investment attraction. Many regional and local authorities have only a basic understanding of what is required and the skills needed to sustain even such things as good regional/municipal web sites in English are often in short supply – or are too expensive for the authorities concerned.

Nevertheless, the government itself has acknowledged some more fundamental challenges that must be addressed if regions and local governments are to be fully engaged, properly resourced partners to the central state in regional development. First, the unbalanced relationship between oblast councils and oblast state administrations remains a problem. Elected councils can formulate priorities for a region but have little capacity to implement their choices, because they lack both financial resources and direct control over the public administration, which falls under the authority of the appointed oblast state administrations. The situation is further complicated by the presence of territorial arms of some national ministries as well.

Inter-regional and inter-municipal co-operation is also weak. As the government has acknowledged, there are practically no horizontal relations among regions. Connections among cities would appear to be somewhat stronger, at least within the framework of the Association of Ukrainian Cities, but its primary role tends to be a representative one – presenting the interests of cities in dialogue with parliament and the government. It also promotes data collection and important policy learning and knowledge-sharing among cities, but co-operation among cities on specific development priorities is still very weak. A large body of OECD work on horizontal collaboration (summed up in OECD, 2013a) suggests that cross-jurisdictional co-operation, whether among regions or local authorities, is difficult, even in situations where the actors involved clearly recognise the need for it. Transaction costs, competitive pressures, resource constraints, differing priorities and fears that the distribution of costs or benefits from co-operation will be one-sided can all impede efforts to bring regional or local governments together, even in the face of common problems. Thus, **leadership from above is often critical in resolving the collective problems that such co-operation poses**.

This can be done in a variety of ways, but it is striking that many of them involve financial incentives, which can be applied in a systematic way, by, e.g. reserving a portion of central investment funds exclusively for collaborative investments, or on an ad hoc basis. Occasionally, they may even be initiated from the bottom up, as when collaborative investments are proposed to the higher funding government level. Regional policy instruments, in particular, may need to be devised so as to encourage cross-sectoral and cross-jurisdictional collaboration for investment. In Ukraine, therefore, it may make sense to reserve some portion of the State Fund for Regional Development for inter-regional projects or to make additional state funding more readily available where regions or cities are prepared to pool their investment resources to develop projects of wider importance. Some of this activity could also be linked to such major national projects with a territorial focus as the government's plans for the Danube corridor. However, although the financial incentive mechanism seems a necessary condition, it is not sufficient. Building the capacity of sub-national levels to engage with other governmental agents and creating a collaborative culture conducive to cross-jurisdictional engagement are essential for facilitating horizontal and vertical co-ordination.

More and better data are needed to support continuous monitoring, evaluation and control

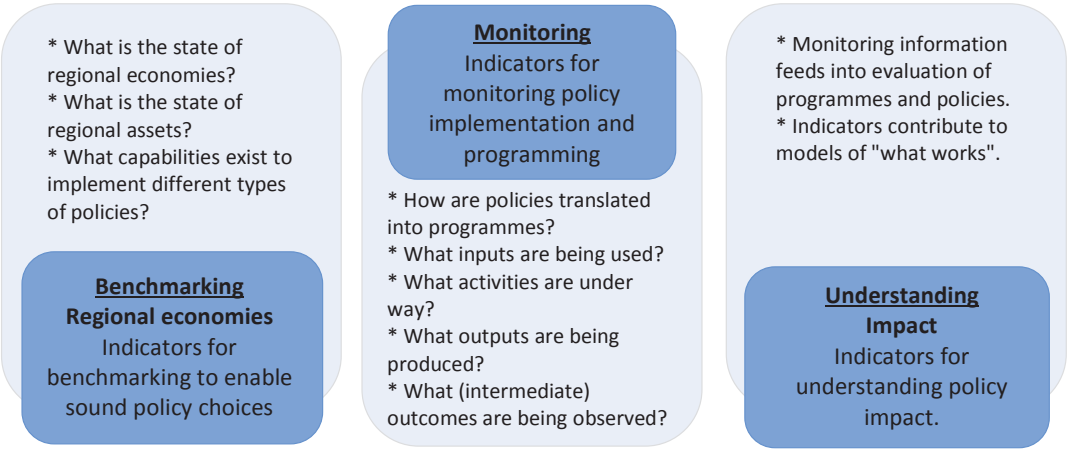
There is still no adequate indicator system for monitoring, evaluation and control of regional policy initiatives. Hitherto, there has been a heavy reliance on basic socio-economic indicators overall, like regional GDP, foreign investment inflows and indicators of mortality and morbidity. The issue is particularly sensitive in Ukraine, owing to the widespread tendency to see governors as responsible for whatever happens in their jurisdictions; the system of evaluating oblast-level state administrations has tended to rest

heavily on such basic data, despite the obvious fact that many socio-economic and demographic developments are largely beyond their power to influence except over the very long term. Critics have also argued that both the selection of indicators and the weights attached to them have been insufficiently grounded in analysis and evidence.

Well-developed information systems can strengthen vertical relations among levels of government by narrowing information gaps that inevitably emerge between national and sub-national actors (Figure 3.3). They can also help to reveal, generate, and distribute information among the network of regional policy actors at all levels of government. The aim is to improve the information base throughout the cycle of policy design and implementation. Consistent and constructive use of information generated by monitoring, evaluation, statistical, and research systems forms the basis for effective, evidence-based decision making.

Devising and implementing such a system poses a number of challenges. The most important of these stems from the fact that **incentive effects are inevitable when monitoring performance**. The strength of incentives, of course, depends on how information will be used and by whom. Attaching explicit rewards (or sanctions) to performance data can be a powerful way to encourage effort and improvement; however, it is not a sufficient condition for success. Moreover, potentially **perverse** incentives often emerge in connection with the use of indicator systems. These incentives may emerge because reporting performance data is not neutral, even when it is not associated with explicit rewards and sanctions mechanisms.

Figure 3.3. **The contribution of information systems to regional development policy**



Source: OECD (2009c), "Linking regions and central governments: Indicators for performance-based regional development policy", presentation by Lee Mizell at the 6th European Conference on Evaluation of Cohesion Policy in Warsaw, Poland, 30 November 2009, http://ec.europa.eu/regional_policy/conferences/evaluation2009/index_en.htm.

Even where there is broad agreement about the principal success factors, final outcomes can be difficult to target in the context of regional policy, owing to problems of attribution and a mismatch between the time-frame for funding disbursal and outcome attainment (OECD 2009d):

- Attribution of outcomes to specific actors or measures can be particularly challenging for regional development policy, which is both multi-actor and multi-sector: often it is the interactions between policies that really matter.

- The time-frame for the achievement of regional policy outcomes can also be lengthy, producing a gap between the time-scales of specific programmes and the time-scales over which it may be reasonable to expect the desired outcomes to materialise (Steffensen, 2010). Longer time horizons also imply a greater need for flexibility and adjustment in response to changing circumstances. In the recent crisis, for example, it would have been unreasonable to expect many regional development programmes to achieve objectives that would have seemed very reasonable in the pre-crisis environment of 2000-07. Yet if targets can be revised too easily, or in an ad hoc fashion, the whole exercise will lack credibility.

In principle, it would be desirable to orient indicator systems to regional and aggregate economic **outcomes**, rather than programme inputs or even narrowly defined programme objectives (outputs). However, this can, somewhat paradoxically, lead to a very short-term focus, as actors sometimes focus conditions on short-term proxies that allow evaluations to be made sooner rather than later but that may only very imperfectly map onto the real economic outcomes being targeted. While the requirements of evaluation, accountability and policy learning all point to the need for the development and employment of good quality indicators in regional policy – including output and outcome indicators – there are serious risks in employing them as part of a policy regime involving significant rewards and penalties (Box 3.5), not least that such an approach could discourage innovation and experimentation. That does not mean that output and outcome indicators should be neglected: their very existence can motivate officials to focus on the objectives of policy and they can provide valuable information about the impact of policy, which, in turn, may need to be adjusted. However, mechanisms linking outcome indicators to any sort of sanctions should be approached with great caution.

It could be tempting, when cascading elements from the national to the sub-national level, to try to "measure everything", resulting in an abundance of indicators of limited usefulness. In fact, it is better to identify a core set of indicators that have clear usefulness. Links to targets should be selected with care, as target setting is a difficult exercise prone to unintended consequences. A combination of indicators, targets, and rewards/sanctions has been used in the context of regional development policy in OECD countries with mixed results (OECD, 2009d). Yet even divorced from rewards or sanctions, monitoring regional capacity indicators could prove useful for Ukraine.

The foregoing implies, first, that there is probably no "optimal" design for performance indicator systems in regional development policy, and, secondly, that implementation of a performance indicator system will be an iterative process, evolving as information about its usefulness and any unanticipated effects is revealed.

Box 3.5. **Lessons from the use of performance indicators in regional policy**

Some important lessons emerge from recent OECD research regarding the use of performance indicator systems for regional policy.

- **Partnership between levels of government is crucial**, particularly if the objective of monitoring is not to control but to build co-operation and promote learning. Rewards and sanctions are more likely to create the intended incentive effects if there is strong ex ante commitment from all levels of government to rigorous assessment of performance. A lack of collaboration can undermine ownership, producing resistance and jeopardising the long-term sustainability of the system.
- **Capacity is needed** to design performance monitoring systems, to implement them, and to use performance information to improve public action. Thus, while monitoring can support capacity building, it also requires competences and institutional background for using performance information.
- **While a focus on outcomes is critical, input, process and output indicators must also be monitored**. Orienting an indicator system solely towards outcomes can reduce the flow of information and transparency needed for strategic short and medium-term decision making, particularly when – as is the case with regional development – policy impacts are expected to materialise over an extended period. Thus, indicator systems should always provide information on inputs, processes and outputs, which may be crucial for monitoring progress as the programme unfolds.

Source: OECD (2009d), *Governing Regional Development Policy: The Use of Performance Indicators,* OECD, Paris, http://dx.doi.org/10.1787/9789264056299-en.

Greater engagement of non-state actors is important for regional development

Thus far, the discussion of institutions and governance of regional development policy has focused on public institutions – on the central state and on sub-national governments. However, this is insufficient. As the experiences of numerous OECD countries attest, successful regional development requires effective engagement of the private sector, universities, civil society institutions and other non-state actors (see, in particular, OECD, 2012c). It is this recognition that underlies the emphasis on partnership and a participatory approach in all stages of EU regional policy, from planning to delivery. Just as partnership across levels of government requires that sub-national units have the capacities required to work effectively with central state bodies, so partnership across the public-private divide requires non-state institutions with sufficient capabilities, resources and integrity to act in concert with the public authorities. Ukrainian legislation clearly envisages the participation of non-state actors in policy-making and, in particular, in the field of regional development. A number of laws adopted since the early 1990s have made provision for public consultation and stakeholder participation,[27] and a 2009 order of the Ministry of Regional Development and Construction provides for the organisation and operation of public councils as consultative-advisory bodies on regional policy. Most participants in regional policy-making, however, report that the participation of non-state bodies has largely been limited to the passive performance of a limited range of consulting functions. The pending law on the foundations of regional policy offers an opportunity to do better, by laying out framework for the more active participation of NGOs and other non-state actors in regional development.

Chief among these are likely to be the regional development agencies (RDAs). RDAs have existed in Ukraine since the early 1990s: the first was created in 1993 in Zaporizhzhya, and there are now agencies in all Ukrainian oblast centres and many smaller towns. The National Association of Regional Development Agencies (NARDA) has around 34 members. To a very great extent, the growth of the RDAs was driven less by local opportunities and demands than by the availability of donor funding, although many have mobilised the support of entrepreneurs and small businesses. Even so, many NARDA members do not acts as RDAs and many are not yet real tripartite (business, state, civil society) platforms. The RDAs have the potential to act as regional co-ordination hubs and to bring together various stakeholders, but they at present have little authority. Their resources and organisational capacities vary widely, though, and their activities are still ill defined in legislation, despite the fact that their role is acknowledged in the State Strategy for Regional Development. The draft law on the foundations of regional development seeks to remedy this lacuna, but this will not be so easy, because they have evolved with varying organisational forms and any attempt to fix their structures in law risks discriminating among them. Many OECD countries allow for RDAs to take a variety of forms, from PPPs to state agencies to private bodies or non-profits (OECD, 2011c). More important than defining their legal form will be creating a framework for defining and executing regional development strategies that motivates public and non-state actors to use the RDAs effectively as a mechanism for public-private information exchange and co-ordination.

Strengthening regional development policy instruments

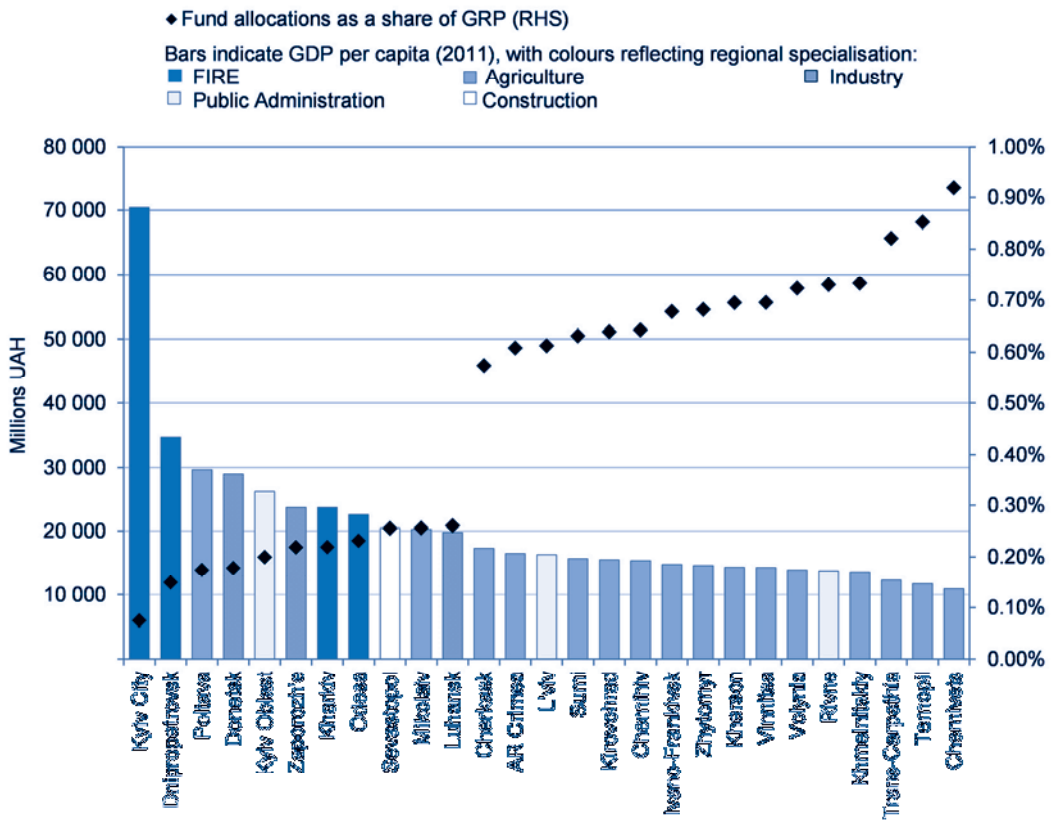
In addition to stronger institutions, Ukraine can still do much to enhance the instruments of regional development. This must regarded as one of the weak points in the draft strategy for the period to 2020: the section describing the "instruments for realising the 2020 strategy" focuses heavily on other documents that will need to be prepared, agreed, reconciled with one another and up-dated at regular intervals, including a national action plan for the 2020 strategy, regional development strategies, action plans for carrying out regional development strategies. Yet it says little about how the authorities will ensure that these documents – which already exist in the present system – can be made more realistic and more effective in practice. However, there are a number of more specific instruments that loom large in Ukrainian regional policy that merit attention. This section will consider three of the most important: the State Fund for Regional Development, the state-region contracts for regional development, various forms of special economic zone, and public-private partnerships.

The creation of the State Fund for Regional Development marks an important step

After years of discussion, Ukraine in 2013 launched its State Fund for Regional Development, created following an amendment to the Budget Code adopted in January 2012. The fund, which is projected to amount to UAH 3.4bn in 2013 (equivalent to around 0.3% of GDP), is effectively an aggregate of various funds earmarked for development. By law, the fund is to receive at least 1% of the income of the State Budget each year. This, in turn, is allocated to the regions on the basis of a simple formula: 70% of the money is allocated among all regions, according to population, and 30% is divided – also according to population – among those regions with per capita GDP less than 75% of the national average. As a result, the fund is much larger relative to GDP in poorer regions than in wealthier ones (Figure 3.4). The redistributive purposes of the fund are

clearly served to some extent, inasmuch as there is a clear and strong negative relationship between the relative weight of fund allocations in a region's GDP and its per capita income levels. The fund thus serves the joint objectives of extending regional development funds to all regions, while concentrating resources in the places of greatest need. However, the 70/30 split with a cut-off at 75% of average per capita GDP does have the effect of introducing a very significant discontinuity into the distribution: regions just above and just below the threshold are treated very differently. The Ukrainian authorities have already indicated a desire to refine the formula in future, and this might well involve some efforts to ensure a smoother redistribution.

Figure 3.4. **Planned allocations from the State Regional Development Fund in 2013**



Source: Derzhkomstat, Ministry of Economic Development and Trade.

The formation of the fund is a promising development, not least because it offers the prospect of stable, multi-year funding for regional development projects and because it relies on a clearly defined competitive allocation process that should do much to improve the quality of project selection. In drafting the fund regulations, the ministry drew heavily on EU principles and strategy documents. Article 24 of the Budget Code sets out the priorities for the fund's use, and a government decree defines the procedures for its allocation. Competitions for funding are held in each region (including Kyiv, Sevastopol and the Autonomous Republic of Crimea); the government has given the regions recommendations as to the composition of the committees selecting projects from among those proposed. Projects approved at regional level are then passed on to a central commission headed by the Minister of Economic Development and Trade and bringing together representatives of other relevant ministries, as well as civil society organisations

and NGOs. (This combination is similar to that recommended to the regions for their own commissions.) The central commission can confirm the decisions of the regional selectors or, if there are problems with project documentation, it can return the proposal to the region with a fixed deadline by which it must correct the problems. Projects applying for fund support must also be co-financed by the regions, but the implementation decree stipulates that sub-national governments can commit to co-financing in future years if funds in the upcoming budget year are insufficient. Preference is given to projects that can be completed in less than three years, and funding may be sought in order to complete projects already begun.

In 2012, the Ministry of Finance allocated funds provided under the budget programme "State Fund for Regional Development". Though in some ways a precursor to the arrangements set in place in 2013, the order for distributing these funds did not provide for a competitive selection of investment projects, something which should contribute to better use of the funds in future.[28] The initial results were in important respects disappointing. According to ministry officials, the first proposals submitted were virtually all rejected. Some regions did not submit proposals at all, and some submitted simple lists of projects, with little supporting documentation or evidence that a competitive selection had even taken place. Others submitted documentation that did not correspond to the specified requirements. Thus, virtually all proposals were initially rejected, with requirements for correction/completion specified. Nevertheless, the experience must in many ways be regarded as a positive one, inasmuch as it demonstrated both the need for considerable capacity-building at sub-national levels, and the readiness of the central authorities to withhold allocations represents should reinforce the incentives for regions to take the process more seriously. In due course, moreover, the pilot programme resulted in the allocation of funds for some 523 investment projects concerned with the renovation of 204 educational institutions, 98 health care institutions, 25 cultural institutions, 55 sports facilities, 8 social protection institutions, and 98 others in the housing, utilities and transport sectors.

A number of issues arise in connection with the further development of the State Fund:

- Some observers argue that the allocation formula for the fund could be adjusted so as to focus more on the socio-economic challenges and capacities facing particular types of place (e.g. rural regions, mountainous western regions, etc.). As noted above, the formula could certainly be refined in future, at least to avoid abrupt differences in the treatment of places with very similar conditions (large threshold effects).
- It has been suggested that the fund could be better integrated with other central spending, so as to ensure that the overall pattern of transfers corresponds to central priorities. This would complicate central government decision-making, but it would also help reduce the risk that the uncoordinated actions of different ministries and departments would result in an allocation of central government transfers that tended to reinforce inter-regional disparities. Something of the sort seems to have happened in neighbouring Russia in recent years (Box 3.6). Given the wide range of policies that various forms of transfer are meant to support, this is probably an unrealistic ambition, but transparency and the goals of regional policy might be well served by a gradual transition towards creating a single channel for all grants/subventions to the regions for capital expenditure. This

should be more feasible now that the prohibition on mixing funds from various budgetary programmes has been relaxed.

- The focus of the fund during the pilot stage in 2012 was somewhat narrow, concerned largely with physical infrastructure and, to a great extent, with the socio-cultural sphere. The list of projects approved by the Cabinet of Ministers on 8 April 2013 reflects these priorities: things like primary schools, kindergartens, boilers, polyclinics, and utilities infrastructure all loom large in the list (KabMin, 2013). These are real needs, but there is room to question whether or not the fund is the appropriate instrument. In future years, the criteria governing the allocation of the fund should be set so as to favour projects that unlock growth potential, rather than addressing (admittedly pressing) social issues. At regional level, the criteria for fund allocations could be linked to state-region contracts and regional development plans. Some effort could also be made to allow more of the funds to support investment in "softer" instruments, like the promotion of innovation and private-sector development programmes, as opposed to "bricks and mortar" investments.

Box 3.6. **The reform of federal transfers in the Russian Federation**

Reforms at the end of the 1990s and in the early 2000s, streamlined and clarified revenue and expenditure assignments, scrapped unfunded mandates (at least in principle) and allocated most federal transfers on the basis of clear equalisation formulae. This greatly enhanced the predictability and transparency of the system. However, the reforms left the vast majority of regions dependent on transfers, as the federal share of general government revenues rose. However, following the reform, there was a sustained decline in the share of formula-driven transfers, owing to the multiplication earmarked grants of various kinds, which have in recent years accounted for close to two-thirds of all transfers. These are allocated by more than a score of central ministries and other federal bodies, often with little co-ordination or assessment of regions' own fiscal capacities. As a result, earmarked subsidies and subventions frequently serve to counteract the effects of equalisation policies. They are also more likely to be allocated annually and often with little transparency. The co-financing requirements attached to some (but not all) earmarked grants also reduce regions' expenditure autonomy. Finally, because they are often allocated in the course of the year, the window of opportunity for regions to use them can be as little as a few months. This "use it or lose it" situation is not conducive to good financial management.

The Russian Ministry of Finance has recently been pushing back against this trend, in favour of a more systematic approach. Reversing the erosion of the transfer reforms of a decade ago is particularly important, because huge and persistent disparities in tax potential across regions mean that federal transfers will continue to play a large role in limiting disparities in access to key public services. For example, primary and secondary educational institutions are now exclusively financed from regional and municipal budgets. This results in considerable regional heterogeneity in public funding. To make the most of youth potential and reduce large spatial variation in educational outcomes, the authorities should consider implementing even stronger federal transfers, especially in poorest regions, which suffer from lower spending per student. A critical challenge will be to ensure that such transfers are predictable, transparent and allocated according to appropriate criteria.

Source: Vartapetov, K. (2010), "Russia's Federal Fiscal Grants: Regional Equalisation and Growth", Post-Communist Economies Vol. 22, No. 4, pp. 471-481; Freinkman, L., K. Kholodilin and U. Thießen (2011), "Incentive Effects of Fiscal Equalization: Has Russian Style Improved?", Eastern European Economics, Vol. 49, No. 2, pp. 5-29; Gornin, L.V. (2012), "Osnovnye napravleniya sovershenstvovaniya mezhbyudzhetnykh otnoshenii", RF Ministry of Finance, St Petersburg, October, www.gosman.ru/content/gornin.ppt.

The fund could be used to expand the range of instruments used for regional development

While a great deal of attention has focused on the potential of the State Fund for Regional Development to support investment in physical infrastructure, one of the most important potential uses of the fund might well be to facilitate the emergence at regional or local levels of "softer" regional development instruments. A number of policy instruments commonly used in OECD countries remain seriously under-developed in Ukraine. These include the creation of business incubators – both within and apart from institutions of higher education and the use of more direct support for start-ups, particularly in high-tech sectors. Given its human capital endowments, these are areas where Ukraine has considerable potential, not unlike that of its northern neighbour, Russia, where public support for the ICT sector has been modest but in many ways very effective, and where regional programmes, including incubators and start-up support have been an important part of the story (OECD, 2011d). Managers in the Ukrainian ICT sector commented to the OECD Secretariat on the far greater availability of financing for early-stage start-ups, in particular, in Russia.[29]

Yet for such initiatives to bear fruit, the national authorities would need to address many of the business climate issues discussed above in tandem with the development of such programmes. At present, the regulatory barriers to connecting up with the wider world are daunting for entrepreneurs, owing to regulations governing things like setting up companies or even opening bank accounts abroad. Such concerns were previously of little relevance to start-ups: firms typically established themselves locally before expanding and then, eventually, moving into export markets. This is no longer the case. In a globalising world, start-up firms often begin with global connections and with foreign markets in mind, particularly those involved in relatively "weightless" sectors like ICT.

In devising new instruments for business support, those involved in regional development should bear in mind the weaknesses of the current institutional environment and the lessons of past experience with business support in Ukraine and elsewhere. Contrary to what is sometimes suggested, this does not mean that nothing can be done. It **does** mean that public interventions need to be realistic in the context. This suggests a number of design principles for business-support programmes:

- Criteria, priorities and processes need to be clarified in advance. Otherwise, it will be very hard to reconcile consistency of treatment with respect for diversity. In other words, for an instrument to be flexible without appearing to be an ad hoc uses of public resources to support favoured actors, it must be very clearly designed from the start, with ex post evaluation built into the ex ante design.
- Policy makers should focus on forms of support that have a natural phase-out period, to avoid "addiction" to public support (see below for more on this point).

More can be done to develop contracts as an effective regional development instrument

As noted above, Ukrainian law provides for regional development contracts between regions and the centre, but little use has yet been made of this mechanism. Indeed, some national-level officials fear that reliance on a contractual approach will lead to the fragmentation of Ukraine as an economic space, as regions individually negotiate bilateral deals with the government that give them special privileges or powers. Such

fears are not without foundation, as the history of Ukraine's special economic zones and territories of priority development attests. The experience of neighbouring Russia in the 1990s illustrates the extent to which such bilateral agreements can create fragmentation, internal barriers to trade, confusion and even corruption (Ross, 2004). Nevertheless, a growing number of countries have found such contracts to be a useful way to structure co-operation between central and sub-national governments (Box 3.7). The challenge here is to balance consistency/coherence across the whole of the country with the need to allow for a place-based approach.

Box 3.7. **The use of contracts for regional development in OECD countries**

Contractual approaches to the governance of regional development are already employed in a number of OECD countries, though the modalities and motivations vary widely. In some countries, such contracts amount to non-binding protocols of intent rather than legally enforceable agreements, whereas in others they are based on legally binding instruments. Yet even in the former cases, they can make a difference, not least by changing the way sub-national officials perceive their roles. In **Denmark**, for example, the first partnership agreements between the centre and the regions, which were concluded at the start of the 2007-2013 programming period, tended to be quite vague, committing the parties to the shared pursuit of some general, non-controversial goals but with few specifics. This is gradually changing, as more concrete measures are incorporated into the partnerships, but the initial agreements appear to have played an important role in motivating regional officials to think seriously about growth- and development-related goals that sub-national authorities had previously tended to see as the province of national governments. As a result, they became much more active in dialogue with the central ministries, which has helped to give the partnerships more substance over time.

There is great variation in the degree of input from the regional side into the content of such contracts. **France**, for example, has used contracts to jointly manage policies in the context of a decentralisation policy, whereas for **Italy** they have tended to be focused primarily on increasing capacities and accountability at sub-national levels, empowering sub-national governments and transferring new responsibilities to them. In Spain, they have been used to manage policies in the wide range of domains in which different levels of government share competences, which can be extremely complex when, as is often the case, regional and national governments are at odds with each other.

More recently, **Switzerland** has begun to apply a more elaborate approach to regional contracts, involving both performance indicators and financial incentives (OECD, 2011e). Programmatic monitoring activities for regional development policy are largely associated with the programme agreement (contract) between the federal government and each canton. Each programme agreement sets out the objectives to be attained over the duration of the agreement (four years). Objectives are monitored on an ongoing basis using indicators selected by the canton and incorporated into the programme agreement. A financial incentive to reach the stated objectives is provided insofar as cantons will receive the proportion of funds corresponding to the per cent of the target achieved, meaning that, in some cases, cantons may be required to return funds if a target is not achieved. This rule, which has not yet been tested, may thus prove highly difficult to enforce.

The Territorial employment pacts (TEPs) in **Austria** have been found effective in bringing all labour market actors across levels of government together to tackle local employment challenges and policy. The TEPs thereby aim at implementing the National Reform Plan for Growth and Jobs that seeks to co-ordinate across relevant policy areas, including employment, education, regional economic and structural policies, using an integrated, place-based approach. The initial regional contracts in **Poland** served as a learning device preparing the regional authorities for the management of the EU Structural Funds in a multi-level setting. These contracts created a stable and multi-annual framework for vertical co-ordination, allowing regional authorities to complete

Box 3.7. **The use of contracts for regional development in OECD countries** (*cont.*)

long-term investment plans. Nonetheless, it has been argued that the contracts remained stuck in what was previously a centralised framework, rather than putting the regions at the centre of regional development policy making. Instead of introducing a co-ordinated, place-based approach, the contracts served as a tool for the local implementation of national programmes, the need for which arose because fiscal decentralisation did not match the regions' assigned responsibilities. This reinforced their financial dependence on the central government. The centre's approach to managing EU Structural Funds further undermined the regions' role, making the regional contracts simply an instrument of the EU-funded programmes instead of instruments for regional policy planning and co-ordination. The National Regional Development Strategy for 2010-2020, which replaces the existing contracts, aims at introducing a more integrated and place-based approach to create synergies between all regional policy instruments with a territorial dimension across levels of government, especially by specifying the sources of funding for the strategy's envisioned interventions.*

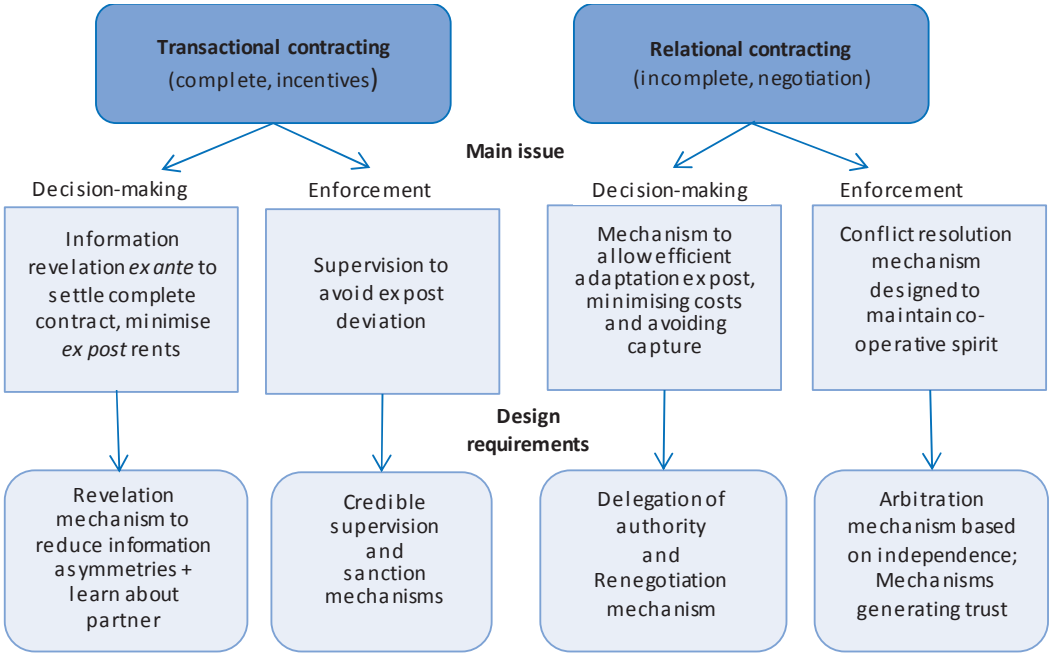
The experiment with the regional growth agreements (RGAs) created scope for the emergence of new forms of governance in **Sweden**'s regions, drawing on the country's strong traditions of co-operation and inclusiveness. Nonetheless, the scheme suffered from blurred accountability and conflict, due to the lack of settled and institutionalised authorities at the regional level (Svensson and Östhol, 2001; Svensson, 2001) as well as the fact that the central government retained strong control over the priorities of the RGAs, which ultimately failed to recognise the regional needs and requests. As a result, the scheme has been discontinued and replaced by regional development programmes (RDPs), strategic documents designed at the regional level and backed by regional growth programmes (RGPs) serving the purpose of a voluntary operational sub-programmes specifying in more detail the priorities and measures outlined in the RDPs. While the RDPs have the advantage of being genuinely bottom-up and designed by the regional actors, they hardly fit the definition of a contract because there are no strong enforcement mechanisms in place and little in the way of dedicated resources. Instruments other than contracts have thus been required for co-ordination.

*Taken from presentations from the meeting of the National Territorial Forum, 15 March 2012, www.mrr.gov.pl/rozwoj_regionalny/Polityka_rozwoju/System_zarzadzania_rozwojem/Debata_Strategiczna_Krajowe_Forum_Terytorialne/Strony/Spotkanie_KFT_Kontrakt_190312.aspx (accessed 3 October 2012).

Source: OECD (2007), *Linking Regions and Central Governments: Contracts for Regional Development*, OECD Publishing, http://dx.doi.org/10.1787/9789264008755-en; OECD (2013), *Investing Together: Working Effectively across Levels of Government*, OECD Publishing, http://dx.doi.org/10.1787/9789264197022-en.

For all their differences, regional development contracts as used in the OECD area are generally relational rather than transactional in character. In other words, **their primary purpose is not to fix the parties into a complete set of binding and enforceable rights and duties but rather to serve as mechanism for collective decision-making which generates trust and facilitates co-operation and information-sharing** (Figure 3.5). In general, trust should make it easier to implement other forms of accountability and conditionality without incurring excessive costs. Where trust is lacking and mechanisms are designed on the assumption that agents will "defect" if possible (i.e. that most agents are "bad" agents), transaction costs rise sharply and flexibility tends to be sacrificed. Often, the result is that opportunistic agents still find ways to evade the rules, but conscientious agents actually find it harder to get anything done (Yakovlev, 2010). In the event of conflict, the emphasis in a relational contract is on arbitration/re-negotiation rather than enforcement and sanctions.

Figure 3.5. **Transactional vs. relational contracting**



Source: OECD (2007b), *Linking Regions and Central Governments: Contracts for Regional Development*, OECD Publishing, http://dx.doi.org/10.1787/9789264008755-en.

This is precisely what one would expect to emerge, given the context in which contracting over regional development policy takes place; the process is characterised by:

- An absence of regulation by competition. Neither party (the state and the region) can really threaten to walk away and negotiate with another potential counterparty.
- Institutional lock-in. The parties are engaged in a repeated-play game from which neither can easily exit. If lack of competition means they cannot choose alternative counter-parties, lock-in implies that they will find it difficult, if not impossible, simply to refuse to contract. They have little choice but to interact.
- An absence of recourse to vertical integration. When the autonomy of sub-national governments is strongly entrenched, the absence of any recourse to vertical integration to solve co-ordination problems gives the central authority an incentive to negotiate.

Theory suggests that contracts negotiated in such circumstances will focus on co-operation rather than the optimisation of a transaction or transactions. Moreover, the wider the scope of the contract and the greater the degree of uncertainty facing the parties, the more likely it is to be relational rather than transactional. Where the parties to a contract do not know how to deal with a policy issue, they need to co-operate in identifying more clearly how the problem(s) can be addressed and how to implement the policy. The only certainty is that the parties are involved in a common venture, in which they will share costs and benefits. This calls for relational contracting aimed at managing new and innovative projects.

Although such contracts may appear "weak", given the lack of emphasis on binding and enforceable constraints, OECD (2007b) finds that they can help sustain a dynamic of co-operation among levels of government over the long run. Batchler and Ferry (2011) observe that they can also contribute to local capacity building. Attempts to strengthen the enforceability of such contracts could lead to very high transaction costs, which might well discourage partners from making commitments to one another, on account of the possible adverse consequences if the co-operation does not prove profitable. In any case, strong enforcement mechanisms would likely be politically difficult to adopt and, if adopted, to administer in connection with cohesion policy.

A further potential advantage of this approach is that complex agreements are needed if co-operation is to extend not only through time but also across a range of policy domains. The empirical evidence suggests that even potentially desirable regional policy interventions in fields like public investment and human capital development can have perverse consequences if undertaken in isolation (OECD, 2009a, 2011a); this points to the need for multi-dimensional policy packages that take proper account of the complementarities and interactions among policies. Where regional growth strategies identify such policy packages, it should be possible to incorporate their key elements into regional development contracts. Moreover, this might even help the national government better co-ordinate its own sectoral policies and ensure that central and sub-national initiatives are more coherent with one another. For example, the infrastructure ministry has been frustrated by situations in which, for example, major national roads, for which it is responsible in the main, are often in very poor condition where they pass through cities, because along those stretches of road it is the sub-national actors who are responsible for maintenance and upgrading.

A relational contract-based model also has important implications for the ways in which performance indicators might be used. As OECD (2009d) observes, the role of indicators and incentives in multi-level governance arrangements will vary with the characteristics of the contractual arrangement between the different parties (see also OECD, 2007a). Where the contract is more "relational", performance indicators can contribute to building co-operation by providing common reference points and objectives. Above all, they will contribute to a common learning process.

Though necessarily flexible, an approach based on relational contracts need not be devoid of strong obligations. The conditions attached to resource transfers, in particular, would still have to be obligatory and enforceable. Owing to the need for a bottom-up approach that allows for flexibility and experimentation, the strictest obligations would probably need to pertain to procedures rather than to the content of policy. Indeed, the greater the weight attached to flexibility and discretion in regional policy, the more important it would be to ensure that decision-making (and dispute-resolution) procedures were well specified, transparent and robust. This is particularly important for their legitimacy: if a single set of standards, definitions and targets cannot (for good reasons) be employed across all regions, then the best guarantee of horizontal equity in the treatment of different places is likely to be a transparent and inclusive decision-making procedure.

Study of the use of cross-governmental contracts for regional (local) development in the OECD highlights two other common lessons that Ukrainian policy-makers should bear in mind when devising any further arrangements for contract-based approaches to regional development (OECD, 2013a):

- Contracts need to be closely integrated with existing administrative and budgetary arrangements. Many contracts remain largely unsuccessful in changing existing fragmented and compartmentalised structures, because the relevant competences that go along with the strategies embodied in the contracts remain unchanged. In addition, contracts may not be undergirded by stable, reliable financing, so implementation is not assured. For example, contract priorities could form the basis for project selection under the State Fund for Regional Development. This would not preclude the use of other resources to fund contractually agreed priorities, but it would ensure a basic level of resource while also providing a foundation for the delineation of the criteria on which competing proposals for the Fund might be judged.
- While contractual arrangements can be employed as a capacity-building device, they sometimes also over-stretch existing capacity, both at the local and the national level. They can create "parallel" structures to existing administrative processes, which increase the administrative burden and also the need for "know-how" at the local and higher levels to engage in these new structures. Therefore, it is crucial to ensure that contractual arrangements are, as much as possible, aligned with existing ways of "doing business" and are accompanied by training for all levels of government in how to implement them.

Thus, it is possible to envisage the use of regional development contracts based on agreed priorities and objectives, identified on the basis of a shared diagnosis of a region's challenges, as well as agreed procedures for fund management, evaluation and reporting. These, in turn, should rest on ex ante assessments of regional challenges and potential, involving both bottom-up and top-down input. Such contracts would specify the main objectives of policy, the instruments to be employed and the kind of benchmarks or indicators that would be used to assess progress with respect to institutional or policy changes, programme implementation and outcomes along the way. They might also specify the procedures by which programme priorities were identified, emphasising, for example, the inclusion of a wide range of stakeholders and the need to ensure that the local process is effective at revealing information about local potential. In the Ukrainian context, this would entail, above all, strengthening the procedures for concluding state-region contracts, linking contracts to real, multi-year budgets and other funding sources, and integrating contractual processes with the elaboration of sectoral strategies.

Devising both national and regional strategies for regional development should be easier than in the past, owing to shifts in both budgeting and sectoral policy planning. Many crucial sectors lacked any kind economy-wide sectoral strategies until relatively recently. The articulation of such strategies for transport, industry, the environment, education, health care and so on should facilitate better contracts, as well as better cross-sectoral co-ordination of national policies, if only because the broad, strategic directions of policy are thereby made more explicit and stable. Moreover, whereas reliance on annual budgeting undercut such strategies in the past, the move to multi-year budgeting should help to link these strategies more clearly to real public action.

The debate about special zones and territories has been renewed

There remains considerable pressure to develop new forms of special zone in an effort to stimulate investment and job creation and to reverse the fortunes of declining territories. The Ministry of Economic Development and Trade is currently studying the identification of territories for new investment areas and the State Agency for Investment

and National Projects is at work on plans for a network of industrial parks across the country. Under legislation adopted in late 2012, the government plans to create ten parks focused on major national projects, as well as other parks at the initiative of the regions and other actors. The criteria for granting industrial park status are still evolving, but the State Agency for Investment and National Projects, which will register the new parks, sees them as a critical mechanism for jump-starting investment in new industrial developments by offering tax incentives and ready infrastructure with a view to reducing operating costs and cutting the time it takes projects to reach the market. Access to the parks will be equal for foreign and domestic investors. According to the State Agency, the proposed tax benefits include duty-free import of equipment not produced in Ukraine that is used for the construction of the parks and/or economic activities within them, an 8% rate of corporate income tax (as compared to the general rate, which will fall from 21% to 16% in 2014), and some reimbursement of VAT. The parks are to last for 30 years and, according to officials, the privileges will be extended for the lifetime of the park. To avoid the transformation of the parks into trading zones (as happened in the past), the authorities plan minimum requirements for the share of land devoted to industrial production, for greenfield investment and for job creation. It will also monitor closely the support extended to the parks in terms of benefits and cost-sharing and will ensure that foreign and local investors enjoy equal access to the parks.

As noted above, Ukraine's history with various forms of special economic regime as development instruments is not a happy one. The authorities are well aware of this, and efforts are being made to avoid a repetition of past abuses. In late 2012, the presidential administration instructed the Ministry of Economic Development and Trade to ensure harmonisation of legislative mechanisms for the functioning of free economic zones and territories of priority development with the norms of the Customs and Tax Codes of Ukraine. Changes proposed in this respect include amendments to articles 401–405 and 415 of the Economic Code of Ukraine, which concern the creation, liquidation and functioning of special (free) economic zones, as well as the regulation of other regimes that offer incentives for investors undertaking activities that are of particularly high priority for the authorities (e.g. for the satisfaction of social needs, including the creation of new workplaces).

In considering the question of special zones in Ukraine, it is important to reflect not only on the lessons of Ukraine's recent past but also on the experiences of other countries with various forms of exceptional economic regime on their territory. This section therefore explores the rationale for zones, the evidence concerning international experience with them and the kinds of considerations that should be kept in mind when contemplating the creation of new forms of special zone in Ukraine.

Ukraine is certainly not alone in wishing to make use of such spatial instruments for economic development. Special economic zones of one form or another are increasingly common in emerging markets, particularly in the developing world. According to the International Labour Organization's database of special economic zones, there were 176 zones in 47 countries in 1986, rising to a staggering 3 500 in 130 countries as of 2006 (Farole, 2011b). While special zones of various types tend to loom larger in the economic strategies of developing countries, they are by no means unknown in the developed world: around one-third of the zones in the FIAS database in 2008 were in developed countries; in the United States alone, there were 66 (FIAS, 2008).

In principle, countries create special economic zones for one (or more) of three reasons. The first is to address **market failures**. For example, where particular activities

generate significant positive externalities, the market on its own is likely to under-supply them, and it may be possible to create conditions which will make such activities more attractive to private agents in specific places. This is the logic that underlies, the creation of special innovation zones of various types (see, e.g. OECD, 2006). One problem that often arises is that the specific provisions governing such zones map rather poorly onto the market failures that are cited as their justification: to the extent possible, the design of the policy instrument should reflect the underlying diagnosis.

The second common motivation is to compensate for **state failures**. This is typically the case where countries with weak institutions and unattractive contracting environments seek to attract investment (particularly foreign direct investment) by creating places in which the regulatory, tax and other institutional conditions are more favourable in the wider economy. The risk is that such zones can aggravate problems of state weakness, in at least three ways:

- They can reduce pressure for more wide-ranging reform and may even foster the emergence of interests that wish to preserve a defective status quo – zone residents may profit from keeping their privileges more or less "exclusive".
- In contexts where, as in Ukraine, corruption, limited implementation and enforcement capacity and cumbersome regulation are among the problems generating pressure for zones, they can simply create new opportunities for corruption and bureaucratic rent-seeking. The authorities may also find it difficult to uphold the rules and regulations governing the zones, which then become the focus of abuse by private firms.
- They can undermine state institutions by fragmenting the national economy, complicating administration. A more promising use of zones to overcome state weakness is by using them to create conditions for more efficient government regulation of enterprises, provision of off-site infrastructure, and environmental controls.

The third motivation is to address **infrastructure bottlenecks**, usually by accelerating infrastructure development in specific places, where governments expect to be able to develop and diversify exports and/or foster the development of clusters. This is a major part of Turkey's Organised Industrial Zone (OIZ) programme, for example: the creation of areas with dedicated infrastructure for industrial production has, in turn, helped to ensure that industrial activities were carried out in appropriate places (in part by removing some dirty activities from urban centres) and strengthened the government's regulatory role. OECD (2008) observes that, in addition to cost-effective infrastructure provision, successful OIZs have fostered dissemination of knowledge and technology, enforcement of environmental regulations and co-operation between industrial firms and universities. Turkey's experience in this respect could prove useful for Ukraine, especially given existing problems with regulatory compliance.

In practice, it must be said, special zones often simply reflect the authorities' judgement that **the market is not delivering the outcomes they desire** – a given sector or sectors are failing to take root in a place or investors seem disinclined to choose it. In other instances, zones may be seen as a way of forcing the pace of a given sector's development by, for example, facilitating faster provision of needed infrastructure, streamlining regulations and/or providing financial incentives to investors. The risk is that political priorities may effectively override the commercial case for the zones, leading to attempts to force the development of sectors and activities in which a country has little or no comparative advantage. This is a point that should be borne in mind by Ukrainian

policy makers as they consider possible zones and industrial parks, particularly when regions seek to formulate "smart specialisation" strategies.

The terminology applied to various types of economic zones, in both the academic literature and common usage, is highly confusing. Terms like "free zones", "free trade zones", "customs-free zones", "special economic zones and "export processing zones" are often used almost interchangeably. However, some basic types of special zones can be identified (Box 3.8).

Box 3.8. **Types of special economic zones**

The first "modern" zone was created in Ireland in 1959. Since then, a number of different types of zone have emerged that are subsumed under the general discussion that follows.*

1. **Free trade zones (FTZs)**, also known as commercial free zones, are fenced-in, duty-free areas, offering warehousing, storage, and distribution facilities for trade, trans-shipment, and re-export operations.
2. **Export processing zones (EPZs)** are industrial estates aimed primarily at attracting export-oriented investments. They cover usually a wide array of manufacturing industries.
3. **Private zones/Single factory processing zones** provide incentives to individual enterprises regardless of location.
4. **Special economic zones (SEZs)** are larger estates and could be considered cities on their own. They usually cover all industrial and service sectors and target both foreign and domestic markets. They provide an array of incentives ranging from tax incentives to regulatory incentives. In addition, they permit on-site residence.
5. **Specialised zones (SZs)** targeted at specific sectors or economic activities. Examples of SZs include science/technology parks, petrochemical zones, logistics parks, airport-based zones, and so on. They may restrict the access of companies in non-priority sectors, and their infrastructure is mostly tailored according to their sectoral targets.

To the above list one might add the wide range of very small urban redevelopment zones of various types that have been created in advanced OECD countries in an effort to reverse the fortunes of declining neighbourhoods (e.g. France's *Zones franches urbaines* or U.K. enterprise zones).

* A slightly different classification may be found in FIAS (2008).

Source: OECD (2009), "Towards Best Practice Guidelines for the Development of Economic Zones: A Contribution to the Ministerial Conference by Working Group 1", Marrakech, 23 November.

Despite their popularity, international experience with special zones is decidedly mixed

To a great extent, the popularity of special zones stems from their perceived success in a number of countries that have reaped significant benefits from them – above all, China (Wang, 2010), but also such countries as Mauritius (Charitar and Narrainen, 2009), Vietnam, Bangladesh and some Central American countries (Farole, 2011b), which stands in stark contrast to the rather poor results of zone programmes in many other contexts, particularly in Africa (Farole, 2011b; Charitar and Narrainen, 2009). In some cases, moreover, zone success, though palpable, has been limited. Both Farole (2011b)

and FIAS (2008) draw attention to countries where zone programmes have generated investment and job creation and yet have failed to have much impact on host economies; instead, they have remained enclaves with few linkages to the domestic economy. By contrast, China has used zones as an important instrument in bringing about a broader economic transformation.

Overall, the cross-country evidence on economic zones suggests the following general lessons:[30]

- They are not a first-best solution. The first-best option is generally to improve the overall investment climate. Zones may make sense as an intermediate step, if their creation will facilitate progress towards that goal. However, because it is often easier to extend fiscal, regulatory and customs privileges than to tackle major institutional reforms, zones can easily become alternatives to reform rather than reform facilitators.
- Zones can have the opposite effect. Once privileges are provided to residents of special zones, a lobby begins to form with an interest in maintaining those privileges. However, beneficiaries may not have any interest in seeing them extended to competitors outside the zone. Moreover, by creating a safe haven for investors in a country and permitting a certain amount of employment creation, zones can reduce the pressure for economy-wide reforms to improve the contracting environment.
- They are only one instrument among many for promoting export development and growth. Moreover, they have, by definition, a limited impact, spatially and, in most cases, sectorally. Here, too, they are most likely to be an attractive option if they are designed in such a way as to generate the broadest possible benefits for the economy as a whole rather than to operate as de facto offshore enclaves.
- For this reason, they work best in countries with good infrastructure and financial markets, where downward linkages can be developed to domestic economic activity; this points to challenges for Ukraine when it comes to any new zone programmes. The degree to which the development of such linkages is feasible depends on both zone design and the state of domestic institutions.
- The belief that zones offering dramatic privileges and incentives can compensate for the poor quality of a country's overall investment climate has little foundation. On the contrary, Farole (2011a) notes that SEZ investment, employment and exports tend to be strongly and positively correlated with a country's overall score on the World Economic Forum's Global Competitiveness Index. This finding calls for serious reflection in connection with any Ukrainian zone programmes or plans for industrial parks. Given that bureaucracy and corruption are the main barriers to investment in Ukraine – a conclusion echoed by many Ukrainian officials. Trying to offset these problems via the extension of tax privileges and free infrastructure is not a promising strategy.
- Zones are distortionary instruments with respect to both foreign trade and domestic markets. Even if wholly WTO-compliant, they can, in particular, distort domestic competition and foster segmentation in domestic labour markets. They may thereby undermine the competitiveness of domestic firms near to but outside the zone.

- The discretion zones introduce into the policy environment makes them highly vulnerable to abuse. Ukraine is by no means the only country to have encountered such problems (FIAS, 2008; Farole, 2011a, 2011b).

It is also worth noting that successful zone programmes tend to share certain common features:

- Successful zones build on countries' existing comparative advantages rather than trying to force the emergence of new ones: Bangladesh's zone programme, achieved very little for many years, as it was focused on high-tech sectors. Only when the focus shifted to garment manufacture, exploiting both the country's abundant low-cost labour and the opportunities afforded by the Multi Fibre Arrangement (MFA), did the zones really take off.
- Zone programmes require a high degree of policy consistency, across both time and policy domains. Charitar and Narrainen (2009) highlight the extent to which the disappointing experience of many African zones is linked to lack of consistency in both the framework of rules for zones and implementation of zone programmes. These are highly relevant concerns for Ukraine, given the problems it has faced with respect to policy consistency over time.
- Ensuring that zones develop positive linkages to the domestic economy often requires that complementary, economy-wide policies in areas like skills development, knowledge-sharing and cluster policy be co-ordinated with zone development (FIAS, 2008). Yet cross-sectoral co-ordination is another area in which Ukraine's public authorities have faced particular challenges.
- Successful zones provide quality infrastructure and a good environment for doing business; they do not always require very highly geared fiscal incentives. Indeed, in a survey of zone investors in ten countries in 2009, levels of corporate taxation ranked fifth among their concerns, behind cost/quality of utilities, access to transport infrastructure, regulatory environment for business and trade facilitation (Farole, 2011a). For example, Charitar and Narrainen (2009) point to the success of the Shenzhen High-Tech Industrial Park, which attracted some 2000 firms while offering only very limited fiscal benefits. Overall, Farole (2011a) finds that infrastructure reliability matters more than fiscal incentives.
- FIAS (2008) observes that privately owned and operated zones tend to offer better infrastructure and amenities at lower cost than publicly operated ones. Since the early 1990s, there has been a dramatic shift world-wide from zones created and operated by the state towards zone models based on public-private partnership or private entrepreneurship.

In addition to the issues above, the most commonly cited reasons for disappointing outcomes from zone programmes include: poor site location, burdensome performance requirements, excessive red tape (even zones promising a favourable fiscal and regulatory environment often impose extensive documentation and reporting requirements) and poor co-ordination of infrastructure provision. In a regional development context, location decisions merit special consideration, because zones motivated by a desire to stimulate activity in particular places are often cited in less advantageous locations. The most promising locations are often in or near existing growth poles (Moberg, 2013).

Ukraine should approach the formation of new special economic zones with great caution

Before creating any new zones or territories, it will be critical for the Ukrainian authorities to identify clear aims and instruments, to conduct a careful cost-benefit analysis of the zones, and to think carefully about the interaction between the zones and the wider economy. The critical point to bear in mind is that **special zones should bring significant benefits to those who are outside them**. The case for providing privileged conditions for some firms and investors (whether they are in zones or not) can only be sustained if there is good reason to believe that their activities will generate positive externalities that will benefit the wider economy. These could, for example, involve upskilling segments of the work force, facilitating the absorption of technology and expertise from abroad or stimulating innovation. What policy makers must not forget is that **zones must be made attractive to potential residents but they must also be beneficial to non-residents**.

International experience points to a number of principles that should be borne in mind:[31]

- There should be a common legislative framework, involving clear criteria and transparent decision-making mechanisms to govern zone location and administration. The proliferation of ad hoc special regimes for specific places should be avoided.
- When designing a zone programme, the authorities need to set realistic expectations and conduct a thorough cost/benefit analysis. This analysis should focus, in particular, on the additionality of the proposed zone. Few things are easier than creating zones that subsidise activities or investments than agents would have undertaken anyway. The analysis should include various scenarios, including the allocation of responsibility between public and private sectors.
- The incentive regime within the zones should be consistent with WTO obligations. This mainly concerns the use of subsidies and tax incentives which are conditional on minimum export requirements or the use of local content requirements.
- Zones should respect the principle of non-discrimination between foreign and domestic investors. Failure to do so can lead to all manner of strategies for gaming the system, as investors seek to operate through structures that qualify for privileged treatment (e.g. domestic players using offshore holdings to gain benefits reserved to foreign investors).
- Physical development standards and clear criteria for approval of privately and publicly developed zones should be put in place and streamlined (e.g. environmental standards, financial and technical track record of the zone developer). Given the importance of utilities and infrastructure to zone investors, this should be seen as a critical priority.

Successful zones could aggravate inter-regional disparities

The creation of zones in the context of regional development policy poses particular challenges. The aim of such zones should be to catalyse development that builds on a place's real comparative advantages. Where incentives and privileges are used in an effort to entice firms to locate in places where their activities would otherwise make little

commercial sense, the result is likely to be an endless flow of support to keep them from exiting (Farole, 2011b). In many countries, zone failures have been the product of poor site location (FIAS, 2008). Success is often linked to proximity to gateway infrastructure, and remote location may also reduce the possibility to profit from agglomeration economies. Zone initiatives thus throw into sharp relief the tension that underlies many facets of regional policy, between trying to raise the performance of lagging regions and seeking to foster the success of growth poles. More peripheral locations are unlikely to succeed unless zones are organised around specific, place-based sources of comparative advantage – usually, sources rooted in relatively immobile assets. Yet politics often makes it hard to manage site selection well. Even when the authorities accept the arguments against situating zones in peripheral, lagging regions, they are often reluctant to be seen focusing on more prosperous places. Often, the result is a process that seeks to spread zone sites relatively evenly across the country, regardless of the efficiency of such a process.

Zones with a regional development focus need to be situated in larger regional development strategies. This must be a part of any decision about zone location or zone type. It should also contribute to the co-ordination of infrastructure development inside and outside the zone, as well as investments in skills development and other complementary policies that may transcend the zone and yet be critical to zone success. Mexico's *maquiladora* programme, for example, was initiated in response to the unemployment shock that affected northern border regions after the end of the U.S. *bracer* guest-worker programme in the 1960s. It required, in addition to specific provisions for *maquiladora* zones, an array of changes in Mexican legislation, as well as changes with the United States in the areas of trade and border management. With time, trade liberalisation and *maquiladora* investment transformed the northern regions' peripheral (in a Mexican context) status to an economically advantageous (in a North American context) location. Declining regions may also benefit from the presence of infrastructure and other assets that is under-utilised and can reduce the costs of zone development, while increasing the chances of success. In this respect, the experience of Bangladesh may, for all the many differences involved, be relevant to Ukraine: a number of Bangladeshi zones were successfully developed on the sites of defunct state-owned enterprises, bring new employment and development opportunities to communities previously dependent on industries in which the country was no longer competitive (Farole, 2011a).

The impact of zone activities on the rest of the economy is crucial

If zones are to contribute over the long term to strengthening the national/regional economy as a whole, then they must be designed so as to engage deeply with the non-zone economy around them rather than developing as enclaves cut off from the rest of the country. OECD (2009c) suggests a number of specific provisions that can help address this concern:

- Consistent with the principle of extra-territoriality, indirect exporter benefits (i.e. duty free access) should be given to firms in the local economy that supply zone residents.
- Collaborative relationships should be encouraged between investment projects in the zones and local firms/research institutions economy.

- Private zone developers should be allowed to supply utilities services (telecoms, water/sewerage, power) to tenants of SEZs. Indeed, zones can play an important role in de-monopolising or de-regulating telecoms and utilities (FIAS, 2008).

In addition, it is important that infrastructure development in zones be closely co-ordinated with regional and national infrastructure development. Overall, conditions governing zones should favour their integration with the domestic economy, including the transfer of technology and know-how, investment by domestic firms into the zones, forward and backward linkages and free movement of labour and entrepreneurs between the zone and the surrounding economy (Farole, 2011a).

Particular attention should be paid to the incentives for zone residents

Incentive packages for zones need to be monitored and evaluated with particular care to ensure they are meeting policy objectives and that they are doing so at a reasonable cost to the budget and to firms and investors outside the zones. (It is critical to bear in mind that zone privileges can impose costs on non-residents as well as on the budget.) Given the damage that can be done to the state's reputation by an ex post withdrawal of zone privileges, it is critical to get the incentive structure right at the outset. In addition, while some specific provisions may make sense in particular contexts or for specific types of zone (e.g. innovation zones as opposed to export-processing zones), these should be kept to a minimum. On the whole, a common set of incentives and privileges for all zones in a country is preferable. The multiplication of different tax, customs and regulatory regimes is undesirable, as it creates complex – and often difficult to foresee – incentives for investors, while greatly complicating the authorities' tasks when it comes to monitoring and enforcement. For similar reasons, performance-based incentives should be included within a country's tax code rather than through special legislation. Having too many tax regimes can strain the resources and effectiveness of national tax administrations.

OECD (2009) suggests a number of general conditions that should be borne in mind when designing incentive packages for special zones. First, all tax and non-tax incentive policies to promote investment should be co-ordinated with one another and with other policies aimed at improving the investment climate, including macroeconomic and trade policies, and governance reforms. Multi-level co-ordination is also important, to avoid the "stacking" of incentives offered by different levels of government. SEZ incentives should thus be set in an overall strategy developed by the ministry(ies) responsible, ideally under an overall expenditure ceiling that accounts for both direct expenditure and tax expenditures. Incentive policies should be transparent with respect to goals and objectives, procedures, criteria and estimated costs. They should, to the extent possible, be rules-based, with minimal scope for bureaucratic discretion. Some capacity-building may be required to ensure that they can be adequately administered by programme administrators.

International experience also points to a number of more specific considerations:

1. Sunset clauses should be put in place where tax incentives are offered. For these to be credible, policy makers need to take them into account when designing incentive packages in the first place. If incentives are so highly geared as to prompt firms to locate production in places where it would not otherwise make commercial sense, then it will be very difficult to withdraw the incentives without triggering exit. If incentives are offered, the aim should be to jump-start

development of activities that can and will become self-sustaining in a given place within a reasonable time frame.

2. If zones are created to promote exports, they should be treated as de facto extra-territorial: tax incentives within the zone should reflect that status, taking the form of relief of customs duties and indirect taxes (VAT and excises). The logic here is that goods entering the zone from the domestic economy are exports. They can then be exported to other countries without tax consequences. This implies that goods entering the domestic economy from the zones are imports for purposes of taxes and customs, and that the perimeters of the zone must be secured and under effective customs control.
3. If direct tax incentives are contemplated, they should be an alternative (not a supplement) to the extra-territorial concessions discussed above and they should be linked to the process of capital formation. For example, accelerated depreciation, investment tax credits or temporary exemptions from duties on capital goods would be preferable to VAT or profit tax breaks.
4. Sweeping measures such as tax holidays are best avoided, as they tend to promote a focus on tax planning rather than productive investment (OECD, 2009c). In particular, they encourage firms to use transfer pricing to shift activity from non-exempt to exempt enterprises. Moreover, they are of little use to start-ups, innovative firms or established firms engaged in large projects that, in the early stages of development, may not be generating a profit anyway and may thus have no tax to pay. Closely related to this is the fact that they tend to benefit projects with relatively short payback times (i.e. within the holiday period) at the expense of longer-term undertakings.
5. When designing incentive structures, policy makers should always look outside the zone. Understanding the potential unintended consequences of zones for non-resident firms and workers is critical. Excessive spatial distortions are can otherwise impose large costs on the domestic economy, as non-residents find it difficult to compete with zone-based firms for finance, labour, material inputs and customers.

It must, of course, be recognised that almost any zone initiative involves some degree of spatial distortion: special zones are, after all, in some sense **special**. However, every effort should be made to ensure that these distortions are no greater than necessary, that they are temporary (special zone regimes should be time-limited) and that the benefits they bring to the wider economy, in terms of positive spill-overs, are greater than the cost of the spatial distortion.

The foregoing suggests that the Ukrainian authorities may want to reconsider plans for offering very low CIT rates for very long periods, as well as privileges with respect to VAT. More investment-focused tax concessions might be better able to ensure that the goals of the zones and industrial parks are realised.

The final point to address concerns public finance management, monitoring and evaluation. Expenditure reporting frameworks should publicly report the cost of zone initiatives, including investment incentives, in terms of both tax and non-tax expenditures. The costs and benefits of current and proposed investment incentives should be assessed rigorously and, to the extent possible, by an independent body. The assessment should encompass quantification of the anticipated direct and indirect benefits of incentive schemes, as well as examining their effectiveness in achieving stated policy

goals. Estimates of the costs involved should include their impact market efficiency and non-zone actors, as well as on public budgets. Broader efficiency issues include consideration of possible alternative (cheaper) ways to achieve the same outcomes. Above all, evaluation should focus on evidence of additionality and spill-overs:

- Attention to additionality reflects the need to avoid deadweight losses, i.e. subsidising activities that agents would have undertaken even without the incentives. While deadweight losses are in a sense "invisible", they are a real cost of many such policies.
- As noted above, spill-over effects are critical – both negative spill-overs, which may impose unanticipated costs on non-residents and positive spill-overs, which are, ultimately, the justification for providing zone residents with special conditions for doing business.

These are complex tasks. While data on investments, exports and employment in zones are important (and relatively easy to obtain), assessing the impact on employment **relative to what would have occurred in the absence of zone privileges** (additionality) can be very difficult, as can assessing the less easily quantified externalities a zone may generate in terms of technology transfer, skills or innovation (spill-overs).

Zones can be used as catalysts for reform

The foregoing considerations largely reflect the disappointing experiences that many countries have had with special zones. However, the successes of countries like China and Turkey highlight their potential to **facilitate** economy-wide structural reforms and to generate positive productivity spill-overs. In creating "reform zones", as opposed to ordinary SEZs, the authorities should bear in mind the following basic principles, in addition to those outlined above:

- It is prudent to focus on provisions and incentives that the government is prepared to live with more or less indefinitely. Sunset clauses clearly have their place, but the fact is that withdrawing privileges can be difficult, and special investment regimes often end up being extended well beyond their planned lifetimes owing to the (sometimes very well founded) fear that investors will withdraw if support is no longer forthcoming.[32]
- Zones can be used very effectively to pilot policy innovations (including regulatory or tax changes) that the authorities would be ready to scale up to the whole economy. Given the evidence that zone residents attach particular importance to administrative and regulatory issues, it could be very useful to pilot reforms to the regulatory environment that could subsequently be extended to the whole economy. In Ukraine, they could be used to pilot reforms aimed at reducing the bureaucratic burden on business, which could then be scaled up to the economy as a whole. This would be the most direct way to use zones to address some of the major barriers to investment.
- To the extent possible, it is wise to try to avoid "addictive" forms of support. Start-up support, for example, is unlikely to prove addictive – if measures are well designed – because new firms will either fail or outgrow it. Similarly, infrastructure provision or tax incentives that focus on capital formation are likely to be more important at the start of a project than they will be later on. By contrast, it is difficult to imagine firms growing so large or profitable that it will

be relatively painless for them to give up such things as energy subsidies or VAT or profit-tax privileges.

- As a rule, zones should be relatively large with free entry. Where zones are very small and conditions within and outside the zones are very different, they tend to lead to far more displacement than generation of new activity (Einio and Overman, 2011; Malgouyres et al., 2012; Mayer et al., 2012). Often, the result is simply to shift a limited number of jobs and firms over very short distances at very high cost to public budgets. In a country the size of Ukraine, moreover, there is no reason in principle why reform zones could not be used to allow entire oblasts to experiment with policy reforms. This would allow a measure of decentralisation and inter-regional competition into Ukraine's otherwise fairly centralised polity. However, since the zones would be authorised under national legislation and would be subject to monitoring and evaluation, the central government would be in a strong position to ensure that policy experimentation did not lead to the fragmentation of Ukraine's spatial economy and to prevent forms of inter-regional competition that might prove undesirable (i.e. a race to the bottom with respect to environmental or labour standards).
- Special-purpose zones should be designed to address identifiable market failures, relying on policy instruments that correspond to the diagnosis. Zone incentives should be linked as closely as possible to the activities they are meant to promote. Innovation-oriented industrial parks and zones, for example, might focus on providing certain forms of hard and soft infrastructure that are important to innovation processes, while focusing tax incentives on R&D expenditure and on making it easier and cheaper to recruit and retain very high-human-capital individuals.
- Where zones are created to addresses weaknesses in state capacities, they should be used for capacity-building. For example, they can be used to pilot environmental reforms. In Turkey, Organised Industrial Zones have been created in part to strengthen regulatory enforcement: zone conditions are attractive to investors, but the price they pay for zone benefits is that it facilitates enforcement of environmental and other norms.

Many countries use public-private partnerships for regional development

Public-private partnerships (PPPs) are one way for private actors to contribute to local and regional economic development. A broad definition of PPP involves different types of co-operation and tenders between public and private actors to deliver public or semi-public services. They are often implemented via a consortium of public and private entities (universities, research centres, and companies). PPPs in many countries also handle the management of tourism destinations involving local tourism organisations and private actors that provide or promote tourism. A narrower definition of PPPs concerns a way of delivering and funding public services using a capital asset where project risks are shared between the public and private sector. A PPP is here defined as a long-term agreement between the government and a private partner where the service delivery objectives of the government are aligned with the profit objectives of the private partner. The effectiveness of the alignment depends on a sufficient and appropriate transfer of risk to the private partners.

In the PPP, the government specifies the quality and quantity of the service it requires from the private partner. The private partner may be tasked with the design, construction,

financing, operation and management of a capital asset and the delivery of a service to the government or to the public using that asset. A key element is the bundling of the construction and operation of the asset. The private partner will receive either a stream of payments from the government, user charges levied directly on the end users, or a combination of both. This definition excludes a wider array of arrangements where non-governmental organisations such as non-profit civil society groups, trusts, church groups etc. are involved in the development and delivery of public or semi-public services.

If the government is responsible for a stream of payments to the private partner for services delivered, their actual payment will likely depend on the private partner's delivery of service and compliance with the contractually set quality and quantity specifications. Public-private partnerships are often undertaken by a special purpose vehicle acting as the government's private sector counterparty. A special purpose vehicle is typically (but not always) a consortium of companies responsible for the main activities of the public-private partnership. A key argument for PPPs is that through harnessing the private sector's expertise in combining the design and operation of an asset – applying a whole of life view – the service can be provided in a more efficient manner than under traditional forms of procurement and production. There are, however, a number of conditions that need to be in place for a PPP to be successful. The ability to write and negotiate PPP contracts are an important public sector capacity requirement, especially given the long term nature and the large transaction costs associated with PPPs. There are a number of particular challenges that need to be addressed when contemplating the use of PPPs to provide services or infrastructure (Box 3.9).

Box 3.9. **Key challenges for developing public-private partnerships**

PPPs are complex instruments which require a number of capacities to be present in government. These involve setting up a robust system of assessing value for money using a prudent public sector comparator and transparent and consistent guidelines regarding non-quantifiable elements in the value for money judgement. The public authorities must also be able to classify, measure, and allocate risk to the party best able to manage it and to adhere to sound accounting and budgeting practises.

The starting point for assessing the desirability of a PPP is the public sector comparator, a comparison of the net present cost of bids for the PPP project against the most efficient form of delivery according to a traditionally procured public-sector reference project. The comparator takes into account the risks that are transferable to a probable private party, and those risks that will be retained by the government. Thus, the public sector comparator serves as a hypothetical risk-adjusted cost of public delivery of the project. The risk here is of manipulation in favour of PPPs, not least because much depends on the discount rate chosen or on the value attributed to a risk transferred. The evaluation, moreover, encompasses qualitative aspects that involve an element of judgement on the part of government. The question is what the government judges to be an optimal combination of quantity, quality, features and price (i.e. cost), expected (sometimes, but not always, calculated) over the whole of the project's lifetime. It ultimately depends, then, on a combination of factors working together, such as risk transfer, output-based specifications, performance measurement and incentives, competition in and for the market, private sector management expertise and the benefits for end users and society as a whole.

The second challenge is risk management. To ensure that the private partner operates efficiently and in the public interest, a sufficient, but also appropriate, amount of risk needs to be transferred. In principle, risk should be carried by the party best able to manage it. In this context, "best" means the party able to manage the risk at least cost. This may mean the party best able to prevent a risk from materialising (ex ante risk management) or the party best able to

Box 3.9. **Key challenges for developing public-private partnerships** (*cont.*)

deal with the results of realised risk (ex post risk management). However, not all risks can be managed and cases may exist where one or more parties to a contract are unable to manage a risk. To those parties, such unmanageable risks are exogenous risks (an example is uninsurable force majeure risk that affects all parties, while political and taxation risk is exogenous to the private party and endogenous to government).

The third key issue is affordability. A project is affordable if government expenditure associated with a project (whether or not it is a PPP) can be accommodated within the intertemporal budget constraint of the government. A PPP can make a project affordable if it results in increased efficiency that causes a project that did not fit into an intertemporal budget constraint of the government under traditional public procurement to do so with a PPP. It can be tempting to ignore the affordability issue where PPPs are off budget, but this is very unwise. Using PPPs also reduces spending flexibility, and thus potentially allocative efficiency, as spending is locked in for a number of years. Given that capital spending in national budgets are often accounted for as expenditure only when the investment outlay actually **occurs**, taking the PPP route allows a government to initiate the same amount of investments in one year while recording less expenditure for that same year. However, the obligation to pay over time will increase expenditures in the future, reducing the scope for new investment in coming years. Government spending might also be affected if the government provides implicit or explicit guarantees to the PPP project and thus incurs contingent liabilities. The system of government budgeting and accounting should provide a clear, transparent and true record of all PPP activities in such a way that there is no incentive take the PPP route based on its accounting treatment.

In some cases, PPPs may be used to circumvent spending ceilings and fiscal rules. There are those that argue that this need not be a problem and that PPPs should be used to invest in times of fiscal restraint. The fiscal constraint argument for public-private partnerships is driven by pressures for governments to reduce public spending to meet political, legislated and/or treaty-mandated fiscal targets. In parallel with this, many governments face an infrastructure deficit stemming from a variety of factors including a perceived bias against budgeting for capital expenditures in cash-based budgetary systems. However, when responding to fiscal constraints, governments should not ignore efficiency and affordability considerations. PPPs may also create future fiscal consequences if they violate the budgetary principle of unity, i.e. that all revenues and expenditures should be included in the budget at the same time. Potential projects should be compared against other competing projects and not considered in isolation to avoid giving priority to the consideration and approval of lower value projects.*

*The case for preferring PPPs to other kinds of investment as a counter cyclical measure is also difficult to sustain as PPPs will often take longer to execute than traditional forms of investment.

Source: OECD (2011f), *From Lessons to Principles for the Use of Public Private Partnerships,* 32nd meeting of the Network of Senior Budget Officials, Luxembourg, 6-7 June, www.oecd.org/gov/budgeting/48144872.pdf.

The use of PPPs in Ukraine is still in its infancy – and is fraught with risks

The use of PPPs is at an early stage in Ukraine. Although laws on concessions and production-sharing agreements were adopted in the late 1990s, the law "On Public-Private Partnerships" was passed only in 2010, along with further legislation concerning public-private co-operation in the fuel and energy complex. Other legislation adopted in recent years concerns the specifics of concessions in fields like road construction. Considerable hopes have been pinned on the development of PPPs as a way to attract badly needed investment into the local utilities sector and on the use of things like Build-Operate-Transfer (BOT) agreements for modernising or extending transport infrastructure.

There is much discussion in Ukraine of the technical legal aspects of PPPs and there are numerous proposals for amending both the PPP law and other legislation in order to clarify matters and make PPPs easier to pursue (see, e.g. IBSER, 2012). However, there are a number of much more fundamental issues that Ukraine must address if it is to develop PPP investments, particularly at sub-national level:

- Much depends on the government's success in improving the overall business climate. PPPs are long-term undertakings and are unlikely to be attractive to investors in an environment characterised by high levels of legal, institutional and policy uncertainty. As noted in Box 3.9, one of the crucial affordability issues concerns the discount rate – the higher the investor's discount rate, the more expensive the PPP to the public authorities. This is directly influenced by the degree of uncertainty confronting investors. Prospects for developing PPPs simply cannot be divorced from the broader institutional reform agenda.[33]
- PPPs present particular risks in the context of high levels of corruption, such as are observed in Ukraine. Corruption in public procurement is already a major problem.[34] The adoption of a new law on public procurement in 2010 was widely seen as an important step forward, but subsequent changes in implementation reduced its impact – the number of contracts awarded without open tenders rose, and measures to increase transparency were compromised (for details, see Siedina and Bizyayev, 2013). Yet a move to widespread use of PPPs could make things worse, given their greater complexity and longer time-scales.
- The use of PPPs in specific sectors will also depend on the progress of economy-wide reforms in those sectors. For example, PPPs in the local utilities sector will require much greater assurance about the direction of state policies – particularly tariff policies – in the housing and utilities sphere, since it is often the state rather than the local partner which regulates the tariffs. In all likelihood, the state will have to take on some kind of guarantor's role even in PPPs concluded with oblasts or cities.
- Successful PPPs involving sub-national governments will considerable capacity-building in many places. Regional or local officials must be capable of identifying strategic opportunities, planning technical projects that co-ordinate many actors over long periods, building local support, identifying and managing financing streams, monitoring and evaluating ongoing efforts, etc. PPPs require a fairly high level of financial sophistication on the part of officialdom, as well as a structure of incentives that prompts them to seek the best outcomes for the public and audit, reporting and control mechanisms that ensure that opportunities for abuse are minimal.

Despite these risks, it is difficult to see how Ukraine can address its tremendous infrastructure investment needs without developing effective forms of public-private co-operation. Ultimately, PPPs are likely to be a part of this picture. With that in mind, there are a number of specific steps the authorities can take to maximise the likelihood of success. Ultimately, they should aim for consistent adherence to the OECD principles for the governance of PPPs (Box 3.10). The most urgent and relevant points for Ukraine are as follows:

- Ukraine has already created a national PPP unit under the Ministry of Economic Development and Trade. It should be supported and strengthened to assist sub-national governments in dealing with PPPs. Dedicated PPP units, which exist in most OECD countries, are organisations set up with full or partial aid of the

government to ensure that the skills needed to handle third-party provision of goods and services are made available and clustered together within government. Such units enhance the capacity of government to successfully manage the risks associated with a growing number and value of PPPs. They provide policy guidance, technical support and capacity-building, and – especially when set up under ministries of finance – they can ensure that PPP processes are aligned the budget process. The unit could establish programmes to train regional and local officials in project finance, appraisal methodologies, risk assessment and other subjects relevant to PPPs.

- All national, regional and municipal PPP projects – including those in the planning phase – should be made as transparent as possible. Tender proceedings, in particular, should be open and subject to ex post challenge if there is evidence of malfeasance. A database of PPP projects should be maintained and should be publicly accessible over the internet.

Even bearing the foregoing points in mind, Ukraine will want to proceed with caution in rolling out PPPs. Pilot projects should be undertaken, monitored and evaluated carefully and only then scaled up. In addition, it will probably make sense to focus in the first instance on projects where the technical and other risks are relatively well understood – basic infrastructure, for example.

Box 3.10. **OECD Principles on Public Governance of Public-Private Partnerships**

Establish a clear, predictable and legitimate institutional framework supported by competent and well-resourced authorities

1. The political leadership should ensure public awareness of the relative costs, benefits and risks of PPPs and conventional procurement. Popular understanding of PPPs requires active consultation and engagement with stakeholders as well as involving end-users in defining the project and subsequently in monitoring service quality.
2. Key institutional roles and responsibilities should be maintained. This requires that procuring authorities, Public-Private Partnerships Units, the Central Budget Authority, the Supreme Audit Institution and sector regulators are entrusted with clear mandates and sufficient resources to ensure a prudent procurement process and clear lines of accountability.
3. Ensure that all significant regulation affecting the operation of PPPs is clear, transparent and enforced. Red tape should be minimised and new and existing regulations should be carefully evaluated.

Ground the selection of Public-Private Partnerships in Value for Money

4. All investment projects should be prioritised at senior political level. As there are many competing investment priorities, it is the responsibility of government to define and pursue strategic goals. The decision to invest should be based on a whole of government perspective and be separate from how to procure and finance the project. There should be no institutional, procedural or accounting bias either in favour of or against PPPs.
5. Carefully investigate which investment method is likely to yield most value for money. Key risk factors and characteristics of specific projects should be evaluated by conducting a procurement option pre-test. A procurement option pre-test should enable the government to decide on whether it is prudent to investigate a PPPs option further.
6. Transfer the risks to those that manage them best. Risk should be defined, identified and measured and carried by the party for whom it costs the least to prevent the risk from realising or for whom realised risk costs the least.

Box 3.10. **OECD Principles on Public Governance of Public-Private Partnerships** (*cont.*)

7. The procuring authorities should be prepared for the operational phase of the PPPs. Securing value for money requires vigilance and effort of the same intensity as that necessary during the pre-operational phase. Particular care should be taken when switching to the operational phase of the PPPs, as the actors on the public side are liable to change.
8. Value for money should be maintained when renegotiating. Only if conditions change due to discretionary public policy actions should the government consider compensating the private sector. Any re-negotiation should be made transparently and subject to the ordinary procedures of PPP approval. Clear, predictable and transparent rules for dispute resolution should be in place
9. Government should ensure there is sufficient competition in the market by a competitive tender process and by possibly structuring the PPPs program so that there is an ongoing functional market. Where market operators are few, governments should ensure a level playing field in the tendering process so that non-incumbent operators can enter the market.

Use the budgetary process transparently to minimise fiscal risks and ensure the integrity of the procurement process

10. In line with the government's fiscal policy, the Central Budget Authority should ensure that the project is affordable and the overall investment envelope is sustainable.
11. The project should be treated transparently in the budget process. The budget documentation should disclose all costs and contingent liabilities. Special care should be taken to ensure that budget transparency of PPPs covers the whole public sector.
12. Government should guard against waste and corruption by ensuring the integrity of the procurement process. The necessary procurement skills and powers should be made available to the relevant authorities.

Source: OECD (2012b), *Recommendation of the Council on Principles for Public Governance of Public-Private Partnerships*, www.oecd.org/gov/budgeting/PPPnoSG.pdf.

Capacity-building efforts will be needed on a very wide scale

This chapter has already touched on capacity needs a number of times in various contexts. The point can, indeed, be generalised. The effective implementation of regional development policy requires well-trained professionals in multiple sectors and at all levels of government. Regional development policy involves managing a substantial amount of complexity in order to achieve positive outcomes that require considerable co-ordination and a consistent focus on medium-to-long-term goals. The specialised knowledge and professional skills needed for effective design and implementation of regional policy is likely underdeveloped in Ukraine – particularly at the local level. There are notable gaps with respect to, inter alia, financial management and planning, strategic planning and strategic management skills, stakeholder engagement.

Mechanisms are in place to support sub-national capacity building, but they could be strengthened. The central government, for example, could step up support for the training of regional and local officials facing the need to implement more sophisticated budgetary rules, PPPs, etc. In some OECD countries, this is often undertaken in co-operation with the municipal associations, and the government might well work with the Association of Ukrainian Cities and other such bodies in this field. Minimum public service standards are also used to ensure a certain consistency (and equity) at the local level. Standards are

established through legislation and by individual ministries. They can assist municipalities by guiding such issues as minimum service level, cost and quality when implementing tasks at the local level. Municipalities can choose how to deliver the service as long as the minimum standard is met (OECD, 2011c).

Provide incentives to innovate and diffuse good practices

Underlying all of the discussion here is the idea of enhanced policy performance – in terms of better design, better informed decision making, more capable actors, stronger partnerships, and greater efficiency. In addition to the recommendation provided thus far, the central government can take an additional, explicit step to alter incentives in a way that encourages innovative approaches to policies and programmes.

The use of pilot initiatives can be useful in ensuring a gradual institutional change and encouraging learning-by-doing. New instruments for regional policy should be rolled out gradually and carefully assessed, to see what results they yield and whether they should be retained, upscaled, modified or scrapped. Asymmetric governance approaches contain risks, in terms of creating institutional complexity and preferential treatment of same places or actors, but at the same time they are ways to better take into account of various territorial, political or cultural situations. Allowing such experimentation can be particularly important in a highly centralised country like Ukraine. Such an asymmetric approach has increasingly been employed for various reasons in France, Sweden and the United Kingdom, all countries with strong traditions of centralism. In many cases, specific governance tools are developed for metropolitan areas. There can also be other reasons for asymmetric decentralisation, such as the need to take account of various territorial, political or cultural situations; in Ukraine, the AR Crimea is a classic example. The Council of Europe also acknowledges that "the same levels of local and regional administration need not exist everywhere in the state; competences of local and regional authorities of the same level may differ".[35] The Swedish experience with pilot regions (which are among the most urbanised regions in Sweden) has empowered regional actors in areas with well-developed local capacities well-suited for regionalisation (OECD, 2010b).

Capacity development often comes from learning by doing and sharing the results. The central government might thus offer matching funds or seed money to encourage new, innovative approaches to regional challenges – such as cross-border initiatives, encouraging inter-municipal actions, or engaging private actors or NGOs. Such funds can also finance the diffusion of the results, to create "learning partnerships" among actors in which parties provides hands-on sharing of successful practices, to fund attendance at workshops and conferences, etc. Private sector actors can also be encouraged to co-finance activities that would facilitate more active engagement at the regional level.

Non-monetary incentives, such as administrative flexibility, can also be used to promote innovation and reveal good practice. The government could consider allowing regional actors or municipalities to apply for "waivers" from administrative requirements that sub-national actors suggest stand in the way of efficiency or effectiveness. Such waivers could require specific proposals to the central government regarding alternative means of implementing existing policies or programmes, which – if applied on a pilot basis – could reveal new, useful approaches that could potentially be extended or expanded to other actors or regions.

Conclusion

The experience of regional policy in OECD – and particularly European – countries suggests a number of general points that Ukrainian policy makers will want to bear in mind as they proceed with the current changes in regional development policy. First, regional policy remains a field in which there is still considerable uncertainty about what policies work best under any given set of circumstances and in which we know more about what **does not** work than about what **does**. It is still very much an "experimental science", and the Ukrainian authorities should proceed in that spirit, viewing measures like targeted interventions as experiments requiring rigorous evaluation and review at regular intervals. This also implies a readiness to drop initiatives that fail to produce results. That said, a few general points are the subject of an increasingly broad consensus (OECD, 2009b, 2012c).

- Regional policies cannot and must not be merely redistributive policies with a spatial dimension. They should be focused on growth and competitiveness, as well as equity, and open-ended support for lagging or under-performing regions is to be avoided.

- Regional development policies are oriented to the long term. Stability of policy is important and many failures can be attributed to an expectation of short-term results and consequently premature change of policy.

- Concentration of effort matters, both spatially and in terms of policy priorities. Dispersion of energy and resources across too many priorities is ineffective and wasteful.

- Assessments of policy interventions should pay close attention to additionality: there is nothing easier than to subsidise agents doing what they would have done anyway. The aim is to stimulate the emergence of activities which would not have been undertaken in the absence of intervention but which can become self-sustaining (i.e. intervention as catalyst rather than open-ended support).

- The information asymmetries involved in regional policy design can only be overcome where the policy process is participatory, involving both top-down and bottom-up input, and engaging private-sector agents early and deeply in the design of regional development strategies.

Box 3.11. **Summary of main policy recommendations on regional development policy**

As indicated in the chapter, the success of regional development efforts will depend primarily on progress with respect to economy-wide reforms designed to reduce the fiscal and bureaucratic burden on business, to provide a more stable and attractive investment climate and to strengthen property rights and the rule of law. Continued improvements in public budgeting at all levels will also be critical. In addition, there are number of more specific steps that can be taken with respect to the design, implementation and governance of regional development policy:

- Avoid the dispersion of resources and risks of perpetuating a culture of dependence on open-ended assistance by identifying a limited number of national priorities for regional policy that help improve aggregate national performance and well-being.
- Support to specific weak regions should be time-bound and should facilitate structural adjustment and promote the capacity for endogenous growth in the long term.
- Use the State Fund for Regional Development (SFRD) as an instrument to foster inter-regional co-operation. It may be helpful to link such efforts to the broader national projects assigned to the State Agency for Investment and National Projects.
- Revise the allocation rules for the SFRD so as to avoid sharp differences in the treatment of similar places. This should be accompanied by steps to enhance the transparency of allocation of other central transfers to sub-national governments.
- Focus the criteria for SFRD allocations on strategic economic development priorities rather than using SFRD funds to meet immediate needs for investment in basic infrastructure and service provision.
- Make greater use of SFRD allocations to promote experimentation with "softer", more flexible instruments for promoting regional development, like start-up support, SME development and innovation-promotion. Issues related to disparities in the provision of basic services should be addressed via equalisation transfers and/or safety nets.
- Make a rigorous cost-benefit analysis of any special zones or industrial parks, designing them with reference to the evidence on international best practice, particularly by working to:
  - minimise spatial distortions and maximise the zone's integration with the wider economy;
  - focus on "non-addictive" forms of support that will foster new, self-sustaining activities rather than on-going dependence;
  - use special zones to pilot reforms that could then be scaled up, possibly including the piloting of decentralisation reforms that could empower regions and cities.
- Better tailor the support to entrepreneurship to the underused labour in different regions (e.g. women) and further promote social entrepreneurship through partnerships with local and regional authorities.
- Strengthen the coordinating and strategic role of central co-ordinating bodies (like the inter-departmental commission) that deal with regional development policy, vis-à-vis both other ministries and with lower levels of government.

Box 3.11. **Summary of main policy recommendations on regional development policy** (*cont.*)

- Implement stronger contractual arrangements to support Regional Development Programmes, with an obligatory status and integration into national and sub-national budgets. Use the contracts as an instrument for agreeing on medium-term SRDF priorities.
- Strengthen capacity building and evaluation mechanisms for sub-national governments and Regional Development Agencies (RDAs), to ensure proper differentiation in the priorities across regions.
- Support the development of RDAs from the bottom up, allowing them to take a variety of institutional forms and helping them to develop as fora for engaging the private sector more deeply in the design and implementation of regional development policy.
- Develop further information and indicators **at the national government level** about regional economies, as well as municipal performance.
- Develop initiatives to measure and reduce administrative burdens at lower levels of government, since important stock and flux of regulations, in particular on spatial planning, is a burden for municipalities
- Consider territorial proofing mechanisms in conjunction with a wide-range of sectoral policies.

Notes

1. The European Business Association's various indices of business sentiment are based on surveys of the 103 CEOs of its members. The EBA results are probably less representative of the business community as a whole than the World Bank and WEF surveys but they have the advantage of appearing quarterly, thus presenting at least some picture of perceived change over time: see http://indices.eba.com.ua/.
2. See, in particular, FEG (2012).
3. See, for example, Kinoshita and Campos (2003) and Kostevc et al. (2007).
4. The European Business Association likewise reports only limited inter-regional variation in member responses to its studies, though the numbers involved are smaller and arguably less representative.
5. See OECD (2007a) for details.
6. A number of organisational forms were eliminated altogether.
7. See SIGMA (2010) for a detailed discussion of these issues.
8. Hellman et al. (2000); World Bank (2001).

9. In conversation with the review team, officials working under the presidential administration estimated that only about 40% of government or presidential decisions were implemented within reasonable timeframes and attributed much of the problem to poor co-ordination (and, at times, conflict) among executive bodies.

10. See the survey results in Transparency (2011), which finds the judiciary rated as the most corrupt institution in Ukraine, ahead even of the police, and in WEF (2012, p. 355).

11. On the contrast between closed (survival-oriented) and open (entrepreneurial) networks, see Huber and Wörgötter (1998); and Stark et al. (2006).

12. On these perceptions, see WEF (2012, p. 355) and OECD (2011b).

13. See the survey results in WEF (2012, p. 355), where tax regulation ranks first among executives' complaints but tax rates only fifth. See also IFC (2011), OECD (2007a and 2011b) and EBA (2012).

14. EBA (2012).

15. On a par with Cameroon, Syria, the Republic of Congo and Eritrea.

16. The Transparency International "Global Corruption Barometer" is based on sample surveys of the population rather than investor perceptions; see Transparency (2013).

17. The questionnaire asks about the education system, the military, the police, the judiciary, civil servants, the legislature, and political parties as well as the media, religious bodies, private business, and NGOs. The average response across all six sectors in Ukraine and 2011 was 4.0, on a scale of 1 to 5, with 1 implying "not at all corrupt" and 5 being "extremely corrupt". This was the third-highest average score in the data, behind the DR Congo and Burundi. The variation in the Ukrainian results is also striking, inasmuch as data for most countries show a good deal more variation in assessments of the level of corruption of different institutions. In Ukraine, most institutions were clustered around the average level.

18. The regimes for the two types of territories differed somewhat. In addition, the SEZs were all defined territories with secure perimeters. TPDs were not necessarily compact or secure: they could encompass entire political-administrative units (including, at one time, all of TransCarpathia).

19. For a detailed analysis, see Grontmij/Carl Bro et al. (2011).

20. Cabinet of Ministers Decree No. 827, 5 September 2012.

21. The State Strategy for Regional Development makes reference to the roles of the Ministry of Finance, the Ministry of Agricultural Policy and Food, the Ministry of Social Affairs, the Ministry of Infrastructure, the Ministry of Justice, the Ministry of Education and Science, the Ministry of Industrial Policy, the Ministry of Environment and Natural Resources, the Ministry of Energy and Mines, the State Statistics Committee, and the State Agency for Investment and National Projects.

22. Article 142 of the Constitution states: "Territorial communities of villages, settlements, and cities may combine objects of communal property as well as budget funds on the basis of agreements in order to implement joint projects or to jointly finance (maintain) communal enterprises, organisations, or establishments, and create appropriate bodies and services for this purpose."

23. Researchers at the Institute for Economic Research and Policy Consulting report that in looking at execution of public expenditure by function, utilities are consistently the

worst treated when it comes to stability of funding, and their capital expenditure comes last. On the more general tendency to use public investment as an adjustment variable, see OECD (2013).

24. The American general Dwight Eisenhower reportedly said, "In preparing for battle, I have always found that plans are useless, but planning is indispensable." Something similar may be said of regional development planning.

25. It should be noted that the discussion of the draft strategy is based on the text made available to the Secretariat in May 2013 and does not take account of subsequent revisions.

26. For the President's assessment of this problem, see his remarks on 17 January 2013, at www.president.gov.ua/en/news/26593.html.

27. See, in particular, Cabinet Regulation No. 1378 of 15 October 2009.

28. This was the "Order of usage of the finances of the State Fund for Regional Development", approved by Decree of the Cabinet of Ministers of Ukraine #312 of 31 March 2012.

29. One incubator's management reported getting over 200 applications for seven slots worth around USD 20 000 each.

30. Adapted from World Bank (2005), FIAS (2008), OECD (2009c) and Farole (2011a).

31. The principles summarised here are based largely on the analyses found in World Bank (2005), OECD (2009c), and Farole (2011a).

32. Such situations are, of course, particularly common in sectors like autos and aviation, where governments' desire to secure local production and the jobs it brings has contributed to global over-capacity.

33. In this context, it is interesting to note the link made between the quality of the investment climate and the provision of public services by President Viktor Yanukovych in January 2013; www.president.gov.ua/en/news/26600.html.

34. Siedina and Bizyayev (2013). In 2011, President Viktor Yanukovych stated that corrupt dealings in public procurement channelled 10% to 15% of the state budget (USD 7.4 billion) into the pockets of officials. Kyiv Post, 1 December 2011.

35. Recommendation Rec(2004)12 of the Council of Europe's Committee of Ministers to member states on the processes of reform of boundaries and/or structure of local and regional authorities.

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